Ten Ways to Measure the Success of Internal Auditing

How do you know if internal auditing is successful? How do you know if it is adding value? Recent publications in IIA Practice Guides and the Common Body of Knowledge provide many ideas, but what is actually being measured in audit departments? Based on many Quality Assurance Review projects and working with internal auditors all over the world, Larry will share his real-world, back-to-basics view of how IA departments can know if they are meeting their organization's needs.

Larry Hubbard
& Associates

Larry's Top Ten

1. Key controls working (risk mitigated)
2. Reported issues resolved
3. Coverage provided (measurement against AAP)
4. Quality assessment – internal and external
5. Measurement using Capability Model
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& Associates

Key Controls Working

2201 – Planning Considerations

In planning the engagement, internal auditors must consider:

- The strategies and objectives of the activity being reviewed and the means by which the activity controls its performance.
- The significant risks to the activity's objectives, resources, and operations and the means by which the potential impact of risk is kept to an acceptable level.
- The adequacy and effectiveness of the activity's governance, risk management, and control processes compared to a relevant framework or model.
- The opportunities for making significant improvements to the activity's governance, risk management, and control processes.

The Most-Ignored Standard

- **2210.A3 –** Adequate criteria are needed to evaluate governance, risk management, and controls. Internal auditors must ascertain the extent to which management and/or the board has established adequate criteria to determine whether objectives and goals have been accomplished. If adequate, internal auditors must use such criteria in their evaluation. If inadequate, internal auditors must identify appropriate evaluation criteria through discussion with management and/or the board.

COSO FUNDAMENTALS: THE PRINCIPLES

Principles Relating to Control Environment

1. The organization demonstrates a commitment to integrity and ethical values.
2. The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control.
3. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.
4. The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives.
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Principles Relating to Control Activities

10. The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.
11. The organization selects and develops general control activities over technology to support the achievement of objectives.
12. The organization deploys control activities through policies that establish what is expected and procedures that put policies into action.

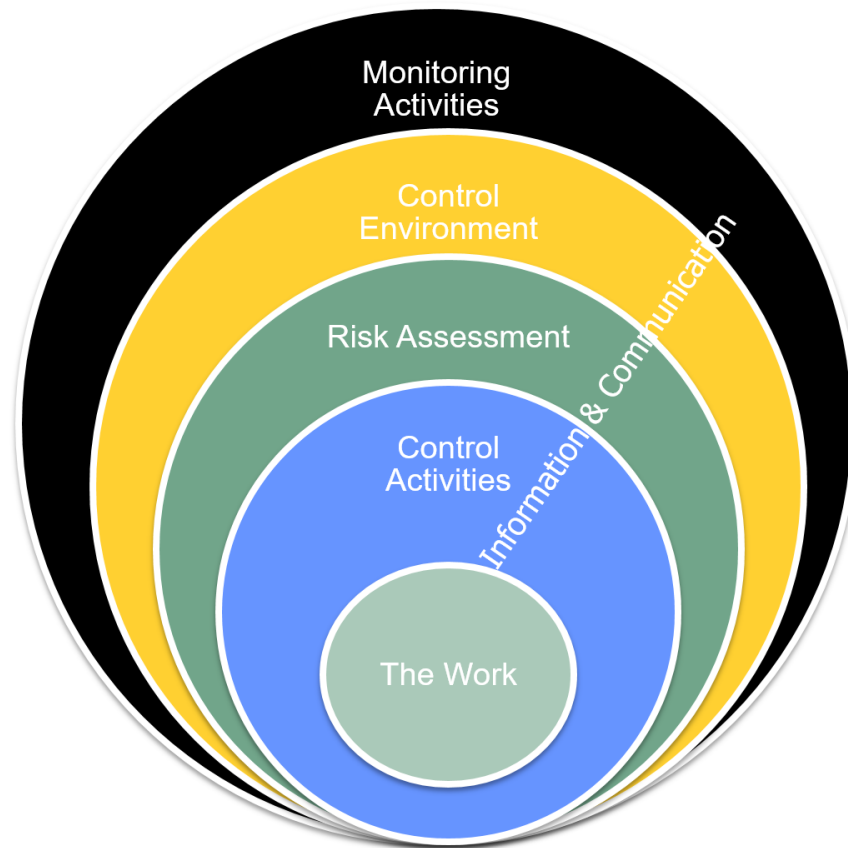## Principles Relating to Information and Communication

13. The organization obtains or generates and uses relevant, quality information to support the functioning of internal control.
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Another View of COSO

Control help ensure the work is done correctly, by mitigating risks to achieving objectives

Monitoring Activities

Control Environment

Risk Assessment

Control Activities

Information & Communication

The Work

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& Associates

QAIP

1310 – Requirements of the Quality Assurance and Improvement Program

The quality assurance and improvement program must include both internal and external assessments.

1311 – Internal Assessments

Internal assessments must include:

- Ongoing monitoring of the performance of the internal audit activity; and
- Periodic reviews performed through self-assessment or by other persons within the organization with sufficient knowledge of internal audit practices.

Interpretation:
Ongoing monitoring is an integral part of the day-to-day supervision, review, and measurement of the internal audit activity. Ongoing monitoring is incorporated into the routine policies and practices used to manage the internal audit activity and uses processes, tools, and information considered necessary to evaluate conformance with the Code of Ethics and the Standards.

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Internal Audit Capability Model (IA-CM)

For the Public Sector

	Services and Role of IA	People Management	Professional Practices	Performance Management and Accountability	Organizational Relationships and Culture	Governance Structures
Exhibit I.5 **Internal Audit Capability Model Matrix**						
Level 5 – Optimizing	IA Recognized as Key Agent of Change	Leadership Involvement with Professional Bodies Workforce Projection	Continuous Improvement in Professional Practices Strategic IA Planning	Public Reporting of IA Effectiveness	Effective and Ongoing Relationships	Independence, Power, and Authority of the IA Activity
Level 4 – Managed	Overall Assurance on Governance, Risk Management, and Control	IA Contributes to Management Development IA Activity Supports Professional Bodies Workforce Planning	Audit Strategy Leverages Organization's Management of Risk	Integration of Qualitative and Quantitative Performance Measures	CAE Advises and Influences Top-level Management	Independent Oversight of the IA Activity CAE Reports to Top-level Authority
Level 3 – Integrated	Advisory Services Performance/Value-for-Money Audits	Team Building and Competency Professionally Qualified Staff Workforce Coordination	Quality Management Framework Risk-based Audit Plans	Performance Measures Cost Information IA Management Reports	Coordination with Other Review Groups Integral Component of Management Team	Management Oversight of the IA Activity Funding Mechanisms
Level 2 – Infrastructure	Compliance Auditing	Individual Professional Development Skilled People Identified and Recruited	Professional Practices and Processes Framework Audit Plan Based on Management/ Stakeholder Priorities	IA Operating Budget IA Business Plan	Managing within the IA Activity	Full Access to the Organization's Information, Assets, and People Reporting Relationships Established
Level 1 – Initial	Ad hoc and unstructured; isolated single audits or reviews of documents and transactions for accuracy and compliance; outputs dependent upon the skills of specific individuals holding the position; no specific professional practices established other than those provided by professional associations; funding approved by management, as needed; absence of infrastructure; auditors likely part of a larger organizational unit; no established capabilities; therefore, no specific key process areas					

ANNEX B — USING THE IA-CM AS A SELF-ASSESSMENT TOOL

This annex provides details of the steps to follow in using the IA-CM as a self-assessment tool. It also includes a sample generic presentation that can be used when introducing the IA-CM to the self-assessment team and other internal audit professionals and stakeholders. The presentation can be tailored to the individual IA activity, if necessary.

Steps to Follow

Understand the purpose and structure of the IA-CM. Documents with varying levels of detail are available to assist in this regard. Begin by reviewing the Overview Section of the "Internal Audit Capability Model (IA-CM) for the Public Sector Overview and Application Guide." Next, review the detailed KPAs.

Identify a team to conduct the self-assessment. The team includes, at a minimum, a person skilled in conducting internal or external assessments of an IA activity and another person who is involved in making improvements to the IA activity.

Conduct the self-assessment.

1. **Familiarize the CAE and other internal audit professionals with the IA-CM.** Begin by reviewing the one-page IA-CM matrix with the CAE and other audit professionals. To help familiarize participants with the IA-CM, it may be helpful to provide a brief presentation on its purpose, structure, and uses. A sample generic presentation is available for this purpose and can be tailored to the IA activity, if desired.

2. **Identify the KPAs that appear to be institutionalized by the IA activity.** Through discussion among assessment team members and with the CAE and other audit professionals, identify which KPAs have likely been institutionalized by the IA activity.

3. **Obtain and review relevant documentation relating to the IA activity.** Relevant documents to support the institutionalization of the identified KPAs can be determined by reviewing the detailed KPAs in terms of "Essential Activities" that would have been undertaken and "Institutionalizing Practice Examples" that may have been implemented. Sufficient documentation should be obtained relating to the identified KPAs in each of the six elements of the IA-CM (Services and Role of IA; People Management; Professional Practices; Performance Management and Accountability; Organizational Relationships and Culture; and Governance Structures). Much of this information will likely be found in the IA activity's governing legislation, its charter, professional practices manual, and the organization's policies. Any recent internal or external reviews (e.g., QAR) may be helpful.
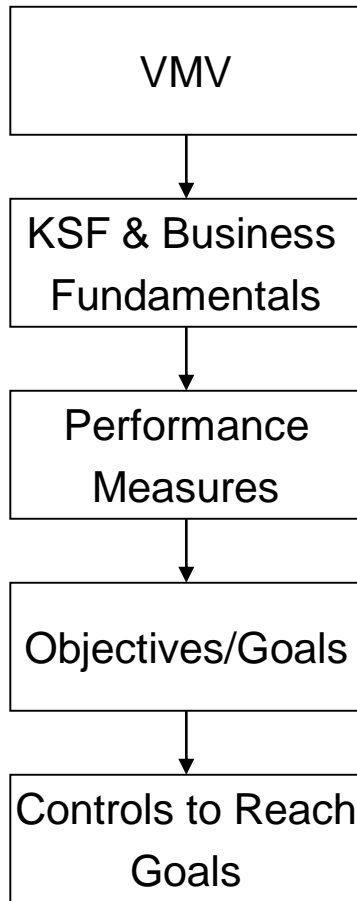
121

Larry's Top Ten

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& Associates

Strategy Measurement Model

```
┌─────────────────────┐
│        VMV          │
└─────────────────────┘
           │
           ▼
┌─────────────────────┐
│   KSF & Business    │
│    Fundamentals     │
└─────────────────────┘
           │
           ▼
┌─────────────────────┐
│    Performance      │
│     Measures        │
└─────────────────────┘
           │
           ▼
┌─────────────────────┐
│   Objectives/Goals  │
└─────────────────────┘
           │
           ▼
┌─────────────────────┐
│  Controls to Reach  │
│       Goals         │
└─────────────────────┘
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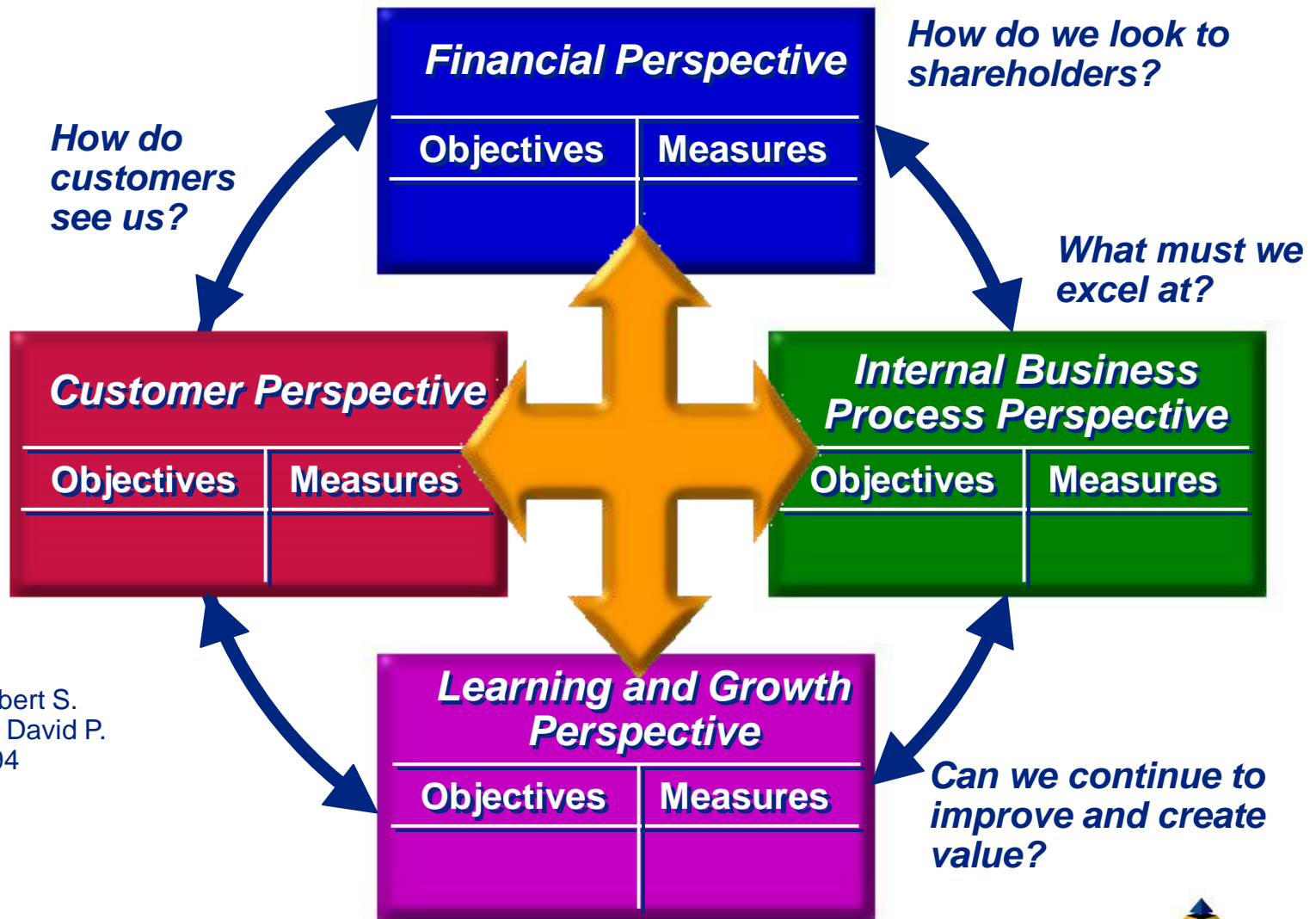
- The future goals of organization
- What the organization is
- What the organization stands for

- What the organization needs to focus on to achieve its vision

- A balanced scorecard
- Past - Present – Future

- The desired annual and long-term levels for each metric

- Controls implemented to achieve the goals

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Larry's Top Ten

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The Balanced Scorecard

Financial Perspective

Objectives	Measures

How do we look to shareholders?

How do customers see us?

Customer Perspective

Objectives	Measures

What must we excel at?

Internal Business Process Perspective

Objectives	Measures

Learning and Growth Perspective

Objectives	Measures

Can we continue to improve and create value?

Source: Robert S. Kaplan and David P. Norton, 1994

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Measures for Auditing

- Control Perspective (instead of Financial)
  - % of issues resolved; % of audits with no control issues; % of key controls working; % of frauds found vs. reported
- Business Process Perspective
  - Report issuance time; Budgets met; Coverage obtained; QA program results
- Learning and Growth Perspective
  - % certifications; Transfers from department; Upward feedback results; Leadership in organizations
- Customer Perspective
  - Client service evaluation scores; # requests for audits; Board, senior management surveys

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Control Perspective, dependent on:

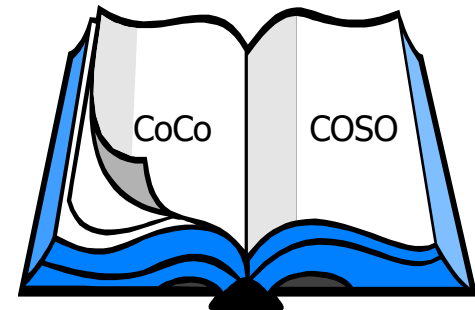## What is a control? Who is a framework for?

Management

Models
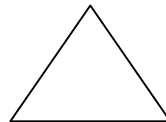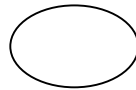
Frameworks

- Management by Objectives
- Balanced Scorecards
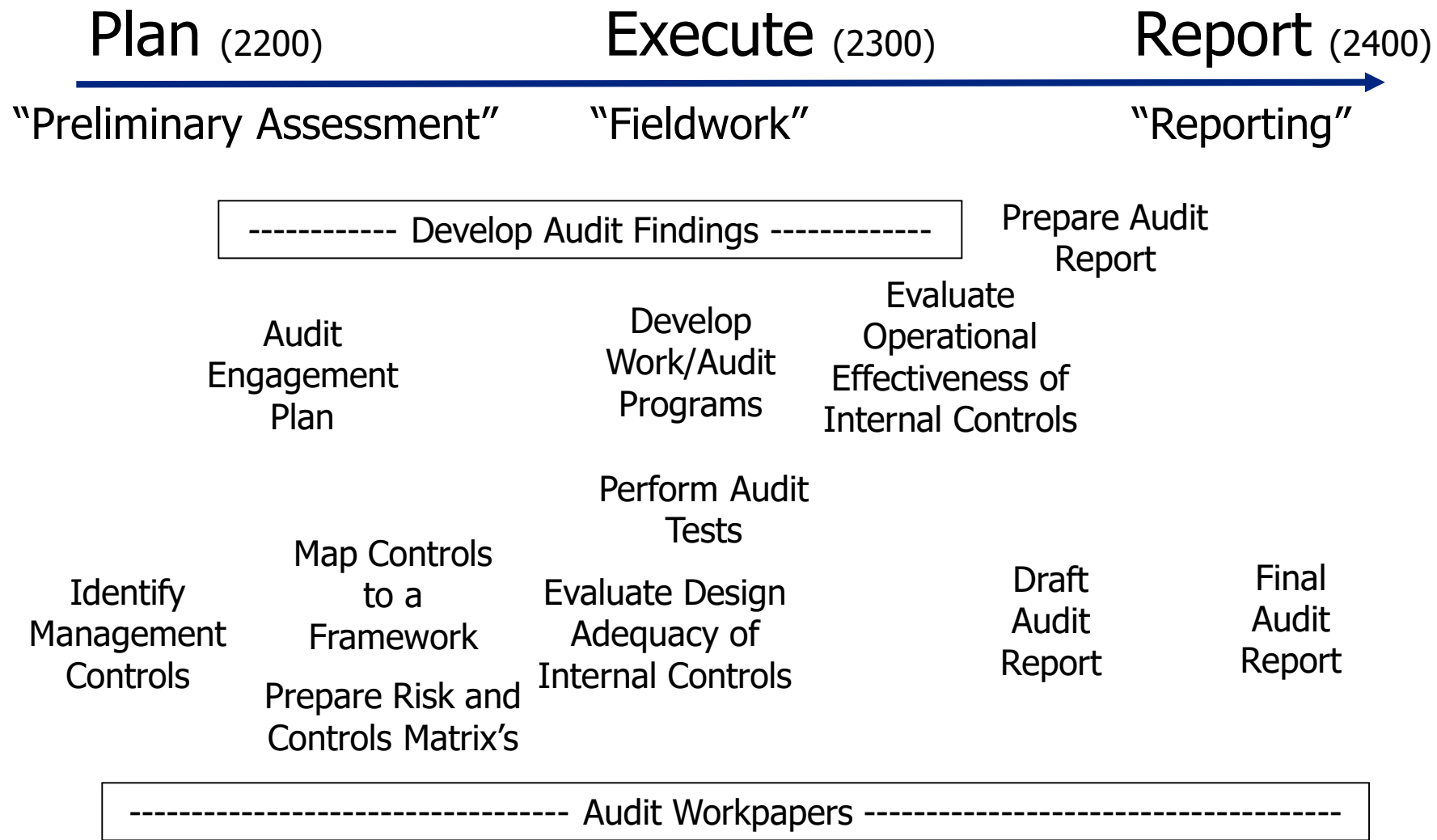- Six Sigma
- Management By Walking Around
- Etc.
- Etc.
- Etc.

CoCo   COSO

Internal Controls

Management Controls

Auditors need some way to evaluate controls in the many different management models we see – that's a framework!

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Business Process, dependent on …

Plan (2200)	Execute (2300)	Report (2400)
"Preliminary Assessment"	"Fieldwork"	"Reporting"

----------- Develop Audit Findings ------------

Prepare Audit Report

Audit Engagement Plan

Develop Work/Audit Programs

Evaluate Operational Effectiveness of Internal Controls

Perform Audit Tests

Identify Management Controls

Map Controls to a Framework

Prepare Risk and Controls Matrix's

Evaluate Design Adequacy of Internal Controls

Draft Audit Report

Final Audit Report

------------------------------- Audit Workpapers --------------------------------------

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Learning and Growth, dependent on …

- A "management model" for the organization, and a related model for internal audit.
  - What is valued?
  - What gets someone rewarded/promoted?
  - How is success measured?

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Customer Perspective, dependent on …

- What does management need from internal audit?
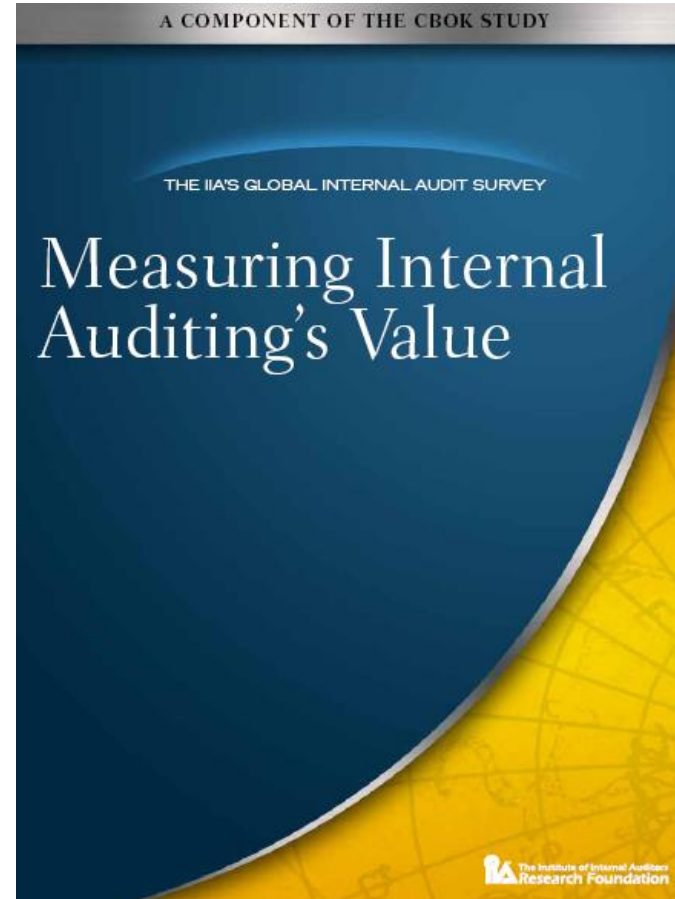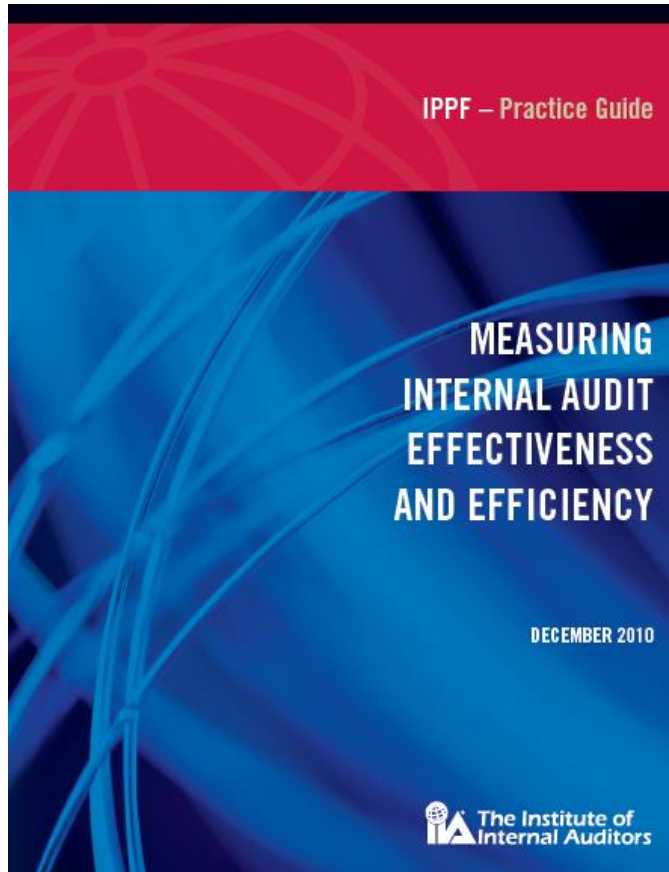
- What does the board need from internal audit?

And, they may not always know …

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It Takes a Score, and a Direction ...

Is 300 people attending this conference a good or bad score?

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& Associates
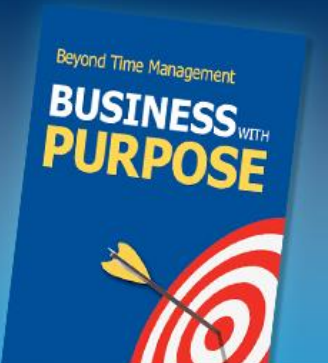
Other Sources - IIA

Still Other Sources

Chicken Sold

Financial Metrics: Show me the Chicken!

What do fowl have to do with finances?

At the Wright Leadership Institute, our staff are testing out a new format for our weekly financial reports. We want to show not only how we're faring financially relative to other years and our goals, but what it will take to get there – activity and results at a glance. We're still working out the kinks, and at last week's meeting one report had everyone at the conference table looking glazed-over.

There were potentially dozens of interesting things to analyze in this tiny spreadsheet, but after several minutes most of us were sorely in need of some focusing. I was reminded of a story our friend Bill Seidman, CEO of Cerebyte, Inc., told us when he was

About Me

Dr. Bob Wright
is an internationally recognized and cutting-edge author,

Bill had studied the high performing managers for Popeye's chicken using a process similar to the one he was walking through. He found that the managers whose stores had the highest total sales read their weekly financials from corporate headquarters very differently than others did.

Amidst the reams of data that arrived, the successful managers zeroed in on just one line: CHICKEN SOLD.

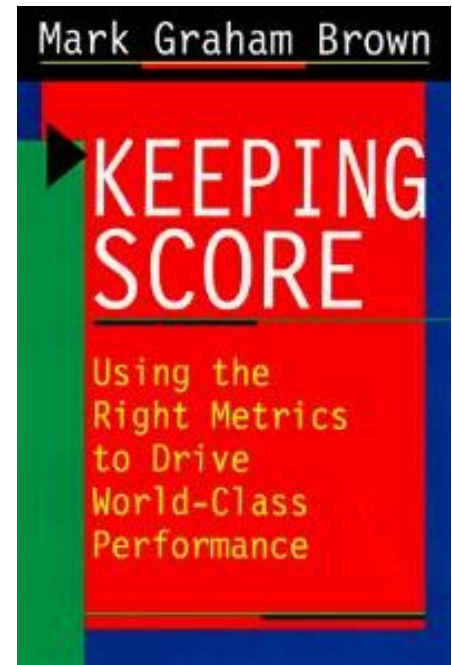Not bodies in store.

Not seasonal offerings.

Just "chicken sold."

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& Associates

Key Concepts - Metrics

- Fewer are better

- Link to VMV, KSF

- Mix of past, present, and future; customers, employees, stakeholders

- Start at top and flow downward

- Combine multiple indices into single index

- Change with environment and strategy

- Need goals based on research; not arbitrary

Mark Graham Brown

KEEPING SCORE

Using the Right Metrics to Drive World-Class Performance

Larry Hubbard
& Associates

Problems with Metrics

- Too much data – 15 to 20 max

- Too short-term focused

- Lack of detail

- Drive the wrong performance – Chicken Measures
  - Courtesy vs. competence
  - Behavior vs. accomplishments
  - Encourage competition not teamwork

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Too Much Data

TOO MUCH DATA

I once worked with a major telecommunications company that had 106 individual databases. Each database contained between 75 and 100 metrics or measures of performance. Every month, the company collected and reported between 7,500 and 10,000 measures. Now, a single individual reviews far less data than that, but many of the managers I talked to said that they commonly review 100 to 200 pages of data every week. When I asked managers how much of the data received was actually used, most said, "About 5%."

Having too much data is the most common and most serious problem an organization can have with its measurement system. The reason is that it wastes a great deal of valuable time. Managers have to weed through mounds of irrelevant data to get to the few buried kernels that they really need to manage their functions. A second and more serious problem is that the data they pay attention to and use are often the wrong data. The metrics they use are selected because of superstition. In other words, managers think that a particular measure is related to success, when there is little hard evidence that this is the case.

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Quantity, not Quality

Ten Pages Per Day

I worked for a company that developed customized training programs for corporate clients. One of the measures for the writers, or "instructional developers," was the number of pages they wrote per day. The standard was that each writer ought to average 10 pages a day. Employees' performance was measured every week against this standard, and for the most part it was met. The quality of those 10 pages varied dramatically, however. Some writers would produce 10 pages of accurate, well-written instruction. Others turned out 10 pages of garbage. Quality was in the eye of the beholder. If you worked on a project for Hal, you knew that he would rip apart your writing and make you rewrite it three or four times before he accepted it. If you got lucky to work on a project for Ray, however, you could turn in 10 pages of trash. If it was neatly typed and contained no glaring errors, it was fine for Ray. How many pages a writer writes per day is easy to measure objectively, but it is not what is really important. How many good pages are written per day is what is impor-

Or, 20 PowerPoints per hour

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Chicken Efficiency

Chicken Efficiency

Most organizations have one or two key measures that are considered far more important than others. They are often called management hot buttons. Sometimes they are profits, sales, or units shipped. For example, at a fast-food chain that specializes in chicken, it's "chicken efficiency." Every restaurant manager and employee knows that chicken efficiency is the most important of all measures. Managers put together graphs to illustrate their chicken efficiency levels to their bosses each month.

Chicken efficiency is a scrap measure. It is a ratio of how many pieces of chicken are sold to how many are thrown away. This fast-food chain has very strict quality standards on how long the chicken can sit under the heat lamps before it has to be thrown away. What performance is this chicken efficiency measure going to drive? A manager explained it this way:

Don't Cook the Chicken!

If I want to look good on my chicken efficiency numbers, all I have to do is one thing: don't cook any chicken. If I cook it and I don't sell it, I might have to throw it away, which messes up my chicken efficiency numbers. If I don't cook it, the customer has to wait about 20 minutes, but very few get mad enough to leave without their chicken.

Here is the scenario that results from this procedure: A customer enters this establishment and orders a couple of chickens. Most likely, they won't be ready and he will have to wait. He might get angry and never return to this establishment even though he loves its chicken. Although the company has effective measures of chicken efficiency, it does not have a method for measuring lost customers. The point is that the chicken efficiency measure drives performances that causes dissatisfied customers. By selecting the wrong measure on which to focus, the company promotes poor service to its companies.

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But They Are Nice!

MEASURES OF COURTESY VERSUS COMPETENCE

A related type of problem is organizations that choose to focus on measures of courtesy versus competence. We encounter this all the time in service organizations. For example, an airline's schedules are always delayed, but the flight attendants always remember to stand by the door and smile and say "good-bye" to us as passengers walk off the plane an hour late again.

Examples of nice but incompetent people can be found in every profession. Sometimes the things that organizations choose to measure drive this nice but incompetent performance. A supermarket in Detroit measured its checkout clerks on whether they told customers to "Have a nice day" as they handed the customers their receipts. They even put in an incentive program to encourage clerks to tell every customers to have a nice day. They kept this up until they did a little research that told them that over half the customers didn't even notice whether or not they were told to have a nice day; many of the other customers said they hated hearing the phrase.

Or, "Can we help you to your car with that?"

Sales

Nordstrom, believed to be the department store with the highest caliber of service, does not measure smiles or how quickly the salespersons greet customers, or what they say. Rather than training its people to be service robots, it encourages each individual to use a style they are comfortable with in dealing with customers. However, Nordstrom's most-important measure is sales. If you work at Nordstrom and you do not sell, you're gone, no matter how nice you are to customers. Nordstrom does focus on courtesy and does train its employees, but it measures them on what really matters: sales and repeat business from the same customers.

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Internal Audit Feedback Survey

1. Opening conference was held and all questions/comments were adequately addressed.
2. The final audit objectives and scope were agreed to.
3. The audit was completed within the timeframe communicated.
4. The audit was conducted in a professional and courteous manner.
5. The audit team kept you informed of key issues throughout the audit
6. The closing conference allowed both sides to adequately discuss and address all comments.
7. The audit report was accurate and findings clearly communicated.
8. The audit report fairly reflected your team's comments and corrective action.

- Give out at START of the audit, to use as a "contract" for doing audit
- Get "many" back at end of audit

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Just One More Thing…

- Consider doing an audit of Audit.

- Use your normal audit approach and techniques on the audit department or the audit process.

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