

REVIEWING THE EFFECTIVENESS OF YOUR INTERNAL AUDIT FUNCTION

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How effective is your internal audit function? The revised Combined Code, supported by the Smith Guidance, requires companies to consider annually the need for internal audit if they have none; and to monitor and review the effectiveness of the internal audit function if it exists.

This should not be a surprise to finance directors and heads of internal audit: would they expect any other corporate function to be immune to assessment of its work? Yet whereas business units can be measured on their contribution to profits, financial targets do not tell the whole story for staff functions. Many individuals and companies seem to have forgotten that value for money means procuring goods and services not just at the lowest cost but at the lowest cost for the *specified quality*.

Take, for example, external audit. It would be encouraging to think we had gone beyond simplistic cost minimisation – except that the pricing of external audits in the 1990s was fuelled by a corporate demand for statutory audit so cheap that the auditors could not afford to do detailed substantive testing. And they dared not challenge this arrangement because that could have risked alienating the same companies as the purchasers of higher margin non-audit services.

So just what is internal audit effectiveness and how can we measure it? The question assumes we know what effective means in this context. The Oxford English Dictionary even gives ‘efficient’ as one meaning – unhelpfully because in value for money terms the two are distinct:

- efficiency is either getting the maximum output from a given input or a given output from the minimum input of resources; and
- effectiveness is the achievement of intended goals.

We can measure both of these in quantitative terms for internal audit functions. Armed with the departmental budget and a simple time recording system it is easy to calculate efficiency targets such as the cost per audit day, the cost per audit report, the number of audit reports (or even recommendations/action points), and the time taken to complete audits and publish reports. And effectiveness is then measured by looking at the completion of the annual audit plan and a handful of other, lesser goals such as responsiveness to management requests for advice or assistance.

However, the trouble with these targets is that the operational goals chosen may not reflect the overall purpose of internal audit. That is:

- to provide assurance to the management, the audit committee and the board on the system of internal control and risk management and
- to assist management to improve its operations, risk management and internal control.

So if we rephrase, “Was the internal audit function effective?” as “To what extent did the internal audit function provide us with assurance? What evidence do we have of improvements in operations, risk management and internal control?” we are closer to what we would like to know but the answers may not be as readily quantifiable.

The answer to the first question is ultimately subjective: to what extent does the work of the internal audit function help us as members of an audit committee, of the board, of management to feel assured that we have adequate controls and a sound system of risk management? As an output measure it lacks the (illusory) certainty of the number of audit reports delivered compared to the number planned, or the completion of all the audits on a list of topics that was first mooted up to 18 months ago. If we ask for such data we need to remember that they are only evidence pointing to assurance, not proof that all was well or that risks will be well managed in future.

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It is therefore helpful to have evidence of management improvements as an indicator of an effective internal audit function. This is relatively straightforward to collect. You can ask your head of internal audit to report the percentage of the audit action points to which management has agreed (what used to be called “recommendations”) that have been implemented within a set period of time, say, after three or after six months. Check specifically on the implementation of individually significant actions. This measures both the responsiveness of management and the skill of internal audit in agreeing improvements that management is prepared to action. It also forces the internal audit function to carry out follow up work – which they often overlook if they are struggling to churn out the agreed number of primary reports.

There are two objections to using the audit action implementation rate as a measure of internal audit effectiveness:

- Internal auditors may collude with management to avoid agreeing or recording hard to implement actions; and
- Management implementation rates may be outside the control of internal audit.

Internal auditors are less likely to collude with management if they have visible support from the audit committee to stand their ground. If everything that comes to you as members of the audit committee is bland and nothing is messy or open-ended, you should enquire further, talking to the internal auditor in private, to ensure that management censorship is not stripping all the difficult issues out of internal audit reports before you see them.

Again management implementation rates depend on both management and internal audit. The audit committee needs to enquire further to find out whether failure to implement is down to management reluctance, changed circumstances, or internal audit forcing agreement to unrealistic recommendations. Holding internal audit and management accountable will focus them both on commitment to workable improvements.

The other problem with effectiveness is that it is a difficult concept to assess usefully because it is time-bound. What we would really like to know is whether the internal audit function is going to be effective in the future. The further we look backward the easier it is to conclude confidently: “That individual/department/system was effective/not effective.” The greater the historical gap the more chance we have of agreement because we have seen more of subsequent events. But effectiveness in the past does not necessarily mean continued effectiveness in the future. Continuing effectiveness is more likely if all the variables involved remain unchanged (individuals, processes, the business environment) – but most companies and their internal audit functions are constantly changing.

The way we try to assess future effectiveness is to look at the processes underpinning effective performance and see whether they are present now and are likely still to be there going forward, perhaps because they are constantly re-enforced by further processes (see figure 1). For example, the skills of a professionally qualified and experienced internal audit team may be seen as a prerequisite for a programme of informative audits. Future effectiveness might be maintained by rigorous formal arrangements for development, training and reward of existing staff and recruitment of new staff in line with orderly succession planning. The Standards for the Professional Practice of Internal Audit from the Institute of Internal Auditors (www.iaa.org.uk/knowledgecentre/professionalguidance/mandatoryguidance.cfm) provide a comprehensive list of process indicators. Figure 2 lists some of those commonly in use in UK internal audit departments.

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Figure 1: Assessing the effective performance and future potential for effectiveness of Internal Audit (Adapted from the work of David Bawden, CHAI)

| Potential↓ | Performance→ | Assurance on risk management | Improvements in risk management | Improvements in internal control environment | Management experience of internal audit |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------|---------------------------------|----------------------------------------------|-----------------------------------------|
| Purpose E.g. audit charter, internal audit work plans tied in to risk registers, etc. | <p>The exact relationships between the elements of actual performance and the underlying processes may not be clear cut. Figure 2 shows some commonly used targets and indicators which may be useful.</p> | | | | |
| Commitment E.g. direct reporting lines, standard audit methods of working, etc | | | | | |
| Capability E.g. sufficient skilled and experienced staff; access to Chairman of the Board, Chairman of the Audit Committee, all personnel and information required by audit work ; adequate IT equipment; travel budget sufficient to reach all planned audits, etc | | | | | |
| Learning E.g. Post audit review processes;, training and development planning, etc. | | | | | |

Figure 2: Targets and Indicators for Internal Audit

| | Input Indicators | Process Indicators | Output Indicators |
|-------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Structural | *Existence of direct reporting line to the Audit Committee Charter specifying right of access to Chairman of the Board, Chairman of the Audit Committee, all personnel and information required by audit work | Frequency of meetings with the Audit Committee without management present *Frequency of meetings with the Chairman of the Audit Committee | |
| Quantitative | *Cost per audit day Cost per audit report (actual/average) *Percentage of auditors' time spent on audit work (versus work for management, administration etc) Amount spent on training and development | Achievement of target dates for audit work/ reports | † Number of reports † Number of agreed actions * Percentage of agreed action points completed within a given time. † Percentage completion of the annual audit plan. |
| Qualitative | *Qualifications and experience of staff | *Appropriate audit methodology documented in staff manual Internal audit work planning Amount and types of training provided to staff | *Post audit feedback from management † Requests for work by management Transfer of staff into other parts of the organisation. |
| *Internal Quality Assurance process | | | |
| *Independent review by qualified and experienced internal auditor | | | |

* *potentially most useful indicators of effective performance*
† *unhelpful in isolation*

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It is worth noting that the Professional Standards of the Institute of Internal Auditors prescribe that internal audit functions

- should have internal quality assurance procedures in place and
- should be subject to external review at least once every five years by a *qualified, independent* reviewer or review team from outside the organisation. It is no longer appropriate (if it ever was) for this review to be undertaken by the company's external auditors.

Despite rumours to the contrary, internal auditors are human and just as prone as other managers to presenting quantitative measurements in the most favourable light. An independent review and feedback from management can both help to ensure a realistic perspective.

The Smith Guidance also highlights a number of areas which the audit committee should review as indicators of effective performance in addition to the management responsiveness described above:

- An accountable reporting line to the audit committee
- Direct access to the chairman of the board and to the audit committee
- An appropriate plan of internal audit work
- Regular reports on internal audit work

Reporting Line

Traditionally internal audit departments have reported to the finance director – occasionally even to a chief accountant or financial controller although that is really too low down in the organisation. It is now recognised that – in what are hopefully rare circumstances – reporting only to a senior executive might allow a finance director or a powerful CEO to censor the output of the internal audit department in order to conceal information from the audit committee. So wherever the head of internal audit reports in the management hierarchy (often to the CEO these days), s/he needs a meaningful line to the chairman of the audit committee.

However, the chairman of the audit committee is a non executive director and cannot be held accountable for executive decisions such as the internal audit departmental budget or the cost of an outsourced function without relinquishing some of his/her independent status.

It's easy to get tied up in theories. In practice the head of internal audit will talk regularly to the chairman of the audit committee – not just in the run up to an audit committee meeting. S/he will be able to warn the chairman if anything is being held back from the committee so that the chairman can raise it with the CEO or finance director as necessary.

Direct access to the chairman of the board and to the audit committee

The guidance states that the audit committee should meet with the internal auditor at least once a year without executive management present. Most audit committee chairmen would also speak regularly with the head of internal audit, at least before each audit committee meeting.

In practice the head of internal audit is unlikely to meet so regularly with the Chairman of the Board but the principle is that no one should stand in the way of their meeting. In order to build up a trusting relationship there should be meetings between them before they are needed, if ever. The topic of discussion is often the highest ranking risks in the organisation. A head of internal audit with a wide remit to review risks and controls throughout the organisation is an invaluable

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source of information to any director, executive or non executive.

Internal audit work plan

Internal audit plans used to be very simple to review. They usually listed all the locations or all the processes in the organisation and showed how they might all be visited or audited within a cycle lasting anything from two to five years. Each year's plan was laid out in more detail and at subsequent audit committee meetings the completion of the planned work or the reasons for alternative work (or work dropped) were reviewed. A low risk profile was sometimes quoted as a reason why a particular area was never the focus of internal audit attention.

When you have to report each year on the effectiveness of internal control and risk management – even if it's only internally – this is not an adequate work plan. There are two key elements to a post-Turnbull internal audit plan:

- the review of the risk management and internal control processes themselves; and
- the conduct of audit work based on management's risk register.

The first is the simpler: the internal auditor checks the processes whereby objectives are set, risks identified and analysed, controls and management assurances recorded, incidents monitored and everything is reported. The internal auditors may also challenge the SMARTness or otherwise of objectives, question the completeness of the risks identified and check whether a sample of the controls and assurances are correctly described and operating.

Preparing an internal audit plan from a risk register can be more contentious. Internal auditors enjoy auditing the more difficult areas but only reviewing the management responses to the highest and most intractable risks is not enough. Every organisation has a large number of areas which are inherently very risky but where management has developed very effective controls – to such an extent that people may not realise how greatly the organisation depends on the functioning of those controls. Only if these areas have been audited and the controls found to be effective should the internal auditor conclude that all is well. However, time can be saved by using an audit approach which relies on other checks before embarking on detailed audits.

The audit committee should therefore question the head of internal audit closely as to how the internal audit work plan ensures coverage of areas with low residual (and high inherent) risk as well as those with high residual risk.

Reports on internal audit work

Internal auditors will provide summary reports to the audit committee at each meeting. The audit committee members need to get into more detail than this on at least a proportion of internal audit reports. The workload can be cut back by requesting only executive summaries and then dipping into further detail when the report's conclusions are negative. Alternatively, if the internal audit remit is wide and the reports are not repetitive, they may be regarded as a rare opportunity to learn how processes work across the business.

Whether you can glean this information from the internal audit reports with which you are presented depends on the way they are written. However, if they don't give you what you need, as the internal auditor's prime customer you are entitled to request an alternative format.

At least once a year the head of internal audit should also present a report on the performance of

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the function – which aids consideration of its effectiveness.

Conclusions

Evaluating the effectiveness of internal audit is not going to be easy for the Audit Committee. However, the guidance from the Smith Report now appended to the Combined Code that sets this requirement does provide a framework and some issues to consider (figure 3). It also lacks the prescriptive quality of the Sarbanes-Oxley Act in the USA, allowing more flexibility and practical realism in that there is no one model for effective internal audit – one size does not fit all.

Figure 3: The Smith Guidance on Internal Audit at a glance

| | |
|---------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Upon establishment and regularly thereafter | Review and approve the internal audit remit, having regard to the complementary relationship with external audit. Ensure internal audit has sufficient resources and access to information to meet its remit and perform in accordance with professional internal audit standards. |
| Annually | Consider the need for internal audit if there is none Otherwise monitor and review the effectiveness of the function and its activities: <ul style="list-style-type: none"> • Direct access to the board chairman, audit committee • Accountable to the audit committee • Assess annual internal audit programme of work • Monitor and assess the role and effectiveness of the internal audit function in the overall context of risk management processes. |
| At least annually | Meet with the head of internal audit without management present |
| At each meeting | Receive reports on the results of internal audit work Monitor management's responsiveness to internal audit findings and recommendations |
| As required | Approve the appointment or termination of appointment of the head of internal audit |

Reaction to the Combined Code and the Smith Guidance from internal auditors has been overwhelmingly positive. They welcome the provision for a broader scope for internal audit by the inclusion of internal controls and risk management systems in the Audit Committee's remit (unless expressly addressed by another high level committee or by the board itself). They appreciate the greater degree of scrutiny from the Audit Committee over their effectiveness and the processes that drive it. They are very pleased that the guidance makes reference to the Code of Ethics and Professional Standards of the Institute of Internal Auditors. Recognition of their profession as such and the requirement to evaluate their performance may be challenging but it means that the Audit Committee must look harder at their work. They thereby hope that more Audit Committee members will come to understand internal audit better and value the range of its contributions.