

Internal Audit Leads the Way to Performance Improvement

A White Paper by Patrick D. Warren, James Hannan, and Craig P. Youngberg

The new internal audit model, as outlined in “A New Decade, a New Internal Audit Model,”¹ leverages existing activities to continuously monitor, manage, and improve business performance based on four key auditing principles: assurance,² performance improvement, compliance, and risk identification. This white paper addresses internal audit’s role in improving business performance over the next decade.³



Organizations today are being called upon to do more with less. Intense economic pressures demand that companies constantly reinvent the way business is done to meet the challenges of a rapidly changing marketplace and regulatory environment. The internal audit function is not immune from these pressures and must find innovative means to help their organizations succeed.

High performance is not an accident. It is the result of continuous, sustained efforts at improvement. Auditors can contribute to this improvement process by integrating performance improvement audits into the audit approach.

In the past, auditors have identified problems but might not have taken the extra step to elevate performance and recommend ways to improve the underlying business practices. The goal of improvement audits is not only to root out inefficient processes and procedures but also to recommend ways to improve business practices in order to help the organization achieve desired results. Even a quick assessment of performance measures as part of a regularly scheduled compliance, financial, or risk-based audit can yield great benefits to the company for relatively modest effort, while providing an opportunity for the audit team to enhance its knowledge of the business.

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Exhibit 1: The Four Principles of the New Internal Audit Model



Trends

Internal audit departments are actively shifting their resource mix to help their organizations achieve improved performance. Crowe Horwath LLP and The Institute of Internal Auditors (IIA) recently completed a survey (“Crowe/IIA survey”) of IA executives among IIA membership to help identify drivers of the change and where departments are allocating their resources.⁴ The results of the survey show a gradual shift in audit focus to more value-driven performance improvement activities.

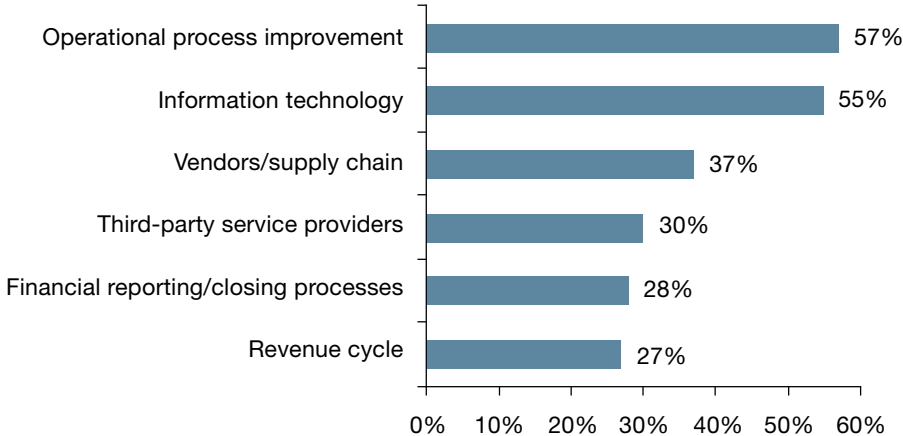
On average, companies are increasing hours dedicated to internal audit; however, where the audit department is allocating those hours is shifting. Audit executives said that hours spent on financial auditing rose slightly from 2008 to 2011, while hours dedicated to compliance with the *Sarbanes-Oxley Act* (SOX) decreased and time spent on general compliance activities remained steady.

Notably, internal audit has been dedicating more time to operations. About 52 percent of audit executives in the survey said they spent more than a quarter of their time working on operational audit issues in 2008. By 2011, that number had increased to 61 percent of the survey respondents. This shift in focus indicates a larger movement toward operational efficiency and improvement efforts from the audit department.

More than half of the audit executives surveyed said they are focusing improvement audit efforts on evaluating IT and business operations, two areas in which inefficiencies are common. Less than one in three of the respondents said they are looking at the revenue cycle or third-party service providers (Exhibit 2).

Exhibit 2: Audit’s Shifting Focus

On what areas of the business will you increase your focus for operational/business process improvement audits in 2011 and 2012?



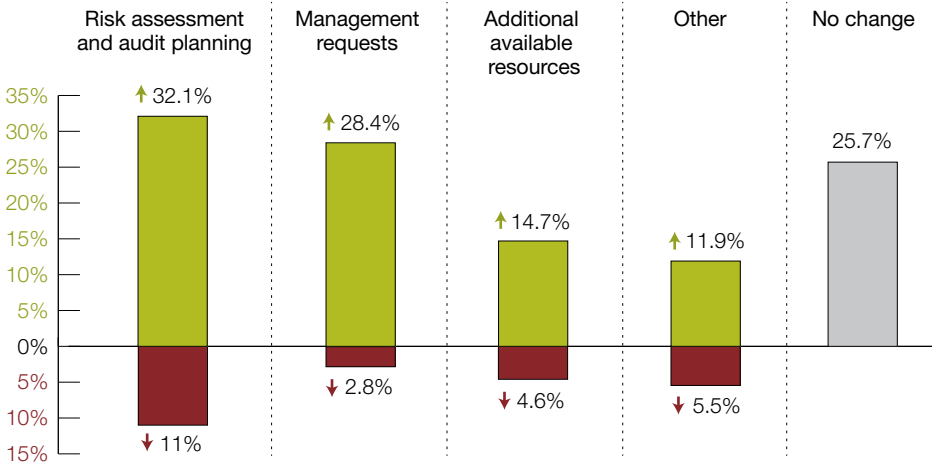
Source: Crowe/IIA survey



Risk assessments and management requests were the primary drivers of the resource shift (Exhibit 3). Thirty-two percent of the organizations surveyed increased their business improvement hours as a result of changes to risk assessment or audit planning efforts; 28 percent cited management requests as the impetus to increasing their business improvement efforts. Of the executives who have increased performance improvement activities, six in 10 said they have done so due to management requests or changes to risk assessment or audit planning efforts. Others noted that a reduction in SOX efforts freed up resources to be redirected toward operational activities for business improvements.

Exhibit 3: Drivers of Changes to Improvement Hours

Why have the hours allocated to business process improvement audits changed between 2008 and 2011?



Source: Crowe/IIA survey

Challenges

Internal audit efforts to help organizations improve performance face a number of challenges, including:

Narrow Audit Skill Set and Focus

Finding auditors with the right skills and capacity to broaden the scope of internal audit to address performance under the new internal audit model might be challenging. Over the past decade, the demands of complying with SOX legislation have narrowed the skill set and focus of many audit functions. The capacity of internal audit teams has been further curtailed by aggressive cost reduction efforts stemming from the economic slowdown of the past several years. As a result, many auditors are finding that their operational and business process knowledge is stale or, worse yet, lost. Others are finding that they lack the expertise to audit specialized business areas, particularly in IT.

Vague Value Proposition

Return on investment is a common measure used to justify investing in new activities. Quantifying the return on investment that management can expect from increasing improvement audit activities can be problematic, though, because process improvements often lead to a reallocation rather than a reduction in resources. For example, if the accounting group closes the books in three instead of four days, the faster turnaround itself may not affect the overall head count and group expenses; however, it might provide intangible value by enabling the group to take on projects or tasks that otherwise may have gone unaddressed.

Management Skepticism/Resistance

Because performance improvement might be a new area of focus for many auditors, management and business process owners who are more accustomed to audit playing a compliance or financial controls role initially might be skeptical about audit's ability to contribute real value in this area.

Management and business process owners might initially be skeptical about internal audit's role in improving business performance.

Gaps

In adopting a new process for improvement audits, auditors who focus on building credibility and obtaining buy-in from the stakeholders – management, the board, and process owners – at the outset are more likely to avoid common pitfalls that can diminish the effectiveness of the audits.

Build Credibility

Internal audit must look for opportunities to share the breadth of its talent and capabilities for performance improvements in small ways and develop a track record of success that stakeholders can trust. In addition, reports that highlight the root cause of an issue have the best chance of providing sufficient justification for change that improves performance and adds organizational value.



Obtain Buy-In

Stakeholders want to see potential results before they agree to change. Internal audit must prove the business case for allocating resources to improvement audits. In addition, stakeholders' commitment to change rises when they are part of the solution, such as when audit and management work together to address deficiencies and implement recommendations resulting from improvement audits. Such collaborative work also fosters trust that can yield new opportunities to improve the business.

Solutions

Crowe® internal audit stakeholder research shows that management¹, CFOs, and the audit committee want more value from their internal audit functions. Implementing a process to audit for performance improvements can lead to more successful business practices and add the type of value that stakeholders are looking for.

"There is no sense in being best of breed for areas that are not mission-critical."

– Respondent to the Crowe/IIA survey

Improvement audits can be completed as stand-alone audits for underperforming areas or simply as part of regularly scheduled audits. Particular attention should be paid to common areas in which inefficiencies or poorly designed processes do not deliver the desired results – when data is manipulated, process ownership is diffused, or new processes or systems are installed.

Auditors who include the following six activities in improvement audits can make great strides toward optimizing performance results.

1. Focus on Strategy and Risk

Auditors should evaluate key strategic and risk-based areas of focus for peak performance on a continuous basis. If, for example, accounts payable internal controls over financial reporting are being audited, as part of their regularly scheduled audit work, auditors can take some additional steps. Internal audit can identify performance measures and use them to evaluate the effectiveness of improvement processes and procedures.

Auditors who plan improvement audits with the strategic goals and risks of the company in mind will add value where it is needed most. If a company's biggest risk is improving profitability, internal audit can contribute to strategic goals by identifying performance improvements that focus on reducing costs and increasing revenue. If a strategic objective is to increase revenue by 10 percent in the next two years, then audit might look closely for inefficiencies in the revenue cycle. If high costs at a company relative to the competition result in a new goal – say, to reduce enterprisewide expenses by 5 percent in the next 12 months – then audit might closely examine significant types of costs across business units to either find areas for improvement or validate the results already achieved by management.

2. Test Existing Metrics

Testing metrics is a two-step process: identify metrics that process owners are tracking to meet operating goals, and identify those metrics that might be overlooked. More progressive audit departments already test metrics for performance improvements. Where metrics are not being tracked in the organization, some audit departments are taking on the task of calculating key metrics and leaving behind the framework for process owners to continuously monitor and report these metrics to management.

Auditors can add value by reporting to stakeholders the answers to the following questions.

Are performance measures in place?

Auditors serve as a catalyst for change when they help management identify better ways to measure performance. Such data can be persuasive in performance improvement efforts and in establishing the auditors' credibility as performance improvement champions. Auditors can rely on monitoring metrics and reporting – both financial and operational – to identify the performance measures that are in place.

Are measures focused on factors that are aligned with strategic goals?

Auditors can improve the value of their audit results by evaluating whether the objectives and actions of business functions adequately relate to the strategic objectives of the organization.

How are performance measures used and reported?

Auditors who verify that performance information is used effectively help management sharpen its focus and evaluate the monitoring process.

Are performance measures accurate?

Auditors play an essential role in verifying that reported performance reflects reality by testing the accuracy of underlying data as well as the methodology and calculations behind performance metrics. Often, the independent perspective of audit on existing measures provides insights that lead to improvement.

Are incentive programs aligned with performance measures?

Auditors bring the various silos often found in organizations together when they reconcile performance measures to financial or operational incentives.

Companies Large and Small

The Crowe/IIA survey indicated that companies with more than \$100 million in revenue are more likely to audit performance measures than smaller companies are, but small companies tend to include benchmarking more often in their audits than large companies do.

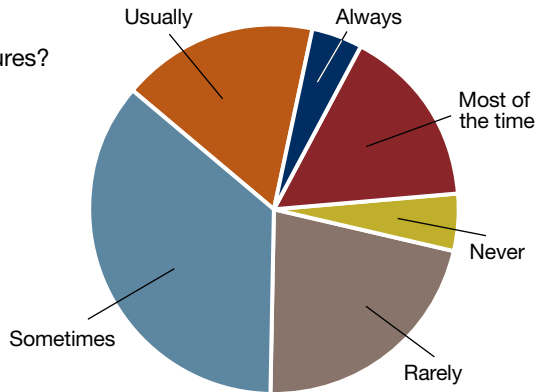
3. Rate Performance Metrics

For areas in which performance is measured, auditors can use existing performance metrics to rate results relative to comparative data, such as benchmarks and best practices (Exhibit 4) and internal standards. This analysis might isolate areas where company performance is lagging or identify better ways to perform tasks through the experience of other companies. With this information, auditors are better able to articulate how processes can be improved to take performance to the next level.

Exhibit 4: Benchmarking and Best Practices in the Audit

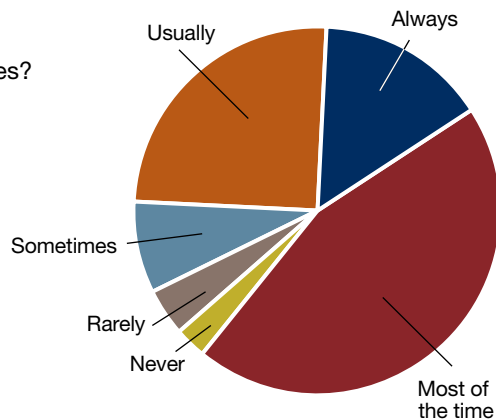
How frequently do you incorporate benchmarking in your audit procedures?

- Always (100% of the time)
- Most of the time (75% – 99%)
- Never (0% of the time)
- Rarely (1% – 24%)
- Sometimes (25% – 49%)
- Usually (50% – 74%)



How frequently do you incorporate best practices in your audit procedures?

- Always (100% of the time)
- Most of the time (75% – 99%)
- Never (0% of the time)
- Rarely (1% – 24%)
- Sometimes (25% – 49%)
- Usually (50% – 74%)



Source: Crowe/IIA survey



Effective Recommendations Bring Real Change

An improvement audit can result in real, measurable change in the organization if its recommendations are effective – that is, if the root cause of the performance issue has been identified, if management has been involved in identifying that cause and developing corrective action, and if the recommendations are practical and actionable.

Comparative data is not always readily available due to differences in the size, sophistication, and industry of various businesses. Many internal audit departments have led the way by instituting a system or process to capture internal and external data for comparison purposes. Auditors also look to a variety of sources for comparative data. According to the Crowe/IIA survey, most chief audit executives – 78 percent – have relied on industry or trade association reports or analyses to gather best-practices data during the past 12 months. Other best-practices sources include a personal network of outside contacts, the Internet, and magazines and other publications. Performance comparisons in areas that contribute directly to an organization's strategic objectives are the most useful. As one surveyed audit executive noted, "There is no sense in being best of breed for areas that are not mission-critical."

4. Audit the Performance Improvement Process

Auditors contribute to the improvement process by evaluating how the organization goes about improving its performance. Does the organization have a process to measure and evaluate results, analyze the root cause, and implement corrective action? If so, is it followed rigorously and does it produce results?

5. Seek Subject-Matter Expertise

Few audit departments have the breadth of expertise to address all key functions within an organization. Across all industry sectors, leading organizations are using a diverse team of resources to add value to their audit processes. Auditors are enhancing department capabilities with subject-matter experts from within the company and outside the organization. The use of objective and unbiased institutional talent or external experts can help focus the audit on critical issues, shorten audit cycle times, and grant auditors instant credibility.

6. Report Results

An audit report that includes recommendations for performance improvements can serve as the catalyst for positive change throughout the organization and set a tone for value-added efforts in the audit department. As auditors strive to bring new ideas to their constituents, they must look for ways to highlight the payoff from resources expended on performance improvement projects.

Conclusion

The internal audit function can adapt to a new decade of value-driven activity with improvement audits geared toward helping the company perform at its peak level and in a way that is consistent with the core objectives and risk environment of the organization. In doing so, auditors are partnering with management and business process owners in new ways that drive excellence and continue to move internal audit up the value chain.

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- ¹ Lawrence A. Rieger and Rick Julien, "A New Decade, a New Internal Audit Model," a Crowe white paper, 2010; www.crowehorwath.com/folio-pdf/Internal-Audit-Model-RISK9122.pdf
 - ² William C. Watts and R. Michael Varney, "Six Steps to Systemic Assurance That Increase the Value of Internal Audit," a Crowe white paper, January 2011; www.crowehorwath.com/folio-pdf/RISK11907_IAModelAssuranceWP_lo.pdf
 - ³ Crowe white papers addressing the two remaining principles – compliance and risk identification – are forthcoming.
 - ⁴ The Crowe/IIA survey was sent to audit executives via IIA's Global Audit Information Network on Jan. 19, 2011, and remained open through Jan. 30, 2011. There were 109 completed surveys. The complete survey results are available only to subscribers of the IIA Audit Executive Center.