

# Management audits, the great unknowns

*Time to review top management performance in public and private entities*



During the last years there have been circumstances (high debt ratios, lack of capital and markets crisis in certain industries) that have pushed for public investment into private companies and whole industries to turn around critical situations. To ensure the fulfilment of this objective, especially considering public scrutiny over the investments, it is advisable to establish governance practices to assure that the situation is solved, properly and on time. One of these governance practices is the Management Audit (MA). This Viewpoint addresses top questions on MAs, such as what they are, why they are implemented, who has to be subjected to them and how to develop them.

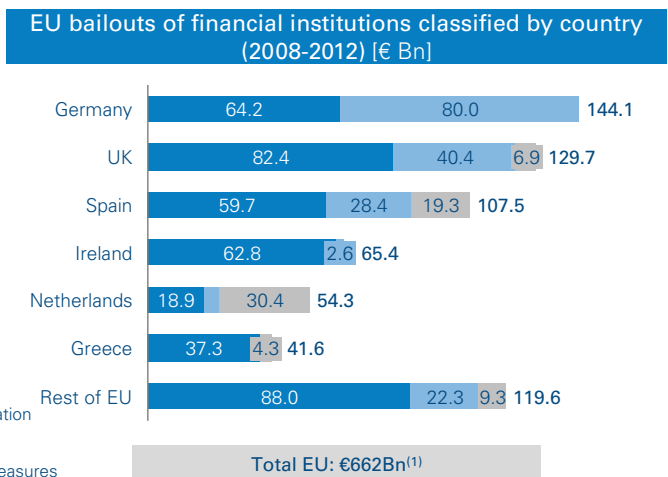
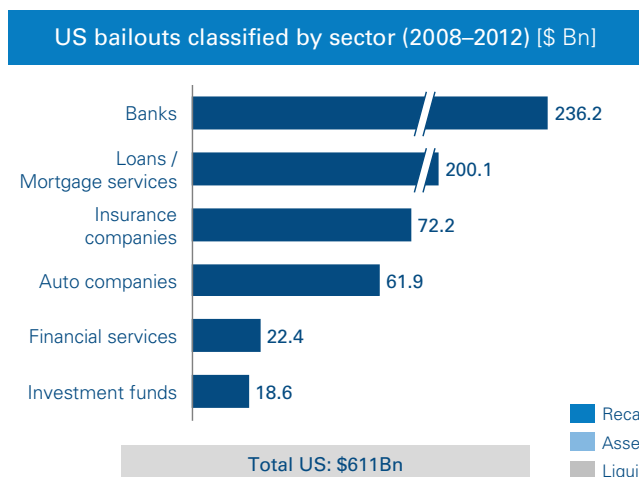
The global financial crisis caused the necessity, being almost an obligation, for many governments to take positions in the ownership and/or management of companies to rescue them or avoid major system failures due to financial downturns, investing only man-hours, public funds, or both. That not being enough, governments have had to create new companies, financed by public and private capital, to ensure the recovery of key national activities (clear examples, in the creation of asset management companies in European countries like Ireland and Spain).

At the same time, the lack of public funding and other parallel

reasons have increased the development of public-private initiatives to develop diverse business activities to cover social necessities, which, in case of failure, should also be rescued by governments.

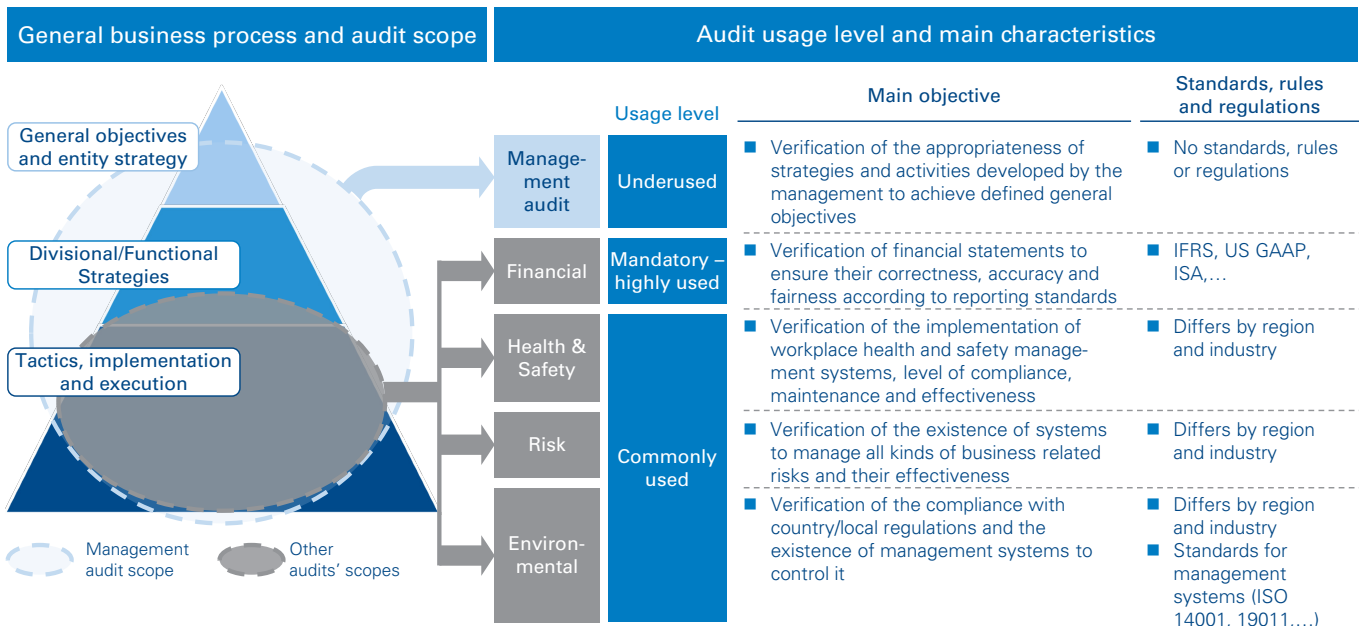
Additionally, also due to the lack of public funding, there has been an increase in the necessity and urgency to impose major control and surveillance on public expenditure – expenditure being managed and controlled mostly by public entities with significant similarities to private entities in their managerial requirements and modes of operation.

## US and EU main bailouts



Note: (1) In addition, in 2009 the guarantee on liabilities programs reached 835.8 €Bn. During the last five years only 2 €Bn of the total guarantees provided have been called  
 Source: Press, European Commission, Arthur D. Little analysis

## Audits' scopes, characteristics and usage



Source: Arthur D. Little analysis

Due to the criticality of all these circumstances and considering their enormous impact on global, national and local economies and industries, and on public opinion, now is the time to reflect on the suitability of developing MAs in these entities – considering that this practice is not mandatory, well established, or regulated by rules or standards.

MAs are understood as a review exercise, developed generally by external independent experts. They are not focused on the traditional financial, environmental, safety or risk functions, but on the strategies and actions developed by the management of an entity to accomplish objectives defined for a specific period. The objectives have to be clearly stated, with related KPIs allowing the measurement of their fulfilment in a time horizon. The execution of this kind of auditing exercise traditionally is established through the governance of the company or demanded by external entities. Both groups are looking to ensure the quality, adequacy and quantity of activities and strategies identified, managed and executed by top management teams, and that these will succeed with the established objectives.

### Why develop MAs? What kind of entities should be subjected to them?

The main reasons and objectives for performing a MA are related, not necessarily at the same time, to:

- Reducing the probability of failure of achieving established objectives
- Offering transparency to the public about the developed activities and strategies to achieve the objectives
- Transmitting commitment and confidence to citizens about management performance

- Monitoring accomplishments of economic budgets and understanding deviations
- Ensuring adjustment of entities' objectives according to environmental or economic scenarios

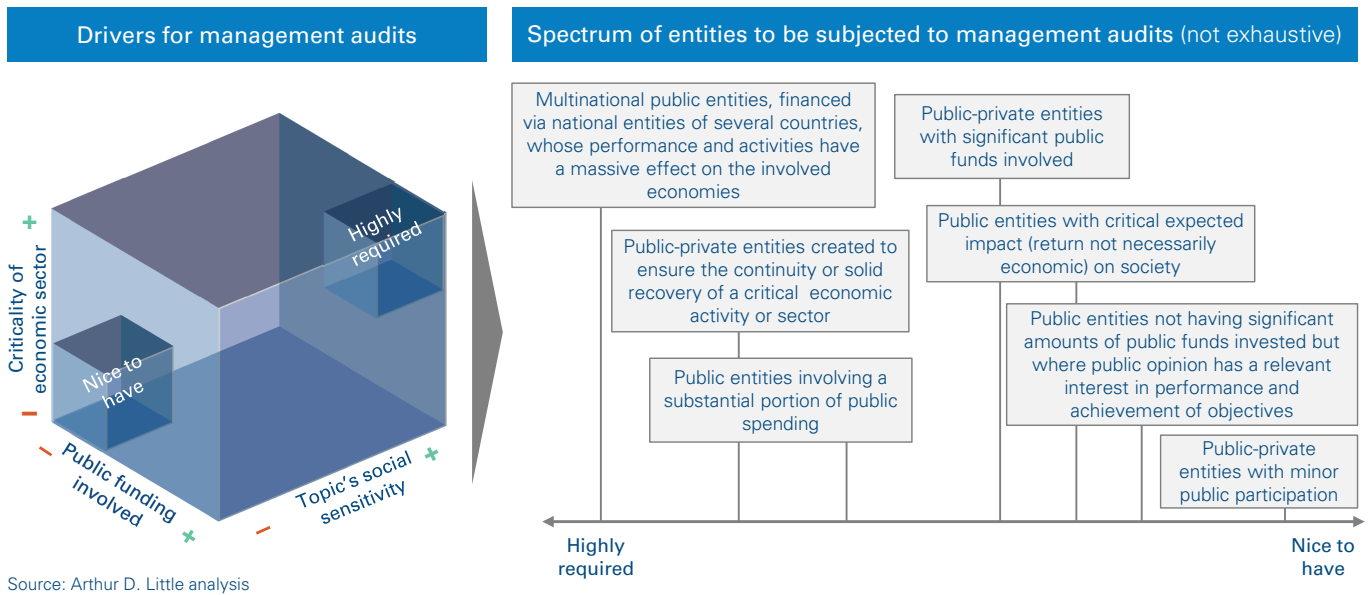
Recent history has proven that, although financial figures of companies and markets show positive performance and good future perspectives, inadequate strategies and plans (or the lack of them) cause major problems. Additionally, once these major problems appear, the implication of public entities, together with the involvement of public funds, makes it necessary to ensure that future strategies and activities are properly identified, defined and executed to ensure the return of the public funds. This return could be in form of economic recovery of the investment, plus some surplus in the best case, or of other improvements for the society, some of them not directly measurable.

Recent history has also shown how public entities fail when managing not only own accounts, but also the general objectives to be covered. In this situation, again, there is a fault in the achievement of the expected return of the invested public funds, not necessarily in economic terms.

In all these scenarios in which public funds are involved and the public is waiting for some kind of return, it is critical to ensure that management teams are performing properly. This encourages performing regular MAs (every year or every other year, depending on the case) to get one or some of the stated objectives.

An additional aspect that should encourage the execution of MAs is the high number of stakeholders, as can be perceived in the majority of the described scenarios, which have different

## Identification of entities requiring management audits



views and interests. In these scenarios, there can be several parts asking for annual reports on management performance or misalignments among the diverse stakeholders regarding the objectives (such as public and private entities, public opinion and citizens). Both scenarios may show the necessity for MAs to ensure that the pursued objectives are the officially established ones, not particular objectives of some of the stakeholders involved.

Although any kind of entity (public, public-private, private or listed entities) is encouraged to perform this kind of exercise periodically, the current scenario puts the focus on those entities that involve public funds, either alone or under partnerships with private entities, and with relevant impact on critical sectors of the economy or on public opinion. These entities are urged to plan accordingly. The framework shown in the figure above states the main drivers to assess the necessity of performing MAs and examples of entities that should plan for it.

### How to develop adequate MAs?

Financial, environmental, safety and risks audits are well established based on accepted and methodologies with international, well-defined rules and procedures, but MAs, although they have a clear *raison d'être*, do not have specific and defined methodologies, rules or procedures. Arthur D. Little, through its experience developing these kinds of services, suggests following the next five rules to ensure the quality, reliability and completeness of a MA:

#### 1. Understand the historic frame and context

A clear and precise understanding of the origins, historic situation and context that generated the necessity to create

the entity under audit is critical to being able to contextualize the evolution of the activities, the heritage received, etc. Not considering these aspects can provoke complete misunderstanding of the topics to analyze.

#### 2. State clear management objectives

The MA should be based on entity objectives. Clear knowledge and understanding of the established objectives is mandatory to ensure that the MA focuses on key topics and answers the critical questions. Are the actions and strategies developed by the management team adequate and enough to ensure the accomplishment of the objectives? Are the objectives effectively accomplished?

If entity and management objectives are not clearly established, the management auditor is responsible for clarifying these and ensuring that the exercise covers the most relevant ones.

Some sources of information when identifying general and specific objectives could be: i) Laws, rules and regulations on specific requirements for the creation of the entity, and their objectives; ii) Foundational documents, statements and statutes; iii) Strategic plans and mission-vision-values statements; iv) Annual business plans and budgets; and v) Key departments' annual development plans.

Additionally, when establishing the objectives to be assessed, it is critical to differentiate:

- General objectives from specific objectives and prerequisites to be fulfilled
- Qualitative from quantitative objectives, when trying to determine levels of fulfillment

Failing at this initial exercise could jeopardize the whole audit.

### 3. Analyze all relevant activities and areas with relevant impact on objectives

Although the areas to be analyzed will depend mostly on the entity, its sector or ambit of operation, its scope, and its age or stage in the life cycle, there are some common topics and chapters that have to be considered:

- Annual objectives definition processes for entity and main departments
- Strategic plan, business plan and budgets definition processes, methodologies and used hypotheses
- Governance and board of directors organization, activities, decisions and performance
- Key departments activities, measuring performance based on fulfillment of stated objectives
- Rules and regulations definition, update and adjustment and track of fulfillment
- Annual economic performance compared with defined budget, main deviations and justifications

### 4. Extremely fact-based exercise

Given the potential audience interested in receiving the outputs of MAs, it is necessary to emphasize the importance of basing the exercises on facts and figures obtained directly from the entity being audited. Although the exercise would include a substantial amount of interviews with key profiles of the entity, no conclusions or considerations should be extracted purely on interview content, as it should be mandatory to get documentation on all the aspects being analyzed.

Additionally, in order to prove the completeness and reliability of the study, it would be convenient to keep a record of all required documentation, content, and dates of receipt.

### 5. Audit result and recommendations based on stated objectives

The exercise should end with a clear statement about the result. This should include both a global result of the audit and a particular assessment of the achievement of each of the objectives under analysis. It is advisable to construct the global result based on the results of specific objectives in order to sum up all the different factors and avoid giving a global result that is slanted by a few unachieved objectives.

An additional look-backwards exercise (Where was the entity a year ago? What kind of information was available? What were the premises and hypotheses?) before issuing the final report is more than convenient for ensuring the fairness of the results.

Additionally, the exercise should include recommendations and risks, not only for unachieved objectives, but also for those that have been achieved but have room for significant improvement or are under risk of underperformance in the next term due to internal or external factors.

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### Arthur D. Little

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