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**Evaluation of Internal Audit Performance by the
Balanced Scorecard (Bs) Method**

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Abstract: The motivation of studying the ways in which the internal audit activity can be improved as well as the impact that this activity has on the decisions of the entity is justified by the complexity of the internal audit field as well as its rapid development. The evaluation of the efficiency and effectiveness of the internal audit function is an important objective of the entity's management, and it must be carried out annually in order to make this function more efficient and to determine the cost-benefit ratio. Analyzing the effective ways of evaluating the performance of the internal audit presented in the specialized literature, two methodological approaches of evaluating the performance of the internal audit were identified: a traditional approach through the structure, quantitative and qualitative indicators, and an approach by the Balanced Scorecard (BS) method, the latter being used in the presented study.

Key words: internal audit; balanced scorecard method; internal audit function; internal audit strategy; risk management.

JEL Classification: M42 - Audit

1. Introduction

Analysing the effective ways of evaluating the performance of the **internal audit** presented in the specialized literature, two methodological approaches of evaluating the performance of the internal audit are identified: a traditional approach through the structure, quantitative and qualitative indicators, and an approach using the *Balanced Scorecard method*.

From the perspective of the traditional methods of performance evaluation, the main quantitative measures of efficiency evaluation are the indicators, in this case it is possible to easily calculate, based on the information contained in the budgets, the daily cost of the audit, the number of audit reports, the number of recommendations made and related to the audit objectives, the time required for the audit, etc.

In the case of effectiveness, this can be measured by comparing the measure of compliance with the audit plan initially established. The difficulty of the quantitative evaluation of the effectiveness, however, comes from the fact that the operational objectives set may not reflect the general purpose of the internal audit, namely the offering of assurances to the management on the internal control system and on the risk management or offering support to the management in order to improve the operations, the control and risk management. Thus, it must be evaluated, the extent to which the **internal audit**

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function has helped the management of the entity to ensure that it has an adequate control system and an effective risk management system.

A way of evaluating the effective performance and the future potential of the effectiveness of the internal audit is presented in figure no.1.

Potential	Performance	Insurance on risk management	Improvements in risk management	Improvements in risk management	Management opinion on the audit
Purpose (audit plans related to existing risks, standardized audit, etc.)	Dedication (direct reporting, standards-based methodology, etc.) Capability (qualified personnel, access to information and data, IT equipment, adequate budget, etc.) Improvement capacity (post-audit review processes, training and development plans, etc.)			↑	↑
Dedication (direct reporting, standards-based methodology, etc.)					
Capability (qualified personnel, access to information and data, IT equipment, adequate budget, etc.)				↓	↓
Improvement capacity (post-audit review processes, training and development plans, etc.)					

Figure 1. Assessing the Effective Performance and Future Potential of Internal Audit Effectiveness

Source: author's point of view

These disadvantages of the traditional approach to evaluating the performance of the internal audit, can be eliminated by using another modern performance evaluation tool, namely the **Balanced Scorecard (BS) method** adapted to the specificity of the internal audit.

2. Literature Review

In the field of internal audit, the theoretical and practical researches were varied and complex, with a large number of specialists who expressed their opinion on the concept of internal audit, the organization and functioning of the internal audit, the procedures and techniques applicable.

In this sense, until the consolidation of the function and its regulation in most European countries, the main researches in the field have aimed: *Strain M.M.(1946) - audit questions from professional examinations, comments on selected cases and topics; Kamp W. H. & Cashin J.A. (1947) - Internal control standards and audit procedures; Cashin J. A. & Owens G. C. & Byrnes W.T.(1963) - Audit, Brasseur J. H. & Miles F.L.(1972) – Auditor's report: cases and illustrations (Brasseur, 1972); Marwick P. & Mitchell & CO (1976) - Research opportunities in audit (Peat & CO, 1976, pp. 129-133).*

The researches of the next specialists are also remarkable *Arens A., Loebbecke K., 2003 (Loebbecke, 2003) or Littleton A. (1961) (Littleton, 1961)* who realizes an integrated approach to audit. Thus, in the elaborated works, they make a general presentation of the internal audit, of the concept, the way of

organization and exercise, of the applicable methods and tools, of the communication in the audit, also speaks about the preparation of the audit mission, the risk assessment; elaboration of audit programs, testing and formulation of findings, as well as reporting the results obtained.

Staciokas R. & Rupsys R., 2005 (Staciokas & Rupsys, 2005) performs a dynamic analysis of the evolution of internal audit responsibilities and states that, “*internal auditors provide advice and recommendations for general management, take part in risk management processes and provide recommendations for improving these processes*”

From a management perspective, *Saam J., 2007* (Saam, 2007, p. 36), believes that the internal audit “*supports the management of the entity in fulfilling its obligations and strengthens the confidence of the owners of the entity in the integrity of the management*”, and *J. Renard, 2006* (Renard, 2006), believes that “*internal audit is all that a responsible person should do to ensure he has good control over business if he has time, or if he knows how to proceed.*”

A study published in the journal “*Maximizing the Internal Audit Function*”, 2010, claims that, for the internal audit function to be effective, the need for eight key attributes in practice, namely: (1) *exploiting the opportunities offered by corporate governance*, (2) *optimizing the risk assessment process*, (3) *developing the scope of internal audit in order to increase the added value of internal audit*, (4) *improving existing skills*, (5) *reducing cost pressures*, (6) *maximizing the advantages of using the technology*, (7) *focusing on critical risks* and (8) *aligning the audit objectives with the needs of the beneficiaries*.

3. Research Methodology

In the elaboration of this research we started from the theory, applying a *deductive type research*, to reach individual conclusions regarding the improvement of the *internal audit*, but also an *inductive type research*, starting from particular judgments to the formulation of general conclusions, by verifying the application in practice of the information obtained. In order to achieve the objectives set in this scientific approach, the methodology used was based on:

Theoretical research, inspired by the following sources: international internal audit standards, specialized books, studies and articles published in nationally and internationally renowned journals, information published on the Internet.

Empirical research, by applying research methods that verify the research hypotheses and establish their own conclusions of a general nature.

The conclusions of the theoretical and empirical research that have contributed to the argumentation of improving the internal audit and increasing its efficiency, at the level of the entities.

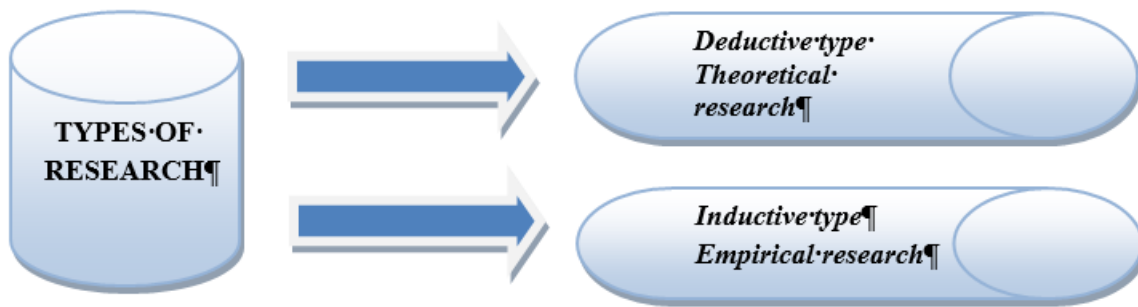


Figure 2. Research Methodology

Source: Own Projection

The main methods used in the research that were the basis of this study were documentation, observation, deductive and inductive reasoning, analysis, synthesis, quantitative statistical and mathematical methods, qualitative methods.

The main categories of documentation sources were obtained on the basis of bibliographic documentation and webgraphic documentation.

Of the two types of observation (external observation and participatory observation), participatory observation was used predominantly, which led to generalizations and interpretations synthesized in conclusions. The participatory observation involved the qualitative approach and the case study, which allowed a detailed description and a thorough analysis of the phenomena analysed.

The quantitative research was carried out by applying mathematical and statistical methods and models, and aimed at quantifying some aspects specific to the phenomenon studied in order to validate the research hypotheses.

The qualitative research aimed to describe the phenomena studied and was combined with the quantitative research during the study.

4. Balanced Scorecard (BS) Method - Delimitations, Relationship with Internal Audit

Belonging to the advanced methods of managerial accounting, the BS method represents a transition between the sequential and linear mode of approach of the performance towards the general, holistic perspective on the strategic changes that take place at the entity level (Olive, Roy, & Wetter, 1999). Overall, the BS method represents a strategic management system that allows the long-term management of the strategy and the specific operations of the entities, which we consider appropriate to be applied at the level of the internal audit function. As the original name of the method suggests, performance is approached from the perspective of the *balance between financial and non-financial indicators*, or the stability of the system of qualitative and quantitative indicators determined. The problem of applying this method is to establish a set of indicators that characterize as relevant, the notion of performance (in our case the **performance of internal audit**). Another benefit of applying the BS method is to ensure *the balance between short and long-term objectives*, between pilot and control indicators, or between the internal performance perspective and the external one (Edwards, 2001).

The initial purpose of the BS method was to design a management system that would allow entities to clarify their vision and strategy and translate them into actions (Chenhall & Langfield-Smith, 2007). The method is based on an approach from the perspective of four dimensions considered to be inducers of long-term value creation: financial information that quantifies profitability, customers, internal processes and the size of growth and learning. Improvements to the method over time have transformed it into an essential tool for practicing strategic management and effective control that can be applied at the departmental level to ensure the balance between the activities carried out by the respective department and the strategy and vision of the entity.

The general scheme of the BS method applied at the level of the internal audit department is presented in figure no. 3.

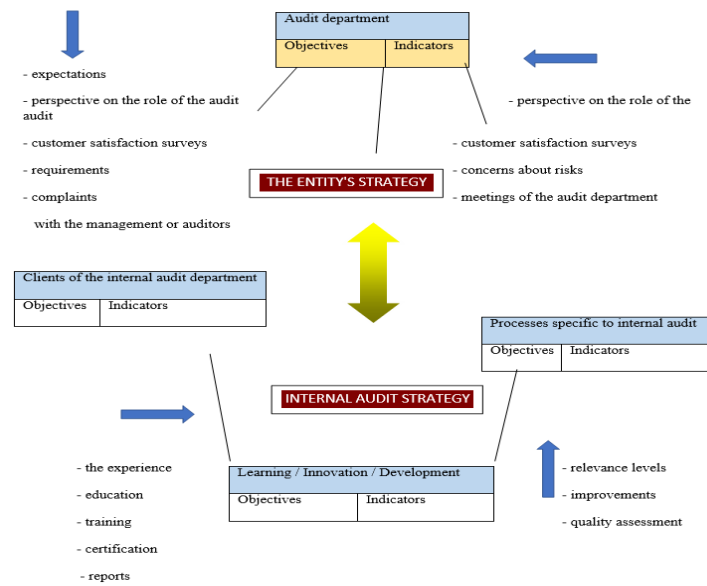


Figure 3. The Dimensions of the Balanced Scorecard Method Applied to the Internal Audit Department

Source: adapted after <http://www.philipatkinson.com/man-Inverclyde-PerformanceMeasures-SLACIAGConference2011.pdf>

5. Evaluation of Internal Audit by Applying the Balanced Scorecard (BS) Method

The construction of a general framework *for evaluating the performance of internal audit through the BS method* is based on a series of hypotheses that validate the use of this method (by adapting it to the specific of the internal audit), even if the method is specific to managerial accounting. These assumptions refer to the importance of evaluating the performance of internal audit from the perspective of management and shareholders (clients) requirements, the need to determine quantitative indicators to evaluate the performance of internal audit, the link between the results of internal audit and the expectations of the interested parties, **the need for continuous improvement of internal audit and its focus on the overall strategy of the entity.**

For the specific situation of the study, we propose an extended model of the Balanced Scorecard method that contains six dimensions: the clients or beneficiaries of the internal audit, the efficiency of the internal audit processes, the risk management, the added value induced by the internal audit, the financial dimension and the human resources dimension involved in the audit. (Figure nr. 4).

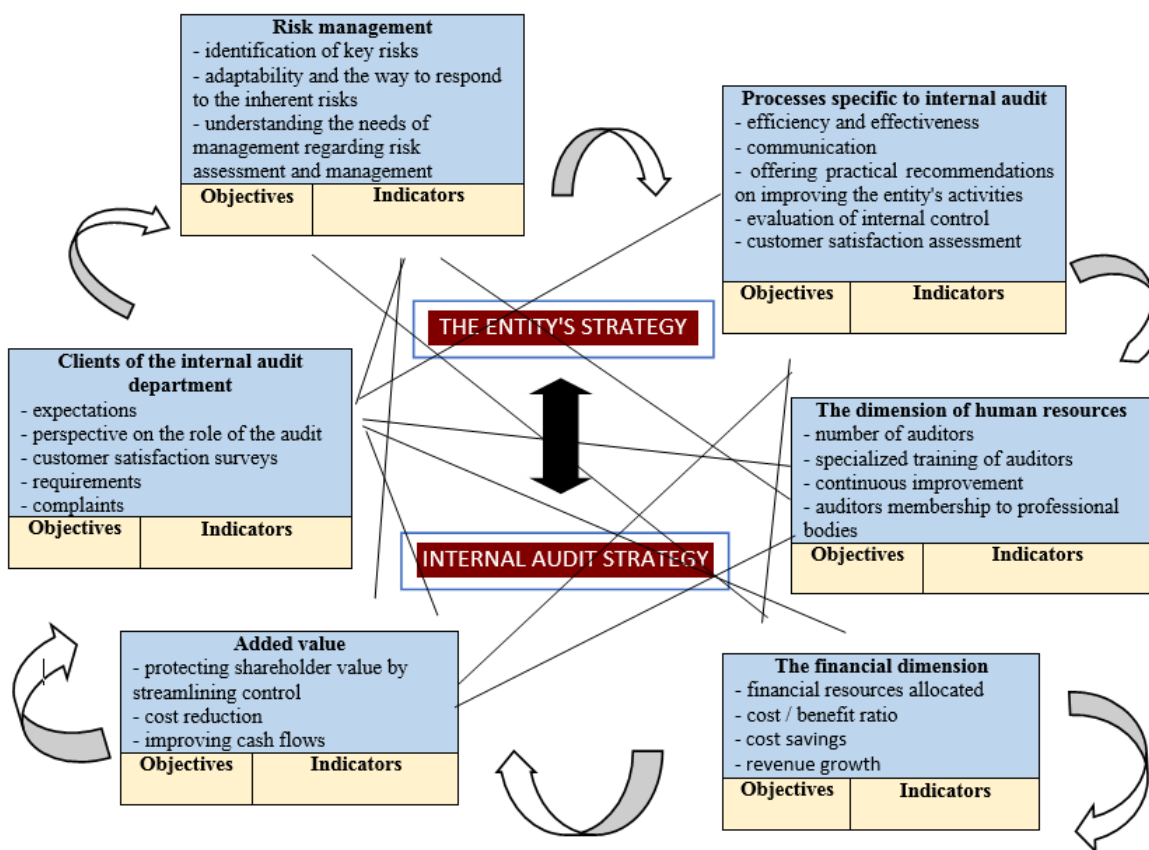


Figure 4. The Dimensions of the Balanced Scorecard Method Applied within an Entity

Source: own conception

Objectives and performance indicators specific to the BS method

Applying the **BS method** requires setting the specific objectives for each dimension, the specific indicators as well as the target values and the accepted minimum values (**table no. 1**).

Table 1. Objectives and Performance Indicators Specific to the BS Method

Objectives	Indicators	Target value	Minimum value	Value 2018	Value 2017	Variation %
Processes specific to internal audit						
Increasing the efficiency and effectiveness of the processes	No. of planned audits / Total number of audits	80%	50%	85%	75%	13.33%
	The percentage of audit objectives achieved within the established deadlines	90%	75%	90%	86%	4.65%
Improving communication	% of respondents who considered that they were continuously informed about the progress of the internal audit	100%	85%	90%	-	-
Offering practical recommendations	No. of approved management recommendations / Total number of recommendations	90%	80%	94%	80%	17.50%
Providing useful internal audit reports at the right time	% of internal audit reports completed within the established deadlines	100%	85%	98%	90%	8.89%
Risk management						
Identifying key risks	% risks approved by management as major risks out of total risks	80%	60%	80%	80%	0.00%
Offering applicable recommendations on risk management	No. of recommendations implemented / No. of recommendations made	90%	70%	85%	70%	21.43%
Beneficiaries of internal audit (clients)						
Identifying clients expectations	The percentage of clients who believe that the expectations regarding the results of the internal audit have been met	95%	90%	100%	-	-
The degree of clients satisfaction	The percentage of satisfied clients calculated based on the received feedback	95%	90%	100%	-	-
The dimension of human resources						
Qualification of internal auditors	No. of qualified personnel / Total number of personnel of the Audit department	100%	80%	80%	80%	0.00%
Continuous improvement	% employees participants in annual trainings	100%	80%	90%	60%	50.00%
The financial dimension						
Evaluation of the	Audit cost / hour	100	115	115	115	0.00%

cost / benefit ratio						
Assessing the impact of internal audit on financial decisions	Annual percentage change of the total expenses of the entity	-10%	-2.5%	+10%	+15%	- 33.33%
Added value						
Protecting shareholders value by exercising effective control	% managers who believe that the entity has an effective control	100%	85%	90%	-	-
Cost reduction	Annual percentage change of the total expenses of the entity	-10%	-2.5%	+10%	+15%	- 33.33%

Both the chosen indicators as well as the target and minimum values were established based on the management and staff consultation of the internal audit department, in order to harmonize them with the general objectives of the management and the entity. If the target values represent a desired goal for a certain interval (2-5 years), the minimum values are of significant importance, representing control values of the results. The specialized software used in the application of the balanced scorecard method uses various warning signals when the value of the indicators approaches the minimum values or falls below them.

Also, in **table no.1** are presented the values of the indicators used in applying the balanced scorecard method for the years 2017 and 2018, as well as the percentage variation of the values of 2018 compared to 2017.

The application of the **BS method** involved both the calculation of quantitative indicators based on the data existing within the audit department and the application of questionnaires for determining qualitative indicators. As can be seen in the presentation table of the value of the indicators calculated under the **BS method**, for the qualitative indicators for 2016 there are no data, due to the non-application of post-audit questionnaires that determine the satisfaction of the audit clients. The activity of probing the opinion of the audit clients was introduced in 2017 with the improvement of the internal audit activity and the reorganization of the internal audit department.

Except for the indicators for which there are no values for the year 2017, the analysis of the data presented in the **table no. 1** allows us to establish the following conclusions:

- all the values of the indicators chosen for the year 2018 were equal to or higher than the values of the year 2017, which demonstrates the positive effects of improving the internal audit activity;
- The practice of an internal audit in accordance with the international standards and the national regulations in force has led to improved results consisting in *increasing the satisfaction of customers, reducing the impact of risks, offering additional value to shareholders, employee satisfaction*;
- the application of the **BS method** for evaluating the internal audit activity offers a global picture of the variables that determine the efficiency and effectiveness as well as the links between them, allowing the management to practice a monitoring and an effective control.

6. Conclusions

Considering the results of the study, we can conclude that the main challenge with important influences on the directions for improving the internal audit relates to the demonstration of how **it contributes to creating added value**. Also, another important direction for improving the internal audit activity is related to the creation of a general framework for evaluating the performance of this activity based on specific methods and procedures for quantifying the performance, which must be analysed in the general context of the overall performance level of the entity. The interdependencies existing between the four dimensions analysed by applying the **Balanced Scorecard** method, highlights the importance of the internal auditors in the audit activity, as well as in evaluating the performance of the entity. In this context, an improvement of the internal audit activity cannot take place in the absence of a continuous process of developing the personnel involved in these activities that require specific skills and habits to perform the specific tasks of internal audit, especially those relating to risk identification and management.

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