

Is your internal audit function effective?

Introduction

The recently revised Combined Code suggests that Audit Committees should review and monitor the effectiveness of their organisation's Internal Audit function. The ICAEW has recently issued a publication (I was a member of the working party that wrote this document) entitled 'Evaluating the Effectiveness of your Internal Audit function'.

In the same way that Internal Audit carry out reviews on different parts of the organisation for whom they work, it is right that they should also be reviewed on a regular basis. Yet we seem to have confusion about what should be included as part of such a review and, indeed, about basic issues such as the role of Internal Audit and who are their primary customers.

Adding value vs measuring performance

There is much talk within the Internal Audit community about 'adding value' and 'measuring performance' and I have already written a couple of articles covering these areas. Many people seem to think that they are the same thing but the purpose of this article is to demonstrate that this is not the case. This article aims to look at why 'adding value' should not be seen to be a core role of Internal Audit.

The role of Internal Audit has developed and changed over the last decade. It has moved from being a compliance or 'policeman' role, through to more of a consultancy role and is now, I suggest, struggling to understand the role that it should be playing.

In January 2003, Cynthia Cooper and her Internal Audit team at WorldCom were being heralded as full of integrity for the role they played in uncovering the extent of the issues at WorldCom. Indeed Ms Cooper was jointly awarded the Time Magazine 'person of the year award' for the role that she and her team played. Interestingly, the other two recipients of the award could also be described as whistleblowers.

Why then in the summer of this year was Ms Cooper and her team so vilified when the Bankruptcy Court of New York issued a second report into WorldCom? It was largely because the WorldCom Internal Audit team were believed to be too obsessed on adding value to the organisation and through this approach to their work, being apparently too close to management. I'm sure that the relationship between Internal Audit and management was as it was for all the right reasons i.e. focus on 'adding value' and then we may get the resources we need which will enable us to do all of the additional assurance work that we should be doing.

I wonder whether the revised IIA definition of Internal Auditing focusing on consultancy and adding value has led other auditors to fall into the same trap?

As a Head of Internal Audit said to me recently: 'Internal Audit is not about adding value, it's about giving value through the work they do to both their primary and secondary customers. Adding value is something that operational managers within the organisation should be striving to achieve, not Internal Audit.'

Responsibilities and accountabilities

It is also important to appreciate that managers are responsible for risk management and internal control – not Internal Audit. Internal Audit should be testing the extent to which management discharge this role by asking questions such as: 'How do you as a manager

assure yourself that risks within your part of the business are being managed to an acceptable level?’

If, when asked this question, managers are able to demonstrate that they do understand their role in risk and control and are able to describe and support the monitoring processes they have in place to do this, then I would suggest that the role of Internal Audit should simply be to validate that they do what they say they do rather than to themselves carry out detailed control testing. Maybe the role of Internal Audit is to test the monitoring process rather than to test the detailed controls themselves?

The Audit Committee role in assessing effectiveness

As well as doing what I do as a consultant, I am also a member of the Audit Committee of a major UK charity. My definite view as an Audit Committee member is that we are the primary customers of Internal Audit and that therefore their key role is to provide us with assurance. If they have any time left over after providing us with this assurance then I am happy for them to focus on consultancy and value from a management perspective. But to me that is very much a secondary role.

As an Audit Committee we have a key role in assessing the effectiveness of Internal Audit. We will do this in terms of the assurance they provide to us rather than as a result of how happy management are with the work they do and the role they perform. In particular, in our annual review of their effectiveness, we will focus on the following areas:

1. The assurance they have provided to us on the effectiveness and operation of the governance, risk management and internal control framework within the organisation.
2. The assurance they have provided to us on the extent to which the significant risks within the organisation are being managed to an acceptable level.

This review will focus on areas including, but not limited to:

- The role of Internal Audit within the organisation
- The status and profile of Internal Audit within the organisation
- The relationship that Internal Audit have with us, the Audit Committee
- The extent to which Internal Audit provide us with the assurance that we need to express an opinion to the Board on governance, risk management and control within the organisation
- Whether Internal Audit have the necessary resources to achieve what they should be achieving
- The extent to which Internal Audit provide a professional service within the organisation.

As part of this annual review we may choose to speak with management and gain their views on the role that Internal Audit plays and the interactions that they, as management, have with Internal Audit. However, I very much see this as a side issue rather than a critical issue.

Conclusion

Going forward, Internal Auditors need to understand who their primary customers are and to focus on providing the assurance required by these key customers. They should be talking about giving rather than adding value and should appreciate that measuring their performance is about their efficiency and effectiveness in providing the assurance they are asked for.