

Risk management in a cost-cutting environment

Paper prepared for the Audit Committee Chair Forum
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The Audit Committee Chair Forum (ACCF) is convened by the CBI and Ernst & Young and is facilitated by Cranfield University.

The Forum comprises a select group of audit committee chairs from the UK's leading companies. Our aim is twofold, namely:

- to influence the direction of regulation as it impacts audit committees, and
- to act as a vehicle to develop points of view and best practice.

The Forum provides an opportunity to contribute to the debate, influence its direction and improve the performance of audit committees.

The Forum is currently chaired by John Buchanan, Audit Committee Chairman of AstraZeneca, with Gerald Russell, Senior Partner at Ernst & Young, and Martin Broughton, President of the CBI.

This is the ninth paper produced by the ACCF. Previous papers include:

- The role and function of the Audit Committee
- The drivers of audit quality
- What is an effective audit and how can you tell?
- Audit Committee regulation: 'Financial literacy' – what does it mean?
- Audit Committee communication: What is said, why, how and to whom?
- The role of the Audit Committee in risk management
- The role of the Audit Committee regarding non-audited information
- The Audit Committee and the credit crunch

To obtain copies or learn more about the ACCF please contact the Forum Secretary, Sarah Woodthorpe at the CBI, sarah.woodthorpe@cbi.org.uk



Executive summary

- **Increased risk**

In times of cost-cutting, organisations may be at increased risk due to poor morale, staff changes, or individuals and divisions cutting corners in attempting to meet the original expectations.

- **Tone at the top**

Boards should set a cultural expectation that everyone in the organisation will act with integrity, and will make it clear what operating and financial practices are acceptable.

- **The need for internal audit**

The audit committee should ensure that internal audit is focused on its prime role of maintaining financial integrity.

- **Increased liaison with auditors**

Audit committees are spending more time with internal and external audit, to ensure that potential problems are known in advance, and risk areas highlighted.

- **Impact on financial results**

Budgets, forecasts and impairment calculations must be prepared with a realistic understanding that the economic environment has changed substantially.

There is less of a push to ‘make the numbers’ than in previous recessions, and more realism about the health of the business.

In some companies, the audit committee is holding management back from issuing profit warnings before they are needed.

‘No surprises’ is the mantra from the audit committee.

- **Going concern**

Proposed changes in guidance from the Financial Reporting Council are unlikely to have a major impact on practice, given what audit committees are currently doing.



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Introduction

After a sustained period of benign economic conditions, the credit crunch and the economic slowdown have hit companies in almost all sectors. For many, cost-cutting has become the order of the day, to maintain profitability and preserve cash at a time when banking covenants have become restrictive and the banks are less enthusiastic about lending. This can have an adverse effect on the culture within the business, and lead to pressure on individuals as well as on financial performance. The need for control and the role of the audit committee are emphasised in this environment.

This paper reflects the discussions of a meeting of the Audit Committee Chair Forum (ACCF) held on 2nd October 2008 to address how audit committees are responding to these issues. The discussion was informed by prior telephone interviews, by previous work of the ACCF, and by a brief review of academic, professional and regulatory publications on the matter.

The meeting on 2nd October was attended by six chairs of the audit committees of leading companies, and three audit partners from Ernst & Young.

The formal questions addressed in the briefing document circulated prior to the ACCF meeting are set out in Appendix 1.



Protagonists and their roles

In addition to the audit committee itself, the ACCF meeting revolved around the risk-management roles of the board and the internal and external auditors.

The board: setting the tone from the top

The culture of an organisation is set by the board – tone at the top is crucial to what happens in the tiers below. All at the meeting agreed that it is essential for the board as a whole, and for directors individually, to set an example of what practices are encouraged and acceptable throughout the group. This is particularly relevant at a time when individuals might feel themselves under pressure to adopt different business practices in order to produce good results.

As always, a good degree of openness, transparency and trust between the executives and independent directors, and in particular the CFO and the audit committee chair, was seen as vital.

Auditors

“A sophisticated internal audit function is probably not spending a lot of time, figuratively speaking, looking at whether the trial balance balances.”

“The control element of the [external] auditor is the independent assurance that you are dependent upon as an audit committee.”

At a time when there are considerable pressures on the executive management, the audit committee chair will be particularly reliant on both internal audit and external audit, and close liaison is required. Auditors need to be fully aware of all of the pressures being faced by the executives and the organisation. Audit work plans which may have been agreed several months previously, in an easier economic climate, will need to be re-visited to ensure that critical risk areas are considered and addressed.

The audit committee is seeking realistic opinions from both of its audit functions, and needs assurance that the auditors are in touch with what is happening in the organisation. Close liaison between the committee and internal and external audit is even more important than in favourable economic circumstances.

“... ask him how his audit plan is responding to this new environment and its challenges.”

When companies are cutting costs, a particular pressure on internal audit may be the requirement for them to undertake special one-off exercises considering where such costs can be cut. Although this is important for the company, it is just as important that they are not diverted from their auditing and risk appraisal duties at a time when these are particularly needed. The audit committee should direct their main role towards the need for cash flow, and integrity of financial systems.



The risks

“Whenever change takes place you risk the stability of the control environment. That has to be front of mind from the point of view of the audit committee chair.”

“You’d expect the risk map to be flexed for these new circumstances.”

The ACCF meeting was convened around the impact of cost-cutting, but the discussion was wide-ranging and constructive, and inevitably included broader matters to do with the credit crunch and the recessionary climate.

The risks discussed could be broadly classified into two areas: those relating to people’s attitudes, and those to do with business performance as evidenced by profitability and cashflow. However, one important point that came out of the meeting was that not all companies are feeling the pressures that lead to these risks. The impact, both on the financials and on the people, was considerably less in companies with a robust financial position than it was for others.

Impact on people within the company

The academic and professional literature suggest that a change in attitudes towards tightening up on expense claims, limiting pay rises and reducing bonuses can have a significant cultural impact on employees and their management. This could lead to a reduction in morale, with an impact on quality and productivity. Changes in staff, either from redundancies or due to dissatisfied people leaving the organisation, also pose a risk to the integrity of systems. Further, changed conditions could lead to a more relaxed attitude to the company's risk management systems, both financial controls and physical processes regarding, for example, health and safety, or incentive payments through the supply chain.

There is research that suggests that companies experience more fraud in recessionary times, as employees seek to replace the monetary bonuses and perks to which they have become accustomed during the good times¹. This might be through direct theft of company money or property, or through manipulation of accounting results to preserve bonuses based on perceived profitability. Systems need to be in place to discourage and limit such fraud, and the audit committee chair should liaise with internal and external auditors on this.

The discussions at the ACCF meeting suggested that audit committees are not taking any additional measures in relation to the possibility of such risk. The systems in place are considered to be robust enough, although it is a matter for discussion with internal and external auditors. The most important control over changes in people's attitudes was considered to be the tone set by the board, discussed previously. It is vital that the Board emphasises the need for potential problems to be reported early enough to be addressed in good time.

“Over the last five years, post-Turnbull, we've all beaten risk management to death. This is the year we're going to find out if it works.”

One matter raised at the meeting was the danger to companies of losing good executives. A comment was made that executive search firms have a lot of individuals on their books whose share options are underwater and who will not be receiving bonuses in the foreseeable future, and who therefore are considering moving on. Boards need to have succession plans in place for such events, and may wish to try to prevent them.

¹ There is also a suggestion in the research that such frauds take place all the time, but are only actually discovered during recessionary times, as companies take more of an interest in where their money is going.

Impact on the financials

Strong financial controls, whilst always important, take on particular importance in difficult economic times. They include the ability of the business to produce meaningful budgets and forecasts, the integrity of the financial reports (internal and external), and the control and management of cash.

Managing business activity, and forecasting

“We are to some extent the prisoners of history.”

“They are not inexperienced people generally, but inexperienced in relation to this environment.”

One difficulty faced by companies in this current recession is that many younger board executives have limited experience of recessionary conditions, and even less experience of leading or managing a business through such times. A particular effect of this is that management, attuned to working in a high-growth environment, have been slow to reduce activity forecasts or to curb their natural optimism about business prospects.

In some cases, this may have arisen not because the executives do not recognise that the benign environment has changed, but because they see it as their responsibility to keep the company on its original track, even if others believe that that is no longer possible. One ACCF member described this attitude as, *“I don’t want the NEDs to think that I’ve given up.”*

Audit committee chairs have a valuable role here as a sounding board, an advisor and a scrutineer of budgetary process.

No surprises

“[We want] no surprises. And in the audit committee, ‘no surprises’ needs to be translated into ‘tell me now’.”

“Will people feel comfortable telling the truth to the next layer up?”

There is a natural human desire to try to avoid delivering bad results. The news might be delayed while efforts are made to improve the trading position, or disguised by the release of some of the reserves and provisions that are hidden within the accounts of every division of every business. However, at some point the true position has to be identified.

From the point of view of the audit committee, it is essential that ‘real’ position is logged in the internal reporting system as soon as possible, so that corrective action can be taken if possible, or markets forewarned. The tone set by the Board and the audit committee can encourage transparency in internal reporting.

This same level of openness is necessary in the pre-year end planning, and the chair of the audit committee should encourage the CFO to document potential exposure points well in advance of the financial year end. These will be fed into the audit planning process.

“We don’t want to know about important risks in February.”

Managing financial results

“You’re certainly not going to go over the top on the numbers, because the market won’t believe you.”

Making the numbers

“That scenario feels very ‘80s.”

There is research evidence to show that in earlier recessions, some companies become more ‘creative’ regarding their accounting policies on, for example, inventories, receivables, accruals, provisions or exceptional items. Also, managers may be unwilling to make the necessary write-downs on asset impairments, as this might reflect badly on previous decisions. This does not necessarily reflect a fraudulent attitude – an overriding characteristic of executives is their ability to see the ‘glass half full’: this optimism is often what makes them good executives. However, this does put the onus on the independent directors and particularly the audit committee chair to examine the downsides more carefully.

When this point of view was put to the meeting, the audit committee chairs generally believed that for the UK and the USA, this was much less of an issue now than it had been a couple of decades earlier. This reflects a change in accounting standards, and also a change in attitudes – CFOs these days “don’t get to the big time by having a reputation for making the numbers”; the good CFO acts as a brake on the CEO’s over-optimism.

However, it was noted that this can be a problem in multi-nationals which have divisions in parts of the world where ‘face’ is very important. Here, it can be more difficult to overcome cultural differences and find out, early enough, what the ‘real’ numbers are.

Talking down the results

“This is the year of the impairment provision.”

Rather than being too optimistic, some ACCF members suggested that management are tending to report more pessimistically than the audit committee deems appropriate, and wanting to take write-downs and issue profit warnings at too early a stage.

In companies which have previously not needed to make impairment provisions, it can be difficult to establish what these numbers should be. This difficulty does not arise in those groups which have established mechanisms to determine write-downs. The advice of external auditors is used to identify and challenge over-provisions.

Managing cash

A discussion on the importance of managing cash reflected in large the matters raised in the ACCF meeting held on 7th April 2008, which discussed the audit committee and the credit crunch. The difficulty of knowing where cash could safely be deposited were also considered.

Audit committee meetings

As stated earlier, a level of openness and trust between the audit committee chair and the CFO is crucial for the systems to run smoothly. In discussing this, the meeting also considered whether or not the CEO should attend audit committee meetings. Although it was agreed that the CEO should attend the audit committee at some point, and should be involved in discussions on risk, there was no consensus. Some took the view that having the CEO always in attendance is bad practice, as it prevents the audit committee from developing a relationship with the CFO. However, others preferred to see the CEO at most of every meeting, so that they knew that the message was being delivered consistently through the executive.

In the current economic climate all of the audit committees were having regular meetings with the company's Treasurer.

It was generally noted that the number of audit committee meetings in a year, and the amount of time the chairs spend dealing with committee matters outside meetings, has increased in recent times.

Changes to 'going concern' regulation

Financial statements are prepared on a 'going concern' basis, on the assumption that the company will continue its business for the foreseeable future². Under the Listing Rules, directors are required to make a statement, reviewed by the auditor, about the going concern status of the company, giving their supporting assumptions if appropriate.

In September 2008 the Financial Reporting Council published a consultation paper³ setting out its proposals to revise the Guidance for Directors of Listed Companies on Going Concern and Financial Reporting which was last updated in 1994.

Some of the areas included in the FRC document are:

- Consideration of the appropriate period to be considered as 'foreseeable future'.
- The need for preparation of rolling 12 month forecasts and longer-term forecasts, and the use of sensitivity analysis to stress-test borrowing requirements and availability.
- Consideration of fair values and impairments for assets on the balance sheet.
- Exposure to financial risks such as derivatives and currency contracts.

In the view of the ACCF members at the meeting, this is unlikely to lead to any changes in practice, as audit committees are already paying considerable attention to these areas where there is any danger of going concern problems.

² Generally taken as 12 months from the date of approval of the financial statements, or 18 months after the balance sheet date.

³ The consultation paper can be downloaded from <http://www.frc.org.uk/images/uploaded/documents/Going%20concern%20draft%204%20vs11.pdf>

Rotation of auditors

The discussion turned to the requirement for audit partner rotation every five years in order to preserve their perceived independence. It was agreed that this presents a problem for large and complex organisations. In such groups the audit partner will spend the first year becoming familiar with the business and its operations, and will spend the last year getting ready for the transition. This leaves only three 'good' years out of the five. This was considered by the audit committee chairs to be highly unsatisfactory, particularly in the present uncertain economic times, as changes in audit partner could lead to an increased level of risk.

It was agreed that this matter would be pursued separately.



Questions to ask yourself?

1. How has the changed economic environment affected the risks faced by our business?
2. What else could our board and audit committee do to set 'tone at the top' and ensure that employees at all levels understand the importance of maintaining the integrity of business and reporting practices?
3. How are we ensuring that internal audit is performing its financial risk management activities, and not getting side-tracked into other business activities?
4. Are we liaising sufficiently with the external auditors, to confirm that their work is addressing all of the new risk areas?

Appendix 1

Questions included in the briefing document circulated prior to the ACCF meeting

1. How is your company managing the cultural impact of these changes: at board level and in the management and the workforce?
2. What additional risk management processes need to be put into place, and how are these being monitored?
3. How have the roles of internal and external auditors, and their interaction with the audit committee, been changed in the current economic climate?
4. What processes do you have to ensure that there is sufficient cash flow and/or funding in place, supported by a rigorous rolling forecasting process, to ensure 'going concern' is not an issue?



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