

# ASSESSMENT OF INTERNAL AUDIT APPEALING TO KEY PERFORMANCE INDICATORS

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## Abstract

*The positive / added value brought by internal audit function to an entity requires effective ways and criteria measured. It is true that it's pretty difficult to establish these sort of values. There are several indicators used to measure / assess the value addition provided in the company, but that does not fully reflect the actual value of the internal audit function. Through this paper, we want to present a method for assessing the internal audit and its effectiveness within an economic entity, through the use of performance indicators. Indicators render the image of internal audit and its effectiveness.*

**Key words:** *internal audit, evaluation of internal audit, performance indicators, balanced scorecard.*

**JEL Classification:** M10, M42.

## 1. Concept of internal audit

Of all resources available to humanity, only one seems to be inexhaustible. This resource is called **Information**. Information is a factor of power, a truthfully one, which can be labeled as a social good that influence directly and immediately the welfare of societies. (Badea et al, 2014) Although, information is not a tangible asset and it is not visible to our eyes, it unmistakably participates in the evolution of the modern society.

Common to all is that we are subject to the same laws of economic and social development. Here we do not refer expressly to the laws and legal regulations, but rather to the natural laws of the economy, for example the law of supply and demand, the law of marginal utility.

Moving on to the main topic of this scientific work, which is reflected in the title, namely internal audit, we note that internal audit is one of the activities of modern society undertaken in an economic entity (at least under its present name, not to mention the fact that it can be correlate with the control activity used since inception), is a scientific activity based on rules, regulations elaborated by international professional bodies (the Institute of Internal Auditors-IIA, L'Institut Français des Auditeurs et Contrôleurs Internes- IFACI), approved / implemented at national level by national professional bodies (in Romania-Romanian Chamber of Financial Auditors - CAFR).

Internal audit is a profession shaped throughout time as an answer to entities' economic needs. Entities' economic needs roughly have the same characteristics as human needs have, such as (Ruse et al, 2014):

- they are unlimited: although the primordial need that identifies itself with the major objective of any enterprise is that of maximizing profit, the economic entity has many more needs/ necessities that, once met, congregate towards meeting the primary need;
- they are complementary: entities' economic needs are numerous and complementary, they complete each other; the need for capital, human resources, material resources, the existence of a legislative and normative framework, etc., all these elements can be classified within the category of needs the economic entity has and without the fulfillment of which it cannot function;
- capacity of regeneration (needs currently disappear when they are met, but they reappear in time): the need for personnel: a vacant job may exist at one given point. Once

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occupied, the need is considered to have been fulfilled, but the company's development can lead to the emergence of new jobs, therefore the need for personnel will be topical all over again. We can also look upon profit from this perspective. Any company wants to obtain profit at the end of the fiscal year. If this happens, the company's need for the respective year shall be fulfilled, but along with the beginning of the financial year, this need will become again the company's major objective. However, the profit gain can be rather seen as a permanent need because it is never extinguished.

- they are conditioned both objectively (according to the economic development degree, the progress degree), and subjectively (each company having its own needs, others than those common to all entities – such as profit gain).

Although internal audit is not a function with applicability in all types of companies,

Internal audit provides to the management of an economic entity, whether public or private, a wide range of specific, comprehensive information about all activities in the company, according to the specific of each internal audit mission.

Although internal audit is not a function applicable to all companies, since legislation does not require setting up an internal audit department in any economic entity, but only within certain types of companies (such as public institutions, banking institutions, certain business entities under Ordinance no. 37 of 29 January 2004, etc.), internal audit is presented, in companies that have already implemented this feature, as a department responsible for effectiveness aiming at identifying nonconformities (of the product / service / activity).

## **2. General methods of assessment of internal audit**

An internal audit department benefits, added-value economic entity, however we can not affirm the existence of such department directly and exceptionally lead to total reduction of non-conformances of any kind (legal, process, form, etc.) whereas that activity can record any mistakes, be they human (an activity undertaken by people through people) or technological (technological system errors, software).

The added value of internal audit is highly difficult to quantify.

The added value of the audit work is not exclusive nor in the internal audit report and any recommendations and conclusions issued. These are just means of communication with the management of the audited entity. (Ghita, 2005)

The value of internal audit is the ability to improve the audited system/process/activity. (Ruse et al, 2015)

Internal audit is a promoter of added value generating savings, creating opportunities, helps to avoid losses by its actions. At the same time, a benefit that internal audit brings refers to the changing of the mentality of those audited (actually of those who undertake the audited processes as internal audit does not audit people, but the activities/processes), even if there is no unity measure to track their progress.

In this regard, it is necessary from time to time that internal audit work to be also verified and evaluated. We can refer to this as a verification, an *audit of an audit*. This would have the effect of determining the degree of effectiveness of internal audit and possibly identifying ways to improve the functioning of audit. Thus, methods have been developed for the assessment of internal audit.

The effectiveness of the internal audit plan can be evaluated by an internal quality control plan and can be internal or external. (As seen in Table no.1). Effectiveness of internal audit is measured using instruments such as indicators, surveys or benchmarking. (Dubis, 2010)

Regarding internal evaluation, the head of the internal audit department can conceive or improve an existing questionnaire on internal audit work carried out by members of the audit team. As advantage of internal evaluation type, we believe that by participating in the mission

and be responsible for internal audit mission, the head of internal audit should be aware of the shortcomings of the mission. Each internal audit mission is different; in that it has a specific target, depends on the process / service audited, on the level and scope of activity of the economic entity, the professional training and experience of the members of the audit team.

**Table no. 1. Evaluation (internal/external) of internal audit**

Type of evaluation	Responsible	Action	It follows
Internal evaluation	head of internal audit department	Supervision	<ul style="list-style-type: none"> <li>• communication quality;</li> <li>• compliance with audit methodology;</li> <li>• choice of investigating tools;</li> <li>• quality and relevance of the findings and observations;</li> <li>• the quality and timeliness of audit;</li> <li>• reports and recommendations realism,</li> <li>• the applicability and effectiveness of the recommendations</li> </ul>
External evaluation	external auditors	Revisions of documents	<ul style="list-style-type: none"> <li>• completeness and compliance with the audit plan;</li> <li>• internal audit standard implementation;</li> <li>• methodology;</li> <li>• quality of audit reports and recommendations;</li> <li>• quality of internal audit manual and audit guidelines;</li> <li>• assessment of internal audit by management.</li> </ul>

Source: Author's personal representation

Models for the evaluation of internal audit were developed by some researchers using management methods such as Balanced Scorecard (Vintilescu et al, 2010) by Kaplan and Norton, first time in an article published in the Harvard Business Review in 1992, then developed in the book the Balanced Scorecard- Strategy Translating into Action in 1997, Gantt chart, usable in internal audit planning and visualization during the mission (stage, completeness).

We consider it appropriate to conduct a survey among employees economic entity in order to identify how employees (as part of the auditory system, not directly, since we are not auditing people, but actions taken by them) perceive the internal audit department and whether they believe in the improvement of the processes / services audited.

Of course, that in order to assess the performance of internal audit we can call any of the methods listed above, we can use combinations of methods, or conceive new methods.

### **3. Performance evaluation of internal audit through the use of performance indicators.**

The added value by internal audit function requires effective ways of measuring. Touching implies internal audit performance, as in any other activity, the existence and effective and efficient combination of resources (financial, material and human). It is important that these resources be properly budgeted and allocated where needed at the time.

Financial resources must be targeted on types of spending, and where internal audit is divided into several main categories: salaries of internal auditors, expenses, training expenses, office supplies necessary to conduct business in optimum conditions, expenses related to trips made under internal audit plan, etc. (Badea et al, 2013)

There are several indicators used to measure / assess the value addition provided the company. Indicators restore the image and quality assessment of internal audit activity and the means of improving efficiency.

Indicators are those that give the image quality of activity and are, in essence, a means of improving efficiency and are calculated in three categories: activity indicators, quality indicators and cost indicators (see Table 2).

**Table no. 2. Performance indicators used in evaluation of internal audit**

Type of the indicator	Indicator	Formula
Activity	Measurement of plan and achievement and outcomes improvements	• number of missions developed/ number of missions set in the plan
	Measurement of the average audit time	• number of audit days / number of missions
	Measuring the time evolution for strict auditing operations compared to the overall time	• number of audit days / days worked
	Measuring the evolution of training allocated to each party auditor	• number of training days / days worked
	Measuring the evolution of the average number of pages of audit reports	• number of pages of reports / number of reports
Quality	Number of missions	• number of unforeseen tasks / number of missions
	Assessment recommendations	• recommendations rejected / total recommendations
	Measuring the quality of implementation of recommendations	• unrealized recommendations / accepted recommendations
	Measurement of working periods for Heads of Mission and senior auditors	• number of days devoted to management / days worked
	Assessing the quality of work	• incomplete audit files / number of missions
Mission Costs	Evolution of budget and staff employees	• cost of service / number of auditors
	Comparison of the workday market costs	• cost of service / number of days of mission
	Professional training expenses	• training costs/number of auditors
	Movements according to the plan	• costs/number of auditors
	Office needs	• costs/number of missions

Source. Author's personal representation

In the following lines, we present a case study aimed at assessing the performance of internal audit, based on some of the indicators mentioned in Table 2. Thus forego entering data into a spreadsheet (Excel format). Please note that the data are indicative.

**Table no. 3. Determining performance indicators of an internal audit mission**

Indicators	Mission's efficiency / activity and quality indicators				Percentaje/Efficiency
Measurement of plan and achievement and outcomes improvements	number of missions developed	6	number of missions set in the plan	5	120%
Number of unforeseen missions	number of unforeseen tasks	1	number of missions	6	83.33%
Assessment recommendations	recommendations rejected	2	total recommendations	11	81.82%
Measuring the quality of implementation of recommendations	unrealized recommendations	2	accepted recommendations	9	77.78%
Assessing the quality of work	incomplete audit files	2	number of missions	6	66.67%
<b>Average percentage</b>					<b>85.92%</b>
<b>Mission's costs (lei)</b>					
					<sup>x</sup> Budgeted/expenses
Evolution of budget and staff employees	expenses	6900	Budgeted	6900	100%
Professional training expenses	expenses	1000	Budgeted	900	90%
Movements according to the plan	expenses	258	Budgeted	200	78%
Office needs	expenses	1000	Budgeted	800	80%
<b>Average percentage</b>					<b>87%</b>
<b>Other indicatos</b>					
Measuring the evolution of the average number of pages of audit reports	number of pages of reports	72	number of reports	6	12.00
Measurement of the average audit time	number of audit days	253	number of missions	6	42
Measuring the evolution of training allocated to each party auditor	number of training days	20	Days worked	253	7.91%
Notes:					
<ul style="list-style-type: none"> <li>• we rely on a number of 253 working days per year for the year 2015, in compliance with the number of official holidays (13 days);</li> <li>• referring to the monthly expenses of the department of internal audit (related to salaries);</li> <li>• travel expenses include fuel expenses for the movement;</li> <li>• office materials costs (monthly) include: paper tops, pens, folders, ink printer, etc.</li> <li>• training expenses include expenses incurred by the entity in order to improve auditors work, attending conferences and / or annual trening</li> <li>• <sup>x</sup>Budgeted/expenses: we have chosen this method of calculation and not the reversed formula : expenses/budgeted, as we see the inconsistency in the budget as a minus in efficiency (strictly related to the costs of the mission, not related to the quality of the work). The reversed formula denotes an efficiency of over 100 % which would result in an incorrect calculation of the overall performance (as shown in Table 5)</li> </ul>					

Source: Author's personal representation

Besides the calculation of these indicators, we consider it appropriate and necessary work undertaken by the internal audit team members to be evaluated based on interviews and assessment by the management of the economic entity and the head of audit structure.

Thus, we consider the average points given by internal auditors entity. Table no. 4- Evaluation sheet of internal audit by the management.

**Table no.4. Evaluation sheet of internal audit by the management**

No.	Object	Ratings					Obs.	
		1	2	3	4	5		
1	Clarity of communications	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>		
2	Sufficiency of information	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>		
3	Added value	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>		
4	Setting goals consistent with activities	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>		
5	Presenting findings in a logical / coherent / structured/ manner	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>		
6	Adequacy of internal audit deployment	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>		
7	Feed-back	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>		
8	General evaluation of the mission	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>		
9	Efficient communication between the auditors and the audited	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>		
10	Appropriate and professional behavior of auditors	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>		
11	Comments							
Total		10	20	30	40	50		
Obtained		0	0	0	16	30	46	
<b>Average</b>	<b>46/50=</b>						<b>92%</b>	

Based on information above, we summarize the results in Table no. 5. Mission performance.

**Table no.5. Mission performance**

Efficiency	85.92%
Costs	87%
Management rating	92%
<b>Average performance of the mission</b>	<b>88.27%</b>

#### 4. Conclusions and proposals

To determine the path to improve internal audit we must evaluate and analyze the performance of the internal audit within the economic entity. Thus, to evaluate internal audit's missions and their results in order to determine the way that were developed and contributed to achieve company's objectives. Then we will consider the review of the implementation of

recommendations made by the internal audit department, especially if they determined visible improvements / measurable processes, leading thus to obtain global performance.

By registering a high level of performance of internal audit directly it ensures a high level of performance of the economic entity. Of course, responsible for the implementation of recommendations made by the Internal Auditor is the manager, but in our opinion, as long as the internal audit department conducts activities / tasks with maximum seriousness, conscientiousness and professionalism, the manager will be to some extent forced to implement the recommendations, having a high confidence in those.

Specifically, internal audits can be more efficient by:

- An accurate and detailed assessment of internal audit to determine the level of overall performance and categories of indicators in order to identify what is and can be improved;

- Identify and implement procedures / methods basically looking for ways to lighten the work, to diminish their efforts, but with maximal effects. This is especially true for the internal auditor's working papers which demand time and effort, when the auditor could allocate more attention to risk analysis;

- Ensuring that internal department has unrestricted access to all information / data about the economic entity and processes audited, as a full and adequate internal audit helps to properly assess processes and be able to find ways to improve. Not knowing the full aspects of a process could lead to the development of incomplete recommendations;

- Ensuring that there are sufficient resources allocated to internal audit mission;

- A continuous professional specialization of internal auditors, that they are aware of the news in the field and are able to cope the dynamic business environment;

- Ensuring of a good knowledge of the economic entity and processes audited. This does not mean that the internal auditor should have extensive knowledge in manufacturing, for example. The internal auditor cannot and does not need to be an expert in every process / activity audited. His duty is to show understanding, to be able to look at the processes audited as a whole and in detail to capture any irregularities.

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