

Measuring the Effectiveness of the Internal Audit Function

Practical tools for internal auditors



The Institute of
Internal Auditors
Netherlands

IIA Professional Practices Committee

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6/21/2016

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Table of Contents

Foreword	4
Introduction	5
Section 1 Laws and regulations, requirements and rules	7
1.1 Professional requirements	7
1.2 Laws and regulations	7
1.3 Banks	8
1.4 Insurers	9
1.5 IA Ambition Model	9
Section 2 Effectiveness and efficiency	11
Section 3 Stakeholders	12
Section 4 Measurement toolkit	13
4.1 Points for attention when designing a measurement toolkit	13
4.2 Effectiveness indicators	14
4.3 Measurement methods	21
Appendix I BCBS principles for the Internal Audit function at banks	23
Appendix II EIOPA guidelines on the Internal Audit function at insurers	25
Appendix III Examples of dashboards	26
Appendix IV KPI's Group Audit	29

Foreword

In 2013, the Dutch central bank (DNB) conducted a study into the internal audit function (IAF) at Dutch banks. At a certain point in the study, the following challenging question presented itself: “When can an IAF be considered effective?” In the meetings between the IIA Netherlands Board and DNB, both parties struggled with this question. It was then already clear that many factors needed to be considered to be able to answer this question.

Around eighteen months ago, a number of internal auditors from the financial sector launched a debate about this issue. In The Netherlands and internationally, an inventory was made of the available frameworks of standards, best practices and performance indicators. There were many discussions and debates to determine to what extent certain elements could help to answer the above challenging question. We would therefore like to thank everyone who provided input based on their individual expertise to help deliver this result. Given that many different people were part of this group at one time or another, I will not thank individuals personally. However, I make an exception for Dennis Webbers, as he showed a tireless commitment at times when the issue momentarily seemed too diffuse to reach a conclusion. ‘When the going gets tough, the tough get going’.

Have we managed to answer the question when an IAF can be considered effective? I cannot give a definitive answer to that question, as it depends on many factors such as: in what sector do you work, how has your mission statement been worded, and how do you collaborate with the Executive Board, Supervisory Board and external auditor? That said, anyone who has read this paper can select a number of relevant indicators appropriate to their own practice to develop a mature performance measurement and the accompanying reporting. And that is a huge plus!

I hope you will enjoy reading this paper.

John Bendermacher

Chair of IIA Netherlands

Introduction

The requirements placed on the Internal Audit function (IAF) by internal and external stakeholders seem to be constantly increasing. As a result of the financial crisis, new laws and regulations have been introduced in the financial sector and supervisory bodies have tightened up and expanded their supervision. In addition, increasing critical attention is paid in the public domain to the design and operating effectiveness of companies' governance and their reporting of non-financial information. As the IAF plays an important role in the governance framework, there has been a corresponding increase in the requirements placed on the IAF. Various stakeholders quite regularly publish interesting documents that introduce additional requirements regarding the quality of the IAF.

Recently, the Monitoring Committee for the Dutch Corporate Governance Code presented its proposals for revising this Code. These proposals envisage a prominent position for the IAF, which is considered “complementary to the external auditor.” According to the Monitoring Committee: *“It is important to have a good interplay between the Executive Board, the Supervisory Board and the Audit Committee, as well as a good communication with the internal audit function and the external auditor.”* An important element in the proposals in relation to the effectiveness of the IAF is also included in guidance 1.5.1, which states that the Audit Committee should supervise *“the relationship with - and compliance with the recommendations of and follow-up given to comments of - the internal auditor and external auditor”*.

The quality of an IAF is primarily related to its effectiveness. How effective is an IAF and how can you measure that? Measuring the effectiveness of an IAF is not easy to do. Besides quantitative aspects, many qualitative aspects play a role. In addition, the various stakeholders have different, and to some extent conflicting, expectations in terms of the role and duties of the IAF. Furthermore, the number of stakeholders and interested parties appears to be increasing, leading to a further increase in the scope, and hence the importance, of the work of the IAF. Lastly, another factor is whether the IAF is part of a financial institution, a company in the trade/industrial sector or a government body.

Therefore, it is important to clearly position the function, to define its role and to safeguard this role by documenting it in a clear charter, as set out in the IIA standards. This charter must then be approved by the Audit Committee and the Supervisory Board¹. The charter must contain a mission statement setting out the duties of the IAF. This statement provides important guidance on how to determine and measure the effectiveness of the function.

This paper gives an overview of the requirements placed by stakeholders on the effectiveness of the IAF. Based on these requirements, practical performance indicators are defined, which can be used by IAFs to report on (the effectiveness of) their performance.

This paper was made possible thanks to a consultation round with various parties, including:

- IIA Netherlands, Professional Practices Committee;
- Dutch Banking Association, Audit Working Group
- Insurers Association, Internal Audit Sounding Board Group

In addition the above-mentioned parties, various individual auditors provided valuable input for this paper. As financial institutions generally lead the way in terms of regulations and the supervisory landscape, this paper will first explore this landscape (addressed in more detail appendices I and II). It should be kept in mind that

¹ This paper assumes an entity with a two-tier Board structure comprising an Executive Board and a Supervisory Board, which is a standard governance structure in the Netherlands and Continental Europe in general.

these regulations are based on the IIA's International Professional Practices Framework (IPPF). Subsequently, in section 2, the concepts of effectiveness and efficiency are discussed, and in section 3 the relevant stakeholders for the IAF are identified. Lastly, in section 4, we discuss the points for attention when designing a measurement toolkit and we present examples of performance indicators. This paper does not envisage that every IAF reports on all these indicators; each IAF should make its own choices leading to a manageable dashboard and/or performance report. Examples of dashboards are shown in appendix III.

1 Laws and regulations, requirements and rules

1.1 Professional requirements

Certain features and characteristics of an IAF are a given, but they are nonetheless subject to change due to the influence of external developments. Based on the current definition of Internal Auditing² by the Institute of Internal Auditors (IIA), the function has the following characteristics:

1. Independence;
2. Objectivity;
3. Provides added value to improve the organisation;
4. Helps the organisation achieve its objectives;
5. Works according to a systematic, disciplined approach;
6. Evaluates and improves the effectiveness of risk management, control and governance processes.

These 'standard characteristics' must be reconfirmed annually and where possible periodically measured and reported on. By maintaining a dialogue with its stakeholders, the IAF can gain insight into the information needs. It can then design an appropriate measurement toolkit.

The IIA has issued guidance to Audit Committees on how to assess the IAF's activities and performance, which includes the Practice Guide 'Measuring Internal Audit Effectiveness and Efficiency' published in December 2010. This guidance is based on IIA's International Professional Practices Framework (IPPF) governing the behaviour and professional practice of internal auditors.

1.2 Laws and regulations

The raison d'être of the IAF at Dutch financial institutions is primarily based on its position under Dutch law, and more specifically the Decree on Prudential Rules relating to the Financial Supervision Act (implementing Section 3:17(2a) of this Act). Section 17(4) of the Decree sets out the obligation to have an IAF as follows: *"The effectiveness of the organisational design and of the procedures and measures will be independently assessed at least once a year. To this end, the financial undertaking or branch office will include an organisational unit that performs this internal audit function. The financial institution or branch office will insure that any identified deficiencies are eliminated"*.

In addition, the regulations set out general requirements for (supervising) the performance of the IAF. This includes, for example, the requirements in Section III.5.4(d) the Dutch corporate Governance Code: *"The Audit Committee will in any case focus on supervising the Executive Board in relation to the role and performance of the internal audit function."* It also includes requirements from the Banking Code, which since 2015 is included in the document 'Future-Oriented Banking' ['Toekomstgericht Bankieren'] (*"To this end, a bank will have an independently positioned internal audit function. The head of the internal audit function will report to the Chair of the Executive Board and will also have a direct reporting line to the Chair of the Supervisory Board's Audit Committee."*); and the requirements in the Sections 5.3 and 5.4 of the Governance Principles

² Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

(Code) for Insurers: *“The task of the internal audit function is to assess the design, existence and operating effectiveness of the internal controls. To this end, it will monitor the quality and effectiveness of the performance of the insurer’s governance, risk management and control processes. The internal audit function will report its findings to the Executive Board and the Audit Committee.”*; and: *“Information will periodically be exchanged between the internal audit function, the external auditor and the Supervisory Board’s Risk or Audit Committee. The risk analysis and audit plan of the internal audit function and of the external auditor will also be discussed as part of this information exchange.”*

The Monitoring Committee for the Dutch Corporate Governance Code has proposed to revise this Code so as to strengthen the position of the IAF. According to the Monitoring Committee, this strengthening can be achieved by:

- establishing more detailed requirements for the allocation of responsibilities within the relationships in place under company law.
- intensifying the Audit Committee’s involvement with the performance of the internal audit function;
- embedding safeguards for an effective performance of its activities;
- clarifying what the reporting by the internal audit function comprises; and
- if no internal audit function is in place, setting out additional requirements for how the Supervisory Board is to determine whether there is a need for such a function.

Particularly the third point in the bullet list above relates to the objective of the paper. In its revision proposal, the Monitoring Committee writes that the IAF should have sufficient resources to be able to adequately perform the duties it has been tasked with, and that it should have access to the information that is relevant to the performance of its activities. The latter is to be achieved through various measures, including by granting the IAF direct access to the external auditor and the Audit Committee as a whole. Lastly, the Monitoring Committee proposes to create room in the discussions between IAF and the Executive Board and Audit Committee for addressing issues relating to the culture and behaviour within the undertaking.

1.3 Banks

In June 2012, the Basel Committee on Banking Supervision (BCBS) of the Bank for International Settlements issued more detailed principles for the IAF at banks. Fifteen of these twenty principles concern the expectations of supervisory bodies in relation to the IAF. These 15 principles are included in appendix I. The BCBS has also issued guidance on these principles. However, this guidance lacks a description of how the (effective and efficient) compliance with the principles is to be measured.

The Dutch central bank (DNB) has clarified how it interprets principle 1³. In its communication issued in 2013 to the banks which participated in a self-assessment in 2012, the DNB stated:

“The Internal Audit Function (IAF) is effective if it manages to prevent problems. In the event that problems come to light, there is a serious burden of proof on the third line to demonstrate that it has made all possible attempts to be effective in order to have the problems remedied. The IAF should design its information delivery in such a way that senior management is sufficiently aware of the impact of the identified deficiencies in the effectiveness of the internal control, risk management and governance systems and processes.”

³ Principle 1: An effective internal audit function provides independent assurance to the board of directors and senior management on the quality and effectiveness of a bank’s internal control, risk management and governance systems and processes, thereby helping the board and senior management protect their organization and its reputation.

This clearly shows that the DNB has allocated a serious task to the IAF in creating sufficient awareness of and remedying deficiencies. To perform this task effectively, the IAF has to at least clearly and convincingly communicate its findings and the root causes, verbally and in writing and, if possible and useful, take steps to ensure that concrete action points are formulated.

In the further communications on this principle, it has become clear that the DNB also believes that the first line is responsible for the actual implementation of improvements. If improvements are not implemented, that does not merit the conclusion that the IAF is ineffective. That said, the IAF does have an important warning role. The tasks of the IAF also include independently and objectively monitoring the implementation of improvement actions (follow-up) and clearly reporting about this, and this is part of its effectiveness.

1.4 Insurers

Within the framework of Solvency II, the European Insurance and Occupational Pensions Authority (EIOPA) has issued guidelines on the system of governance at insurers. This includes Guideline 5, which sets out that the IAF is one of the key functions that insurers should put in place. In addition, Guidelines 35 to 37 contain more detailed principles for the IAF at insurers in terms of what aspects should be safeguarded by Supervisory Boards in insurance undertakings. These guidelines are included in appendix II.

In its thematic study into the effectiveness of the IAF in small and medium-sized insurers, the DNB applied six assessment criteria/categories:

1. Effectiveness;
2. Performance requirements;
3. Audit Charter;
4. Scope;
5. Outsourcing;
6. Proportionality.

In its survey into the design of the IAF in small and medium-sized insurers (2015), the DNB stated that it expects insurers to expressly assess and evaluate their IAF on the basis of concrete and appropriate criteria. The DNB also bases this expectation on the applicable legislation.

1.5 IA Ambition Model

In addition to the aforementioned sources, the IAF's own objectives also contain guidance on measuring its effectiveness. These objectives are expressed by formulating a mission statement, which is then included in a charter. The IAF's objectives should express a certain level of ambition, setting out a growth path along various stages of maturity.

An Internal Audit (IA) Ambition Model is available that provides assistance in clearly describing this growth path. The IA Ambition Model contains ambition levels and concrete best practices to help CAEs with the formulation of strategic objectives. The IA Ambition Model can also be used in the communication between the IAF and the Executive Board and Audit Committee when discussing and making decisions on the envisaged duties and role of the IAF. The IA Ambition Model is also a self-assessment tool that can help the CAE and its stakeholders in evaluating the IAF and defining a roadmap to achieve the set objectives. The IA Ambition Model has been created by IIA Netherlands in collaboration with the NBA's Internal and Government Auditors

Members' Group (NBA LIO). IIA Netherlands plans to start using the IA Ambition Model for benchmarking purposes in 2017. Those wanting to participate can register via ambition@iia.nl.

One the themes in the IA Ambition Model is 'Performance Management and Accountability'. This theme covers both the IAF's business plan (budget, technical support) and reporting on the IAF's efficiency and effectiveness (KPIs, management reports, etc.). As such, the IA Ambition Model overlaps with this paper. This paper should therefore be regarded as an in-depth discussion of the existing sub-themes.

2 Effectiveness and efficiency

Effectiveness and efficiency are related but distinct concepts. As these concepts are often used interchangeably, we first need to introduce an unambiguous and clear definition of both effectiveness and efficiency. We have opted for the following definition of effectiveness: *“Effectiveness is the extent to which the set objectives are achieved”*. Efficiency can be defined as *“The extent to which resources have to be deployed to achieve a certain objective”*.

Therefore, assessing effectiveness requires knowledge of the set objectives. The set objectives are usually related to providing assurance and delivering ‘added value’ to the financial institutions and its stakeholders. In its clarification of how to interpret its performance standard 2000 ‘Managing the Internal Audit Activity’, the IIA provides the following explanation of ‘added value’:

“The internal audit activity adds value to the organization (and its stakeholders) when it provides objective and relevant assurance, and contributes to the effectiveness and efficiency of governance, risk management, and control processes”.

In the IIA Practice Guide ‘Measuring Internal Audit Effectiveness and Efficiency’ issued in December 2010, an explanation is provided of ‘performance measures’:

Effectiveness and efficiency measurements can be quantitative and qualitative. In addition to compliance with The IIA’s International Standards for the Professional Practice of Internal Auditing (Standards), audit activity performance measures may include:

- *Level of contribution to the improvement of risk management, control, and governance processes.*
- *Achievement of key goals and objectives.*
- *Evaluation of progress against audit activity plan.*
- *Improvement in staff productivity.*
- *Increase in efficiency of the audit process.*
- *Increase in number of action plans for process improvements.*
- *Adequacy of engagement planning and supervision.*
- *Effectiveness in meeting stakeholders’ needs.*
- *Results of quality assurance assessments and internal audit activity’s quality improvement programs.*
- *Effectiveness in conducting the audit.*
- *Clarity of communications with the audit client (often referred to as “auditee”) and the board.*

The above points remain rather abstract. More concrete measurement indicators are presented in section 4.2 of this paper.

3 Stakeholders

This IAF has a range of stakeholders. These are various bodies and functions within and outside of the organisation to which the IAF provides services or which make use of its work⁴, and which have expectations that determine the IAF's effectiveness. Stakeholders may include:

Direct

- Audit Committee/Supervisory Board
- Executive Board, and below it:
 - Senior management (decentralised management, process owners) and the operational departments
 - second line of defence (including Control, Compliance, Risk Management).

Indirect

- Supervisory bodies;
- External auditor;
- Shareholders and other investors (bond holders) and any investor associations;
- Monitoring committees;
- General public.

Each IAF must, in collaboration with the organisation's top management and with due observance of laws and regulations, determine its envisaged added value for the organisation and, where possible, achieve alignment with the expectations. Without clear expectations, there is no clear definition of the IAF's value to the organisation. Furthermore, the IAF's added value is generally not only in providing assurance, but also in submitting proposals or recommendations on improving governance, risk management and internal control, and monitoring the follow-up given to these proposals or recommendations.

Both the Supervisory Board and/or Audit Committee and the Executive Board and senior management primarily seek assurance on the control of risks that are relevant to the achievement of the organisation's objectives.

In addition, Supervisory Board and/or Audit Committee specifically seek assurance on the control of risks. This assurance helps them to render themselves accountable with respect to their responsibilities in the areas of governance and supervision. The Executive Board and senior management benefit from receiving assurance on risks that can help them to achieve success.

By deploying the right mix of assurance, added value and consulting activities, the IAF can ensure that it is increasingly regarded as a 'trusted adviser' or 'change agent'. But in doing so it will have to consider the requirements and expectations of all stakeholders, and ensure adequate segregation of duties between auditing and consulting to prevent a conflict of interest.

It is crucial for the IAF to be continuously updated on the requirements and wishes of its stakeholders. The easiest way to achieve this is by regularly asking for this information. In addition, the IAF has to keep up to date on relevant social developments, incidents and changes in laws and regulations.

⁴ In addition to providing assurance, the IAF can also provide consulting services. Any mixing of consulting and assurance should be avoided so as to prevent any perceived conflict of interest.

4 Measurement toolkit

4.1 Points for attention when designing a measurement toolkit

This section discusses the various tools the IAF can use to measure its effectiveness (and efficiency) and present this to its stakeholders.

It is not easy to develop an effective framework of measurement tools. In practice, it often turns out that different indicators affect each other; they are mutually reinforcing or conflicting. The challenge is to put together a balanced and limited set of KPIs that are periodically measured and on which the IAF can report to its stakeholders.

In addition, IAF by definition have to comply with certain quality requirements pursuant to the IIA's Internal Professional Practices Framework (IPPF). As these basic quality standards can be regarded as 'hygiene factors', an IAF cannot raise its profile by complying with them. Examples of such hygiene factors include:

- Independence and objectivity (IIA Standard 1100)
- Proficiency and due professional care (IIA Standard 1200)
- The Quality assurance and Improvement Programme (IIA standard 1300)

In addition, since 1 July 2015, the IIA Core Principles for IAFs apply:

- Demonstrates integrity;
- Demonstrates competence and due professional care;
- Is objective and free from undue influence (independent);
- Aligns with the strategies, objectives, and risks of the organisation;
- Is appropriately positioned and adequately resourced;
- Demonstrates quality and continuous improvement;
- Communicates effectively;
- Provides risk-based assurance;
- Is insightful, proactive, and future-focused;
- Promotes organisational improvement.

It is important to know the consequences of different measurements, as 'you get what you measure'. For instance, if there is a strong focus on driving productivity (direct hours billed to audits), this may adversely impact the time spent on courses and lead to erosion of the knowledge level in the IAF. Furthermore, achieving the audit year plan does not automatically mean that the IAF is perceived to be effective by its stakeholders. If the audit year plan is not adjusted during the year, for example to audit the control over significant newly arisen risks, the effectiveness of the IAF can suffer despite achieving the year plan. Other examples are including the number of audits as an indicator, which may lead to performing audits 'for the sake of performing audits', and including the number of findings as an indicator. In the latter case, for instance, an audit report with three recommendations may produce more action than a report with 30 recommendations.

So it is important to apply a thorough approach in compiling the measurement toolkit. Obviously, it is important to ask the stakeholders for input and to provide insight into the interdependencies between the effectiveness indicators. In addition, a clear and concise dashboard with a limited number of key indicators

will be more effective than a dashboard with 25 ‘indicator lights’. A dashboard is a tool and certainly not an end in itself. After all, it does not relieve the CAE of his duty to personally find out what is going on in the organisation and within the IAF.

In the section below, we present a list of indicators that can be used to measure the effectiveness (and efficiency) of the IAF. This list is obviously not exhaustive and will have to be tailored to the specific organisation to arrive at a workable list (see also the remark above about the number of indicators). The measurement method will differ per organisation, for instance, as will the timing of measurements (due to different requirements of stakeholders). Lastly, a norm will have to be formulated for each KPI in consultation with the stakeholders. The selected performance indicators must be periodically evaluated and adjusted where necessary.

4.2 Effectiveness indicators

The KPIs used to provide insight into the performance of the IAF as presented in this report are based on the format shown below. This format derives from the IIA’s IPPF Practice Guide ‘Measuring Internal Audit Effectiveness and Efficiency’ (December 2010). The KPIs listed in the Practice Guide have been supplemented with the input of internal auditors to arrive at practical guidance.

Model 1: Balanced scorecard type approach (IPPF Practice Guide ‘Measuring Internal Audit Effectiveness and Efficiency’, IIA, December 2010, page 6)



IIA quadrant model	Effectiveness indicator (where relevant, to be supplemented with a trend analysis over time, e.g. x prior quarters)	Detailed description
Audit Committee	<ul style="list-style-type: none"> • Opinion of Supervisory Board/ external auditor on performance of IAF • Presence at Audit Committee meetings • The extent to which the IAF can perform audits on its own initiative • Reporting by the IAF meets the information needs of stakeholders in terms of timeliness/accuracy/ completeness • Number of completed mandatory audits (supervisory bodies)/ number of planned audits/number of unplanned audits (flexibility) • The number of (operational) risk incidents per period for which no corresponding audit finding was included in the audit reports for the past x years 	<p>In accordance with the various corporate governance codes, as well as their interpretation by the IIA, the Supervisory Board must actively supervise the IAF. In doing so, the Supervisory Board will form an opinion on the design of the function and the effectiveness of its performance. The members of the Supervisory Board (particularly the Chair of the Audit Committee) are to be involved in the appointment, assessments and, if applicable, dismissal of the Chief Audit Executive. Adequate supervision of the IAF by the Supervisory Board has a positive impact on the effectiveness of the IAF.</p> <p>In line with the proposed revisions to the Code, the Chief Audit Executive must be present at the Audit Committee meetings and play an active role in these meetings. He must periodically have bilateral meetings (private sessions) with the Chair of the Audit Committee.</p> <p>The IAF's audit charter shall ensure that the CAE can initiate the performance of any audit that is deemed relevant, so that the IAF can conduct audits into important, urgent risk areas without having to be engaged by a direct client.</p> <p>The IAF must periodically submit reports to the Executive Board and the Supervisory Board (Audit Committee) containing a summary of the findings from the performed audit work and monitoring of the follow-up steps to be taken by business. To optimise its effectiveness, the IAF will make clear arrangements in terms of which individual audit reports are issued to the Supervisory Board (such as reports on strategy, governance and risk management in general).</p> <p>The IAF will report the progress made on the audit plan, clarifying the extent to which the plan has been achieved and explaining why this is so. This reporting will include the reports made 'mandatory' by the Audit Committee and other supervisory bodies. Unplanned audits provide insight into the flexibility of the IAF.</p> <p>If incidents occur, the Audit Committee will consider the IAF to be more effective if it turns out that the IAF had already warned about this in the past.</p>

IIA quadrant model	Effectiveness indicator (where relevant, to be supplemented with a trend analysis over time, e.g. x prior quarters)	Detailed description
	<ul style="list-style-type: none"> • Timeliness of reporting (or escalation) of material findings 	<p>It is crucial for the Audit Committee to be immediately informed of material findings. Depending on the arrangements made on this, the CAE must ensure there is information symmetry between the Executive Board and the Audit Committee.</p>
Internal Audit Processes	<ul style="list-style-type: none"> • IAF's actual expenditure in relation to (financial) budget • Up-to-date audit universe • Number of completed audits in relation to number of planned audits. • Direct hours versus indirect hours and hours spent on business monitoring • Lead times for audits/engagements/reviews, including % per phase (planning, fieldwork, reporting) 	<p>Regarding the budget, the audit charter must stipulate that the CAE can at all times perform additional work if necessary. In regular cases, this will require approval from the Executive Board; in exceptional cases, this will be approved by the Audit Committee (if the Executive Board is not in favour and the CAE escalates the matter to the Audit Committee).</p> <p>Notwithstanding his right to initiate audits, the CAE will manage his budget with due care. In qualitative terms, he must ensure that there are sufficient resources and that they have sufficient qualifications, continuing professional education and tooling.</p> <p>The IAF will apply a logical division of its working field into 'auditable entities' and base its (multi-annual) planning on an annually updated audit universe.</p> <p>The IAF will report the progress made on the audit plan, clearly clarifying the extent to which the plans have been achieved and explaining why this is so.</p> <p>To be effective, the IAF will calculate the required resources, including by calculating what percentage of the resources will have to be available for performing 'direct' work. The actual hours spent must be monitored, which indicate the effectiveness of the deployment of resources.</p> <p>The audit plan will include the planned audits, along with an estimate of the hours required for each audit. Although by definition this cannot be accurately determined, and the planning can only proceed on a surer footing after concrete preparations have been made, it is nonetheless advisable to monitor if the actual work is in line with the planning.</p> <p>The IAF's audit approach will also include an assumption on the allocation of hours within individual audits. The extent to which the actual allocation is in line with the planned allocation, as well as the extent to which deviations</p>

IIA quadrant model	Effectiveness indicator (where relevant, to be supplemented with a trend analysis over time, e.g. x prior quarters)	Detailed description
	<ul style="list-style-type: none"> • Planned audit coverage versus achieved audit coverage in relation to the organisation's key risk and strategic targets • Quality Assurance and Improvement Programme 	<p>are adequately explained in the file, partly determines the effectiveness of the function. We also note that adopting a strategy of staying within the planned hours by limiting the scope of the audit work can actually have an adverse impact on effectiveness, as it will lead to risks or indicate control staying undetected.</p> <p>Achieving sufficient audit coverage in terms of processes, risks and strategy is an important part of the objectives of the IAF. Only then is the function effective in this respect. The planned and the actual work must be in line with each other when considered over the entire planning horizon.</p> <p>In accordance with the IIA's professional rules, each IAF must design a Quality Assurance and Improvement Programme (QA&IP). This consists of periodical self-reviews, peer reviews and regular external reviews, followed up by action plans to (further) improve performance. Having in place a QA&IP is a safeguard for the effectiveness of the IAF.</p>
Innovation and capabilities	<ul style="list-style-type: none"> • Availability of up-to-date job descriptions and competency profiles for staff members • Number of auditors per 100 FTEs • Number of audits per auditor • Availability of core competencies (such as perseverance and persuasiveness) 	<p>To ensure the effective deployment of resources, it is important to design a balanced job matrix. In this context, it is important to keep job descriptions and competency profiles up to date.</p> <p>Through benchmark studies, the number of internal auditors relative to the total number of staff members can be compared for different sectors. A lower ratio compared to peers may lead to reduced effectiveness, and therefore requires further examination.</p> <p>Through benchmark studies, the average number of audits performed per auditor can be compared for different sectors. A lower ratio compared to peers may imply reduced effectiveness. Please note, however, that the number of audits depends on how the IAF is organised and the vision regarding integrated auditing.</p> <p>An IAF's effectiveness is highly dependent on the internal auditor's required core competencies. Annual assessments of skill matrices and a hiring policy and professional education plan tailored to these matrices are good ways of ensuring effectiveness.</p>

IIA quadrant model	Effectiveness indicator (where relevant, to be supplemented with a trend analysis over time, e.g. x prior quarters)	Detailed description
Management/auditees	<ul style="list-style-type: none"> • Experience of staff members in years • Staff member satisfaction • Staff members' educational level • Internal auditors' percentage of completion of required continuing professional education • Extent of compliance with the 'fit and proper test' under Solvency II (insurers) • Staff turnover, including break down into internal and external new staff • Hours of training/auditor • Benchmarking & maturity indicators 	<p>The effectiveness of staff members increases in proportion to their experience. There should be an adequate mix of staff members, supported by job descriptions, competency profiles, skill matrices, professional education plans and staff member performance assessments.</p> <p>An IAF's effectiveness increases when its staff members are satisfied and 'engaged' with their role.</p> <p>Education and experience normally go hand in hand with the development of internal auditors and the growth of their effectiveness. As mentioned before, the IAF must keep competency profiles and skill matrices up to date and ensure an adequate professional educational level for the department as a whole and the individual staff members; this must be monitored.</p> <p>Mandatory CPE credits (for chartered accountants and IIA certification) must be attained and registered.</p> <p>In its position paper 'The role of Internal Audit under Solvency II', the European Confederation of Institutes of Internal Auditing (ECIIA) stated that compliance with the IIA Standards is a good way to demonstrate compliance with the fit and proper test .</p> <p>The IAF's effectiveness depends on the level and mix of the staff members. Excessive staff turnover is not a good sign, but neither is no staff turnover at all. Some staff turnover towards the business is good. It complements the IAF and demonstrates that it produces good staff members. This could be included as a separate performance indicator if this is an objective of the IAF.</p> <p>Together with the elements 'educational level' and 'CPE requirements', the number of hours of training is generally an indicator of the extent to which the IAF stays up to date and up to standard.</p> <p>The IIA offers the GAIN benchmarking tool in which auditors can annually participate, specifically per sector and per country or worldwide and for all IAFs and sectors combined. The benchmark indicates, for a number of</p>

5 ECIIA: "To assess the adequacy of an Internal Audit function in an insurance undertaking under Solvency II, including the fit and proper requirements, the ECIIA recommends using the IIA Standards as benchmark."

IIA quadrant model	Effectiveness indicator (where relevant, to be supplemented with a trend analysis over time, e.g. x prior quarters)	Detailed description
	<ul style="list-style-type: none"> • Extent to which developments in Internal Audit profession are absorbed: - governance audits in scope - model validation in scope - compliance with laws and regulations in scope - regulatory reporting in scope - soft controls audits in scope/behaviour & culture considered in audits/engagements - change management/project audits in scope 	<p>characteristics and ratios, whether the IAF's performance is in line with the applicable professional practices. Besides the GAIN benchmarking tool, an IA Ambition Model is available. In addition, almost all IAFs at the 'Big Four' firms perform a comparable assessment. Peer benchmarking reveals on what points the IAF's performance may be lagging behind the standards.</p> <p>The IAF's effectiveness increases when innovative developments are absorbed in a timely manner.</p> <p>The various governance codes require that the IAF reports on the design and operating effectiveness of the governance.</p> <p>The use of models for scenario analyses and forecasting mechanisms is increasing. The IAF is increasingly expected not only to audit the process of system development, design and management, but also to include the adequate operating effectiveness in the audit scope.</p> <p>Where regulations are relevant, the planning in the IAF's audit plan can no longer be based solely on risk analysis. Instead, specific audits into compliance with laws and regulations will have to be planned, in addition to taking into account relevant laws and regulation in the regular audits.</p> <p>Where specific reports to external supervisory bodies are required, these must be included in the audit plan.</p> <p>There is increasing awareness and recognition of the importance of culture and behaviour in the control of an organisation. These concepts are also included in the corporate governance codes. This means that the IAF must develop an adequate approach for auditing culture and behaviour. The audit approach, skills and communication techniques must be aligned to this.</p> <p>A recent development in this respect is issuing a 'Management Awareness Rating', through which the IAF rates management's handling of risks and/or the organisation's risk culture.</p> <p>Many organisations spend more than substantial components of their budgets on organisational and technological</p>

IIA quadrant model	Effectiveness indicator (where relevant, to be supplemented with a trend analysis over time, e.g. x prior quarters)	Detailed description
	<ul style="list-style-type: none"> - types of IT audits in scope (IT governance, cyber security, 'bring your own device' (BYOD), social media, etc.) - use of van modern IT solutions (CAATs), such a data analyses, data mining and process mining 	<p>changes. Controlling these change programmes is important to control lead times, costs and project outcomes. The IAF must include change programmes in the audit plan.</p> <p>IT environments and IT threats have changed rapidly in recent years and there is a fierce struggle with cyber attackers. The IAF must be prepared and able to audit these new developments.</p> <p>The use of computer assisted audit tools (CAATS) can help to increase the IAF's effectiveness and efficiency, because it allows auditing large amounts of data and identifying/ analysing correlations, which may or may not represent causal relationships.</p>
Management/ Auditees	<ul style="list-style-type: none"> • Monitoring effectiveness of follow-up on recommendations • Reduced external auditor costs because the IAF performs certain procedures or audits • Client satisfaction per engagement/review/audit • Extent of collaboration with second line of defence (Risk Management, Compliance) and external supervisors (external auditor) • Percentage of ad-hoc audits following requests by management 	<p>Where possible and useful, upon the completion of audits the IAF will make recommendations for improving the governance, risk management or process control; sometimes this involves agreeing on very concrete actions. If this leads to actual improvements, the IAF's effectiveness is optimal. In accordance with the IIA's professional rules, the IAD must monitor the implementation and report on it; this is an important effectiveness measurement that requires 'business relevant findings.'</p> <p>Where possible, the IAF can be deployed on (parts of) engagements that would otherwise be allocated to an external auditor. This way, the organisation can save costs and the IAF can be effective. Obviously, any deployment on these engagements may not affect the IAF's core activity, as that would reduce the function's effectiveness.</p> <p>For each engagement, the IAF will normally require the auditee to complete a review form or provide feedback in some other way; by also asking for input on the experiences with the process and communication, this feedback can also be used to measure effectiveness.</p> <p>An adequate collaboration with the second line of defence, and with the external auditor, can increase the IAF's effectiveness.</p> <p>To be effective, the IAF will have to reserve part of its resources for unplanned engagements, which may be ad-</p>

IIA quadrant model	Effectiveness indicator (where relevant, to be supplemented with a trend analysis over time, e.g. x prior quarters)	Detailed description
	<p>and/or internal and external supervisory bodies versus relevant allocated time in the audit year plan.</p> <ul style="list-style-type: none"> • Timeliness of reporting (or escalation) of material findings 	<p>ded to the audit plan at the request of the Executive Board, Supervisory Board and/or external supervisory bodies or on the CAE's own initiative. The extent to which the IAF provides for this in its planning and thus anticipates the latest developments, is an indicator of its effectiveness.</p> <p>It is crucial for management to be timely informed of material findings. If the IAF too often fails to do so, this may have an adverse impact on its perceived effectiveness.</p>

4.3 Measurement methods

The measurement indicators listed in section 4.2 require a range of different methods, as some of these indicators are quantitative whereas others are qualitative.

Both quantitative and qualitative indicators are important for measuring the IAF's effectiveness. The performance on both types of factors can be compared to norms (objectives), the performance in prior periods and/or stakeholder expectations.

Quantitative indicators are often based on existing or available data and can be easily interpreted. Compiling these indicators is generally relatively easy and they can be directly compared to the same indicators used in other organisations. A service available to help with this is the IIA GAIN benchmark⁶, which contains a number of indicators, including:

- Presence at Audit Committee meetings;
- Percentage of audit plan achieved;
- Development of staffing level;
- Number of certified staff members;
- Percentage of implemented findings.

Qualitative indicators are often based on a collection of unique data gathered using more hands-on methods such as surveys or interviews. They usually offer a broad perspective on the IAF's performance, thus enriching the qualitative indicators.

In addition to GAIN, the IA Ambition Model can be used as input for the effectiveness measurement, as described in section 1.5 of this paper.

Lastly, external quality assessments are a good way to periodically receive input on the IAF's effectiveness. IIA Netherlands' Regulations regarding Quality Assessment require that external assessments of the system of quality control are performed at all IAFs at least once every five years. These quality assessments are directed

⁶ GAIN (Global Auditing Information Network) is the benchmarking tool that has been developed by IIA Inc. With this tool IAFs can rapidly and efficiently assess their performance in comparison to a large number of IAFs from all over the world.

by the Quality Assessment Board of IIA Netherlands in accordance with these Regulations. The aim of this assessment is to express an opinion on the extent to which the design and operating effectiveness of the internal system of quality assessment meets the generally accepted standards of professional practice.

It is advisable to periodically report the findings of the measurements to (a selection of) the direct and indirect stakeholders listed in section 3. This requires aligning the content as well as timing of the reporting to the information needs of the recipients. A number of illustrative examples of this are shown in appendix III.

Appendix I

BCBS principles for the Internal Audit function at banks

In June 2012, the Basel Committee on Banking Supervision (BCBS) of the Bank for International Settlements issued more detailed principles for the IAF at banks. Fifteen of these twenty principles concern the expectations of supervisory bodies in relation to the IAF:

- *Principle 1: An effective internal audit function provides independent assurance to the board of directors and senior management on the quality and effectiveness of a bank's internal control, risk management and governance systems and processes, thereby helping the board and senior management protect their organization and its reputation.*
- *Principle 2: The bank's internal audit function must be independent of the audited activities, which requires the internal audit function to have sufficient standing and authority within the bank, thereby enabling internal auditors to carry out their assignments with objectivity.*
- *Principle 3: Professional competence, including the knowledge and experience of each internal auditor and of internal auditors collectively, is essential to the effectiveness of the bank's internal audit function.*
- *Principle 4: Internal auditors must act with integrity.*
- *Principle 5: Each bank should have an internal audit charter that articulates the purpose, standing and authority of the internal audit function within the bank in a manner that promotes an effective internal audit function as described in Principle 1.*
- *Principle 6: Every activity (including outsourced activities) and every entity of the bank should fall within the overall scope of the internal audit function.*
- *Principle 7: The scope of the internal audit function's activities should ensure adequate coverage of matters of regulatory interest within the audit plan.*
- *Principle 8: Each bank should have a permanent internal audit function, which should be structured consistent with Principle 14 when the bank is within a banking group or holding company.*
- *Principle 9: The bank's board of directors has the ultimate responsibility for ensuring that senior management establishes and maintains an adequate, effective and efficient internal control system and, accordingly, the board should support the internal audit function in discharging its duties effectively.*
- *Principle 10: The audit committee, or its equivalent, should oversee the bank's internal audit function.*

- *Principle 11: The head of the internal audit department should be responsible for ensuring that the department complies with sound internal auditing standards and with a relevant code of ethics.*
- *Principle 12: The internal audit function should be accountable to the board, or its audit committee, on all matters related to the performance of its mandate as described in the internal audit charter.*
- *Principle 13: The internal audit function should independently assess the effectiveness and efficiency of the internal control, risk management and governance systems and processes created by the business units and support functions and provide assurance on these systems and processes.*
- *Principle 14: To facilitate a consistent approach to internal audit across all the banks within a banking organization, the board of directors of each bank within a banking group or holding company structure should ensure that either:*
 - *the bank has its own internal audit function, which should be accountable to the bank's board and should report to the banking group or holding company's head of internal audit; or*
 - *the banking group or holding company's internal audit function performs internal audit activities of sufficient scope at the bank to enable the board to satisfy its fiduciary and legal responsibilities.*
- *Principle 15: Regardless of whether internal audit activities are outsourced, the board of directors remains ultimately responsible for the internal audit function.*

Appendix 2

EIOPA guidelines on the Internal Audit function at insurers

Within the framework of Solvency II, the European Insurance and Occupational Pensions Authority (EIOPA) has issued guidelines on the system of governance at insurers. This includes Guideline 5, which sets out that the IAF is one of the key functions that insurers should put in place. In addition, Guidelines 35 to 37 contain more detailed principles for the IAF at insurers in terms of what aspects should be safeguarded by insurers' Supervisory Boards:

Guideline 35 - Independence

1.70. When performing an audit and when evaluating and reporting the audit results, the internal audit function is not subject to influence from the administrative, management or supervisory body that can impair its independence and impartiality.

Guideline 36 - Internal audit policy

1.71. The undertaking has an internal audit policy which covers at least the following areas:

- a. the terms and conditions according to which the internal audit function can be called upon to give its opinion or assistance or to carry out other special tasks;*
- b. where appropriate, internal rules setting out the procedures the person responsible for the internal audit function needs to follow before informing the supervisory authority; and*
- c. where appropriate, the criteria for the rotation of staff assignments.*

1.72. The responsible entity ensures that the audit policy at the level of the group describes how the internal audit function:

- a. coordinates the internal audit activity across the group; and*
- b. ensures compliance with the internal audit requirements at the group level.*

Guideline 37 - Internal audit function tasks

1.73. The undertaking requires the internal audit function, at least:

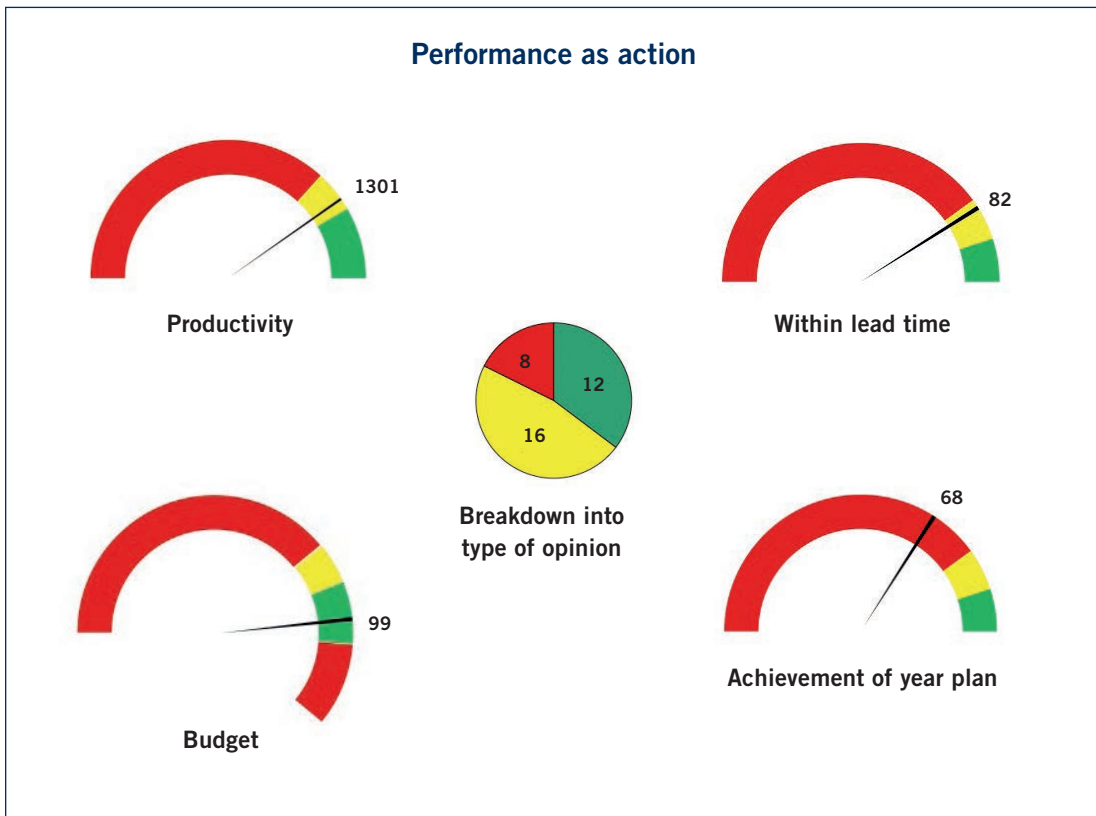
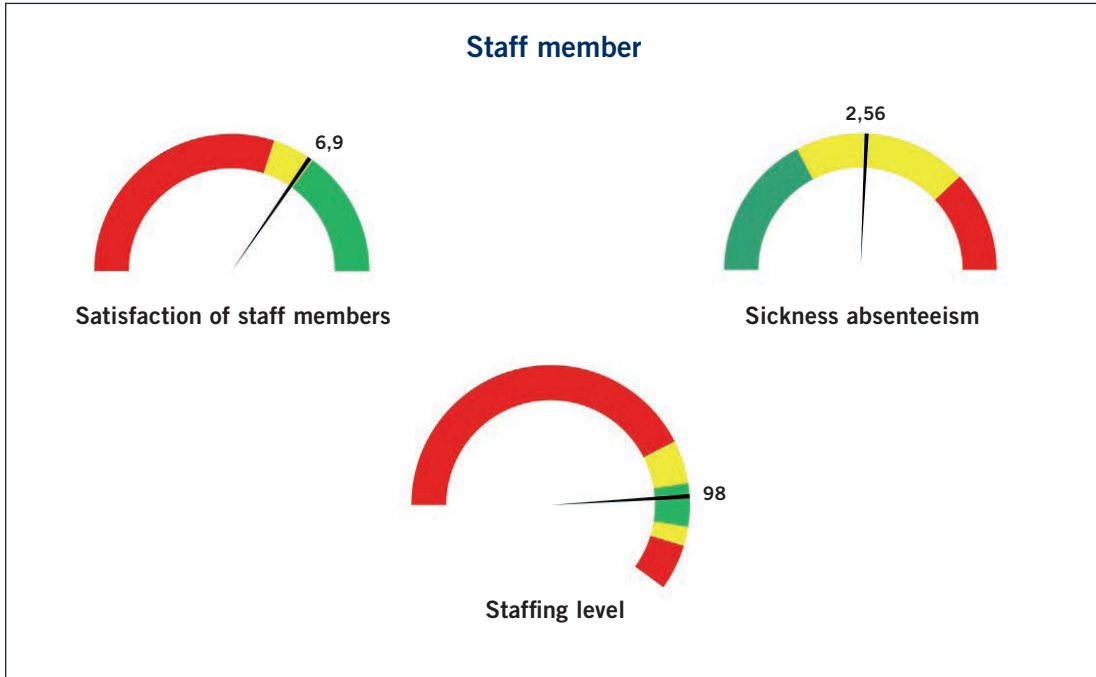
- a. to establish, implement and maintain an audit plan setting out the audit work to be undertaken in the upcoming years, taking into account all activities and the complete system of governance of the undertaking;*
- b. to take a risk-based approach in deciding its priorities;*
- c. to report the audit plan to the administrative, management or supervisory body of the undertaking;*
- d. to issue an internal audit report to the AMSB based on the result of work carried out in accordance with point (a), which includes findings and recommendations, including the envisaged period of time to remedy the shortcomings and the persons responsible for doing so, and information on the achievement of audit recommendations;*
- e. to submit the internal audit report to the administrative, management or supervisory body on at least an annual basis; and*
- f. to verify compliance with the decisions taken by the administrative management or supervisory body on the basis of those recommendations referred to in point (d).*

1.74. Where necessary, the undertaking provides that the internal audit function may carry out audits which are not included in the audit plan.

Appendix III

Examples of dashboards

Performance group audit



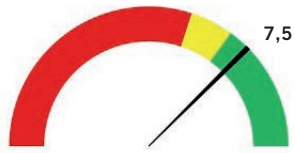
Earning clients



Satisfaction of Executive Board



Satisfaction of BU management

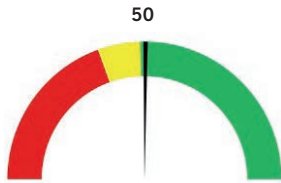


Satisfaction of senior group management



Implementation of GA recommendations

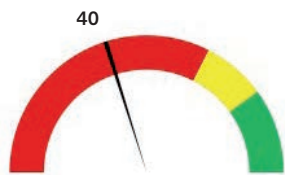
Learning capability (daring to choose)



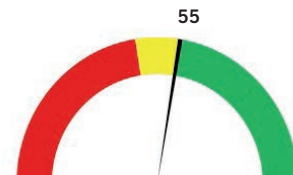
Qualifications of auditors



Internal assessment



Implementation of ICS issues



Hours of training

Area	Indicator	Q1	Q2	Q3	Q4	Comments
Audit plan	Number of audits realised YTD / Number of audits planned full year (#)	.. / ..				
	Percentage of audits realised YTD	%				
	Regulatory audits realised YTD / Regulatory audits required full year (#)	.. / ..				
	Percentage of regulatory audits realised YTD	%				
	Direct audit hours / Indirect hours per Q (%)	..%/..%				
	Number of management requests (# fulfilled / # request) (#) YTD (not in Year Plan)	.. / ..				
Audit Process Management	Number / Percentage of audits realized within agreed assignment letter deadline per Q	/ %				
Quality	Hours of training per auditor YTD (hrs)	-				
	Average Audit Client Satisfaction p/Q, scale” Good=3, Satisfactory=2, Unsatisfactory=1 per Q	-				
	Client score on ‘Audit added value’, scale: Strongly agree=5, Strongly disagree=1	-				

Appendix IV

KPI's Group Audit

	Performance indicators	KPI	Norm
Staff members	1. Productivity	1. The productivity of auditors is at least 90%. For management it is 60% and for support functions 25%. The weighted average productivity is at least 80%.	80%
	2. Percentage of completion	2.1 At least 70% of the original year plan is achieved in the relevant year.	70%
	3. Performance assessment	3.1 All staff members have a tasking.	100%
		3.2 If staff members receive a score of 2 or lower in their performance assessment, this is followed up through an improvement plan.	100%
	4. Education	4. Auditors in Group Audit have at least a RA/RO/RE/CIA degree or are studying towards such a degree.	90%
	5. Experience level of staff members	5. The average level of working experience among staff members is at least 10 years.	10 years
	6. Staff departures	6. Maximum of 5% staff departures per year	5% per year
	7. Sickness absenteeism	7. Maximum average sickness absenteeism among Group Audit staff members of 5%.	5%
	8. Budget	8.1 The number of available hours/FTEs is adequate to execute the year plan.	Adequate
8.2 The financial budget of Group Audit is adequate for the continuing professional education (CPE) and insourcing of external experts.		Adequate	
9. Continuing development	9.1 All Group Audit staff members fulfil their annual CPE requirement.	100%	
	9.2 All staff members have a personal development plan.	100%	
	9.3 Meetings on technical audit matters are held at least twice per year	100%	
Effectiveness	10. How many findings are accepted	10. All findings are included in Action Tracking.	100%

	Performance indicators	KPI	Norm
	11. Performance of mandatory audits	11. 100% of the mandatory annual audits is performed in the relevant year.	100%
	12. Frequency of contacts between Group Audit Director and Chair of Executive Board	12. The Group Audit Director and the Chair of the Executive Board meet at least once every four weeks.	Once every four weeks
	13. Frequency of contacts between Group Audit Director and CFO	13. The Group Audit Director and the CFO meet at least once every three weeks.	Once every three weeks
Independence	14. Staff deployment on projects	14. In the case of deployments on projects, steps are taken to ensure that the auditor remains independent and that Group Audit does not assess its own work.	100%
	15. Task rotation	15. If auditors are deployed at auditees, steps are taken to ensure adequate task rotation.	Adequate task rotation
	16. Number of meetings with the Chair of the ACC	16. The Group Audit Direct meets with the Chair of the ACC at least three times per year.	Three times per year
Stakeholders	17. Survey response rate	17. A review is conducted for at least 25% of audits (in writing or verbally)	25%
	18. Reporting to ACC and Executive Board	18. Group Audit reports to the ACC and Executive Board once per quarter.	Once per quarter
	19. External auditor	19. Formal meetings with the external auditor are held at least twice per year	Twice per year
	20. DNB	20. There are contacts with DNB at least four times per year.	Four times per year