

*Managing in volatile times:*  
The role of Internal Audit



‘We believe central bank liquidity injections, US rate cuts and possible bail-outs of key institutions will help normalise financial markets *so substantial fall-out for the real economy can be avoided.*’

The Economist Intelligence Unit, September 2007

Risk management: even the experts get it wrong.

# Setting the scene

In May 2007 Deloitte surveyed over 100 chairs and directors from the top ASX 200 companies. Only 28% of those interviewed at the time saw a changing economic environment as a key agenda issue. Even 12 months ago it is likely that few corporate scenarios would have included contingency planning for:

- a significant fall in forecast GDP growth from 3.0% in 2008 to 2.3% for 2009
- a roller-coaster \$AUD which actually headed close to parity before falling into the high 50c range – while forecasts for 2008/9 were for rates in the mid to high 70c range
- oil prices ultimately reaching 110 \$USD before falling back to 50 \$USD – when forecasts were for 60-70 \$USD for 2008 and 2009
- a fall in the consumer confidence index from 120 in September 2007 to below 80 by July 2008, the lowest in many years.

After all, much of corporate Australia had seen significant growth for more than 10 years.

The recent decline in economic conditions has been unwanted, unexpected and, in some ways, unprecedented.

It has all the hallmarks of a corporate strategist's worst nightmare. But is it a Risk Managers' dream opportunity?

At the Deloitte Risk Series round table in November 2008, Chief Risk Officers and heads of Internal Audit, considered the implications of current market conditions on key components of organisational performance: revenue, costs, assets and 'expectations' or stakeholder management.

Key issues related to each component of performance were identified, reviewed and ranked.

**The following is a summary of the discussion – including the consensus of the 'voting' to rank current issues – as well as views on the opportunities for Internal Audit to assist their organisations and the need to revisit Internal Audit Plans.**

# Revenue

**Q: What do you see as the key risks affecting your organisation's revenue: pricing, growth strategy, revenue assurance, customer segmentation, online strategy, mergers and acquisitions, other?**

Price taking and the ability to deliver projected growth were ranked as the top two most significant risks to revenue by more than 60% of the group who attended the Risk Series round table.

Attendees noted that while there had been a real focus on costs over much of the last decade organisations were now focussed on pricing because of its greater impact on the bottom line. It was agreed that pricing strategy needed to be reviewed periodically by senior management in order to maintain or build strong revenue streams, and to achieve competitive edge over market rivals.

Organisations who didn't align their pricing strategy to market conditions were assessed as being at risk of finding themselves 'priced out of the market'. One organisation present stated that it now conducts monthly pricing reviews using market intelligence, and had recently introduced a 'pay by the month' option for one of its product suite in response to increased competition. Another organisation had significantly reassessed its position re spot and contracts markets.

Other comments from attendees centred on the importance of customer segmentation – as both a risk and an opportunity to pricing and growth. Consolidation of the customer base was seen to be critical as well as managing reputation risk or customer 'trust'. Online strategy was seen to be key for some organisations, as well as ensuring that remuneration

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**'Our growth strategy is nine months old. I wonder if it would be better for us to fall short than to take risky or purely short-term measures to reach those targets'**

Participant, Deloitte Risk Services round table, November 2008

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**'There is opportunity among chaos. Even as many of its arms are being savaged the online share trading sector of financial services is reporting huge increases in the number of daily trades – upwards of 50 to 250 thousand per day – with a further 7-10% increase anticipated when naked selling comes off.'**

Ron Loborec, Head of Deloitte Risk Services, November 2008

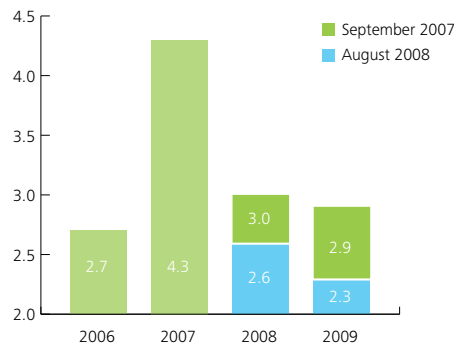
strategy – especially for sales forces – was in alignment with the behaviours required in the new conditions. It was also noted that current conditions virtually guaranteed the increase of sales fraud as sales staff find it increasingly difficult to meet targets.

Risks to revenue were also seen to include culture, incentives, fraud and reputation. For those organisations with cash or capital, being sufficiently flexible and agile to take advantage of well priced acquisition opportunities – without signing up for any surprises! – was also seen to be key to growth.

**Some general comments drawn from Deloitte’s experience on the opportunities re pricing and growth:**

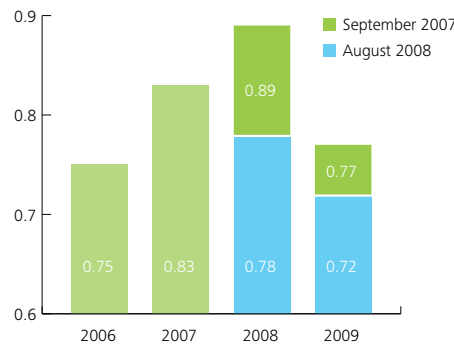
- there is significant difference between list and pocket price due to price leakage
- experience internationally demonstrates a 3-5% margin improvement from addressing price leakage alone
- fewer than 3% of organisations effectively manage, communicate and enforce pricing
- a granular approach is key to growth – the focus needs to be on increasing opportunities for profitable growth by developing a rigorous cluster-based framework
- a granular approach creates strategic measures for the Board and senior management, streamlining the strategy and planning process.

**Forecast GDP – September 2007 vs August 2008**



...as a result, growth planning decisions could have been wrong by 15-20%

**Forecast \$AUD to \$US – September 2007 vs August 2008**



It is also likely that forecast USD earnings and transactions could have been overstated by 15%

# Costs

**Q: What are the key risks impacting your organisation's costs: tax, supply chain, SG&A (Salaries-general & administration) cost reductions, procurement/accounts payable, loss of key personnel, contract reviews?**

**Q: What cost control initiatives could Internal Audit assist with?**

Risks associated with cost reduction in SG&A as well as supply chains were seen as the top two risks affecting organisational costs by 63% of the Internal Audit and Risk representatives participating in the round table discussion. Another 27% of participants nominated risks associated with procurement /accounts payable or contract reviews as their organisation's key risks.

There were numerous comments around the need to ensure, with retrenchments taking place, that procedures were documented so that service – and the control framework – could be maintained afterwards. Associated with this, was the need for training of remaining or replacement resources, as well as a higher level need to ensure that key resources were not 'lost' or enticed elsewhere. It was agreed that, at a fundamental level, any cost cutting needed to be checked back to overall organisational strategy; that there was no point cutting costs if it prevented delivery of the organisational strategy.

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'Our Internal Audit plan has focussed on this area costs... we recently identified three trucks being sent to deliver products to Melbourne but only 35% full. As a result we have reduced the number of trucks on that particular delivery route and reduced distribution costs.'

Participant, Deloitte Risk Services round table, November 2008

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'We recently reduced head count in order to reduce overall costs. While the retrenchment related mainly to staff at the front (operational) end, it has created challenges for the back (corporate) office staff in supporting compliance with certain regulatory requirements.'

Participant, Deloitte Risk Services round table, November 2008

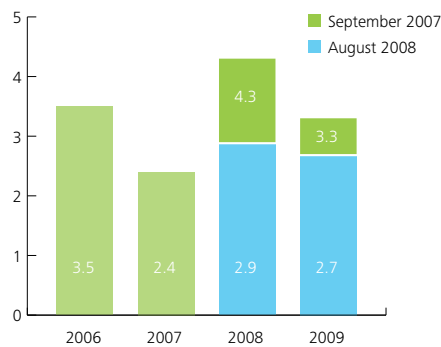
Driving efficiency and optimising the cost structure of the supply chain was seen as a key area for the business in which Internal Audit had an important role. In response to decline in demand for its products brought about by the economic crisis, one organisation had focussed its Internal Audit Plan on optimising distribution channels. Other Internal Audit functions had responded to the dangers of dependency on key suppliers by working alongside procurement teams to update them on the changes to the organisation's risk profile. As a consequence, models of shared service had been revisited and supplier bases 'federated'.

In many respects, cost management was seen as part of day to day business management rather than a response to volatility or crisis, with 'belt tightening' seen more as delaying expenditure rather than as program for sustainable change. It was agreed that a key challenge for Internal Audit and the Internal Audit Plan was to be more timely. Specifically it was agreed that there is a need to keep pace with sudden changes rather than the traditional three year or five to six year cycle of assessment across the business as a whole. At the same time, the consensus was that management's appetite in respect of Internal Audit's recommendations is changing.

**Some general comments drawn from Deloitte's experience on the opportunities associated with cost reviews:**

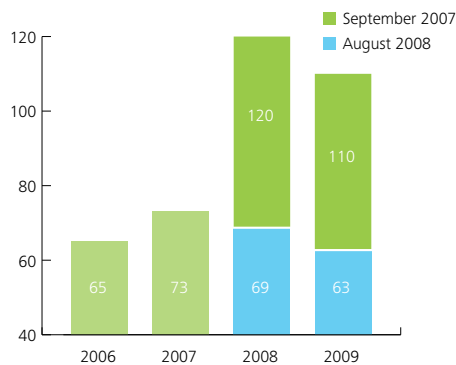
- despite top line impacts, earnings can be maintained through controllable and sustainable cost reduction and process efficiency improvements
- re-engineering can reduce costs and eliminate non value add work
- cost reduction initiatives require project management, leadership and communication to be sustained
- improved supply chain strategy and execution across procurement, manufacturing and distribution is key. Better quality orders and physical flow of goods improves cash flow by reducing mistakes and improving stock availability and services levels
- tax is the big sleeper: one of the most widely demanded services Deloitte has had in this period so far has been our tax 'tool kit' for uncertain times.

**Forecast CPI – September 2007 vs August 2008**



...as a result cost budgeting around CPI could have been wrong by 30%

**Forecast \$US Oil – September 2007 vs August 2008**



It is also likely demand and cost decisions impacted by petrol prices could have been wrong... by up to 100%!

# Assets

**Q: What are the key risks affecting your organisation's assets: treasury risk management, divestiture strategy & execution, working capital & cash optimisation, capital management, executive & board remuneration, GST cash savings, other?**

**Q: What successes have come from the Internal Audit of assets during the current volatility?**

Internal Audit and Risk functional heads attending the round table saw management of working capital and the optimisation of cash as the area of greatest risk to their organisation's assets (45%), with significant minorities rating capital management (27%) and treasury risk management (21%) as their most significant risks.

Participants agreed that 'cash is king' in the current environment, and that Internal Audit's recent role in improving cash management practices had ranged from targeted risk and control reviews of inventory management, claims reserves processes, accounts receivables, and shared services and other support functions.

One organisation reported that its sustained focus on WIP and debtors had freed it up to be in a position to consider acquisitions. One manufacturer said an inventory review had revealed inflexible bulk purchasing arrangements with a supplier which, when subsequently renegotiated, had freed up significant working capital otherwise previously tied up in stock. Another organisation reported that

an Internal Audit-led review of its treasury function – it works in more than 50 currencies – had led to process improvements with significant savings. Other positive outcomes from reviews mentioned included: the identification and sale of obsolete inventory, improvements in the ageing process for receivables, a focus on protection of intellectual property and divestiture of non-vanilla products.

A number of participants commented that it was important not to overlook the organisation's investment in research and development – nor let it walk out the door! That as part of paying attention to key people as assets, it is a good time to re-examine the 'bench' and do some succession planning, as well as being a good time to review and change the way in which staff are compensated.

A number of participants commented on: recent reviews of executive compensation, managing the impact of reducing or removing bonuses, changes to align compensation to longer term targets and overall company performance, and generally aligning performance measures to ensure an appropriately controlled enterprise while still attracting the best people.

Participants saw robustness of valuation processes, assessment of underperforming assets in order to deliver more cash to those parts of the business facilitating better working capital management, and assessment of the stability of key suppliers and customers, as further avenues for Internal Audit to deliver value to the organisation.

The challenges for Internal Audit in the current environment were seen to include:

- the difficult balancing act in getting underlying processes changed but retaining relationships with the business
- the potential conflict arising where Internal Audit is involved in providing business advice and in developing processes, and is later required to audit them
- the need to maintain independence so that Internal Audit does not become the owner of a process
- the need to add further value to the business rather than a focus on compliance.

**Some general comments drawn from Deloitte’s experience on the opportunities associated with the review of assets:**

From experience we know that cash-efficient organisations have a heavy weighting on cash management in their management’s KPI’s. We are also aware that working capital blowouts commonly occur where there is a disconnect between sales and marketing and between demand planning and procurement. Key to achieving a ‘cash culture’ is the implementation of a cash forecasting regime with reliable reporting tools.

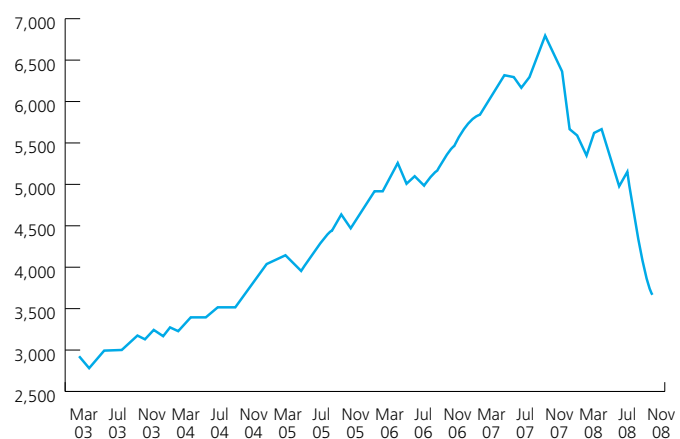
With regard to capital management: in the current context the amount of capital held, and how these assets are structured, is vital in preventing severe financial distress. The complexity of financial instruments has heightened the need to gain a greater understanding of risk. Capital calculations, capital enhancement and enterprise risk management are needed to quantify the elements of risk.

Likewise, in terms of treasury risk management, risk management policies should be re-tested in view of current conditions, and boards will want an understanding of how earnings may be impacted by market volatility and the impact of fair value accounting on the balance sheet. Inadequate pricing models may expose organisations to unintended risk.

‘Nine months ago a 3% drop in the value of the ASX would have been cause for a fair degree of panic. Currently we think a 3% decline on the day’s trade is somehow OK. We’re relieved that it wasn’t greater but nonetheless are sort of comfortable with it. There is new danger that we are growing immune to the dangers of volatility. And the opportunities.’

Dennis Krallis, National Lead Partner, Risk Services, Business Process Improvement, November 2008

**CommSec index March 2003 - November 2008**



# Stakeholders/expectations

Q: What are the key risks affecting your organisation's expectations: managing a profit downgrade, managing financiers, issues & crisis management, risk reviews, supplier reviews, or continuous disclosure in an uncertain economy?

Q: How well equipped is Internal Audit to address some of the risks?

Participants were relatively divided as to which were the key risks affecting 'expectations'. 25% of attendees thought risk reviews were the most significant. 18% regarded managing a profit downgrade as the most critical, with a similar percentage nominating supplier reviews as the most significant. Meanwhile 15% thought crisis management posed the greatest risk to their organisation.

There was an overall comment from participants that good risk management is about anticipating and planning so that crisis management is avoided or, at the very least, minimised. There was awareness that Internal Audit's role had become more 'relevant' and 'important' during the current conditions – it was seen to be providing an independent review of how the business was managing and, in many cases, was viewed as a key 'change agent'.

A number of participants mentioned that their organisations are looking at supplier reviews to ensure they are not over-reliant on any single supplier. A number of organisations are also funding arrangements for key suppliers (and customers) to ensure they don't start to struggle with refinancing.

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**'Internal Audit and Risk need to play a more significant role than they currently do. In good times 'risk' is not that risky. In bad times Internal Audit and Risk need to deliver the bad news. Proper risk management avoids crisis management.'**

Mark Sercombe, Partner Deloitte Risk Services,  
November 2008

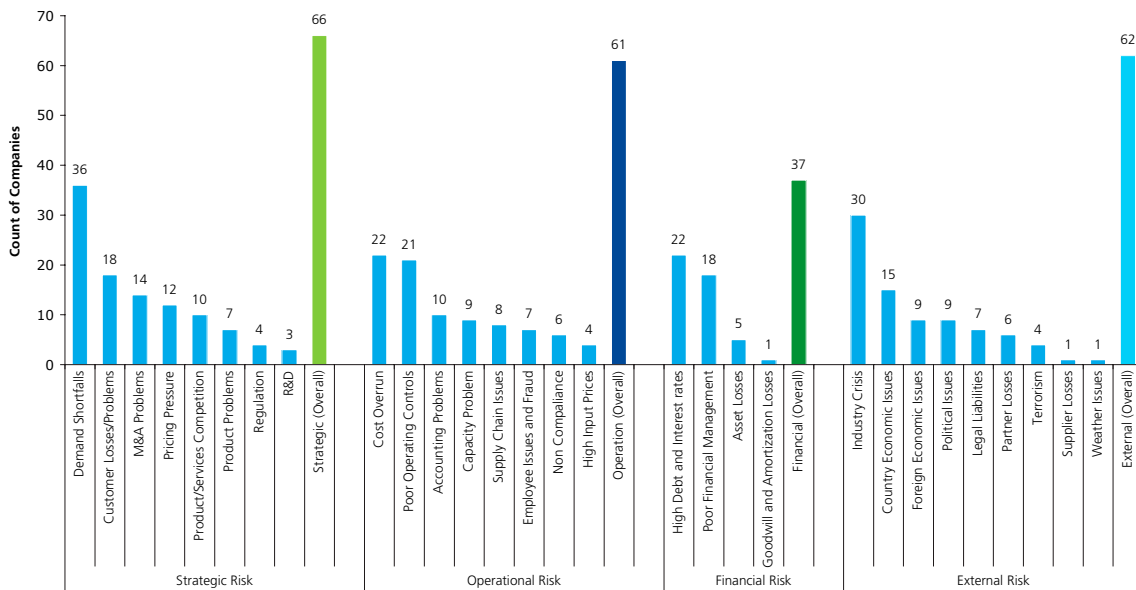
One organisation commented that it was important to consider suppliers of technology and related services as well as more 'tangible' goods. It had identified key risks associated with reliance on particular IT service providers, internet connectivity, software and hardware.

Participants also commented that Internal Audit Plans needed to be updated to address the issues of fund raising and accessing capital, that previous 'gentlemen's agreements' were no longer in play for wholesale funding. Liquidity generally was cause for concern, with realignment of positions and requirements occurring with growing frequency. There was comment that a lot of countermeasures had still to take noticeable effect, and that legislation would not adequately deal with market complexity.

**Some general comments drawn from Deloitte's experience on the opportunities associated with expectations:**

- enhancing an organisation's 'risk intelligence' to efficiently and effectively manage risk to reduce the cost of risk management, and to improve strategic flexibility, is key to delivering the agility required to manage volatility and ensure maximum reward
- supplier reviews need to go beyond standard 'health checks'
- managing a profit downgrade: since investor confidence is currently particularly fragile, organisations need to have in place a process that quickly identifies if there is a need for a downgrade, takes advantage of an independent perspective to enhance the boards' decision process, and enables timely, credible and consistent communications to all stakeholders
- environmental scans are essential to avoid potentially dangerous loss of organisational value. (see Deloitte Research study *Disarming the value killers*).

**Destroyers of organisational value: source and frequency**



Source: Appendix 2: *Disarming the value killers: A Risk Management study*, Deloitte Touche Tohmatsu 2005.

# The need to update the Internal Audit Plan

**Q: Do you consider that your Internal Audit Plan needs to be updated to address the risks that have arisen in these volatile times?**

Attendees were asked to re-evaluate their organisation's Internal Audit Plan (IAP) in light of their consideration of each component of organisational performance. By and large assessment of IAPs did not vary significantly when viewed through different 'filters'. Whether in response to risks associated with revenue, costs, assets or 'expectations', the majority of attendees thought their IAP required limited tweaking only, although a significant minority thought a moderate level of re-casting was required.

Generally participants were more comfortable with their existing plan in terms of addressing expectation-related risks rather than the risks associated with either revenue or assets (93% thought limited or moderate change required). As a whole, participants were least comfortable with their existing IAPs in addressing risks associated with costs. 44% thought a moderate level of change was required in relation to cost risks, with a further 17% nominating that their plans needed significant update in this respect.

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**'This is a fabulous time for risk professionals to not just protect but to enhance value. A crisis is a terrible thing to waste.'**

David McCarthy, Partner Deloitte Corporate Reorganisation Group, November 2008

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‘Managing in volatile times is a bit like white water rafting. One thing’s for sure with white water rafting. There is no guarantee that the craft that hits the bumps first will emerge first out the other end, if at all with boat and crew intact. The challenge for Internal Audit is to relish being at the front of the boat. Seeking the advantage of being the first to see what is coming and attempting to alert the rest of the crew to what dangers are rapidly approaching and to be ready for them.’

Ron Loborec, Head of Deloitte Risk Services,  
November 2008

# If you would like further assistance...

We have services specifically designed to assist your organisation adapt and grow in the current economic environment.

Revenue	 Pricing	 Revenue assurance	 B2B online
	 Granularity of growth	 Customer segmentation	 M&A strategy
Cost	 Tax Tool Kit for Uncertain Times (TKUT)	 SG&A Cost reduction	 Exit interviews
	 Supply chain	 Procurement/Accounts payable	 Contract reviews
Asset	 Treasury risk management review	 Working capital & cash optimisation	 Board & executive remuneration
	 Divestiture strategy & execution	 Capital management	 Cash Savings - GST
Expectations	 Managing a profit downgrade	 Financier management	 Risk reviews
	 Supplier reviews	 Continuous disclosure in an uncertain economy	 Issue & crisis management
Foundations	 Scenario planning	 Information management	 Benchmarking
	 Talent retention	 Board & executive reporting	 Cash/Business Modelling

If you or your team would like to discuss any of these services, or how Deloitte can help you manage in the current economic environment, please contact:

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