THE IIA's CIA LEARNING SYSTEM®

3 Business Knowledge for Internal Auditing

The Institute of Internal Auditors

Section I: Business Acumen

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Part 3: Business Knowledge for Internal Auditing

Welcome to Part 3 of The IIA's CIA Learning System®.

The self-study text for the learning system includes the content addressed in The IIA's CIA syllabus. (You can download the syllabus from the online Resource Center or from The IIA's website.) However, in some cases, the content has been reorganized to facilitate instruction and understanding. Refer to the Table of Contents for an outline of the content.

To get the most out of the course materials, complete the course in this order:

1. Begin by accessing the course at www.learncia.com.
2. Read the overview and return to the menu. Select Part 3 from the menu.
3. Complete the pre-test and view the report to help focus your study efforts.
4. Read each section and follow the Next Steps directions included at the end of the section.
5. Complete Part 3 as outlined in the online overview.

Note that Part 3 of the CIA exam will consist of 100 multiple-choice questions and test takers are given 120 minutes to complete this portion of the exam. You can go to https://na.theiia.org/certification/CIA-Certification/Pages/CIA-Certification.aspx to register for the exam separately.

Study Support

The IIA's CIA Learning System includes online tools to support your study. These tools may be accessed from the menu at any time.

- Glossary—Refer to the glossary for definitions of terms used in all three parts of The IIA's CIA syllabus.
- Reports—Refer to the reports to review your most recent test scores

and progress through the learning system.

- Resource Center—Refer to the Resource Center to access information about The IIA's International Professional Practices Framework, updates, test-taking tips, printable flashcards, related links, and reference material and to provide feedback to The IIA regarding the learning system.

The IIA's CIA Learning System®

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Acknowledgments

The IIA would like to thank the following dedicated subject matter experts who shared their time, experience, and insights during the development and subsequent updates of The IIA's CIA Learning System.

Pat Adams, CIA

Terry Bingham, CIA, CISA, CCSA

Raven Catlin, CIA, CPA, CFSA

Patrick Copeland, CIA, CRMA, CISA, CPA

Don Espersen, CIA

Michael J. Fucilli, CIA, QIAL, CRMA, CGAP, CFE

Al Marcella, PhD, CISA, CCSA

Markus Mayer, CIA

Vicki A. McIntyre, CIA, CFSA, CRMA, CPA

Gary Mitten, CIA, CCSA

Lynn Morley, CIA, CGA

Lyndon Remias, CIA

James D. Hallinan, CIA, CPA, CFSA, CBA

Larry Hubbard, CIA, CCSA, CPA, CISA

Jim Key, CIA

David Mancina, CIA, CPA

James Roth, PhD, CIA, CCSA

Brad Schwieger, CPA, DBA

Doug Ziegenfuss, PhD, CIA, CCSA, CPA, CMA, CFE, CISA, CGFM, CR.FA., CITP

Part 3 Overview

This part of The IIA's CIA Learning System focuses on key areas of knowledge that can help internal auditors directly or indirectly with audit engagements. Some subjects will be directly applicable to any internal audit activity, such as effective management and leadership skills. Knowledge in subjects such as financial management or global business environments can also help the internal auditor to demonstrate to stakeholders that he or she has a firm understanding of the organization's business practices and industry environment. Internal auditors who are perceived as having business savvy and familiarity with the organization will be in a better position to deliver value and insight. Decision makers will place more weight on recommendations that demonstrate sensitivity to the organization's strategy and the complexities of its global challenges. In this way, internal auditors can elevate their role in the organization to one that is perceived as adding value.

In brief, the sections in Part 3 are as follows:

- **Section I: Business Acumen**—organizational objectives, behaviors, and performance; organizational structure and business processes; data analytics
- **Section II: Information Security**—common physical security controls, various forms of user authentication and authorization controls, data privacy laws and their potential impact, emerging technology practices, existing and emerging cybersecurity risks, and security-related policies
- **Section III: Information Technology**—application and system software, information technology (IT) infrastructure, IT control frameworks, disaster recovery, and business continuity
- **Section IV: Financial Management**—financial accounting and finance and managerial accounting

References are made throughout Part 3 to specific external auditing or accounting standards (e.g., U.S. GAAP and IFRS). Your focus should be on the learning point rather than the specific language of the auditing or accounting standard.

Section I: Business Acumen

This section is designed to help you:

- Describe the strategic planning process and key activities.
- Define objective setting.
- Identify globalization and competitive considerations.
- Explain the process of aligning strategic planning to the organization's mission and values.
- Examine common performance measures.
- Explain organizational behavior.
- Describe management's effectiveness in leading, mentoring, and guiding people and in building organizational commitment.
- Describe management's ability to demonstrate entrepreneurial skills.

The Certified Internal Auditor (CIA) exam questions based on content from this section make up approximately 35% of the total number of questions for Part 3. Some topics are covered at the "B—Basic" level, meaning that you are responsible for comprehension and recall of information. (Note that this refers to the difficulty level of questions you may see on the exam; the content in these areas may still be complex.) Other topics are covered at the "P—Proficient" level, meaning that you are responsible not only for comprehension and recall of information but also for higher-level mastery of the content, including application, analysis, synthesis, and evaluation.

Section Introduction

In a tightly competitive market, increased demand and cost savings have organizational ramifications beyond matching or surpassing competitors. Customers demand more for less and have access to multiple sources of quality goods and services at competitive prices. Organizations are examining every business process with an eye toward improving quality and performance in order to address these rising customer expectations. Proponents of quality also point out that a key long-term benefit of investing in quality is that organizations have a strong potential to improve their revenue/profit due to repeat business from loyal customers. This section will examine a number of different techniques and concepts that organizations can use to help them analyze business process performance and be more competitive.

Chapter 1: Organizational Objectives, Behavior, and Performance

Chapter Introduction

Organizational behavior refers to the way individuals and groups behave in the organizational setting. The organization can be thought of as a system with interdependent parts. The culture and other factors influence the way individuals and groups respond. In turn, individual and group dynamics affect the dynamics of the organization.

Organizations foster certain behaviors by their operational and motivational frameworks. This chapter touches on factors that affect how motivated and empowered organizations, groups, and individuals feel. These factors include organizational structure, management style, exertion of power and influence, organizational culture, cultural differences, communication strategies, and employee recognition and reward systems.

Internal auditors need to understand organizational behavior because different controls work differently in the control environment and in different organizations. Also, the root cause of a control deficiency may lie in dysfunctional organizational behavior. Auditors will benefit from a broader, enterprise-wide view of organizational behavior. The auditing activities become a knowledge source in the organization.

Topic A: The Strategic Planning Process and Key Activities (Level B)

Objective Setting

An organization's objectives define what the organization wants to achieve, and its ongoing success depends on the accomplishments of its objectives. For most organizations, a primary blanket objective is to enhance stakeholder value. Objectives also indicate what is expected from a governance, risk management, and internal control perspective. At the highest level, these objectives are reflected in the organization's mission and vision statements. To generate buy-in, a best practice is to get input from people at all levels of the organization when developing or updating these statements.

The mission statement is a broad expression of what the organization wants to achieve today. It needs to clearly indicate the organization's purpose, including its reason for being and how it proposes to add value for its customers and other stakeholders. The mission statement serves as a day-to-day guide or charge to the individuals in the organization on how to achieve this purpose. It also serves as a bridge between the organization's purpose and its vision statement. The vision statement conveys what the organization aspires to achieve or become in the future. It represents the highest aspirational view and goals of an organization in the context of serving and adding value to its stakeholders.

Types of Objectives

Objectives may fall under several categories. Though these categories are distinct, there is often overlap. An objective may address more than one need or responsibility or may relate to different segments of the business or different individuals.

Strategic Objectives and Strategic Planning

Strategic objectives are goals set by management that specifically relate to stakeholder value enhancement, especially over the long term. They are reflected in the organization's strategic plans, which are long-term plans for multiple years into the future. The strategic plan is an important source for many types of assurance and consulting engagements, because other plans and objectives need to align with and integrate into these top-level plans. Also, strategic plans are a valuable communications tool that can set the tone for proper governance. Because strategic objectives and strategic planning are so critical to an organization's success and growth, this is a key area to consider as part of the audit universe. Too often this area is overlooked and a strategic plan is simply used as an input to audit planning rather than being seen as an opportunity for adding value from a consulting perspective (such as improving the strategic planning process itself) or as an area for providing assurance coverage (such as ensuring effective communication of the plan). Ensuring that an organization has sound strategies and a strategic planning process is an important component of effective governance.

Operational Objectives

Operational objectives relate to the effectiveness and efficiency of operations. This includes but is not limited to operational and financial performance goals and safeguarding of assets.

Reporting Objectives

Reporting objectives relate to financial and nonfinancial reporting, both internal and external, and may include reliability, timeliness, transparency, completeness, or other terms as identified by the standards setters, regulators, or policies of the entity.

Compliance Objectives

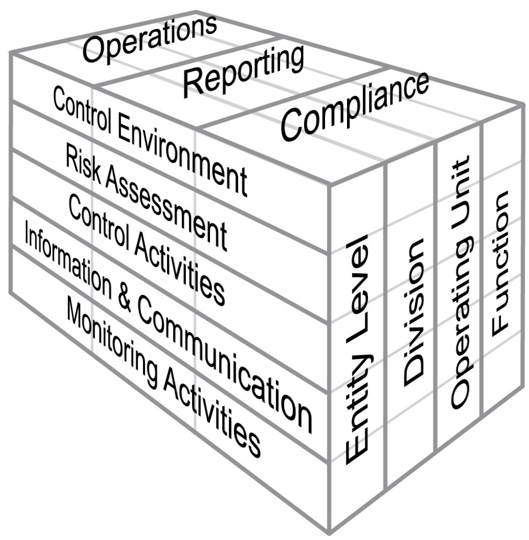
Compliance objectives relate to the laws, regulations, policies, and procedures to which the entity is subject and the entity's adherence to the same. Compliance objective subcategories could include contract compliance, compliance with industry standards and best practices, policy compliance, and so on.

Relationships Between Objectives

There is a direct relationship between the objectives that an entity strives to achieve. This includes the components that represent what is required to achieve the objectives and the entity's overall structure, including operating units, legal entities, and other organizational structures and substructures.

The relationship between these objectives can be illustrated in the form of a cube, as depicted in COSO's *Internal Control—Integrated Framework* model and shown in Exhibit I-1.

Exhibit I-1: COSO's Internal Control Framework



COSO is a U.S.–based framework that is used by organizations to evaluate internal controls. The purpose of a cube metaphor is to show that each side of the cube relates to and influences the other sides of the cube (i.e., the framework has multiple dimensions). The rows represent the five components required for adequate governance, risk management, and internal control: the control environment, risk assessment, control activities, information and communication, and monitoring activities. Adherence to last four of these components is highly dependent on the quality of the first, the control environment, especially the organization's values, attitudes, and ethics. The columns represent the three categories of objectives: operations, reporting, and compliance. The entity structure, which represents the overall entity, divisions, subsidiaries, operating units, or functions, including business processes such as sales, purchasing, production, and marketing and to which internal control relates, is depicted by the third dimension of the cube.

Globalization and Competitive Considerations

An organization sets a strategy to determine not only what type of organization it wants to be but also how such an organization will be likely to thrive in its environment, which is sometimes called an organizational ecosystem. It might, for example, want to be an agile organization that adapts well to changes or a large organization that can offer economies of scale and thus low prices. The organization's success in its strategy depends not only on the successful execution of the strategy but also on the opportunities and risks that exist in the organization's environment.

Globalization has expanded most organization's environments to include access to larger potential customer bases at relatively low costs (opportunities), but this also results in more potential competitors from all around the world (risks). The organization will likely have some competitive advantages relative to its competition. A competitive advantage is a relative advantage one organization (or nation) has over its competitors. Here are some potential sources of competitive advantage:

- **Labor market.** Access to low-cost or high-skill labor, a wide labor pool.
- **Suppliers and raw materials.** Access to materials at favorable prices, good or long-term relationships with suppliers, some degree of ownership or control of (or independence from) suppliers, supplier proximity.
- **Customer base.** Established customer base/market share, loyal and satisfied customers.
- **Process and methodology maturity.** Risk, control, quality, change management, manufacturing, or other frameworks; their maturity level and difficulty in achieving that level of maturity.
- **Supply chain and transportation.** Relative cost and speed of supply chain, number of options for and level of convenience to customers.
- **Competitor maturity and ease of market entry.** Relative number of

competitors, competitor sophistication, capital investment needed to become a viable competitor.

- **Technology.** Labor-saving or insight-generating technology, proprietary technology.
- **Regional economy, politics, culture, legal, and regulatory environment.** Regional economic prosperity, favorable politics and taxation, culture that promotes good values such as hard work or innovation, favorable laws and regulations.

Successful strategies leverage the organization's competitive advantages relative to its competitors. However, competitors' strategies will likely rely on their own competitive advantages due to their geographic location, size, access to capital, and so on. The organization's strategy therefore works to find a way to leverage relative strengths and mitigate relative weaknesses in order to succeed in leveraging opportunities wherever they exist (e.g., in local markets, by expanding globally, by leveraging the online global marketplace) while minimizing the probability or impact of risks, including the threat of competitors taking market share.

Internal auditors may be in a position to help evaluate whether the organization is accurately assessing the current state of its strengths and weaknesses relative to changes in globalization and the competition. For example, this may include assessing whether the organization is altering its strategy in a timely enough fashion to continue surviving and thriving when such factors are changing quickly.

Mission and Value Alignment

Recall that the organization's mission expresses what the organization wants to achieve today. Part of this mission will be to provide and add value to stakeholders; another part will be to state and live up to the organization's values. One way organizations align their mission with their organizational values and ethics is to create corporate social responsibility (CSR) or sustainability programs. The basic concept is that organizations are not responsible for just short-term financial results; they are also responsible to the communities in which they operate, to their workers, and to the environment that sustains all humankind. As organizations implement formal sustainability programs and practices, they develop related performance measures. Internal auditors are starting to play a role in auditing sustainability programs and the design and reliability of the related measures. One way to do this is with a balanced scorecard, which is discussed in the next topic. For more information on CSR, see the discussion in Part 1, Section V, of this learning system or review The IIA's Practice Guide "Evaluating Corporate Social Responsibility/Sustainable Development."

The CAE's Role

The role of the chief audit executive (CAE) related to strategic objectives includes establishing a risk-based plan to determine the priorities of the internal audit activity, aligned with the organization's goals. To ensure that the risk-based plan is aligned with these goals, the CAE must consult with the entity's board and senior management and obtain an understanding of the organization's strategies, key business objectives, associated risks, and risk management processes. Additionally, the CAE must review and adjust the plan as necessary in response to changes in the organization's business, risks, operations, programs, systems, and controls.

Topic B: Common Performance Measures (Level P)

Internal auditors may need to assess the organization's performance measurement system or the performance measurement system of an audit area and determine whether it is efficient, effective, and timely. Can it measure whether central organizational objectives are being achieved? Does it provide reliable information in a timely enough fashion to enable decision making and control? The basic considerations in assessing performance are:

- Identifying related standards for performance.
- Assessing the reasonableness of performance standards in addressing organizational and audit area objectives.
- Comparing performance to the identified standards.
- Evaluating performance gaps (deviations or variances from the standards).

Required corrective actions should be specified and completed in a timely manner. Ultimately, an effective performance management system is one that supports the achievement of organizational goals and objectives, audit area objectives, or, for personnel performance measures, individual and personal goals and objectives.

The most common weaknesses in performance measurement systems involve using the wrong key performance indicators or the wrong number of indicators. **Key performance indicators** (KPIs) focus on accomplishments or behaviors that are valued by the organization and are needed to successfully achieve the organization's strategy and mission. They are valid indicators of performance if they measure the right things and are understandable to management (who use them to guide and improve performance).

An audit of a functional area, for example, may include review of its performance measurement system to ensure that its local or detail-level KPIs align with the organization's strategic objectives and most recent risk assessment. The CAE may also review the entire organization's KPIs for continued relevance. For example, take a manufacturer who sets a strategy to distinguish itself in its market through innovative products built on resource-intensive research and development (R&D) programs. In this case, the CAE may review the organization's KPIs to ensure that they include measures related to R&D efficiency and/or effectiveness. This could be the number of R&D leads at a certain level of development or the number of ideas used in new products that generated a certain level of revenue. The internal audit activity can also audit for controls on the security of proprietary information.

The CAE should also consider whether the organization is meeting its goals, possible reasons for performance gaps, and the role internal auditing could play in addressing these gaps. For example, if a credit card company has not been able to lower customers' default rates, the audit activity might evaluate the credit functional area's KPIs around customer credit approval, timeliness of monitoring delinquent accounts, collection staff productivity, and so on.

In addition to determining whether the KPIs are supporting effectiveness toward reaching goals, another part of the assessment can focus on the efficiency of the KPIs in promoting goal achievement. Too few KPIs might mean a lack of incentive to pursue some of the organization's objectives, such as managers not being assessed on whether they are supporting or promoting the sustainability policy. Too many KPIs is a more common occurrence, and this can also cause problems. The first word in the phrase is "key," and, while the organization can have lots of performance indicators, only a small number should be designated as "key." Too many KPIs can create a situation of information overload. This can confuse or delay decision making or lead to the wrong conclusions, such as allowing a minor criterion to have more weight than it deserves, with an unintended consequence of obscuring the more vital indicators.

Prior to discussing key performance indicators further, this topic first introduces two broad ways of assessing organizational performance.

Organizational Performance

Many of the themes discussed later in this course are examples of things that may affect an organization's performance:

- Trends in the industry and marketplace
- Life cycle of the product and current demand
- Orientation and skills training for employees
- Cross-cultural communication
- Employee motivation and rewards
- Job design and work group design
- Management styles
- Team effectiveness
- Individual and team communication
- Organizational dynamics such as expectations, organizational structure, politics, workplace ethics, change, and diversity
- Advances in electronic communications technology
- Maturity level of an organization in its use of technologies, processes, frameworks (e.g., risk management), collaboration, or other areas

An organization's ability to execute its goals and the results it achieves are prime indicators of its overall success in accomplishing its performance objectives. Performance objectives are the goals and activity-based targets related to the organization's strategy. The performance success factors are indicators of success, which will look quite different from one organization to another.

We'll now discuss two important concepts in this regard—productivity and effectiveness.

Productivity

Productivity is the ability to produce a good or service. In an organization, it refers to the quantity of the outputs (products and services) in relation to the inputs (human and physical resources). Productivity is a way to achieve cost and quality advantages over the competition.

Quality refers to an organization's standards of excellence related to product or service output. The meaning of quality will vary by the type of organization. Physical product quality factors include features, reliability, durability, serviceability, performance, and conformance. Service quality factors include responsiveness, trust and assurance, reliability, and perceptions of customer care. Performance measures related to quality may include things like the number of defects or rejects located by inspection, the number reported by customers, the response time for recovery (e.g., from customer errors), the degree to which the product or service is meeting customer needs, and so on.

Efficiency refers to minimizing the use of resources in a product or service process as compared to standard expectations. Various ratios generally measure the resources actually used against the resources that were planned to be used. Other measures of efficiency include turnover ratios, such as inventory turnover, or the number of times per year inventory is sold and replenished. Efficiency ratios, however, do not indicate the quality level of the outputs. The standards used for the assessments may also need to be reviewed to see if they are still accurate and realistic yet challenging.

Productivity is also linked to profitability, but it is only one factor. Profitability refers to making a profit, or achieving financial gain from an effort over and above the expenses that were required to generate that profit. Various profitability measures are generated by determining which expenses to include or exclude from the analysis, such as operating profit, which measures the earnings before interest and taxes (EBIT) and can help show whether core operations are efficient enough and management is competent enough to keep the organization viable. While productivity measures primarily relate to the short term, profitability can relate to both the shorter and the longer term and may take into account other internal and external factors.

The basic guidelines for improving productivity are to:

- Determine where improvements are needed the most and set priorities.
- Select appropriate measurement tools.
- Assess the current level of productivity.
- Identify and analyze the key factors affecting productivity.
- Set new improvement standards (e.g., best business practices) and provide resources (e.g., funding, new technologies) and support.
- Communicate changes and conduct training if necessary.
- Establish procedures to monitor the new efforts.

Performance measures are used to improve productivity. Simply put, if the quality or quantity of products or services increases, there is an increase in productivity for the organization. Or, if there is the same level or quality of product and service outputs but fewer resources are needed, there is an increase in productivity.

There are several ways to measure productivity, and the methods will depend on the circumstances. A few strategies are noted here:

- Time and motion studies determine how much time is involved in an activity.
- Sampling techniques use observation and samples from processes and outputs to assess workflow and quality.
- Capacity planning identifies the capacity for workflow and outputs.
- Volume analysis looks at product volume and ways to meet product demand.
- Task analysis looks at the tasks involved in jobs and the appropriateness of job design.

- Cost analysis studies cost allocation, cost-effectiveness, cost-benefit tradeoffs, and the possible effects of changing costs.

There are other systematic ways to monitor quality and make continual improvements:

- Benchmarking can be used to compare the organization's practices against the best practices of one or more comparable organizations.
- Quality approaches for continual quality improvement, such as total quality management (TQM), can be used.
- Improvement processes can be implemented, such as Six Sigma, which seeks to improve processes by eliminating defects, and lean, which seeks to improve processes by reducing waste.

It is more difficult to measure performance in nonmanufacturing and knowledge-based industries, such as financial or legal services, because the outputs and value creation are often harder to measure or could include intangible benefits. In other words, performance in some industries may need to be stated more qualitatively and less quantitatively than in others. In these cases, it is important to use more than one performance measure.

An example of a set of operational KPIs for one organization might include the following:

- Gross profit margin
- Net profit and net profit margin
- Debt ratio
- Employee productivity
- Employee adherence to values, ethics, and regulations
- Inventory turnover
- Return on marketing spend
- Customer acquisition cost

- Perfect customer orders (zero defects, correct items, complete items, on time, etc.)
- Customer satisfaction

Note that the first few of these metrics are defined later, in Section IV, Chapter 1.

Effectiveness

Effectiveness relates to outputs and the degree to which an organization's goals and objectives are achieved. Productivity, quality, efficiency, and profitability are all part of the overall effectiveness of the organization.

Today's organizations need to be adaptive and innovative to respond to unexpected internal or external events. Organizational learning and knowledge management are important. Organizations that learn from their mistakes, formulate best practices, and share knowledge are more likely to be successful.

The organization's structure and its work systems, procedures, and processes make a difference in employee motivation, adaptability, and creativity.

The interrelation of the organization's physical location, external environment, management style, resources, and other considerations directly impact organizational effectiveness.

Organizations strive to be high-performing. In a high-performance culture, employees not only contribute to the success of the organization but are in a mindset to continually assist the organization with improvements. They are encouraged and rewarded for thinking smarter, making new suggestions, and being innovative.

The use of work teams is a strategy in high-performance cultures. Collaborative efforts often produce better problem-solving and decision-making results. Others in the organization are also more likely to accept the outcomes from a team.

Some other ways that an organization might improve effectiveness are to:

- Foster organizational learning and knowledge sharing.
- Encourage improvement on a continual basis.
- Develop a culture of trust, which is critical to individual and team work.
- Provide adequate physical space and workspace flexibility.
- Restructure management and reporting lines.
- Redesign jobs to reflect changes in the internal or external environment.
- Form strategic alliances or out-source.
- Make technology and equipment improvements.

These strategies help measure and monitor organizational effectiveness:

- Determine critical success factors that align with performance objectives.
- Determine ways to measure the critical success factors.
- Use sound data for measurement, monitoring, and control processes.
- Capitalize on information technology and knowledge sharing.
- Make ongoing improvements as necessary.

Key Performance Indicators

The organization and each of its subsets need to take care to identify appropriate performance measures—measures that are aligned to and target the performance necessary to meet the organization's objectives. The IPPF Practice Guide "Measuring Internal Audit Effectiveness and Efficiency" describes a four-step process for establishing an effective performance measurement process for the internal audit activity. This same process can be adapted to help determine whether a functional area (or the organization as a whole) has established effective and efficient performance measurement. We will use an assessment of a credit department's KPIs as an example.

Step 1: Define Effectiveness.

The effectiveness of KPIs is based on whether the KPIs can be linked to achievement of the area's objectives and, by tracing upward to summary or aggregate levels of KPIs, whether they also can be linked to the organization's overall objectives. Assessors and perhaps experts in the area can determine what constitutes an effective set of KPIs by coming to an internal consensus regarding completeness of the KPIs in meeting all of the needed objectives at the local and overall organization levels. There is also a benefit in a discussion of how many KPIs is the right number for the area and then working to get to that number. For customer credit, this could include ensuring that the rate of default remains within tolerance levels and that credit is still liberal enough to attract a sufficient number of new and return customers, among other things. These will then point up to overall organizational objectives related to profit margins and growing the base of trustworthy, profitable, and loyal customers.

Step 2: Identify Key Internal and External Stakeholders.

Internal stakeholders may include the board, senior management, operations and support management, and the audit area's internal customers (e.g., areas that rely on the outputs of the functional area being assessed). External stakeholders may include customers, shareholders, third-party vendors, regulators, standards-setting bodies, and external auditors. In-depth interviews and surveys can be conducted to develop a clearer understanding of the needs and expectations of each of these stakeholders. An example of an internal stakeholder for the credit area is the sales functional area. Sales will want a higher percentage of customers approved. Finance will be another internal stakeholder, and finance will want to limit defaults on credit payments, which will tend toward fewer approvals. The chosen performance indicators will need to account for both of these interests and find a way to keep them in balance. External stakeholders may include customers who will naturally want to be approved but should be in a position to repay in a timely fashion if they are. Regulators who work to ensure that the credit policies provide equal opportunity and not predatory are also stakeholders.

Step 3: Develop KPIs for Effectiveness and Efficiency.

KPIs are valuable to each functional area in an organization (and the organization itself), because they allow management to detect shortcomings in execution and plan remedial action. They also allow the functional area to demonstrate its value to its internal and/or external customers. KPIs can be used to support requests for resources needed to support the desired level of performance. Because of the close relationship between the KPIs and the expectations of important stakeholders, it is important that certain stakeholders be consulted with (or at least informed about) the KPIs being considered. This helps ensure that the KPIs focus on meaningful performance that is aligned with the organization's strategic goals.

Whether internal auditors are evaluating KPIs during an audit project or are looking at organization-wide KPIs, they need to get answers to several questions related to effectiveness and efficiency:

- Are the KPIs designed effectively? (Are these the right measures?)
  - Do they cover all the objectives?
  - Can users understand them?
  - Do they ensure that higher-priority objectives get sufficient weight in decision making?
  - Do they consider other priorities to the degree possible while remaining efficient?
- Are the KPIs operating efficiently?
  - Are there just the right number of KPIs to enable timely and methodical decision making?
  - Can the data be collected, prepared, and analyzed in a timely and cost-effective fashion?
  - Are the reports or analysis ready by the time decisions need to be made?
- Are the KPIs operating effectively?

- Do they result in positive changes in actual performance?
- Are the calculations accurate?
- Are the information sources reliable?

Usually, KPIs measure outcomes (e.g., sales, production). Sometimes they measure process characteristics (e.g., timeliness, accuracy). KPIs may be quantitative (e.g., the percentage of customers who repay in full without delinquency) or qualitative (e.g., appropriate use of red flags when evaluating customers who are borderline for credit approval or denial).

Sometimes KPIs measure risk (e.g., delinquency rates, the trend in error rates); these are referred to as key risk indicators, or KRIs. KRIs are often used as leading indicators of risk. That is, if the KRI trends dangerously upward or crosses a predefined threshold, management can identify and correct the root cause before actual damage occurs.

Balanced Scorecard

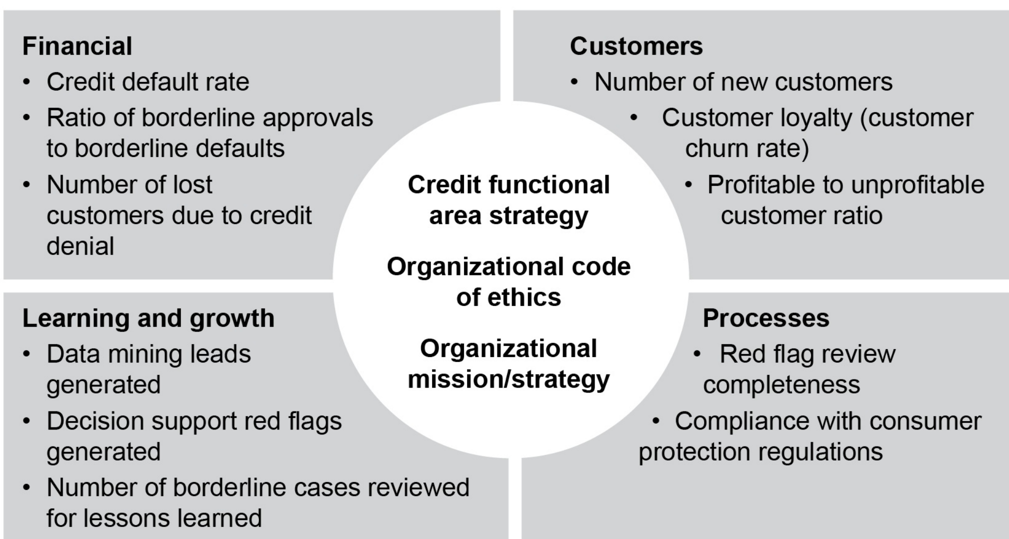
A **balanced scorecard** approach can be used to develop specific KPIs. A balanced scorecard examines performance from four different perspectives: financial needs, customer satisfaction, business processes required to accomplish the activity's mission, and learning and growth to ensure continuous improvement. Many organizations include customized categories that are meaningful to the industry, organization, or functional area. A balanced scorecard is often used by organizations who want to embrace sustainability or corporate social responsibility. Increasingly, organizations are reporting their corporate social responsibility performance measures to external stakeholders. Internal auditors are starting to play a role in auditing sustainability programs and the design and reliability of the measures.

The idea is to create long-term value for the organization and the communities in which it operates. Even as organizations work to add long-term value by considering customers, processes, and learning and growth, they need to stay in business to do so; therefore, the financial perspective is still a necessary and vital area of an organization's performance even as it expands its perspective. Examples of financial metrics (some of which might be designated as KPIs) are discussed later, in Section IV, Chapter 1.

While financial metrics will be primarily quantitative in nature, the other three balanced scorecard perspectives may contain a mix of quantitative and qualitative measures. Some of these other areas are more difficult to measure, especially over the short term. For example, as organizations implement formal sustainability programs and practices, they are developing related performance measures, and some of these may be quantified while others will be more subjective or require estimation, such as the impact of higher quality or the impact on customer loyalty of a particular loyalty program.

Exhibit I-2 shows an example of a balanced scorecard that might be developed for the credit functional area of an organization. Note that the sources of the organization's objectives are shown in the center.

Exhibit I-2: Balanced Scorecard for Credit Functional Area



Step 4: Monitor and Report Results.

When providing consulting or assurance related to an audit area's KPIs, it is important to verify whether or not performance against the KPIs is monitored, considered as the basis for quality improvement, and reported at an agreed-upon frequency to the appropriate levels of management (and perhaps the board, depending on the area) and in the manner desired by the area's stakeholders (e.g., presentations, automated dashboards, emails). Occasionally, in-depth interviews and surveys should be conducted with stakeholders. Internal auditors may also want to benchmark the audit area's KPIs against those of similar functional areas of competitors, of industry leaders in a given functionality, or of similar functional areas in different business units.

Assurance or consulting engagements may also assess the quality and accuracy of the data used, the correctness of the calculations or formulas used in ratios, whether automation is being used properly to make data collection and analysis seamless (and more likely to be done on a regular basis), and the risk of errors in the analysis and reporting systems as well as how the errors might be introduced (e.g., a spreadsheet is easy to create but also easy to alter, creating a significant risk of errors being introduced even into a previously error-free spreadsheet).

Topic C: Organizational Behavior and Performance Management Techniques (Level B)

Internal auditors who understand what motivates people will be in a better position to determine whether a given decision, performance measure, incentive/penalty, policy, procedure, or control may be efficient and effective at encouraging people in the organization to work toward organizational goals. They will also be more versed in human nature and therefore more able to detect when these things are likely to generate unintended consequences (the negative or counterproductive side effects that can result from a decision, measure, control, etc.). This could be a manager not budgeting for sustainability improvements because sustainability is not part of that manager's performance assessment. Or it could be a control weakness that promotes altering, ignoring, or finding loopholes to exploit in the control for personal or organizational gain. Part 1 of this learning system looks at three conditions—opportunity, motive, and rationalization—that can suggest the possibility of fraud if present in the right proportions. Learning about the motivation of individuals and groups can help internal auditors understand more about each of these conditions.

Human motivation is complex, especially considering that organizations have a certain degree of cultural diversity and contain persons from different generations and age groups. Due to these and other complexities, no one motivational theory has been determined to be the best for predicting organizational behavior in all situations. Many experts have generated motivational theories, and the ones discussed below have had some staying power. Learning about these various motivational theories will provide internal auditors with a grounding in this area of considerable research and debate.

This topic will then go on to discuss some ways to understand the organizational environment and the people in it. This understanding is needed for the effective design of performance management techniques such as job design or customizing rewards, which form the conclusion to this