

INTERNAL AUDITING VALUE ADDED CONCEPT

Ph.D. **Marin POPESCU**
E-mail: marin.popescu@senat.ro
„Athenaeum” University
Bucharest

Ph.D. **Emilia VASILE**
E-mail: rector@univath.ro
„Athenaeum” University
Bucharest

Abstract:

The analysis showed that no risk management process is perfect for identifying all failures and in order to avoid them, the managers must take into consideration the recommendations of the internal auditors.

Key words: internal audit, value added, manager, internal control, auditing committee

JEL classification: M12, M42, P17, P35, P2

1. Value added concept

IIA standards used the value added term in developing the concept on internal audit. However, there are lots of debates on the ways to assess value. Analyzing these production processes it is much easier to establish the added value, as in this case the value is obvious most of the time.

In case of internal audit it is difficult to quantify work on added value to the audited organization. Of course, *one can consider added value: the change of mentality of the audited, recommendation on the assessment of risks and reorganizing the managerial control system, but these are hard if not impossible to quantify.*

Most of the managers are waiting for support in their decision-making process, from the conclusions and recommendation given by the internal auditing, which is an effective aid compelling the auditing service to become a more and more valuable service to management.

Services granted by the internal auditing structure imply either advising management to make things better, or providing operability to the internal control system, and eventually the manager is liable for his/her decisions.

Generally, internal audit is implemented by using internationally recognized internal audit standards. In Romania there is a legal, normative and procedure framework in full progress, and the internal audit standards become a practice for most of organizations.

IIA standards are the only to be recognized and accepted for the internal auditing on international level and they provide the necessary framework to guarantee enforcing the best practices in this field.

The auditing capital gain is not only its report and neither its recommendation and conclusions, which in fact are means of communication to the audited managerial entity.

The internal audit value is represented by its capacity to improve the internal control system of the organization.

At the same time, the internal auditor is the promoter of the added value through the savings generated by it, through the opportunities created, through the losses which can be avoided due to its actions, but also a factor ensuring transparency in the organization's activities; it contributes to make organization's policies more efficient.

Reaching the above-mentioned objectives, which are in front of internal auditing, is based on risk management and analyses, representing a major concern for general management too.

Managers agree that creating and promoting an awareness culture on risks within organizations represents a priority.

However, the people in charge with the internal audit consider that managers do not pay enough attention to assessing their own risks that they are facing, and that they make no priority out of training specialists in this respect.

The leadership activity is still empiric, without taking into account the recommendation of the auditors and the good practice recognized in this field. Internal auditors feel a modification in the organizational culture regarding the risk assessment, but they are not optimistic in the respect of improving managers' attitude in real time.

The culture to acknowledge risks, so that every employee within organization to play a certain role in the risk management, is not really taken seriously; this is why most of organizations granted too little attention to creating certain systems to identify potential risks in an incipient stage by building up an early warning system on the risk tendencies.

Practice clearly proved that no risk managing process is perfect to identify all flaws and to avoid possible "surprises".

Generally, when analyzing the significant financial fails, most managers stressed as causes the following:

- *Lack of conformity to internal policies and procedures;*
- *Risks unidentified in due time;*
- *Risks identified, but that were considered as being improbable to happen, and which had major influence on the following period of time;*
- *Weakness of the internal control system etc.*

The above-presented findings led to a series of unfavorable considerations , such as:

- The fact that the internal policies and procedures were not observed means that management failed in fulfilling efficiently one of its fundamental roles;

- Not identifying risks or wrong consideration that the identified risks are improbable to happen proves not granting the necessary attention to this activity;
- Not updating systematically the risk analysis and not being concerned with determining line managers and the other employees to draw their own attribution, on the background of the existing risks, contributes to appearing weaknesses in the internal control system of the organization.

In this situation, internal auditors have to step in to make managers more aware. Thus, it is necessary that directors understand the audit recommendations and the fact that these have to be put into practice in order to avoid more the eventual risks.

Providing a risk management system and an efficient internal control system implementation is probably the biggest challenge to managers; internal audits are called to play a major part in this.

The good international practice in this field and the part of the audit committee, where it exists, in monitoring management performance considers that *directors and internal auditors working together to assess specific risks for an organization, and to reorganize the managerial control system will be able to get a larger added value from the internal audit structure.*

After the last years' big financial scandal in the USA, the debate on corporative government that followed came to the conclusion that the role of the audit committee is still not enough felt.

*In Great Britain and Northern Ireland this debate finalized until now though a report, paid by the government, on the role which the auditing committee has to play in good governing; it was published under the name of **Smith Report**, and it will probably have an important effect on the working manner of the internal audit committees in monitoring efficiency of internal audit.*

Excerpts from Smith Report:

- In the practical activity of the internal auditors there is a major concern that they can be involved in insuring on the big risks of businesses, and at the same time, not to have access or have restricted access to all pieces of information relevant to allow them developing and providing insurance.

- Generally, directors and heads of internal audit are in a large consensus on how and where the internal audit provides values, which is making sure whether the most important risks to the business (taking into account the fact that administrating a public institution has to be treated as a "business" which is profitably) are well managed and the general framework is efficiently operating.

- Out of this practice, it is obvious that while directors wish the internal audit to provide insurance on risks extended to the general framework of internal control, the heads of internal audit compartments would like to play a more important part through the consulting which they can give, through sharing the best practices.

Directors do not feel these “other activities” of internal auditor are so important, therefore in future, *internal auditors should seek ways to convince the managerial body that advising activities can produce value.*

- Audit committees, which play the role of checking and *monitoring efficiency of internal audit*, should find ways to quantify its value through *adopting a more rigorous approach way to performance*. Thus, there is the opportunity for internal audit to suggest alternative methods to measure performance which could be more useful.

- *Internal auditors need a good understanding* in order to be able to monitor situation in time and notice whether *the role of internal auditing needs in its turn to be changed*. Internal auditing helps identifying new risks which managers might face, but responsibility to identify risks belongs to managers.

- Audit committees have to make sure that *internal auditing has the necessary resources and access to information to allow fulfilling their mandate*, and also make sure that they are equipped to operate in conformity to professional standards and their own standards.

- *Internal auditors have to be permanently concerned with providing higher value to the managers not only in the respect of resource solicitation.*

- *Directors consider that internal auditors have to develop skills by improving quality of people and concerns of being in touch with changes*, enlarging scope and deepening their abilities, in the respect of the entire way of operating and in their relation to every individual auditor.

We consider that many aspects aimed at by *Smith Report* will soon be current concerns for managers and internal auditors of the Romanian organizations.

2. Quantifying added value of internal auditing

The ENRON and WORLD COM cases in the USA, and other financial scandals in the world put higher pressures on the internal auditing in order to provide to the managerial body a better assessment of the general framework of internal control so that to reduce organizations' risks.

The value which the internal auditing function adds to the organizations implies concrete ways and criteria of measuring this.

In this respect, **the heads of internal auditing departments** assess the value provided by organizations, according to *a series of indicators* which, however, do not give an objective measure to the value of the internal auditing function, as follows:

- “*The general respect*” to internal auditing department manifested within the organization;
- The quality of finding out and recommendations forwarded to managers;
- Making up high quality reports, and delivering them in due time;
- Presenting reports to the management board or to the auditing committee;

- Attending the auditing committee meetings or those of the management boarder;
- *Proving the value "right away", all the time;*
- Pursuing the opportunities to satisfy customers and beneficiaries;
- *Higher savings and efficiency produced by the findings of the internal auditing*, which are considered a pay in advance for the production costs;
- The number of letters received from other compartments of organization for the internal audit contributions in the business projects etc.

The above mentioned findings raise several important questions, which we will have to be given proper answers in time, as follows:

- *Is internal auditing doing the right job?*
- *Is internal auditing providing value?*
- *How can the internal auditing prove its value to the business?*
- *How can the internal auditing convince us they improved their activity?*

Recent modification to the concept of corporative governance in USA, Great Britain, Canada, etc. aim at improving the role of the non-executive directors and of the auditing committee. Thus, there will be higher pressures on the internal auditing to make sure in face of the managerial-body and to prove that the internal auditing function provides value. The non-executive directos are more exigents, as they are not directly involved, especially in case of the companies not included by the stock exchange.

Strict rules of corporative governance imposed by *Sarbanes & Oxley Ammendment* requires higher responsibility of the managerial-body to provide precise financial reports of the organization. This means that internal auditors will be under higher pressures to provide due reliability on the financial reports presented to the managerial-body.

The new situation will impose that organization re-analyzes effieency of internal auditing department and to make sure that these are equipped the right way to fulfil tasks. This implies that internal auditing department has to establish performance measure systems to prove they develop specific activities the proper way.

Internal auditors have to keep *evidence of concrete savings* produced by their work. For instance, if the internal auditors find out a double payment or even a fraud, and then they take measures to recover the respective funds by the managerial-body, this is a concrete aid for the organization, and it is a clear sign to prove that the internal audit function adds value. It is also important for internal auditors to prove that they create "*financial value*" and not only "*insurance*", as it is very difficult to assess the insurance in concrete currency.

Internal auditors can also check and count the financial beneficies produced by line managers that are making changes to the processes of the organization as a result of the recommendations made by the internal audit department. The

procedure changes implemented by the line managers, and recommended by the internal audit, such as: updating certain internal control activities, revising and improving working procedures, proposals of lowering expenses and personnel, changing suppliers etc. can allow internal auditors require other cost lowering resulted as a consequence of their own program of added value.

At the same time, *the value of the internal auditing can be measured in a way that can be proved through the assessment of what the financial impact would be on the organization in the future*, if, as a result of the internal audit, the internal control or processes were modified or improved in a certain period of time. The implementation cost of the new control activities can be proved to be lower than before applying the respective changes in the difference of costs. For instance, if the internal auditors suggest changes on the way in which the purchasing processes to be led in order to improve control in progress, the function can look for the potential difference in the saving of costs, in a projected period of one year, reporting to the managerial-body they will lower purchase costs by the amount coming out of the calculations, which is, for instance, by 25%.

In order to measure the value which the internal audit function adds to the organization there are other instruments available.

Many organizations of the entire world used versions of the Synoptic score table, proposed by TARLOK TEJI, a partner of DELOITTE & TOUCHE¹ Company, as a method to measure the performance of the organizations' internal auditing departments. This approach allows aligning to measuring performance in comparison to the target of the organization, through the strategic performance management.

Using the Synoptic score table, the internal audit department delimits the main fields where it can bring supplementary value (benefits) to the organization. This could include the impact of the function on the financial performance of the organization, focussed on the customer, and the recommendations made to the line managers who order improving business.

The internal auditing department, after consulting the auditing committee, defines the main aims for each of these fields to add value to, and establishes the targets and the way of improving these. For instance, if one of the key-objectives of the organization is how that purpose can be reached the best – by lowering time of cashing, by reducing the number of complaints from customers, etc., the internal auditing can then measure the value of its work by calculating the measure of reducing time of cashing and the number of complaints. As each organization has unique objectives, each synoptic score table will be also unique.

Tarlok Teji shows that this Score Table, typical for the internal auditing heads, has to include several of the elements presented in Table 1 – Synoptic score table of Tarlok Teji.

¹ Internal Auditing & Business Risk Magazine – The Institute of Internal Auditors UK and Ireland.

Perspectives	Purposes	Objectives	Measure
Customer	Continual increase of the customer's satisfaction	- reducing the time of cashing - increasing the importance of deliveries in due time - reducing the number of the complaints from customers	- the overage time of cashing - the percentage of deliveries in due time - the number of complaints from customers
Financial	Continual increase of financial performance	- lowering costs - increasing sales - increasing market quota	- overage unitary cost - increasing profit ratefor sales - market quota - investment rate of rentability
Internal business	Continual improving of internal processes of the business	- reducing the cycle of time - increasing quality - increasing productivity	- the overage time of the cycle - the number of flaws and repaired items - production/worker

Table 1 – Synoptic score table of Tarlok Teji

Source: *Internal Auditing & Business Risk Magazine – The Institute of Internal Auditors U.K. and Ireland in association with Deloitte & Touche.*

Recently IIA of Great Britain and Northern Ireland launched its own publication on the topic entitled “The Framework of the synoptic score table for the internal auditing departments”. This describes the way of using the table to measure the performance of their own internal auditing in comparison to the strategic objectives of the organizations as a whole, identifying **six key-topic** which should be approached by the managers of the internal auditing when developing the framework of the synoptic score table to measure performance, precisely:

- a. To determine the way the internal auditing measure performance reflects the mission of the internal auditing function;
- b. To examine the efficiency of measuring the internal audit department performance in relation to the organizational strategy;
- c. To check whether the performance measuring includes both indicators of more rapid cashing of credits, as well as later paing back of debts;
- d. To assess which the good measuring of performances reflect the proposition of highering the added value by the internal auditing department;
- e. To make sure the connection between the various measures of performance are understood and administrated the right way;
- f. To determine whether measuring the performance support the strategic role of the internal auditing function within the organization.

This publication also presents a four-step-process to develop a framework for the synoptic score table for the internal auditing function regarding the assessment of the strategy, designing, viewing strategy, identifying measures of performance, refining the synoptic table, as follows:

- To fulfil assessment of strategy, the heads of the internal auditing will wish

to make a SWOT analysis, respectively to assess the strong and weak points, opportunities and menaces to the department;

- Focussing on the key-strategic topics in developing the strategy map;
- Identifying the performance measure in connection to strategic goals established and presented at the first two steps;
- The continual process of assessing the utility and efficiency of the synoptic score table.

Some of the internal auditing departments developed other approaches of standardization in order to prove to the managerial-body that they were providing value.

Other internal auditing departments developed standards so that internal auditors to be able to assess their performance in comparison to the internal auditing functions from other similar orgnaizations.

The internal auditing has to have their methods of measuring the acheived performances in order to be able to prove that they are well doing their duty, which is they are adding value to the organization.

BIBLIOGRAPHY:

1. Robert de Koning, Public Internal Financial Control, Belgium, 2007;
2. Zecheru Vasile, Marin Năstase, Managementul obiect de audit intern (The Management – Object of Internal Auditing), Editua Economică, 2007;
3. Dascălu. D., Feleagă, N., Auditul intern în instituții publice (Internal Auditing in Public Institutions), Editura Economică, 2006;
4. Order of the Ministry for Public Finances nr. 3055/2009 for the approval of the regulations in accordance with the European directives, published in the Official Gazzette nr. 766/2009.