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Whitepaper

Auditing operational effectiveness

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Level 7, 133 Castlereagh Street, Sydney NSW 2000 | PO Box A2311, Sydney South NSW 1235
T +61 2 9267 9155 **F** +61 2 9264 9240 **E** enquiry@iia.org.au **www.iia.org.au**

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Background

Purpose

The purpose of this White Paper is to provide guidance for auditors in auditing the effectiveness of business operations.

Background

"When effectively managed, internal auditing becomes an important element in helping an organisation achieve its objectives. Organisations with internal audit activities are better able to identify business risks and system inefficiencies, take appropriate corrective action, and ultimately support continuous improvement," according to the International Professional Practices Framework (IPPF) practice guide *Measuring Internal Audit Effectiveness and Efficiency*. In order to help organisations achieve their objectives, it is important to audit the effectiveness of business operations.

Operational auditing adopts an approach to audit economy, efficiency and effectiveness of the topic subject to audit.

Auditing effectiveness of operations is often significantly more challenging than auditing the economy or efficiency of operations. This White Paper is presented to clarify some of the key issues and provide guidance for auditors seeking to audit effectiveness.

Discussion

Issue

Auditing the effectiveness of operations is a core activity in operational and performance auditing, and is arguably the most challenging of the areas of focus. This White Paper provides guidance to help ensure that auditors meet the expectations of management and other relevant audit stakeholders when auditing effectiveness.

History

Considerations of economy, efficiency and effectiveness have been the concerns of value- for-money auditing, management auditing, operational auditing and performance auditing. Internal audit manuals referring to operational auditing existing since at least 1875. The methodologies used for operational and performance audits have become increasingly sophisticated in recent years.

It should be noted that operational auditing and performance auditing are ostensibly the same thing, with operational auditing generally used in the corporate world, and performance auditing in a public sector context.

Discussion

Process perspective

In any process, there are inputs, outputs are produced, and outcomes result. For example, in a road-building process inputs may include asphalt, gravel, machinery, employees and contractors. The process is the traditional road construction and the output is the new road. In terms of economy, efficiency and effectiveness, it is useful in very broad terms to think of the cost of the inputs as a measure of economy, the number of outputs compared to the inputs as a measure of efficiency, and the result of the outcomes as a measure of effectiveness.

In the example, outcomes, and therefore the effectiveness, may include shorter travelling times, reduced incidence and severity of road accidents, fewer fatalities, increased economic development through improved travel, more satisfied road users, and other roads being safer and less congested as a result of the new road.

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Economy and efficiency are usually easy to control and measure, and are therefore relatively easy to audit. Effectiveness is typically more complex, more difficult to control and especially measure, and is thus often more difficult to audit. More audit rigour is typically required in the assessment of effectiveness.

The relationship between output and outcomes

If outputs are well thought-out and well produced, they are likely to result in good outcomes and therefore high effectiveness. The outcomes may be difficult to identify.

There are a few key questions the auditor should ask in order to identify the key outcomes, including:

- Who are the most important stakeholders of the process, and what do they really want from it?
- How do the activities or projects really contribute to organisational objectives?
- How do the activities fit in with the organisation's mission, vision, values and strategic plans?
- Why the activities were undertaken and approved, and how they were justified to senior management?
- What value is contributed to the immediate internal customers?
- Do the activities contribute to external customer value?

Auditors should ensure they look below the surface to the most important outcomes and effectiveness measures. People subject to audit may not always welcome such scrutiny, as it is common for glib and easy-to-achieve effectiveness measures to be used by operational and project areas.

There are a number of sources to help auditors identify the key outcomes, including strategy and other planning documents, project strategy documents, key performance indicators used, identifying similar projects or activities in other organisations and researching what effectiveness measures were assessed and the methodologies used for their assessment, benchmarking, surveys and focus groups. Interviews may include those with manager subject to audit, the manager's manager, employees, sources of best practice, benchmarking partners and facilitators, customers and stakeholders.

If management have difficulty finding these types of documents or answering these kinds of questions, it may be indicative of management not having a clear concept of the benefits of the activity or the project.

It is a reasonable expectation that in general, management should have consulted with key stakeholders and particularly customers to assess what they consider to be important about the outputs of the activity or project.

Focussing on customers

In many operations, the customer is the focus of a business area's effectiveness. Different categories of customers may want different things, and the assessment of effectiveness may often be enhanced by dividing customers into groups. Examples in a sales environment might be new customers and existing customers; capital city customers and regional customers; retail customers and wholesale customers; and the top 10% of customers compared to the rest of the customers.

In general, for each category of customer it is useful to know what they want from you. The importance of that customer category dictates how important their wants are. For the top 10% of customers it may be essential that you meet their needs, whereas for the bottom 10% it may be irrelevant.

When considering the effectiveness of customer service, you may need to consider not only the present position, but strategic issues and projections for the future.

The stages of your assessment might include:

1. Working out who the customers are.
2. Dividing the customers into appropriate categories.
3. For the important categories, finding out what the most important things are that the customers want.
4. Finding out how often there is delivery, or failure to deliver, the important customer requirements.
5. If there is often failure to deliver, work out why there is failure, and how to improve the processes to reduce the number of failures to an acceptable level. If they are succeeding, assess if it is practical for further enhancements be made to further improve the success rate, and what lessons can be learnt for other parts of your organisation.

It is important to focus on the most important requirements, not every requirement. It is a reasonable expectation that management have researched what the customers want. The

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methodology used by management should be reviewed, and the reliability of their research assessed. It may be appropriate to verify the results in your audit.

When considering the issue of customer service, it is useful to consider factors such as whether employees exhibit the attitudes and behaviours of mediocre customer service or good customer service. An example might be the attitude of employees to complaints. Do they welcome complaints as an opportunity to win the customer back, and as an opportunity to highlight where processes can be corrected to provide better customer service. Or do they view complaints as a nuisance and waste of their time? Do they view each complaint in isolation, or do they perform an objective assessment to identify areas for improvement?

Key performance indicators (KPIS)

Most areas of an organisation will have their own performance measures. Sometimes the measures are selected because they are the best way to monitor the most important activities. On the other hand, they are often selected because they are the easiest to meet or manipulate. In addition, the measures tend to focus on efficiency and effectiveness, rather than properly considering effectiveness.

An example of a key objective might be to "achieve a high level of customer satisfaction". There should be some measures of whether they are achieving the required customer satisfaction. Appropriate measures could include:

- Percentage of customer responses to the customer satisfaction survey of "very high level of satisfaction".
- Reduction in the level of serious customer complaints.
- Repeat business from customers.
- Number of referrals from customers.

We might examine the key activities that are undertaken by the business to achieve a high level of customer satisfaction.

One of the activities could be dealing with customer queries on the telephone. Key measures of this might be:

- Number of customer queries solved without the need for a call-back.
- Number of customer queries solved within 10 minutes.
- Percentage of customer queries solved without a formal complaint.
- Percentage of customer queries solved with the customer expressing satisfaction with the resolution.

In practice, some KPIs measure the effectiveness of operations directly, whereas others examine the quality of the outputs as an indirect measure of effectiveness.

When assessing KPIs, it is may be useful to consider if the management focus on KPIs has resulted in unintended or ignored consequences, or other operations or processes being affected, whether adversely or positively.

It is worth noting that it is common for there to be medium-term and long-term outcomes from operations. In some circumstances, the medium-term and long-term outcomes may compete with short-term outcomes. For example, the profitability of a process may be increased in the short-term through aggressive cost-cutting, that in the longer-term threatens the viability of the process to produce high quality goods or services, and leads to reduction in sales and profits. It may therefore be important for auditors to consider not only short-term effectiveness, but also medium-term and longer-term effectiveness.

Control models

When conducting an operational audit, it is essential that you consider both soft controls, as well as hard controls. It is often the soft controls that have a greater influence on whether the organisation's objectives will be achieved.

Using a control framework may be helpful. The two most useful frameworks are the Criteria of Control (CoCo) and the Committee of Sponsoring Organisation (COSO).

The CoCo model is intuitive and easily applied. The four components might be simplified as four basic questions:

- Purpose – Does management know what to do to be effective?
- Commitment – Does management really want to be effective?
- Capability – Does management have the resources to be effective?
- Monitoring and learning – Does management monitor their effectiveness and learn to be more effective?

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The components of the COSO framework may be simplified as:

- Control environment – Does management have the people, structures and cultures to be really effective?
- Risk assessment – Does management understand the risks that might prevent these operations from producing effective results?
- Control activities – Does management have good internal controls in place to mitigate these risks?
- Information and communication – Does management communicate and provide information to ensure that they are effective?
- Monitoring activities – Does management monitor effectiveness and the control framework required to produce effectiveness?

Conclusion

Summary

Auditing the effectiveness of operations may be enhanced by considering the outcomes produced by activities, and how the quality of outputs affects the outcomes. Focusing on key stakeholders, and especially the customer, helps ensure that important aspects of effectiveness are covered. Key performance measures should be carefully considered, including the longer-term perspective. Using an internal control framework is useful to help ensure soft controls are adequately examined.

Conclusion

Auditors should assess the effectiveness of operations with great care, as there are significant challenges involved.

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Purpose of White Papers

A White Paper is an authoritative report or guide that informs readers concisely about a complex issue and presents the issuing body's philosophy on the matter. It is meant to help readers understand an issue, solve a problem, or make a decision.

Author's Biography

Written by: Barry Davidow
BCom, BAcc, MTaxLaw, ACA, CFE, CRMA, PFIIA, Advanced Diploma of Government (Management), Diplomas in Risk Management and Business Continuity, Government (Fraud Control), Government (Investigation) and International Financial Management

Barry is a Director of Fraud Prevention & Governance Pty Ltd, and has over 20 years of experience in internal audit, fraud and corruption control, investigations, governance and compliance. He has contributed to books on fraud control, computer fraud, communications and sociology.

He co-authored IIA–Australia White Papers on Fraud Risk Indicators, Corruption Indicators in Internal Audit, Corruption Related Risks in Decision-Making, Conflicts of Interest: A Framework, Conflicts of Interest in the Award of Contracts, Conducting Fraud and Corruption Investigations and Fraud and Corruption Risk Assessments.

Naveen Moda
BCom, Chartered Accountant (CA ANZ), Diploma in Public Sector Management, Diploma in Investigation

Naveen is currently working with the Department of Finance, Services and Innovation (DFSI) in the New South Wales Government, and has 15 years of internal audit experience. He has over 10 years of experience in the public sector, and

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has managed and delivered a large range of operational, compliance and performance audits.

Edited by: Andrew Cox
MBA, MEC, GradDipSc, GradCertPA, DipBusAdmin, DipPubAdmin, AssDipAcctg, CertSQM, PFIIA, CIA, CISA, CFE, CGAP, CSQA, AIPA, AFA, MACS Snr, MRMIA

About the Institute of Internal Auditors–Australia

The Institute of Internal Auditors (IIA) is the global professional association for Internal Auditors, with global headquarters in the USA and affiliated Institutes and Chapters throughout the world including Australia.

As the chief advocate of the Internal Audit profession, the IIA serves as the profession's international standard-setter, sole provider of globally accepted internal auditing certifications, and principal researcher and educator.

The IIA sets the bar for Internal Audit integrity and professionalism around the world with its 'International Professional Practices Framework' (IPPF), a collection of guidance that includes the 'International Standards for the Professional Practice of Internal Auditing' and the 'Code of Ethics'.

The IPPF provides a globally accepted rigorous basis for the operation of an Internal Audit function. Procedures for the mandatory provisions require public exposure and formal consideration of comments received from IIA members and non-members alike. The standards development process is supervised by an independent body, the IPPF Oversight Council of the IIA, which is appointed by the IIA–Global Board of Directors and comprises persons representing stakeholders such as boards, management, public and private sector auditors, regulators and government authorities, investors, international entities, and members specifically selected by the IIA–Global Board of Directors.

IIA–Australia ensures its members and the profession as a whole are well-represented with decision-makers and influencers, and is extensively represented on a number of global committees and prominent working groups in Australia and internationally.

The IIA was established in 1941 and now has more than 180,000 members from 190 countries with hundreds of local area Chapters. Generally, members work in internal auditing, risk management, governance, internal control, information technology audit, education, and security.