Internal audit functions need to improve the way they measure and demonstrate their value. Numbers alone are not enough, says Sir Andrew Likierman of the London Business School, who offers some suggestions.

"The Institute guidance raised the bar for good performance significantly"
with the power to make a tangible contribution to the stewardship, efficiency and profitability of the organisation...” This rightly signals that meeting minimum specifications is necessary but not sufficient, and that performing well cannot be defined in terms of satisfactory processes alone, particularly if the Institute’s aspirations are to be met.

Doing so will rely on perceptions which are not always easy to capture. Questions about performance are certainly a useful means for audit committees to think about the issues, but they do not provide a basis of assessment. For example “Is the internal audit function proficient at communicating the results of its findings?” could give the gut-feel response “Yes” but the answer would probably rely on an unstated and untested measure.

I would like to set out four ways of improving measurement by building on existing professional work. But first, two caveats are necessary: the suggestions are related to the private sector, though public sector bodies may find aspects useful; and there are, of course, significant variations between companies in terms of size and sector. My suggestions, therefore, need to be adapted as necessary.

1. Ensure the assurance requirement matches organisational objectives:

The primary role of internal audit is to provide assurance to the board, audit committee and management. But is there a common view about assurance and what providing it means? As many internal auditors know only too well, the view of the board and management more generally is often uninformed. Do they really know about the trade-offs involved? In practice, interpreting how the process of providing assurance is to be...
measured (and therefore the performance of internal audit) in practice rests largely with the audit committee.

The audit committee’s role in this respect is certainly not straightforward. The ICAEW guidance suggests that the audit committee’s report to the board should include statements about internal audit’s “responsiveness” and “effectiveness.” A joint IIA and Deloitte study – The value agenda: Understanding, measuring and improving the value delivered by internal audit – notes that board directors and internal audit agree that the two most important ways that internal audit add value is through assurance that risks are being managed “appropriately” and the risk management and internal control framework is operating “effectively”.

These are not precise terms and it is therefore all the more important that the audit committee agree their meaning with internal audit and communicate this to the board. The audit committee must also be prepared to make judgements about whether they are being met in relation to the specific needs of the organisation without being able to rely on cut-and-dried general definitions. Setting out annual objectives, together with relevant performance measures, will be essential here, including consideration of whether internal audit should focus on improving processes and indeed going further into any consultancy-type role.

2. Improve the sophistication of the measures:

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As already noted, the move from activity and cost measures has already gone a long way in best-practice internal audit environments. Measures are increasingly focussed on outputs and outcomes, including the risk agenda and customer responses.

This process needs to be pushed further to ensure that the measures properly reflect performance, including such matters as identifying surprises in relation to the risk framework and improvements driven. Equally, thinking on setting targets needs sharpening to make sure that measurement is against carefully considered objectives. Risks and trade-offs (not least on a shared understanding of the role of internal audit in adding value) should form a central part of the discussion.

A balanced scorecard may be worth considering as a means of gathering measures into a single framework (examples can be found in A balanced scorecard framework for internal auditing departments, published by the Global IIA Research Foundation in 2002). But their relative importance still needs to be considered, and auditors should beware the most common problem with scorecards – too many measures.

Greater sophistication also means comparing performance against others wherever possible. A balanced scorecard may be worth considering as a means of gathering measures into a single framework (examples can be found in A balanced scorecard framework for internal auditing departments, published by the Global IIA Research Foundation in 2002). But their relative importance still needs to be considered, and auditors should beware the most common problem with scorecards – too many measures.

This is unlikely to involve straight comparisons by benchmarking the function as a whole, since few companies have a sufficient number of truly similar comparators. If overall benchmarking is possible, it will be very useful as long as interpretation of the results doesn’t get bogged down in arguments about whether comparisons are justified.

In practice it may well be better to compare individual elements of the internal audit process, such as quality measurement or follow-up to recommendations. Disaggregated comparisons of this kind can draw in a far wider range of companies, since they do not have to cover the same industry. It is also worth considering comparisons with the relevant parts of other functions in the organisation. The information technology function may well have similar issues on client management and the research and development department could also be grappling with similar issues of senior managers’ ability to make informed judgements.

Proper comparisons help to frame a number of key questions, such as what is not in the audit plan. At a deeper level, they enable the function to meet high absolute standards, rather than the possibly limited organisational aims. So wider experience is crucial to this process. The
external auditors and hopefully at least some audit committee members will have experience of internal audit in other organisations. As much use as possible should be made of it.

3. Improve feedback to and from the function: Paradoxically, ignorance about internal audit may help to make the value case. Expectations may well be low, giving opportunities – which must be taken – to inform senior management. The danger is that internal audit will talk largely to those already well informed. Others in key positions must know enough to be able to give proper feedback and internal auditors need to get out to discuss internal audit matters with a wide range of management.

Good feedback to the function means a great deal more than sending out a questionnaire after each audit or on an annual basis. If most managers do not know what to expect from internal audit, they will not know what to ask for. Few know enough to be able to answer questions about whether internal audit is tackling urgent issues, whether the internal control framework is operating effectively or even whether the reports are “good.” What’s more, managers’ judgements could well be coloured by defensive feelings about internal audit, so that they are “too busy” to send feedback conventional satisfaction questionnaires. Any answers may be ill-informed, political or perfunctory and the messages a confusing mixture of complacency, indifference and even hostility.

So questionnaires need to be very carefully constructed to get useful comment. Questions should probe the realities. “How confident are you that internal audit provides you with assurance on risks?” on a five-point scale from “Very” to “Not at all” does not assume technical knowledge and should get more valuable feedback than asking senior managers to rate their “satisfaction” with the function.

Face-to-face feedback after each assignment and by the head of internal audit on a periodic basis will be an important way for getting a further feel for issues. Board and audit committee meetings are themselves opportunities to explain how the function can add value. This is particularly important if the audit committee is not well-informed. The annual budget cycle and the personal appraisal of the head of internal audit provide further opportunities for feedback in both directions.

4. Acknowledge the limitations of the measures: However clearly defined the objectives, however sophisticated the measures, and despite best efforts with comparisons, numbers alone cannot tell the whole story behind internal
audit’s performance. The difficulty of finding a combination of suitable measures to encapsulate success, of clearly identifying outcomes and of linking action to result are only some of the reasons. These are common to most internal service functions and judgement will be involved in many – probably most – of the measures chosen, especially on quality. A commentary is therefore essential.

For example, since all recommendations are not of equal weight, the percentage implemented has to be put in context and possibly categorised further – just adding up the numbers gives little feel for the substance of internal audit’s work. Even more important, a commentary will help avoid perverse incentives, such as pressure to complete audits by compromising quality in order to improve the “Percentage of audits completed on time” measure.

Some elements of performance will rely entirely on a commentary. Relationships with external auditors, the approach to parts of the risk agenda and managing distance from senior executives are only some of the areas where a qualitative approach is appropriate. Reducing these to numbers makes a mockery of the measurement process. Finally, of course it would be desirable to have a number to show value added by the function. But even if we could, the key comparator – what might have happened if the internal audit function had not existed – remains a matter of judgement.

The commentary is essential, too, in giving weight on what isn’t happening. Problems averted are less easy to identify than those which occur, and the risk framework must to some extent be judged on omissions and risks averted. These less tangible elements can then be taken up in more detail in the head of internal audit’s annual report to the audit committee.

Great strides have been made in recent years to improve performance measurement for internal audit. But more needs to be done to provide a better understanding of how well the function is doing.

Poor measurement means that internal audit will almost certainly be operating below its potential and will not be able to meet the Institute’s aspirations for influence and added value. Better measures improve the function’s ability to make key choices and are a crucial means of delivering professional excellence.

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