

## Managing in a downturn

How PwC can help you to stay flexible, anticipate and react quickly to changing times.

# The role of Internal Audit in difficult times

After a few years of strong economic conditions and stock market growth, we are now experiencing an unprecedented environment as the impact of the credit crisis moves from financial services companies into the broader market and economy.

In Hong Kong:

- We are seeing very low levels of interest rates as measured by both the prime lending rate (5.08%) and the Hong Kong Interbank Offered Rates (3-month HIBOR of 0.8% as at 12 Jan 2009).
- The benchmark Hang Seng Index declined from a high of 31,958 on 30 Oct 2007 to 10,676 on 27 October 2008 (decline of 66.6% in a 12 month period).
- Oil prices also declined from historical highs of US\$140 per barrel to recent lows of US\$ 38 per barrel.
- Slowing growth of the China economy (ten-plus years of >10 % GDP growth to around 8% predicted in 2009) has a big knock-on effect to the Hong Kong economy.
- Business confidence and forecasts are suffering in light of pessimistic worldwide conditions.

Globally, there is real risk that three of the four biggest economic regions are going into a deep and prolonged recession (i.e. US, Japan and Europe Zone).

### The role of Internal Audit

In these times, it is important to step back and look at the role of Internal Audit to ensure that it is addressing key risks. It is also important to recognise that for many internal audit functions, team

members may not have experienced an economic downturn. A discussion is needed about the market conditions and how these should be changing internal audit focus, the nature of the issues and risks that may emerge, and the value that can be added by Internal Audit, particularly to business areas under stress.

The following checklist can be used by Chief Internal Auditors and their teams to assess their ability to add value to the organisation during difficult times.

### Checklist

#### How aware is your team?

- Who in the team has experienced an economic downturn?
- Have you drawn on the experience (from both the team and the business) of people who were there for the 1997 Asian financial crisis, the 2001 collapse of the dot-com bubble and the 2004 SARS induced economic downturn?
- In current conditions and based on past downturns, which companies and businesses have been most affected and why?
- Is your team used to dealing with an increased risk of fraud? In the 4 years after 1997, there was a 25% year-on-year increase in reported fraud.



## Does your plan need to change?

- How has the change in market conditions affected your organisation's risk profile? For example: can cost rises be passed on, what will be the impact of a fall in new business start-ups, will there be a loss of knowledge with redundancies, how are counterparty and credit risks affected?
- Is your plan focused on the areas of greatest risk? Are you able to refocus the plan as conditions change? For example, should you re-assess fraud risk, areas of the business with a track-record of control issues, complex business areas?
- Consider the organisation's risk culture and how it may change with stress. How does management react to bad news? Could issues such as the following emerge?

• Liquidity management	• Subjective asset valuations
• Gearing	• Acquisitions not delivering as expected
• Compliance with funding covenants	• Overstated performance

- If you are happy with the plan, is the scope at the individual audit level still appropriate? Do you need to think differently about the conditions and review specific risks? Have you re-considered fraud risk (e.g. financial reporting, sensitive transactions etc)? Are you routinely testing for fraud and unusual transactions on all internal audit projects (e.g. using Computer Assistant Audit Techniques)?
- Have the internal audit needs of your stakeholders changed?
- Is your organisation doing scenario-testing?
- Do you have the broad co-operation of management?
- Could the team skills be limiting the areas on which you focus?
- Could Internal Audit be focusing its limited resources more effectively and more efficiently?

## Do you need to communicate differently?

- Have you discussed the market conditions with the CEO and chair of the audit committee? Do you have their support to probe more deeply into different areas?
- Do you need to consider calling senior management to voice your views and concerns about business conduct / behaviours that could be putting the organisation at risk?
- Are there long-standing audit issues which could have more significance in the current environment? Would any issues hit the headlines if they became public? Do these issues need to be re-communicated within the current context to ensure that management and the board are aware of the potentially heightened risk?
- Are there pervasive issues in specific business areas which need to be summarised and re-communicated?

## Are you teaming with the right people?

- Have you discussed your views with functions such as risk, compliance, legal and the external auditor? Are you able to support each other in the communication of the key messages and changes in risk?
- Do you have the skills to audit some of the more complex areas which could be critical to the business? (Options: form relationships with business specialists and include them as guest auditors; co-sourcing of external specialists; outsourcing to specialist firms on specific areas e.g. treasury, IT, investments)
- Have you exchanged high-level issues and focus areas within your external network of peers?

## Finally, are you taking the opportunity to add more value?

- This is an opportunity to provide clarity to the organisation about the key risk areas, and to support those areas of the business that are under stress. Have you positioned your role and your communications to provide this value and further enhance Internal Audit's standing in the organisation?
- Should you be critically assessing the costs of your department and be ready to defend the value you bring?

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## PricewaterhouseCoopers' Systems & Process Assurance (SPA) Practice

Business today is increasingly complex – from the way organisations are managed and structured, through increasing integration with business partners and service providers, to the ever greater levels of reliance placed on underlying information systems and business processes. In addition, new regulations – domestic and international – are placing a greater emphasis on the effectiveness of internal controls and this often requires independent assurance. PricewaterhouseCoopers' specialists within our Greater China SPA Practice provide a wide range of advice and services related to internal control, risk management and governance across all aspects of our client's business.

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