

Adding a Traceability Review to the External Audit

© 2008 AgInfoLink Global, Inc. Submitted as an article for the January 2008 issue of Food Traceability Report.

By William R. Pape and Robert Sadler C.A., AgInfoLink Global, Inc.

External audits are designed to provide peace-of-mind to key company stakeholders not involved in the company's day-to-day operation. Without third-party audits, stakeholders must rely solely upon status updates from management to understand the state of a company. While these updates are usually accurate and fairly represent a company's status, there have been disconnects between management guidance and actual operational events, resulting in catastrophic stakeholder consequences. The third-party, external audit is designed to minimize these unpleasant surprises.

While instances of external audits can be found as early as the 14th century in England, U.S. companies were not required to perform external audits or file external audit results prior to the stock market crash of 1929 and the resulting Great Depression. The Securities and Exchange Act of 1934 changed that practice and required, for the first time, publicly-traded U.S. companies to begin performing external, financial audits. Today, the annual financial audit is taken for granted for any company that is trying to establish its credibility, whether it's publicly-traded or not.

Even though the financial audit is very much a fixture in today's corporate world, it is important to remember, less than four short generations ago, audits were viewed as a revolutionary innovation. Other corporate tragedies, such as the Enron collapse, have expanded the audit role beyond basic financial reports to include compliance updates on a number of corporate operational areas, such as section 404 of the 2002 Sarbanes-Oxley Act. These expansions to previous audit protocols are usually a reaction to newly enacted government regulations or the recent corporate misstep. Recent events strongly suggest that it is now time to once again expand the external audit function to include an entirely new audit section -- an external review of a company's traceability system.

Why Create New External Audit Category? Some of the key drivers for this call to add a new, external review of a company's traceability system include:

- Just a few weeks ago, the record-keeping requirements of the Bio-Terrorism Act of 2002 for food and beverage companies, their transportation haulers and their packaging companies became fully operative for any food and beverage company with fifteen or more employees,
- The demise of Topps Meat Company makes it very clear that the risk of inadequate traceability for food and beverage companies are both very real and very severe,
- A recent survey of food and beverage executives reports that only 7% of the surveyed companies believed they had a traceability system which would provide the necessary information in the required time period, and
- The number of tainted goods episodes continues to grow each year and every recall, whether it kills or cripples the company, not only reduces company revenues and profits but also depresses demand for other companies supplying product in the same category. Consumer concerns over food and product safety continue to rise. A recent consumer survey shows 61% of Americans are worried or very worried and food and product safety, with 55% more worried than a year ago. A whopping 27% of survey respondents said they have owned a recalled food product!

As noted above, the FDA rules under the Bio-Terrorism Act are now firmly in place, and the FDA has provided a number of published clarifications about the Act's intent and the operational activities needed to satisfy government regulators. This Act potentially can levy massive penalties to the food and beverage companies as well as their managers and directors and to the brand-owning companies and their executives selling their products so there is a new risk today that didn't exist a decade ago.

No company has yet to be charged as deficient under this Act, and the FDA, under the current Administration, is taking a low-key position on enforcing the law. However, this posture could change quickly in the face of yet another front-page recall scenario in a presidential election year. Food and beverage companies which choose to take a wait-and-see attitude, deciding to play the “legal lottery”, may provide their stakeholders with a nasty surprise.

How Can Consumer Product Companies Best Protect Themselves? In the face of increasing risks directly attributable to a food and beverage company’s traceability system, company management as well as their third-party professional support organizations in the legal and accounting profession need to increase their protection and the protection for their company by voluntarily endorsing a call to the auditing companies to add a new, traceability review section to their company’s external audit. This voluntary endorsement sends many messages, not the least of which is a strong message to the consuming public about the industry’s desire to be proactive in the face of growing public concern.

Why an External Audit? Won’t an internal management review suffice? This new, external audit section would review the company’s traceability capability and go much further than the current in-house management reviews. Self-analysis and internal reviews including table-top recall simulations are no longer sufficient to adequately protect the company, its managers, its directors and its stakeholders. Many of the companies in the past two years who have seen damaging recalls had successfully performed these internal reviews, but still were caught in the backwash of an escalating recall tragedy. Management thought that their companies were properly prepared but they were not.

The disconnect between management’s perception of their company’s traceability capability and the operational reality stems, we believe, from a lack of visibility about the company’s actual operations. Management has opinions about the operations but these opinions are not always based upon actual operational data. Nearly a decade of installing traceability systems for customers has shown us that it is only when a real-time process monitoring system is installed and operational dashboards are provided to senior and mid-managers showing deviation from key operational business rules, that management perceptions synchronize more closely with reality, and internal review of any process gains credibility. Even after a process-monitoring traceability system has been installed, though, these systems still need to have external review to make sure that any gaps are plugged.

In addition to the disconnect between perception and reality, an external review of the company’s traceability practices is required because traceability requirements have become increasingly complex and, just as no major company today can rely exclusively on an internal review of their financial reports, food and beverage companies must look to highly focused, impartial, traceability experts to give them a sense of where their company stands with respect to this increasingly important requirement. In the past, many external auditing firms have included a side comment about the company’s traceability system in their qualitative discussion of the company’s operations. Very few of these reviews, in our opinion, have been sufficient. Most have been very cursory. We envision a traceability review as a stand-alone audit section, following a formally prescribed set of audit procedures conducted by auditors or third-party companies who are traceability specialists. This approach is the only way we feel that company directors as well as prospective and existing shareholders can be provided with the information they need to fully evaluate the company’s traceability risk.

What Should an External Traceability Review Audit Include? During the traceability review, these traceability specialists need to dig below the surface to analyze traceability issues such as

- product movement across the company’s different legal entities,
- the preservation of identity across various internal process transformations,
- the method of collecting traceability information,
- the type of information being collected with respect to the required reporting regulations,
- the methods the company uses to retrieve regulatory information in the event of a tainted goods episode,
- company process and business rule compliance monitoring systems, and

- the company's recall history.

What Type of External Audit Should be Performed and by Whom? It has been suggested that the review of a company's traceability system should be the responsibility of the quality audit. While for some companies incorporating this review as part of the quality program might be appropriate, we would argue that given the severe risks to the food and beverage company's prosperity and even survival by a failure of this system, the traceability review should be incorporated into the company's annual, integrated financial audit by their external auditors, using independent third party traceability experts. Any lesser treatment does not give this audit its proper due.

In conclusion, the corporate and personal risks of not having a top-flight traceability system have increased and there is no suggestion that this pressure will be reduced any time soon. The most likely scenario is that the pressure will increase. To properly protect their company and their corporate managers and directors, food and beverage companies need to be working with their external auditing organizations to add a full and complete review of their company's traceability procedures using independent third party trained traceability experts. The new year is a good time to add a new component to the annual audit so that stakeholders have the fairest and most complete understanding of the company's state and the risks it faces.

Further information can be found at www.aginfoink.com.