RISK IN FOCUS 2021

Practical guidance on macroeconomic and geopolitical uncertainty

How to tackle associated risks and harness opportunities?

EUROPEAN CONFEDERATION OF INSTITUTES OF INTERNAL AUDITING
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Introduction

This practical guidance is part of the Risk in Focus 2021 publication.

Ten European institutes of internal auditors in Austria, Belgium, France, Germany, Italy, Luxembourg, the Netherlands, Spain, Sweden and the UK & Ireland developed the document to help internal auditors address some of the key risks identified in Risk in Focus 2021, with the aim of contributing to the reduction of their impacts on businesses and stakeholders.

For the 2021 edition, practical guidance will be available on the following three chosen topics from the report:

- **Cybersecurity and data security**
- **Macroeconomic and geopolitical uncertainty**
- **Climate change and environmental sustainability**

These topics have been selected due to their current and foreseen importance for most organisations and taking into consideration the needs for Chief Audit Executives to strengthen or expand their knowledge and experience in auditing these three fast-developing risks.

Please keep in mind that we intentionally chose to dive into some specific components of these three risks. Whilst we have endeavoured to explore what we think are the key focus areas of these risks, a thorough understanding of their application may require additional research on your part, but we aim to provide a selection of what would be of the most benefit to the profession in the current context.

All practical guidance is designed to firstly help practitioners learn from experienced professionals (experts, operational teams and internal audit) and, secondly, offer practitioners useful reflections that we believe are of particular interest when auditing these topics and their associated risk management processes.

Why should macroeconomic and geopolitical uncertainty risks be on your radar?

33% of the CAEs surveyed in Risk in Focus 2021 cited macroeconomic and geopolitical uncertainty as a top five risk, and 8% say that this is the biggest single risk their company is currently exposed to. However, only 3% say that this is an area where internal audit currently spends most time and effort.

We have taken this as an opportunity to take a closer look at how internal audit should approach macroeconomic and geopolitical uncertainty risks. What can internal audit do to ensure that the organisations they serve are prepared for these risks?

What situation are we in?

Macroeconomic and geopolitical risks have moved up the agenda as the world seems to be going through a period of high political volatility - from trade wars and revolutions, to terrorism and insurgency.

The United Kingdom has left the European Union. Populist and nationalist movements have won elections in former democratically-led countries. The coronavirus pandemic has also exacerbated nationalist tendencies. Questions are asked about the risks arising from the dependence of Western industries on China. The US and Chinese technology sectors have already begun to decouple, with implications for strategic industries. Governments are introducing restrictions on foreign investments. Global contracts are being cancelled and trade conflicts are being created. Economic challenges and higher unemployment rates may contribute to the already high level of social unrest and civil disobedience. This makes the macroeconomic and geopolitical environment more challenging than it has been for decades. Protests against discrimination and the growing gap between rich and poor parts of the world also show that the potential for uncertainty about the future is growing. The enormous increase in public debt in many countries in the wake of the coronavirus pandemic raises the question of who will repay the debt.

These are examples of macroeconomic and geopolitical events that can have a major impact on businesses. One of the lists of risks for 2020 cites the top five global corporate risks for the year as follows:[1]

1. **Geopolitics in the shadow of the US election campaign:** The way allies and opponents dealt with the massively ideologically charged election has had a major impact on the geopolitical risk landscape for companies in 2020.

1. Wie die Weltpolitik zum Risiko für Unternehmen wird | Springer Professional

2. **An increasingly activist society:** Worldwide, social pressure and coordinated activism in areas such as environmental protection, human rights, inequality and data protection led to rising requirements for companies.

3. **Cyber warfare on the rise:** In conflict zones of strategic importance, where traditional military measures are out of the question, these will increasingly be replaced by cyber-attacks. While leading companies achieve reliable resilience, this is not the case for national infrastructures worldwide.

4. **Economic concerns meet political vulnerability:** The global economy collapsed in 2020. It is unlikely that an increasingly fragmented world can provide a coordinated policy response.

5. **Political leaders without strategic vision:** Politicians who do not look beyond the next crisis lead some of the world's most important countries.

What are external risks?

Dealing with macroeconomic and geopolitical risks requires knowledge about the specific characteristics of this type of risk. For that, the model of Kaplan and Mikes offers some insight.[2] They say risks can fall into three categories. All of which can be decisive for the survival of a company.

Preventable risks

These are internal risks that are controllable and should be eliminated or avoided altogether. Examples of such risks are inappropriate actions by employees and managers. Companies try to eliminate or reduce these risks as effectively as possible because they cannot derive any strategic benefit from taking on these risks.

Strategic risks

A company voluntarily takes a certain amount of risk in order to achieve higher returns with its strategy. For example, companies take risks through their research and development activities. Strategic risks are not inherently undesirable. However, one tries to reduce the likelihood of occurrence and the impact of damage in a cost-effective way, should the risk materialise. The management of these risks is a key factor in achieving the company's objectives.

External risks

Some risks arise from events outside the company. They are therefore beyond the company's influence or control. These include natural disasters, geopolitical events and macroeconomic risks. Like strategic risks, they are a threat to the potential success of a company and may, should they materialise, result in the failure of the chosen strategy.

In addition to natural and economic disasters with immediate effects and competitive risks with medium-term implications, geopolitical and ecological changes with long-term effects also belong in this category. This includes geopolitical changes such as major political upheavals, *coups d'état*, revolutions and wars, long-term environmental changes such as global warming, climate change and the depletion of critical natural resources such as fresh water, along with longer-term economic impacts, e.g. long-term recession and loss of markets.

2. Managing Risks: A New Framework | Harvard Business Review

External risks should have a particular importance in the context of risk analysis. However, external risks require a special approach: since companies cannot prevent such events from occurring, their management must focus on identifying and mitigating their impact.

Nevertheless, some organisations underestimate the potential impact of geopolitical factors and believe that they are only of interest to other industries. Many external risk events also have a low probability of occurrence. For some managers it is therefore difficult to imagine the occurrence of such risks as part of their normal strategy processes.

Moreover, companies often believe that these risks will have little direct impact on their operations unless they operate in dangerous parts of the world. However, medium-sized companies also suffer from the macroeconomic impact of geopolitical risks, such as higher fuel or commodity prices and lower disposable incomes in emerging markets, which can lead to a reduction in consumer spending.

CATEGORY 1 **Preventable Risks** Risks arising from within the company that generate no strategic benefits	CATEGORY 2 **Strategy Risks** Risks taken for superior strategic returns	CATEGORY 3 **External Risks** External, uncontrollable risks
RISK MITIGATION OBJECTIVE		
Avoid or eliminate occurrence cost-effectively	Reduce likelihood and impact cost-effectively	Reduce impact cost-effectively should risk occur
CONTROL MODE		
Integrated culture-and-compliance model: Develop mission statement; values and belief system; rules and boundary systems; standard operating procedures; internal controls and internal audit	Interactive discussions about risks to strategic objectives drawing on tools such as: • Maps of likelihood and impact of identified risks • Key risk indicator (KRI) scorecards • Resource allocation to mitigate critical risk events	'Envisioning' risks through: • Tail-risk assessments and stress testing • Scenario Planning • War-gaming
ROLE OF RISK-MANAGEMENT STAFF FUNCTION		
Coordinates, overseas and revises specific risk controls with internal audit function	Runs risk workshops and risk review meetings Helps develop portfolio of risk initiatives and their funding Acts as devil's advocates	Runs stress-testing, scenario-planning and war-gaming exercises with management team Acts as devil's advocates
RELATIONSHIP OF THE RISK-MANAGEMENT STAFF FUNCTION TO BUSINESS UNITS		
Acts as independent overseers	Acts as independent facilitators, independent experts or embedded experts	Complements strategy team or serves as independent facilitators of 'envisioning' exercises

Kaplan and Mikes, Harvard Business Review

What impacts can macroeconomic and geopolitical risks have?

According to Kaplan and Mikes, macroeconomic and geopolitical risks threaten the strategic success potential of a company and can result in the complete failure of the chosen strategy.

Examples of direct impacts are tax increases, customs duties, export bans, trade sanctions, expropriation and confiscation of assets. In addition, armed conflicts lead to the destruction of entire production plants and other assets.

Examples of indirect impacts are unforeseeable price fluctuations for energy and other raw materials, disruption of supply chains due to destroyed infrastructure, sharp fluctuations in exchange rates or a massive drop in demand for products and services in affected countries.

Many authors describe geopolitical risks generally as unforeseeable. What does this unpredictability mean for companies? A sustainable investment in a market that seems safe today may be exposed to considerable risks tomorrow. This does not mean, of course, that companies can and will forego the growth opportunities in emerging markets. However, limiting the potential impact of geopolitical risks should be standard practice for internationally active companies today.

How should management deal with macroeconomic and geopolitical risks?

Identify the relevant external risks

The question to ask is, upon which factors does the long-term success of a company depend? What risk (especially threats) dependencies are these success factors exposed to? These threats to the central success factors are the main risks, which also often threaten the existence of the company. In this context, particular attention must be paid to mega-trends in the external environment that could jeopardise the company's future success.

For example, where should a service be provided to be efficient? Geopolitical developments may significantly influence strategic decisions on foreign locations. What influence do they have on the success of the organisation if the desired locations are no longer available for political reasons? Another example is that geopolitical uncertainty can lead to volatile exchange rates, which can in turn increase supply chain costs.

However, the opportunities associated with geopolitical risks must also be identified. The positive effects of geopolitical risks identified in the Risk in Focus 2021 research are (in order of importance):

1. New opportunities for retailers due to market price fluctuations.
2. Based on the resilience of companies, the competitive advantage over rivals and the ability to benefit from crises and volatility will increase.
3. Opportunities for companies to advance the political or regulatory agenda/environment by influencing governments.
4. Better and cheaper access to finance for companies with stable business.

Risk assessment

A reasonable risk assessment not only requires an inventory of all aspects of geopolitical risks. Companies should also stress test all scenarios and their influence on investments in their target country. It also makes sense to consider a number of different scenarios and assess their impact and influence - precisely because geopolitical developments are difficult to predict. In addition to expertise, foresight is therefore required when assessing risks.

For external risks, scenario planning and stress tests are particularly suitable methods of risk assessment. Scenario planning is suitable for long-term analyses and is a systematic process for defining the plausible future status of the location. Stress testing helps to assess major changes in specific variables whose impact would be significant, even if the timing is unpredictable. The usefulness of stress testing depends on assumptions about how much the variable in question will change.

A major problem with geopolitical risk is that it is difficult to obtain reliable and timely information, especially when events are developing rapidly, for example in the event of a *coup* or invasion. Another challenge is to be able to quantify their impact.

Reducing risks

The range of risk-reducing measures extends from evacuation plans to alternative production sites and predefined processes and resources in the event of a loss. The coverage of financial losses through insurance is also an important factor in risk reduction.

Companies have no influence on the probability of risk events identified by such methods. However, managers can take specific measures to mitigate their impact.

Macroeconomic and geopolitical risks: A topic for internal audit?

Geopolitical risks affect all companies, regardless of where they operate, because of their impact on the global economy and on supply chains. Internal auditors may play a major role in raising the profile of these risks at board level and supporting to improve both management systems and control processes.

Internal audit should have an open and constructive discussion with senior management and the board about how to identify, assess, manage and mitigate external risks and how to embed these discussions in strategy formulation and implementation processes.

As with the management of a company, it is important for internal audit to have the ability to identify the risks the organisation is exposed to, and to assess, communicate and consider them correctly.

None of the current geopolitical risks will disappear any time soon, but new ones will appear. Organisations should be prepared for all scenarios: the worst, the best and everything in between. Organisations need to know whether they can react quickly to changing circumstances. Internal audit is best placed to provide assurance on this and therefore should include macroeconomic and geopolitical risks in their audit plans, subject of course to the relevance of the risks to their organisation.

Internal audit approaches: How well is your organisation prepared for macroeconomic and geopolitical risks?

It is the role of internal audit to ask the board of directors and management questions and challenge them on the risks that the company faces. In this respect, macroeconomic and geopolitical risks are no different from any other category of risk.

Internal audit can add value by highlighting the importance of external risks and providing assurance to management and the board of directors that sufficient resources are devoted to these risks and that the latest available geopolitical information is considered. In order to assess the consequences of risks, internal audit may also use risk indicators provided by organisations such as Freedom House, Transparency International, the World Bank, or the International Monetary Fund.

Adaptability

It is difficult to predict which goods and services will be affected by geopolitical risks and to what extent. However, the organisation's ability to respond to geopolitical changes and implement contingency or mitigation strategies is something that internal audit can provide assurance on. Organisations need to know whether they can respond and adapt to changing circumstances, and internal audit can verify that this capability is strategically and operationally possible. The speed at which organisations can adapt has never been more critical than in recent years, given the unpredictability of political decisions. Internal audit should have the capacity and capability to assess the organisation's ability to adapt in a timely manner. For example, are there carefully prepared plans in case politically motivated trade conflicts escalate with their impact widening across the globe e.g. trade sanctions between major countries?

A group of subject matter experts interviewed as part of Risk in Focus 2021 noted that a critical factor that needs to be examined by internal audit is the company's capability to react quickly in the event of unexpected macroeconomic and geopolitical uncertainty. In this case, they should consider two options:

(a) Implement an internal structure, to be applied, in the event of a crisis. It must include a range of stakeholders that are empowered to take decisions as a group with the ability to act quickly and effectively based on the latest information available. Internal audit can verify the effectiveness of such a structure and whether or not that structure is effective as part of business continuity scenario testing.

(b) A decision-making process that enables the company to reduce its exposure to major market changes and to reallocate resources quickly and in a controlled manner. Internal audit should examine such a process.

Strategy

Internal audit must verify that macroeconomic and geopolitical uncertainties are taken into account during the development of the company's business strategy. In this context, the subject matter experts interviewed as part of the Risk in Focus 2021 research suggested that internal audit ensures the existence of strategic development processes that allow regular updates to identify, assess and incorporate the latest state of political and economic risks in key markets. Additionally, any practical experience or lessons learned should be fed back into a feedback loop. It is the role of internal audit to provide assurance that such factors are considered and that measures taken to minimise risks are appropriate.

Internal audit can verify that any possible external developments have been considered by

independent analysis of the markets in which the company operates, and which pose the greatest geopolitical risk. The question for internal audit to consider is whether macroeconomic and geopolitical uncertainty has been taken into account when developing the company's business strategy?

Risk management

Is the company aware of how geopolitical risks affect its operations? Internal audit should assess whether the measures taken by the company to manage risks are appropriate. It can also provide assurance that macroeconomic and geopolitical risks are considered in the risk management process. Moreover, it should draw conclusions about the organisation's ability to mitigate macroeconomic and geopolitical risks.

It is essential to provide assurance that all risks that could disrupt business operations are identified.

Internal audit can play an important role in assessing risks and can provide an objective view in case of disagreement. For example, managers in a particular region may conflict with risk managers at headquarters because their perception of local risk differs.

Whether the risk management function uses scenario planning and stress testing effectively should be the subject of internal audit assessments.

Internal audit should assess the quality of the information available to management for decision-making. Internal audit can independently assess whether risk managers in certain regions are overly cautious and focus on risks that are unlikely to ever occur.

Internal audit can assess whether the company forecasts macroeconomic risks and is prepared to withstand an economic recession. For example, will expansion projects depend on sustained economic growth? Would such projects fail if financing conditions were weakened significantly?

A political crisis can also bring opportunities. Organisations need to look for the benefits that change offers, not just think about the threats. Internal audit should provide assurance that this is in place.

Supply chains

Internal audit must ask management questions about how it reviews the company's supply chains and its arrangements for preventing disruption of operations and whether these are tested regularly. Internal audit should also make clear that while the company's direct exposure to geopolitical risks may be low, indirect exposure via the supply chains and customers might be high, depending on where the company purchases raw materials and sells goods. In general, it is advisable not to use only a small group of suppliers or not to have all suppliers from the same region.

Are the goods produced or the raw materials used by the company affected or likely to be affected by potential trade tariffs? Is the company aware of the expected duties and the potential impact on the company and does it have an appropriate strategic response in place, e.g. adjusting its supply chains? It is not for internal audit to say whether supply chains should be restructured, but it can provide insight into the process of assessing strategic decisions, responding to geopolitical risks and provide assurance that the operational impact on the supply chains is being considered.

Internal audit should address the question of whether the company is aware of sensitive suppliers or customers that could jeopardise future success. Have such questions been addressed by the risk management function, and are the risks detailed in risk registers across the organisation?

A major recession can cause the bankruptcy of important business partners in the supply chain. Have provisions been made for such disruptions, e.g. contingency plans and/or insurance?

Internal controls

Internal audit is able to help design controls and measure their effectiveness, e.g. by recommending alternative procurement channels, increasing insurance coverage or maintaining a disaster management plan.

Location decisions

Has the company considered whether it might become susceptible to state tax policy in a certain region? What will it do if this is the case, e.g. withdraw from that region, legally restructure companies to protect profits, or cooperate with the government at an early stage? Internal audit should consider whether such location issues are appropriately and effectively included in decision-making processes.


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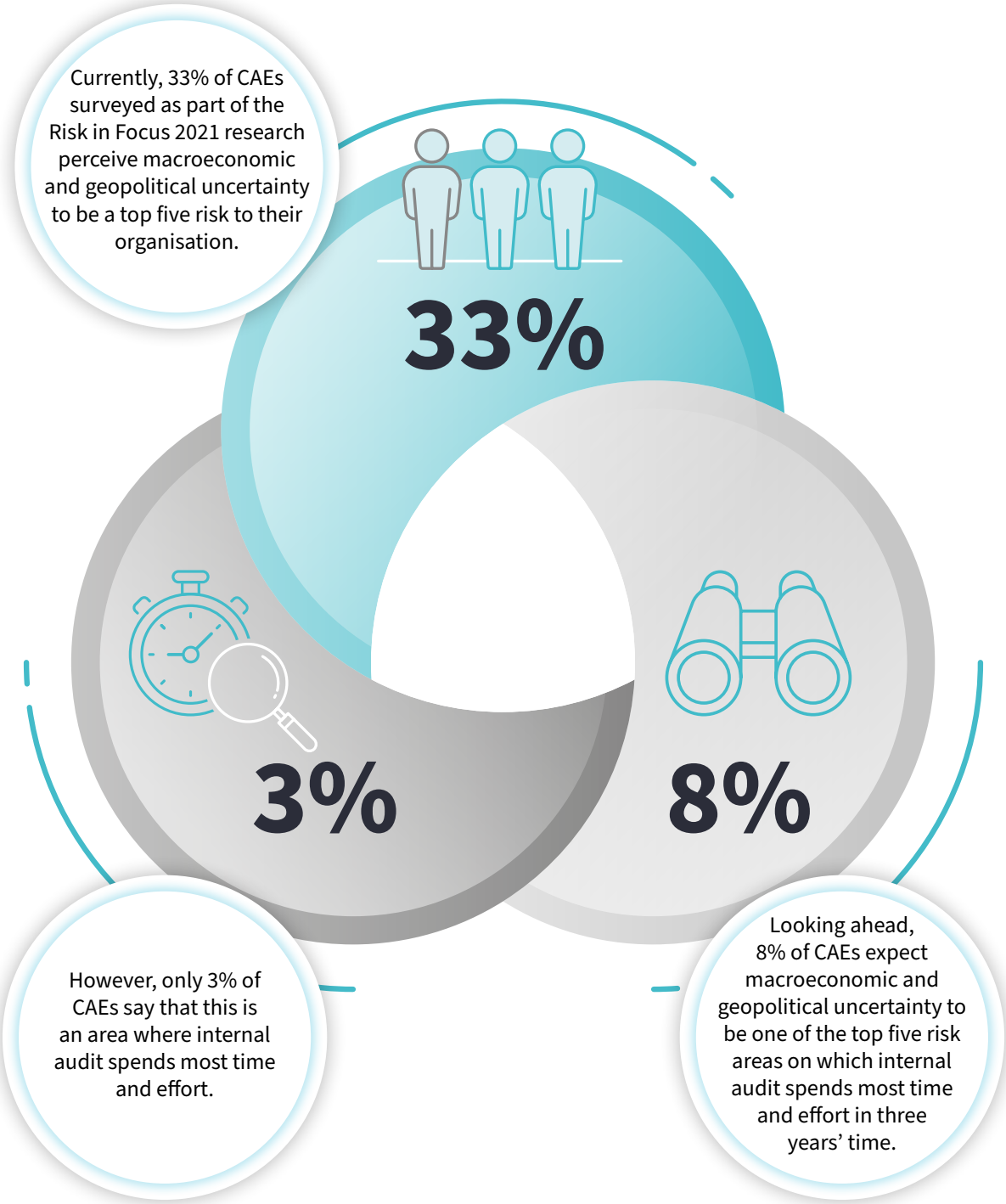
Currently, 33% of CAEs surveyed as part of the Risk in Focus 2021 research perceive macroeconomic and geopolitical uncertainty to be a top five risk to their organisation.
33%
3%
8%
However, only 3% of CAEs say that this is an area where internal audit spends most time and effort.
Looking ahead, 8% of CAEs expect macroeconomic and geopolitical uncertainty to be one of the top five risk areas on which internal audit spends most time and effort in three years' time.

"A firm's ability to weather storms depends on how seriously executives take risk management when the sun is shining and no clouds are on the horizon."

Kaplan and Mikes

About the Institute of Internal Auditors Luxembourg

The IIA Luxembourg is affiliated with The Institute of Internal Auditors (The IIA).

The Institute of Internal Auditors Luxembourg (IIA Luxembourg) is a member-led organisation that draws on the skills and knowledge of our members in the private and public sectors across the country.

We've been established in Luxembourg since 1986. Members are part of IIA Global network of 200,000 members in 170 countries, all working to the same International Standards and Code of Ethics.

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