Metrics by design

A practical approach to measuring internal audit performance

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At a glance

Expectations of Internal Audit are rising. Regulatory pressure is increasing. Budgets are tightening. Internal audit scope is expanding. In this environment Internal Audit must always start with delivering increased value, but must also demonstrate its value to the organization—not just by showing how well it runs its operations—but by capturing and reporting the contribution it is making to the organization. To do this well, leading Internal Audit functions are re-designing their balanced scorecard of metrics to better align with what matters most to stakeholders.

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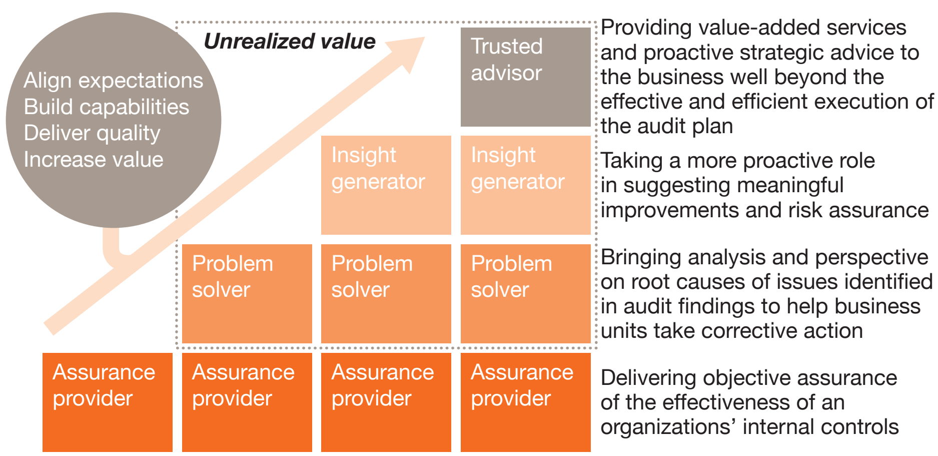
Introduction

Is your Internal Audit metric scorecard influencing the perception of the value you deliver? Is your scorecard driving behaviors and results that are perceived as valued by your organization? According to PwC's 2014 State of the Internal Audit Profession Study, stakeholders of organizations where internal audit functions are delivering at a Trusted Advisor level (see Figure 1) consistently report that they receive a significantly higher level of value compared to those stakeholders where Internal Audit is performing at the Assurance Provider level. This paper explores how all internal audit functions, regardless of where they operate along the continuum, can leverage metrics to both communicate the value they are providing and drive results.

Figure 1: PwC internal audit operating continuum



Source: PwC's 2014 State of the Internal Audit Profession.

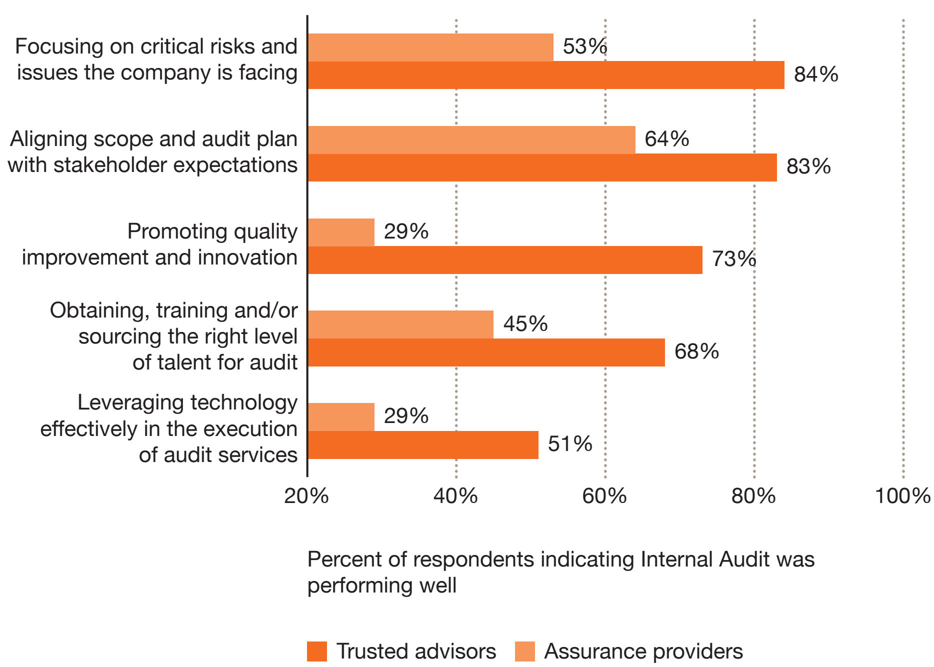
Expectations are rising
Metrics must keep pace

Expectations of Internal Audit have increased as companies find themselves in a more complex risk environment. In response, leading internal audit functions have transformed themselves to help their organizations manage risk more effectively. Evolving from being relied upon largely to meet financial reporting compliance requirements, Internal Audit is now challenged to help the organization protect itself from risks ranging from globalization of supply chains to cybercrime. According to PwC's 2014 State of the Internal Audit Profession Study more than 70% of board members want Internal Audit more involved in technology, security, reputational, and big data and business analytics risk, just to name a few. Despite—or perhaps because of—rising expectations, stakeholder perception of Internal Audit performance is relatively low. Overall, senior management believes Internal Audit performance should improve. We found that only 63% of senior management believes Internal Audit is performing well at focusing on critical risks, only 50% believe they are delivering cost effective services and a mere 36% believe Internal Audit is leveraging technology effectively. These are all indicators that internal audit functions are either not keeping pace with the changing risk environment and rising expectations *or* they are not reporting the value being delivered through the metrics they are using.

When we dug deeper into these stakeholder perspectives, we found an astounding difference in the perceived value of internal audit functions performing more Trusted Advisor types of services than those performing more traditional Assurance Provider services. As Figure 2 illustrates, Trusted Advisors are outpacing Assurance Providers at performance on a wide range of areas from their audit plan addressing the critical risks of the organization to leveraging technology effectively.

As expectations have risen, leading internal audit functions have not only adjusted their core working practices to keep pace, they are also adjusting the metrics used to drive results and report value.

Figure 2: Performance of trusted advisors vs. assurance providers



Source: PwC's 2014 State of the Internal Audit Profession.

Never a one size fits all solution
But a common approach

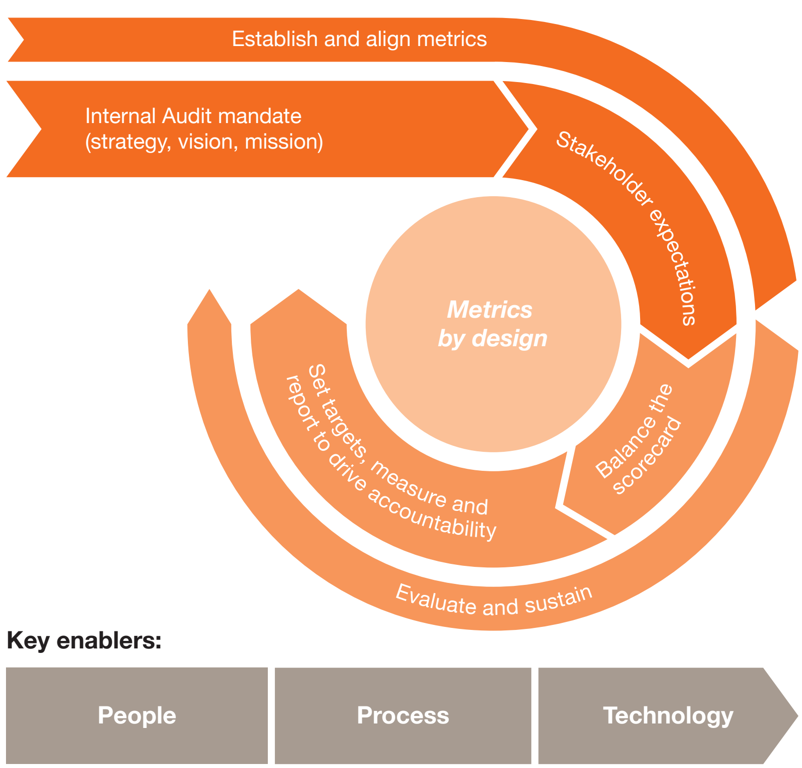
Since expectations of Internal Audit vary widely across industries, geographies and company size, there is no single set of "best practice" metrics. That said, Chief Audit Executives (CAEs) of leading internal audit functions follow a common approach to designing their metrics. They consistently align metrics to their mandate (that is—their strategy, vision and mission) as well as stakeholder expectations. They establish clear targets to provide more relevant and valued performance indicators of both their own operations as well as perspectives on enterprise levels of risk. Keeping metrics relevant ensures they are continually reporting the value they deliver their function evolves and as their organizations' risk profiles change. In other words, leading practice metrics are "right sized" for the function and fluid to change with an organization's evolving expectations (see Figure 3).

Establish and align metrics

Starting from Internal Audit's mandate is essential as the mandate provides clarity of the scope of services and role of Internal Audit. From our research, Internal Audit tends to have mandates ranging from Assurance Provider to Trusted Advisor, as represented in Figure 1. As such, the most effective metrics, which will vary based on where a function operates along this continuum, clearly measure and communicate the value the internal audit function is providing to the organization as established by its specific mandate.

Internal Audit functions have always had methods in place to assess the department's operational performance such as adherence to budget, coverage of the plan and timeliness of report issuance. While these metrics are essential to stay on top of how the function is operating, they are often internally focused and don't align to what stakeholders value most. Aligning metrics to stakeholder expectations is not only important for Internal Audit, but has been true of leading corporations for decades. Numerous companies are no longer in business because they missed major market shifts as they focused on internal performance rather than stakeholder (or market) expectations. Conversely, corporations that focus on stakeholder expectations have remained relevant because they are opportunistic as expectations shift and proactive at addressing risks. The same approach holds true for Internal Audit. Internal audit functions with metrics that report the value they deliver to stakeholders are receiving higher performance marks from stakeholders.

Figure 3: Common metrics approach



Evaluate and sustain metrics

When metrics are aligned with what matters most to Internal Audit's stakeholders they drive results and performance that add value to the organization—however, a balanced approach is still needed. Leading internal audit functions not only purposefully design metrics that focus on delivering superior operating results, they focus on balancing their scorecard across a few critical areas, such as process effectiveness, people, risk coverage and value. They also adapt the nature of the metrics to be reflective of where they are operating along the internal audit continuum. While there is never a one size fits all approach, we have observed similar types of metrics used by leading internal audit functions across this continuum (Figure 4).

Balance the scorecard

As metrics are identified across the balanced scorecard, careful consideration should be given to ensure that the mix of internally focused and risk based/strategic metrics is appropriate and that the metrics are sufficiently tailored for each unique stakeholder group. For example, metrics that measure the efficiency of the internal audit department processes, while important to drive internal operational efficiencies, may not be seen as critical to senior management or the Audit Committee when compared to metrics that measure the coverage of key or emerging risks or involvement with transformational initiatives. This may mean that certain metrics are reported to one stakeholder group and different metrics are reported to others. The key is to select a succinct number of balanced metrics that are appropriately tailored, tracked and reported to each of Internal Audit's stakeholder groups. The considerations for balancing the scorecard using appropriate metrics become more clear by looking closely at a few examples.

Figure 4: Metrics considerations for the balanced scorecard

Illustrative Internal Audit balanced scorecard

Value	• % of audits and SOX testing completed within schedule and on budget • % of completed audits that utilized data analytics • End of audit client satisfaction survey results	• Business process improvements resulting from Internal Audit • Level of management requested involvement with strategic initiatives • Stakeholder assessment and feedback themes compared with expectations • Level of insight and proactive advice delivered • Training sessions or involvement with enhancing internal control/risk management knowledge of the organization	**Value**
Risk coverage	• % of the audit plan aligned to major risk categories (i.e., financial, operational, strategic, etc.) • % of non-IT versus IT audits included in the plan	• Visual representation of alignment of audit plan to individual enterprise risks • Level of focus on emerging risks or transformational initiatives • Alignment and coordination with other compliance functions (i.e., enterprise risk management, SOX compliance, legal/compliance, etc.)	**Risk coverage**
People	• % of Internal Audit staff with relevant certifications • % of IT versus non-IT staff • Internal Audit department turnover • Departmental headcount compared to budget	• Alignment of talent to enterprise risks • Leverage of subject matter specialists and guest auditors • Placement of internal audit staff into advanced Internal Audit positions or rotation to the business	**People**
Process effectiveness	• Overall Internal Audit department budget compared to prior period • Number of audits completed within the budgeted timing • Audit report findings by status and division • Audit report ratings issued during the period • Number of days from fieldwork to report • % of audits with internal quality review performed by the end of fieldwork	• Cost effectiveness of services • % of audits where tools (i.e., data analytics, dashboards, databases, continuous auditing routines, thought leadership, etc.) were provided to the business • Number of audit findings remediated before report issuance • % of audits using data analytics to drive scoping decisions—resulting in hour reductions	**Process effectiveness**

Assurance provider → *Problem solver* → *Insight generator* → *Trusted advisor*

Note: The above illustrative balanced scorecard is not intended to be comprehensive, rather to provide areas to consider as functions build their scorecard and to show the movement of metrics as functions operate along the Internal Audit Operating Continuum.

Process effectiveness metrics are typically used to drive the behaviors of the internal audit department as well as measure the responsiveness of management to audit findings. A typical metric we see being used by an Assurance Provider is reporting the number of audit findings by division/location. While this metric is excellent at reporting on the level of issues by division, it can also result in unintended consequences. For example, when an internal audit department focuses too heavily on measuring audit findings by division it can result in an inordinate amount of time debating ratings with management to improve the metric, versus addressing the control improvements needed. In comparison, some leading internal audit functions are addressing this by focusing on metrics that evaluate the level of process and control corrections made by management before reports are even issued. The result—greater alignment between Internal Audit and stakeholders, more immediate improvement in the control environment and elimination of unproductive time spent debating ratings.

People metrics are often crafted to ensure that the right talent resides within the function. As we explored these metrics, we found them to differ widely across internal audit functions. A typical internally focused metric might include measuring turnover in the department and certifications held. In contrast, leading practice internal audit functions are focusing on measuring alignment of talent with business risks and the critical operations of the business, as well as measuring the advancement of internal audit personnel within the organization. The latter metrics better demonstrate that Internal Audit has the right skills in place to address the key risks of the organization, is deploying these resources in a strategic manner to add maximum value and that the function is delivering against a mandate of training and developing talent for the organization.

Risk coverage metrics are at the heart of any well-balanced scorecard and these metrics can either report the facts (example, % of audits covering enterprise risks) or they can focus on measuring the value of risk coverage. One Trusted Advisor CAE we spoke with shared how she has adjusted Internal Audit's top tier executive management and audit committee reporting metrics to better demonstrate the interconnectivity of each enterprise risk to their audit plan and audit findings. They now report quarterly on each enterprise risk covered and the relevancy of audit findings in these areas to achieving their business objectives. To create this metric and gain alignment with the various management stakeholders, the CAE also had to change individual audit reports to be reflective of these same points of view. These changes not only provided a better frame of reference for their stakeholders as to the level of risk associated with audit findings, but also significantly enhanced the value stakeholders were receiving from Internal Audit.

Value metrics are the most difficult to develop and consistently measure, but often are at the heart of the high marks stakeholders give on satisfaction with Internal Audit's performance. A common approach to report on value tends to be on adherence to plan, with metrics such as the percentage of audits completed within budgeted hours or cost savings generated. While these are certainly important internal performance metrics, aligning to stakeholder expectations of value has been a key to enabling leading internal audit functions enhancing their brand. Examples of value-based metrics shared with us included stakeholder feedback programs similar to brand health indices, process improvement ideas generated and level of involvement with enterprise-wide strategic initiatives. These metrics, while more qualitative in nature, provide greater measurement of how Internal Audit is delivering value as defined by its stakeholders, including greater transparency around its impact on the effectiveness and efficiency of the business.

Set targets, measure and report to drive accountability

Metrics are most relevant when they provide a basis for taking action targeted at reducing risks and improving the overall control environment. To better report the value delivered and drive performance improvement, metrics need to be reported in comparison to established targets and linked to the variety of stakeholder expectations. Doing so enables Internal Audit to better demonstrate the value it is providing to its various stakeholder groups.

And, of course, sustainable metrics and their related targets need to be evaluated periodically to ensure continued relevancy. Routinely assessing where Internal Audit stands relative to the metric targets enables greater agility to either

"We have been working on enhancing our performance/value reporting matrix. The way Internal Audit was capturing performance was very activity based and didn't allow us to speak to the outcomes we are driving. Reporting on the number of audits, percent of recommendations implemented—these are fine but they don't tell a story on value or the impact to the company. We continue to enhance our value-based auditing and tie our work and performance metrics to the company value drivers. While our metrics are evolving, I finally have a values based scorecard—hard core, qualitative and quantitative elements that tie back to the strategy of the company and how it performs."

– Vice President Internal Audit, Major Retail Company

seize opportunities or intervene when needed. If targets are consistently being exceeded they may not be holding Internal Audit or the organization to a high enough standard. The most successful CAEs we spoke with recommend re-evaluating and refreshing metrics (and targets for each of the metrics) annually, in conjunction with stakeholder feedback programs or strategic planning process.

Further, having a sustainable process in place to measure and reward the function, the organization and internal audit team is of course an important part of any effective metrics program. This includes holding the department and the individuals within it accountable for results through linking departmental metrics to performance and compensation. Leading practice internal audit departments clearly communicate the metrics to the team, visually display progress against the metrics so that the team is continuously updated on the overall progress and include metrics as a topic at department meetings to demonstrate their importance. One CAE we spoke with shared how he, similar to many of the plant locations within his company, has a bulletin board outside his office with the internal audit department metrics displayed to highlight the team's progress and areas for continuous improvement. The key is that tracking and reporting applies to both internally focused metrics and metrics that track the value Internal Audit is providing to the business.

Enable through people, process and technology

Creating the balanced metric scorecard is only the beginning of the effort. Having a meaningful metrics program will perhaps mean cultural change, and change must be managed through people. CAEs will need to provide the vision for the future in which metrics will be aligned with stakeholder expectations by creating a clear communication plan that expresses the future state and at the same time define the behavior that is expected.

When communicating metrics, the audience should be clearly understood and the method, frequency and approach for reporting adjusted to meet stakeholder needs. This includes leveraging data visualization to analyze trends over time, depict progress against targets, identify where actions are required, and determine the details on actions being taken as needed.

That said, without a sustainable process to gather the metrics data, even the best change management plan will fail. To support metrics reporting, leveraging technology is a 'must'. Sustainable metrics programs are supported by data plans that outline each metric's data source and frequency for updating, as well as ongoing validation. Undoubtedly, as internal audit functions strive to enhance their metrics, gathering and/or obtaining new data will be a challenge. But similar to any other process improvement effort, performing a gap assessment of the data sources needed, having a roadmap for when the data will be available, and a stakeholder communication plan for the timeline of revised metrics are the steps that successful CAEs have taken.

As reported in PwC's *'The Internal Audit Analytics Conundrum—Finding your way through data'* significant advancements have been made in the availability, cost and ease of use of a variety of data analysis and visualization tools. Leading internal audit departments are not only using these tools to improve the overall efficiency of their audit process, they are leveraging their capabilities to accumulate and report metrics via dashboarding and data visualization that are more visually appealing and create a greater understanding of the value they are delivering. Further, data visualization allows Internal Audit to better demonstrate the interconnectivity of its metrics to what matters most to stakeholders.

What's next?
Making it matter

As expectations continue to rise, Internal Audit must keep pace by adjusting working practices and demonstrating its value to the organization. To do this well, leading internal audit functions make sure they are contributing to the organization's strategy and objectives and have well-run operations. Importantly, they also track and communicate Internal Audit's value to key stakeholders by focusing on a succinct number of balanced metrics that matter the most and are tailored for different stakeholder groups.

Taking a fresh look at Internal Audit metrics can have significant payoffs which lead to greater value creation. Doing so aligns Internal Audit and its stakeholders on its mandate, clarifying any ambiguity that may be present across stakeholder groups. It opens the communication channels between the board, management and Internal Audit on expectations and performance. Furthermore, it improves Internal Audit's ability to rapidly adjust working practices, seize opportunities to take corrective action, and strive for continuous improvement.

As Internal Audit sets objectives in the coming year, make metrics an integral part of the discussion. By purposefully designing metrics that align to your mandate and stakeholder expectations, Internal Audit will be able to drive performance and communicate value in more meaningful ways.

Reach out to your PwC representative or the individuals below for a further dialogue around selecting, tracking and reporting on the metrics that matter the most for your internal audit function.

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