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Operating in a Down Economy – Key Strategies and Opportunities for Internal Audit

Doing more with less to improve an organization's risk management, control, and governance processes.

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Risk & Business Consulting.
Internal Audit.

Overview of Economic Trend and Impacts

Stating the Obvious

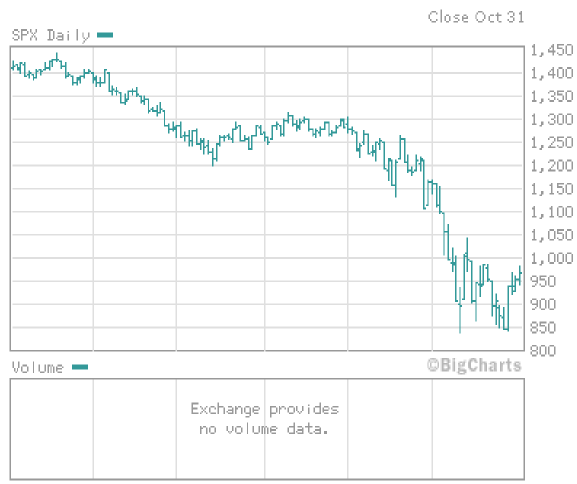
The current economic environment is placing a significant amount of stress on consumers and business alike. Business as usual doesn't apply.

House of Cards

- Rapid rise in gas prices coupled with a dramatic increase in mortgage and credit card defaults
- causes rapid escalation in commodity pricing and a monumental meltdown in the financial services sector
- which results in downward pressure on business profits and a global credit freeze
- that virtually shuts down the global economic engine;
- which drives a further stock market declines and increases in bankruptcy filings
- that spurs government intervention
- which results in a huge bailout package
- that causes confusion and angst in the business sector and loss of confidence by consumers
- which puts further pressure on business to preserve profits and maximize cash from operations.

The Fallout

S&P 500 12 month trend



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What Companies Are Doing

Challenges

- Increased uncertainty
- Challenges in forecasting
- Tightening credit and increased cost of capital
- Reduced demand and increased pricing pressures
- Declines in asset values (investments, pensions, etc.)
- Personnel reductions
- Investment rationalization

Significant change will be the norm as companies shift from an emphasis on growth to an emphasis on preservation.

Opportunities

- Increase fiscal discipline
- Focus on core values
- Grow market share
- Upgrade talent
- Improve cost management practices
- Address organization structure issues
- Improve/Add core capabilities
- Exit marginal businesses
- Acquisition opportunities

Identifying and seizing opportunities during this period of change and uncertainty will differentiate the winners from the losers.

How has the current economic crisis impacted the internal audit profession?
GAIN Flash Survey

Impact on Companies

- 87% said current crisis has negatively impacted their organizations
- 45% said that the impact was moderate or worse
- 4% said the impacts threaten the future viability of their organizations

Impact on IA Budgets

- More than 50% have experienced a decrease
- 53% of Fortune 100 reported decrease
- 27% experienced decreases of less than 10%
- Almost 25% have experienced decreases of more than 10%

Variety of methods observed

- 80% have reduced travel expenses
- 70% have reduced training expenses
- Heavy reductions in administrative and co-sourcing support
- Numerous respondents have a hiring freeze in place
- One-third have laid off staff

Source: 2009 GAM Presentation by Richard Chambers, President of the IIA

What should internal auditors be doing differently now given the challenging global economy?

Changing Times…Changing Risks

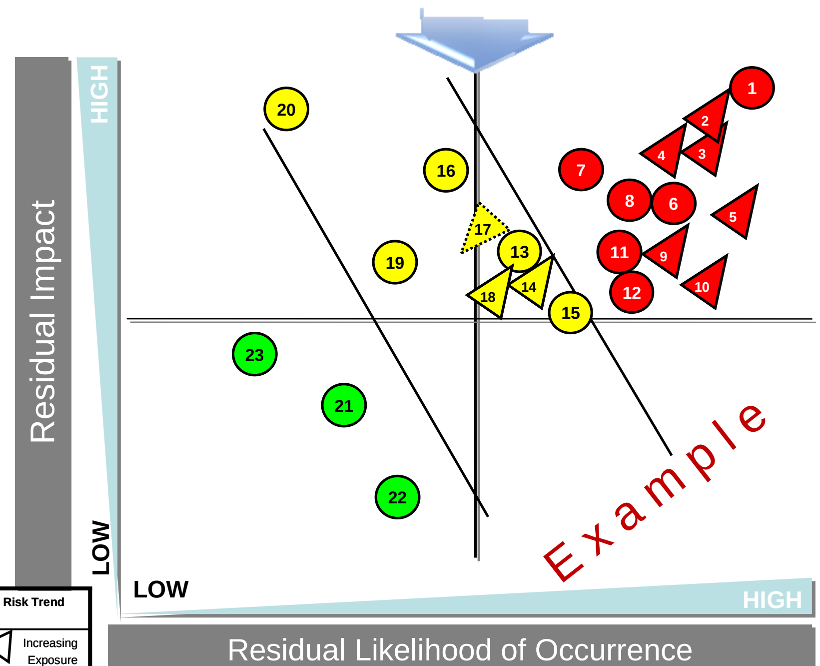
Re-Assess Company Risk Profile

The financial crisis has increased uncertainty and created change. Changes to strategic plans. Changes to operating budgets. Changes to organizations.

Uncertainty and change increase the need to effectively identify, understand and manage risk. If properly managed, risks can be transformed into opportunity and competitive advantage, especially during times of uncertainty.

SOURCES OF UNCERTAINTY

- **ENVIORNMENT RISK** — Uncertainties Affecting the Viability of the Business Model
- **PROCESS RISK** — Uncertainties Affecting the Execution of the Business Model
- **INFORMATION FOR DESCISION MAKING RISK** — Uncertainties Over the Relevance and Reliability of Information



Risk Level	Risk Trend
High	Increasing Exposure
Medium	Decreasing Exposure
Low	Neutral

Legend
1. Customer Satisfaction Risk
2. Capital Availability Risk
3. Regulatory Risk
4. Efficiency Risk
5. Commodity Risk
6. Compliance Risk
7. IT Security Risk
8. Product Development and Pricing Risk
9. Third Party Fraud Risk
10. Human Resources Risk
11. Planning and Strategic Risk
12. Measurement Risk
13. Treasury/Cash Management Risk
14. Change Management Risk
15. Employee Fraud Risk
16. Product Failure Risk
17. Legal Risk
18. IT Infrastructure Risk
19. Default or Counter Party Risk
20. Disaster Risk
21. Taxation Risk
22. Health and Safety Risk
23. Scalability Risk

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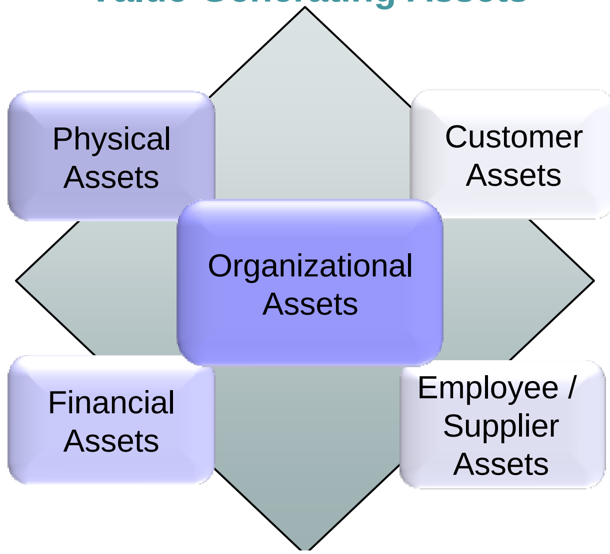
Possible Questions to Consider

Value-Generating Assets



PHYSICAL ASSETS

- Are we adjusting inventory levels based upon reliable leading indicators?
- Should we adjust our capital spending and major maintenance plans?
- Do we have assets that we should sell?
- Are there assets we need that could be available at a more reasonable value now?

FINANCIAL ASSETS

Cash
- How reliable is our cash flow forecasting?
- Should we analyze scenarios, including worst case, to better understand liquidity exposures?
- Should we suspend our dividend / stock repurchases to preserve capital, or should we accelerate stock repurchases to capitalize on current prices?

Credit
- How costly will a covenant violation be?
- Will we have access to our current lines of credit, should we need them?
- Should we pursue additional financing options, even if it means higher borrowing costs?

Investments
- Should our investment strategy change?
- How are we monitoring concentrations and counterparty risk?

Receivables
- Will we be able to collect?
- Is our working capital deteriorating?
- Should we loosen or tighten credit policies?

Hedging
- Should we be adjusting strategies and / or hedging other exposures given recent volatility?

Reporting
- Should we review assumptions used in accounting estimates and models given changes in business?

ORGANIZATIONAL ASSETS

- Is our budgeting process providing the information we need? Is reporting available to monitor performance effectively?
- Is our strategic planning process able to identify appropriate market opportunities in a rapidly changing environment?
- What do we do better than our competitors? How can we capitalize on our core competencies?
- Do we face reputation risks that need to be carefully monitored as we adjust our strategy?
- Do we have broken processes or areas that are clearly lacking necessary capabilities? Can they be fixed, or should we outsource?
- Are we efficiently spending our IT dollars?
- Are we investing appropriately in research and innovation?
- Is our ethics program effective?
- Do we have increased risk of noncompliance or exposure to failures in managing risks, due to cost cutting?
- Can we provide the risk transparency and reporting that the Board will demand?

CUSTOMER ASSETS

- How do we maintain customer satisfaction with more limited resources?
- How are customers being impacted?
- Do we have customer concentrations that we should be concerned with?
- Is customer demand for our products changing, and does our demand forecasting consider multiple scenarios and the related impact on our cost structure?
- Should we change our product mix?
- Are we creating customer trust and transparency?

EMPLOYEE / SUPPLIER ASSETS

- What is the financial condition of our key suppliers? Do we need contingency plans to maintain supply?
- Could we be sourcing more effectively to reduce costs?
- Are our business partners capable of meeting their commitments? Should we be monitoring them more closely?
- Is our workforce focused, and are we communicating appropriately with our workforce?
- Are we prepared to “do more with less”?
- Are our short-term incentive programs in line with long-term shareholder and organizational value?
- Is our workforce focused on “doing the right thing” from a compliance and ethical behavior standpoint as we react to market conditions?
- Have workforce reduction plans been developed in the event that reductions are necessary?

Impact of the Current Global Crisis
GAIN Flash Survey – Shifts in Coverage

- Financial risks – 41% have increased coverage
- SOX – 64% remained the same or decreased
- Operations risks – 47% increased coverage
- Compliance risks – 65% decreased or remained the same
- Credit and liquidity risks – approximately a third increased
- Effectiveness of risk management – 35% have increased coverage
- Company exposure to third-parties in financial distress – 39% have increased coverage
- Cost reduction/containment – 47% increased coverage
- Model validation – 47% decreased or remained the same
- Off-shoring/vendor risks – 19% increased
- Reputational risk – 69% remained the same or slightly decreased

Source: 2009 GAM Presentation by Richard Chambers, President of the IIA

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Reassess the Internal Audit Plan

Areas to Consider Shifting Additional Focus to . . .

Fraud – Revenue and Procurement

- Revenue recognition
- Procurement
- Embezzlement
- FCPA

Working Capital and Cash Management

- Days Sales Outstanding
- Days in Inventory
- Days Payables Outstanding

  = Total Days "Trapped" in Working Capital

Controls Automation

- Manual controls cost more to execute and to audit
- Automated controls can provide higher levels of assurance
- Maximize the ERP effectiveness

Cost Containment and Reductions

- Organizational control structure/span of control
- Third-party contract administration, including outsourcing agreements
- Construction and capital projects
- Sales commissions
- Vendor payments and contract compliance, including erroneous payments
- Overtime payments
- Revenue assurance
- IT infrastructure spend
- SOX costs

The Internal Audit Process Itself

- Data mining and CAATs
- Smarter, better, quicker
- Look at all components – planning, execution of fieldwork and reporting
- Measure, benchmark and improve
- Support the audit process with technology

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Cost Containment and Reductions
Spend Assessment

Approach

Spend Analysis

- Periodic & Continuous Audits of:
    - A/P, P-Cards, T&E, Claims, Contract Compliance and Fraud
- Purchasing and Account Payables Consulting:
    - Working Capital Improvement Projects (Payment Terms, Early Payments, etc.)
- Spend Remediation:
    - Vendor Master File Cleanup
    - Profit Recovery Projects
    - Reconciliation Projects

Possible Opportunities

Working Capital Impacts

Profit Recovery

- Identify duplicate and fraudulent payments
- Utilize outstanding credit memos

Maximize Cash on Hand Position

- Limit early payments (relative to contracted payment terms)
- Accept favorable Payment Incentives (1% 15 Net 30 Days, when benefit is to your company's advantage)
- Implement standard payment terms and negotiate terms into all contracts for goods and services

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Working Capital and Cash Management
Sample Metrics and Benchmarking Ideas

	Benchmark Metrics	Results for 2007	Results for 2008	Change	Industry* Median	Industry* Best	Gap from 2008 to Median	Gap from 2008 to Best
	DSO (Days Sales Outstanding)	17.2	21.9	4.7	35	16	n/a	5.9
+	DIO** (Days Inventory Outstanding)	24.2	26.2	2.1	24	18	2.2	8.2
-	DPO** (Days Payables Outstanding)	21.5	13.7	-7.8	31	40	17.3	26.3
=	DWC (Days Working Capital)	19.9	34.4	14.6	28	8	6.4	26.4

A reduction of one day in DWC will increase your company's average cash balance by: $ 21,917,808

Using the following costs of capital, net annual impact of a one day reduction in DWC will be:

Low	5.0%	$ 1,095,890
High	10.0%	$ 2,191,781
Average	7.5%	$ 1,643,836

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Working Capital Improvement

Order-to-Cash

Components & Value Drivers

Order-to-Cash

- Decrease DSO
- Reduce Invoice Error Rate
- Reduce Unauthorized Deductions
- Reduce Uncollectible A/R
- Reduce Processing Costs

Procure-to-Pay

- Increase DPO
- Reduce AP Processing Costs
- Reduce Lost Discounts
- Reduce Financial Leakage
- Reduce Spend / TCO

Inventory

- Decrease DIO
- Reduce Inventory Carrying Costs
- Reduce inventory (WIP / FG)
- Reduce Excess and Obsolete
- Reduce Inventory Write-Offs

Possible Ideas

Decrease DSO

- ✓ Improve turnaround time to generate invoices after activity (shipment, service delivery, etc.) by accelerating data collection, entry, and validation
- ✓ Enhance communication with customers to improve dispute and collections management
- ✓ Enforce payment terms and penalties

Reduce Invoice Error Rate / Processing Costs

- ✓ Standardize (and consolidate) invoicing processes
- ✓ Leverage ERP functionality / automate manual process
- ✓ Improve Customer Master File data integrity

Reduce Unauthorized Deductions

- ✓ Improve monitoring capabilities (short payments, unauthorized deductions, aging reports and outstanding balances)

Reduce Uncollectible A/R

- ✓ Improve credit monitoring and enforcement procedures

Improvements in Working Capital Management can free up cash and generate significant annual savings and impact to the bottom line!

Working Capital Improvement
Procure-to-Pay

Components & Value Drivers

Order-to-Cash
- Decrease DSO
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Inventory
- Decrease DIO
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Possible Ideas

Increase DPO
- ✓ Improve integrity of Vendor Master File
- ✓ Monitor and enforce use of approved Payment Terms – extend where feasible
- ✓ Update existing agreements upon expiration

Reduce Invoice Error Rate / Processing Costs / Lost Discounts / Leakage
- ✓ Standardize (and consolidate) AP processes
- ✓ Increase use of Purchase Orders to automate matching process (decrease Pay-on-Approval volume)
- ✓ Leverage ERP functionality / automate manual process
- ✓ Enhance supporting capabilities
- ✓ Develop / improve monitoring and reporting

Reduce Spend / Total Cost of Ownership (TCO)
- ✓ Strategic Sourcing (Total Cost of Ownership (TCO), leverage volume, specification improvements, global sourcing, etc.)
- ✓ Manage contract compliance

Improvements in Working Capital Management can free up cash and generate significant annual savings and impact to the bottom line!

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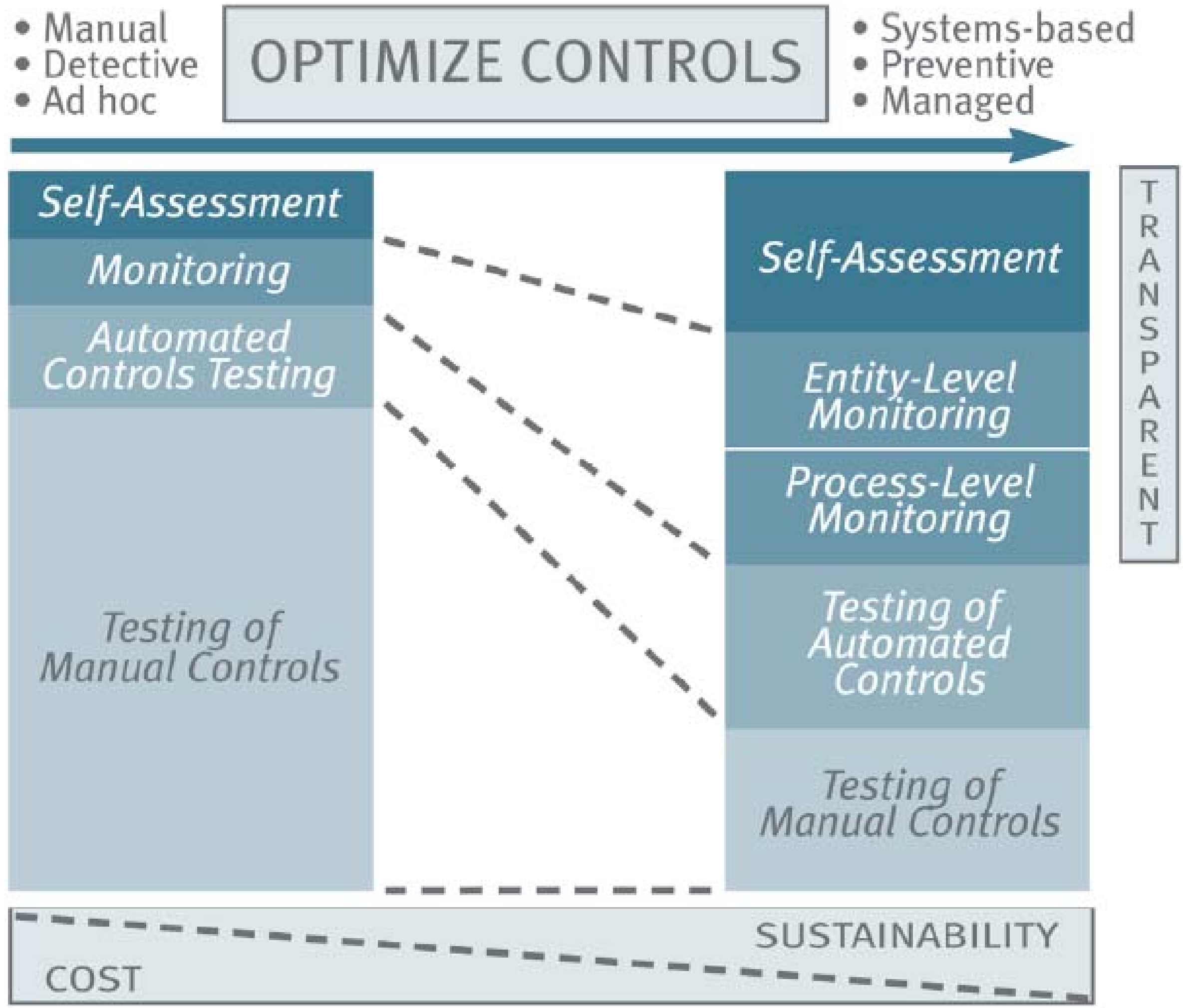
Controls Automation and SOX Costs
Linkage to Each Other

The key drivers of SOX compliance costs rest in a combination of:

- The number of controls you have defined as SOX controls.
- The nature in which those controls operate in your organization.

Targeted improvement in the efficiency of the controls environment will lead to improved operational efficiencies in the business and vice versa.

These rules do not just apply to the world of SOX!



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Looking to the Future
Likelihood of Increased Focus Next Year

- Financial Risk (general) – 56%
- Operational Risk – 56%
- Effectiveness of Risk Management – 47%
- Credit Risks – 43%
- Compliance Risks – 39%
- Liquidity Risks – 31%
- SOX Testing/Support – 11%

Source: 2009 GAM Presentation by Richard Chambers, President of the IIA

Meeting Today's Challenges
In Summary

- It cannot be understated that poor risk management contributed to the current economic turmoil
- Today, internal auditors must:
  - Understand the current challenges of today's environment and the organization's key objectives
  - Ensure key controls and processes are addressing new changes and key risks
- Internal audit plays a critical role in helping management:
  - Successfully "manage change"
  - Understand, assess, mitigate, and manage risk
  - Ensure the organization "stays the course" with the audit plan but be nimble and flexible when needed
- In today's business climate, internal audit's success lies with:
  - The commitment to ongoing learning and improvement
  - A deep understanding of and ability to meet the organization's needs
  - THE VALUE DELIVERED TO THE ORGANIZATION!

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