Metrics matter

How Internal Audit can help organizations assess performance measurement
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Introduction

Why do metrics matter?

Through the years, organizations have developed and implemented a variety of metrics to drive employee behavior. Sometimes these metrics work as planned; sometimes they fail – in ways that impact the bottom line. In many cases, that failure is foreseeable – and preventable.

Internal Audit (IA) should help the organization not only by evaluating the processes and controls surrounding these metrics, but also by taking the natural next step and evaluating the metrics themselves. IA should use its unique knowledge of the enterprise to offer sharp insights that can directly impact the organization and its objectives. It should move beyond business process to business performance.

Consider the story of one organization that recently attempted to improve the responsiveness of its IT help desk by developing a metric intended to reduce the average age of trouble tickets. Managers received monetary rewards when their team reached the target. The help desk managers responded by closing and then reopening particularly troublesome tickets, helping them meet the goal while avoiding the underlying customer complaint.

By implementing a metric that encouraged the help desk to close trouble tickets as quickly as possible but did not adequately address quality concerns, the organization did not address the challenge at hand. IA could have helped the organization avoid this outcome by evaluating the metric and its potential impact before implementation.

“What gets measured gets done, what gets measured and fed back gets done well, what gets rewarded gets repeated.”

John E. Jones, noted author and leadership trainer

Quote accessed from: http://www.frontrangeleadership.com/quotes_on_leadership.html
The use of metrics today

Metrics are used in companies as performance measures for areas including finances, productivity, product quality and customer satisfaction. By setting a desired goal of performance achievement, metrics can also serve as a way to clearly communicate the organization’s objectives and to drive employee behavior. As such, they also are commonly used as part of employee compensation programs.

Companies can use a variety of metrics to motivate employees. Metrics can be company-wide (e.g., net income), specific to a department (e.g., accounts receivable collection rates) or specific to the individual (e.g., performance goals, productivity). For example, bonuses will be awarded only if the organization’s profit target is met. Or it can opt for a metric that is more within the employee’s control such as reaching one’s personal sales target for the month.

Metrics, when used successfully, can bring benefits to the organization and the employee. A successful metric helps drive behavior consistent with the organization’s culture and mission while aligning activities to the organization’s objectives. An effective metric also gives employees an objective way to measure their progress and success, and it helps them stay motivated by enabling recognition for their good work.

But when metrics are poorly chosen, poorly implemented or both, they can result in behaviors that hit the target but don’t achieve the desired outcome. These behaviors are counterproductive and can bring negative unintended consequences to the organization.

Some common reasons for failed metrics include:

- **Miscalculation:** where a metric results in unintended consequences. For example, a company develops a metric designed to reduce payroll costs. Management meets the target, but the result is understaffing, reduced customer satisfaction and eventually declining profit.

- **Gaming:** as when employees figure out a way to meet the metric without achieving the true goal. For example, a restaurant chain seeking to reduce the amount of chicken thrown out at the end of the day developed an efficiency metric. Workers hit their numbers by cooking less chicken — at the expense of turning away paying customers. Not surprisingly, profits declined.¹

- **Sandbagging:** as when employees delay reporting numbers once they’ve reached their goal for that period. For example, workers at a given company, having hit their sales goal for the month, move sales made in the current quarter to the next quarter to get a head start on the next sales goal.

- **Misalignment:** motivating employees to engage in behaviors that extend beyond their capabilities or control, leading to a decrease in employee satisfaction. For example, a factory focused on throughput — producing as many widgets as possible in the shortest possible time, often in large lots — can make the fulfillment of individual customized widget orders difficult. The order fulfillment team is not likely to achieve its goals, through no fault of its own.

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Metrics matter: how Internal Audit can help organizations assess performance measurement
A unique opportunity for IA

The study of metrics matters because metrics that aren’t aligned to the organization’s objectives can make those objectives harder to reach. IA, as a natural extension of its mandate to provide independent, objective assurance on the effectiveness of risk management, has the skills and tools needed to undertake that evaluation.

IA can also add its unique enterprise-wide perspective to any evaluation of metrics, offering valuable insight into their impact both within a specific business unit and across the organization. IA can help the organization determine if the metrics are operating as intended, moving beyond assurance and enhancing its value as a strategic business advisor.

IA can identify high-risk areas, evaluate the metrics in use, and offer recommendations to management on the design of metrics that will drive the desired behavior. IA has the knowledge and experience to provide a cost-effective evaluation that can bring significant value to the organization.

Getting it done

IA can evaluate metrics as a part of audits that are already being performed or contemplated, or as a stand-alone review. We’ll focus on the integrated approach.

As is standard in an assurance review focused on controls and possibly process improvement, the audit team can get up to speed on the defined audit area, making sure that it understands the current state. It can work to understand the organization chart and structure, obtaining details about key roles and responsibilities, key processes, and relevant policies and procedures. A thorough understanding will also encompass the relevant strategy, objectives and initiatives, including significant priorities (e.g., year-over-year growth).

To expand its scope to metrics, the audit team can assess the area’s metrics through the lens of its business objectives and the objectives of related business areas. The team can evaluate the metrics’ stated purpose and determine whether that purpose can help the business achieve its objectives. The team can also assess the policies and procedures governing the metrics and work to determine whether the metrics have been appropriately calculated and reported, in addition to whether they have been appropriately communicated to the workforce.

To generate information that can yield insights, the team can work to understand the end-to-end process affected by the metric (e.g., days payable outstanding in the procure-to-pay process) and evaluate the objectives and related metrics of business functions and units related to the area under audit.
Poorly designed metrics can lead to unintended, and often negative, consequences.

<table>
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<tr>
<th>Looking at the metrics</th>
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<tr>
<td><strong>How the metrics are used</strong></td>
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<td>IA can seek to understand what the metrics measure, whether they are measurable and readily quantifiable, and whether they clearly and objectively measure the intended performance.</td>
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<td><strong>How the metrics are designed</strong></td>
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<td>IA can attempt to determine whether bottom-up feedback was taken into account during the design process, as well as whether the people who designed the metrics had insight into the relevant department’s day-to-day operations. The review can also ascertain how often the metrics are revisited and re-evaluated, as well as whether the metrics have been adequately communicated to the workforce.</td>
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<td><strong>How the metrics are reported</strong></td>
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<td>IA can determine whether the metrics are self-reported or tracked independently. Its review will also encompass the ease of use and reliability of the methods used to monitor metrics, the frequency of reporting, and the party or parties responsible for oversight.</td>
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<td>Then, IA can evaluate whether the metrics are operating effectively and support the organization’s objectives.</td>
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Auditors can ask these key questions:

- How well do the metrics drive achievement of organizational objectives?
- Are there metrics that are in conflict with each other within the business unit/function or across related business units/functions involved in the delivery of products or services?
- How effectively is the organization communicating these metrics, incentives and expectations?
- How much have metrics changed from year to year? Have they resulted in improvements in business operations or financials?
- How well and how frequently is oversight performed? Are there instances of unwanted behavior? Are there opportunities for unwanted behavior?
- How well do current controls prevent these behaviors?
- Does management consistently assess the actual results expressed by the metrics and adjust the metrics to better drive the behaviors that will help achieve objectives?

If the review identifies issues, IA can perform a root cause analysis to determine specifically where the process broke down.

The team can first identify the contributing factors — situations or circumstances that increased the likelihood of failure but wouldn’t have caused it on their own (e.g., documentation issues in reporting metrics, lack of communication regarding metric thresholds).

The team can then analyze the contributing factors to identify the underlying issue (e.g., poorly designed metric, metric too narrowly focused resulting in negative impact on adjacent business units/functions, no process in place to consistently and adequately report metrics, lack of a standard procedure by which new hires are notified of performance metrics).

Internal Audit should take a qualitative and quantitative approach to metrics.
Useful tools

When it comes to assessing and evaluating metrics, a split approach — both quantitative and qualitative — might work best. By using both data analytics and behavioral models, IA can delve to the root issues more quickly and provide useful, actionable recommendations.

Data analytics allows IA to leverage the vast amounts of data available at almost every company to report, visualize and understand the company’s performance. Using data analytics, incentive payouts can be compared against the primary metric (e.g., sales) and other metrics (e.g., customer satisfaction), as well as overall business objectives.

Data analytics allows IA to evaluate the metric in a rich context, providing a more complete picture of the metric’s overall impact; helping to identify unwanted behaviors; and allowing for easier benchmarking against industry comparables, permitting the development of metrics that incorporate industry averages as reference points.

At the same time, IA should look at the culture and behaviors of the organization or group, and its review should acknowledge the key role of employee behavior. An impeccably designed metric can still prove ineffective if it doesn’t account for the culture in which it must operate. By studying the behaviors that define the culture and measuring them against organizational and individual success factors, IA can not only better evaluate the effectiveness of a given metric, but it can also offer substantive recommendations on a metric’s design and implementation.
How can EY help?

With just under 50% market share, EY is the clear leader in providing risk advisory, internal control and internal audit services. As the global leader in Sarbanes-Oxley (SOX) compliance services, we serve 42% of the Fortune 500. And as the clear leader in internal audit, we provide internal audit services to more Fortune 500 companies than all of the other Big Four combined. We’re also the global IPO leader among the Big Four, in terms of both number of deals and value of capital raised.

We’ve taken the lead thanks to the depth and breadth of our knowledge and experience, our global reach and integration, and our diversity and inclusiveness. We are able to offer our clients the services they need, when they need them, wherever they need them, provided by teams with a healthy diversity of skill sets, experience and backgrounds.

We also know how to work with high-growth companies. We are the world leader in advising, guiding and recognizing entrepreneurs. Each year, we celebrate high-impact entrepreneurs and their achievements through programs such as EY Entrepreneur Of The Year™, EY Entrepreneurial Winning Women™ and our EY Strategic Growth Forum™ events. And we’ve developed a range of tools and resources for high-growth companies, including our Global Center for Entrepreneurship and Innovation (ey.com/entrepreneurship) and our Global IPO Center of Excellence (ey.com/ipo).

Our experience and knowledge will help us understand and further your growth strategy. And as your organization moves toward a robust, reliable risk management environment, we can help make sure that you have the infrastructure and controls you need. We can help you develop an agile, scalable risk management capability that meets your needs and fits your budget. And our co-sourcing and outsourcing capabilities can help your organization get the most value for its money, with benefits such as:

- The approach you need at a cost you can afford. You pay only for productive time; we make the investments in methodology, technology, training, recruitment/retention and our cost-effective global talent hubs.
- The skills you need when you need them. We can bring in the right people from our global network of subject-matter resources to address the issues at hand.

We have the resources, methodology and tools to help you develop the appropriate risk management environment and IA function in an efficient and cost-effective way, embedding leading-edge analytics as well as co-sourcing, outsourcing and global delivery teaming. Our global internal audit methodology features:

- A proven, consistent global approach, enabled by technology
- A focus on higher-risk issues with integrated subject-matter resources
- Governance and execution protocols with the rigor to drive change
- An emphasis on flexible risk assessment and on continuous communication of root cause issues as well as improvement recommendations
- Key performance indicators that drive accountability and performance
Metrics matter: how Internal Audit can help organizations assess performance measurement
IA should incorporate the evaluation of metrics designed to drive employee behaviors into its risk assessment and plan. It should go beyond business process to business performance.

Using established procedures and processes, IA can evaluate these metrics in a stand alone audit or through an increase in audit scope as the organization’s needs and cost constraints dictate. The result will be effective and efficient metrics that mitigate potential regulatory or reputational risks while avoiding unintended consequences.

With IA providing the keen insights it is uniquely placed to offer, the organization will create metrics that minimize perverse incentives and curb unintended behaviors that could negatively impact products, customer service and the organization in general.

**Critical questions**
The questions IA should be asking when it comes to metrics:

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<tr>
<th>Key question</th>
<th>Key considerations</th>
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<tr>
<td><strong>What are the metrics?</strong></td>
<td>› How many metrics are used per person/department/company?</td>
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<td></td>
<td>› Are they aligned to the organization’s strategic and business objectives?</td>
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<td>› Are they formal or informal?</td>
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<td>› Are they within the employer’s direct control?</td>
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<td>› Are they appropriate for the job position?</td>
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<td>› Are they easy or difficult to obtain?</td>
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<td>› Are there pressures within the organization to meet the metric?</td>
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<td><strong>Who establishes the metric?</strong></td>
<td>› Did the organization include bottom-up input in establishing these metrics?</td>
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<td>› Did the team establishing them understand whether the metrics were achievable?</td>
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<td></td>
<td>› Did the team consider the impact of a business unit’s or function’s metrics on other business activities along the end-to-end process?</td>
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<td><strong>How is performance reported?</strong></td>
<td>› Is the performance reported independently (e.g., system generated) or self-reported?</td>
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<td></td>
<td>› Can the measures be objectively or independently verified?</td>
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<td><strong>What oversight is performed?</strong></td>
<td>› Who performs the review? How frequently is it performed?</td>
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<td>› Are there policies around understanding performance outliers?</td>
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<td></td>
<td>› Does management monitor and take action when metrics do not produce the desired outcome or when they have unintended consequences on other aspects of the operation?</td>
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Want to learn more?

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We innovate in areas, such as risk consulting, risk analytics and risk technologies, to stay ahead of our competition. We draw on in-depth industry-leading technical and IT-related risk management knowledge to deliver IT controls services focused on the design, implementation and rationalization of controls that potentially reduce the risks in our client’s applications, infrastructure and data. Information security is a key area of focus where EY is an acknowledged leader in the current landscape of mobile technology, social media and cloud computing.
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To find out more about how our Risk Advisory services could help your organization, speak to your local EY professional or a member of our global team, or visit: ey.com/advisory

Our Risk Advisory leaders are:

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| Iain Burnet                   | iain.burnet@au.ey.com      |

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<td>Yoshihiro Azuma</td>
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