The Importance of Monitoring

Auditors should pay close attention to how management reports on risks that may impede the organization's progress.

BY JILL BENSON

A STRONG INTERNAL AUDIT DEPARTMENT not only knows how an organization monitors risk, but it also has an opinion about how well the organization does it. Organizations with good risk management and governance processes monitor risk proactively. Yet, despite their efforts, some organizations fail to monitor risk effectively either because they are not watching the right metrics, the reporting is not accurate, or the right people are not receiving well-balanced reports.

Organizations commonly have several objectives that could have a negative impact on one another; thus it is important for management to have balanced initiatives related to its goals. It is an internal auditor's job to ensure the organization monitors risk and to evaluate whether the reporting is balanced. If each business unit only monitors what it believes is important, it is easy to lose sight of the impact its activities have on the organization as a whole and how the unit may be affected by other initiatives.

Senior management and boards of directors have started asking internal audit departments to help them gain a better understanding of how the organization manages risk, but rarely do they explicitly ask auditors to help them assess how they measure risks that could impair progress toward their objectives. This is an area ripe with opportunity for internal audit shops that are looking for new ways to add value to their organization. Auditors can approach this opportunity within each process or location audit, or as a stand-alone project in the audit plan; both approaches enable auditors to review and assess the accuracy, relevance, and comprehensiveness of management's reporting. When initiating risk monitoring projects, auditors need to answer several key questions.

ARE THE ORGANIZATION'S OBJECTIVES CLEARLY DEFINED AND MEASURABLE? Auditors should begin their assessment of management's risk reporting by fully understanding the organization's objectives, how progress is reported for each objective, and who has the primary responsibility for achieving these objectives. If the business has not defined how progress is measured, internal auditing can help management identify day-to-day activities and related metrics that will help the organization achieve its desired results. Clear accountability and performance metrics are critical to efficient and effective operations.

DOES MANAGEMENT HAVE INITIATIVES UNDERWAY TO ACHIEVE ITS OBJECTIVES? Most organizations dedicate resources to initiatives focused on achieving key objectives such as increasing revenue or market share. Auditors should have a clear understanding of each initiative's purpose, who manages it, and the expected results. Organizations without clearly defined action plans can benefit from an audit team that helps the business understand the risks associated with its initiatives and how to monitor them, thereby increasing the likelihood of achieving the key objectives.

COULD ANY INITIATIVES HAVE A NEGATIVE IMPACT ON ANOTHER PROJECT? Most organizations have revenue growth and cost management objectives, but when the same people are not responsible for both areas, their business activities may conflict. Although it may make sense to assign responsibility for these initiatives to different people, it is imperative that both parties make decisions using a balanced perspective based on what will help the organization achieve its overall objectives. For example, a company trying to increase revenue from its best customers, while also attempting to reduce inventory and cut raw material costs, must evaluate the impact that working solely with the lowest-cost supplier may have on its ability to deliver quality products on time to these customers.

Additionally, management must consider how activities aimed at increasing market share may affect its overall profitability. Without balanced metrics, there is the risk that management will focus on short-term results for a single objective. In successful organizations, management considers the long-term impact when making key decisions, which requires a balanced set of metrics that is reviewed regularly and is re-evaluated to confirm key assumptions are still valid.

FOR EACH OBJECTIVE, HOW DOES MANAGEMENT REPORT PROGRESS? Internal auditing should understand what information pertaining to all objectives is currently provided to the board and senior management. The team should know what is in the reports, as well as the source of the information, and how it is compiled. In addition to reporting progress on all strategic objectives, management should note whether any activities related to these objectives are negatively affecting another objective and how it intends to adjust either its goals or activities.

QUALITY INFORMATION IS KEY

Decision-making based on incorrect or dated information is another risk internal auditors must monitor. The board and top executives typically focus on what the organization needs to achieve overall objectives, not on day-to-day details. They rely on others within the organization to provide the information they need to make strategic decisions and keep the company on course. Management and the board can easily misinterpret information compiled by individuals who have a different understanding of what the organization, division, or function is trying to achieve. Moreover, they may have a different set of assumptions that would prevent them from making appropriate decisions quickly. By assessing the quality of information senior management receives based on three key questions, auditors can help reduce the likelihood that decisions will be made based on bad information.

IS MANAGEMENT USING THE RIGHT METRICS? Well-developed objectives are measurable. Senior management needs a metric that indicates whether the organization is headed in the right direction. Just as important, the metric should communicate which activities could affect the accuracy of the information and potential problem areas that may impede the organization's ability to meet its objectives.

A good metric has a complementary measure that trends consistently with the results-oriented metric, yet also alerts management if the numbers it is focused on are no longer a good indicator of desired performance. For example, budget-to-actual variances indicate how an organization is using resources; however, if the business is under budget because it has open positions that negatively affect performance, simply reporting "we are under budget" is misleading. A more balanced report would include the budget variances, as well as metrics covering available and budgeted resources, operational performance, and ability to deliver products and services under the approved budget.

Looking at the same metric from the opposite perspective, the organization may be spending over budget, but what if the spending is a result of increased revenue, which affects variable compensation? Or, what if the price of raw materials increases, which is driven by commodity markets? Although reporting that "revenue is growing" seems to offset the increased expenses, how does management know that the growth does not hurt profitability? When senior executives have enough information to differentiate costs that are externally driven and costs that directly correlate with revenue from costs that are controllable, they are able to understand the organization's true progress and measure its return on investment in both the business and cost-cutting initiatives better.

In addition to evaluating how well-balanced management's metrics are, auditors should validate the accuracy of underlying data and identify data elements that could be manipulated. If data affecting the metrics can be updated during or after a transaction, changes should be monitored and taken into account when reporting results. Understanding the volume and nature of changes to transactions will not only highlight potential data integrity risks, but will also help management gauge how efficiently the organization is operating.

The simpler a metric, the easier it is for management to highlight potential data integrity risks. However, even basic metrics can be compiled with different data sets and use more than one formula. As a result, management must understand the processes that drive the reporting and determine if the right data set and appropriate formula have been applied.

IS MONITORING REPORTED AT THE RIGHT LEVEL OF DETAIL AND FREQUENCY? It may make sense for senior management to review consolidated metrics, but in many cases, more detailed metrics should be reported to individuals at lower levels of the organization, such as at a business unit, location, or product level. Reports that are written for too high a level may not help the organization improve performance and mitigate risks. For example, if a company misses a delivery date, it should not only report the miss, but also why it was missed, allowing the business to understand and address the root causes close to when the failure occurred. This practice helps continually improve the process and track performance trends and root causes over time, allowing the organization to better identify true risks and address them more efficiently.

The organization should also understand what is driving performance issues so that significant concerns can be addressed effectively. In many cases, the root cause of a performance issue differs by location, depending on the local business environment, product line, and customers. As a result, it is unlikely that the same action taken across the entire organization will have the same results. The more distributed the organization's operations, the more important it becomes to push objectives and related monitoring to lower levels, based on the facts and circumstances for each business unit or location. Understanding the drivers behind performance differences is imperative. Once management understands the differences that may affect performance within each location, business unit, or product line, a set of metrics should be designed to monitor for changes and ensure the organization is still considering comparable data. Organizations should continually test assumptions and determine if these factors are actually the reason performance differs.

Reporting frequency is also important. Not all metrics are created equal. Some are more important to monitor in real time, while others are more meaningful when reviewed over the long term, due to fluctuation from period to period. Additionally, the frequency of review may differ based on the audience. Senior management may review some metrics quarterly, but operational management might review similar metrics monthly or weekly to make timely decisions. Moreover, if reports are sent to senior management more frequently than necessary, or if they contain too much detail or are not easy to generate, the organization could be expending resources unnecessarily. Executives may not be able to focus on what really matters if the volume of information they receive is too high.

HOW ACCURATE AND TIMELY IS THE REPORTED INFORMATION? The best reports are generated straight from financial and transactional systems, which improve the reliability of reporting by reducing human error. However, the more an organization relies on financial and transactional systems, the more important it is for both internal auditing and management to be aware of system changes that could affect report reliability, as well as be cognizant of changes to processes and how the system is used.

Although system changes can affect the accuracy of data in reports, changing processes and how data is entered and used influences the meaning of report data and the metrics themselves. Process changes should always trigger a reassessment of reports for management, including board-level reporting. Although the overall metrics related to the intended results may not change, the complementary metrics, which are vital for assessing the validity of metrics, could change. If an organization changes how it conducts business in a way that changes its risk profile, the company's key monitoring metrics also may need to change.

THE OUTLOOK ON RISK

In some organizations, it may seem obvious that the internal audit function should take a close look at risk monitoring and reporting, while in others, this could be a new concept that the audit committee may find intriguing. In both cases, it is worth consideration during the organization's next audit planning cycle. After all, the internal audit department's mission is to help the organization accomplish its objectives through a systematic, disciplined approach to evaluating and improving risk management processes. No organization can effectively manage risk and achieve its business objectives without accurate, timely, and comprehensive monitoring and reporting.

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