

LEAN AUDITING - RETHINKING INTERNAL AUDIT USING LEAN TECHNIQUES TO ENHANCE ADDED VALUE AND REDUCE WASTE

- BY JAMES C PATERSON

When I was Chief Audit Executive (CAE) for Pharmaceuticals company AstraZeneca PLC, I became increasingly interested in two key questions about internal auditing:

- How could I be sure the internal audit function **was adding the maximum value** it could?
- How could I be sure the internal audit function **was as efficient as it could be** – moving beyond benchmarking and going back to first principles?

One of my audit team alerted me to lean manufacturing (which revolutionized the Japanese motor industry in the 1960s and 1970s) and suggested we could adapt this to internal auditing. After an initial review we agreed that lean techniques could help us and thereafter we worked to apply these to what we did, creating a lean auditing approach and obtaining positive recognition internally and externally, and also driving efficiency improvements of around 20%.

Several years later I started to work as a freelance consultant and took what I had learned at AstraZeneca and applied and enhanced it with my clients. I also started to run training on lean auditing for the IIA UK and thereafter gained interest overseas in Belgium, Sweden, the Middle East, South Africa and as far afield as Canada and Australia.

In 2013 I was approached by John Wiley & Sons, Ltd and asked if I would write a book on lean auditing - and after much consideration - I started to plan the book in the autumn of 2013. I was aware that some of the ways of working that I would be proposing would be challenging to some internal auditors, so I decided to discuss the principles and practices with a range of heads of audit, some of whom were my clients and some not, to validate and enhance what I was planning to write.

In addition to interviews with more than twenty heads of audit, I was also lucky enough to interview Richard Chambers the CEO of the IIA in the USA, Norman Marks, a leading thought leader in GRC in the US and also Chris Baker the technical manager of the IIA UK. With all these interviews, as well as eight years experience working on lean auditing I had too much material to fit into one book, but finally produced an 83,000-word manuscript, which is now with the publisher for final proofing and due for release early in 2015.


I thought it might be useful to offer a brief overview of lean, lean auditing and some of the key messages from the book.

What is lean and what can it offer us?

The label “lean” was first used in 1987 by John Krafcik, a student at that time of the Massachusetts Institute of Technology (MIT) who examined the Toyota Production System that had revolutionized their production methods and observed: “It needs less of everything to create a given amount of value, so let’s call it lean.”

After this first use of the term lean came a series of important books including:

- “The machine that changed the world” by Womak, Jones and Roos and
- “Lean Thinking” by Womak & Jones, which was published in 1996.



Lean techniques have now been successfully applied in a range of sectors outside of motor manufacturing (e.g. in white goods and pharmaceuticals manufacturing) and, increasingly, in service sectors (e.g. airlines, healthcare). Typical benefits obtained from lean ways of working include:

- Reductions in: Defects, Lead times, cost, inventory and waste;
- Improvements in: Customer satisfaction, Productivity, Capacity, Responsiveness and Quality.

Lean ways of working have also been used in relation to finance, HR and IT. And the application of lean to internal auditing can be thought of as just a continuation its application. However, the key to success is to understand how to intelligently apply these principles and techniques whilst respecting key IIA standards.

Key principles of lean

The 5 key principles of lean can be summarized as:

- Specify value from the point of view of the customer;
- Identify the value stream;
- Create activities that Flow;
- Pull through “just in time”;
- Always strive for perfection.

It is important to recognize therefore that lean is not simply about reducing costs although managing and reducing costs is a by-product of lean ways of working. This also means that working in a lean way is often a much more positive thing than most people realize and is something that regularly is told to me during the lean auditing workshops I run.

It is outside of the scope of this article to outline the excellent range of tools and techniques that lean gives us (though they are contained in the lean auditing book) but some key points likely to be of interest are:

- Being clear who are the customers of audit work

As one head of audit explained to me:


“When I first started out in audit, some 20 years ago, I was more interested in the value I added to the business managers I was auditing. One, it's an easier life, you keep people happy who you are dealing with 95% of the time, but over time I see it's a mistake to forget that you've got competing interests in terms of what other stakeholders might want”.

- Being very clear what those customers really want (and what they do not want).

When considering the audit report one head of audit I interviewed explained:

“A report is only valuable when management and the board use it and see that it helps them.

If they briefly look at it and then put it aside, then it is basically useless in my view. On the other hand, if they look at the report and say 'yes, this is something I think will help me manage my business' or if they discuss the contents of the report with other parts of the business, then it is a good sign.



My measurement of the value of an audit report is not about the contents or the number of issues raised but by how management and the board use it to manage their business.”

Another key area of focus is the way in which audit work creates dissatisfaction and steps that can be taken to reduce this.

- “Going to look see” what is really going on (the Gemba Walk):

In the context of an audit assignment think about delays and difficulties that can arise just getting information to start an audit; think about inefficiencies in testing or getting actions agreed (one audit function I have worked with sometimes produced ten drafts of the audit report before it was final).

- Paying close attention to identifying Muda (waste)

The founder of lean Shingo Shigeo said: “The most dangerous waste is the waste we do not recognize”. Much of my consulting and training is focused on helping audit functions to more clearly see the ways in which time or effort is wasted. In addition lean techniques address issues around unevenness in assignment delivery. For example in an audit context postponed or delayed assignments can often result in a peak of activity at the end of the year that can impact both the delivery of the audit plan and the quality of the assignments delivered at the end of the year (when there can often be a greater focus on finishing the assignment to time that driving real value from the assignment).

Of course, which lean tools to apply and how apply them needs to be situation specific and appropriately tailored to internal audit work.

The consequences and benefits of using a lean auditing approach

The benefits from using these tools and techniques can range between each audit function and will depend on the extent to which best practices are already in operation. One of my interviewees makes a key point:

“I think that there can be issues around peoples’ understanding of lean auditing. People can easily see it as just finding an efficient way of doing an audit. In other words, it is the methodology that is related to lean, not the focus of the audit and the outcome. They might think it's meant to relate to cutting out unnecessary administration and trying to avoid long drawn-out audit reports and taking ages to get your audit report produced. This probably comes from the lay mans understanding of lean which is that its about cutting things back to their bare bones.

Of course lean has an element of this but its not just about cutting out unnecessary activities, its just as much about getting the focus of the audit right and using the time more wisely and more effectively”.

Thus the key benefits from a progressive, lean audit approach are many fold for both internal audit and the wider organization but can include:

- The creation of an audit culture that is focused on delivering value add

- An audit plan that is more closely, and demonstrably, aligned with the key value drivers of the organization on an ongoing basis;
- An audit function that plays a key role in understanding the overall risk assurance landscape of the organization
- An audit plan that is scheduled and delivered with the minimum of delays or difficulties;
- Audit findings, reports and other forms of communication, that are short, insightful and recognize the wider context of the organization and the challenges it is facing;
- An audit function that is able to highlight appropriate efficiency opportunities in the wider organisation, including instances where the streamlining of compliance and control processes would be beneficial;
- A function that can clearly demonstrate a positive return on its cost.

Insights from those interviewed

Of course there can be a range of barriers to achieving benefits from a lean audit approach but these are often about changing the mindset of the audit team and key stakeholders. Here are some extracts from the interviews I had with heads of audit and other thought leaders (whose details I am keeping anonymous at this stage).

Managing stakeholders:

One person I interviewed explained:

“If your audit committee says, ‘We want you focused on assurance over financial controls,’ and executive management says, ‘We really would like for you to give us more insight and advice on key operating controls,’ then you have a dilemma.

As a head of audit, you have a responsibility to serve both management and the board. If the board is telling you one thing and management is telling you another, it's a slippery slope. You can't just say, ‘Well, management, I'm sorry but the board wants this,’ because, ultimately, management allocates internal audit's resources.”


My advice, when there are differences between key internal stakeholders, is to get a reconciliation of expectations”

Audit as Investment or expense?

Another head of audit explained:

“We work with a large number of different audit committees and senior management teams, so there is a degree of change every year. As things change we organize time together, for example, a half-day away day.

We say: do you want to treat audit as an investment or an expense? We work together to help these stakeholders see audit as an investment. And if you want to invest in something you want the best possible return. And if you want to get the best possible return that's about investing time on an ongoing basis where we can sit round the table and explore what we are planning to do for you and why. As a result we can see these stakeholders valuing more audit work in relation to business projects and other strategic issues, rather than just core compliance and financial control areas.



I think its fundamental that we continue to get the debate going on investment versus cost in relation to audit. That's where lean comes in. Concentrating on the right areas first, then once this is clear cutting out the waste, the things that we've done because of tradition rather than because they are really important".

Lean requires a degree of innovation:

One of my interviewees explained:

"I think the profession needs to be prepared to do some things differently. I think we get stuck sometimes because something has never been done before. We're not that adventurous as a profession.

Whilst being innovative might feel risky to some audit functions, if this innovation is informed by insights based on what stakeholders like and do not like, then the risk is going to be quite low, especially if new approaches are positioned as pilots. Indeed I would argue that the greater risk to audit in the long run is that it does not change with the times, and becomes sidelined".

Focus the plan on what matters:

One interviewee, who has experience of External Quality Assessment (EQA) explained:

"I've just been doing an EQA in an organization where the audit plan is split up into lots of pieces of work. I can see that the Audit Committee are very unhappy, and I am too, looking at it. Because they've got too little depth on things that are important, and even where they are looking at processes it appears that they are focusing on the stuff that's tickable.

Every member of the audit committee that I've spoken to so far has basically said, well the audit reports don't really tell us anything. They're generally saying everything's all right because they are looking at the stuff that's easy to audit and they are not asking more fundamental questions in relation to the risk areas that are much more significant".

As a result I would strongly encourage audit teams to spend a bit more time on their audit planning process, including looking more closely at the risk audit universe.


Resource assignments appropriately:

Of course whilst the overall audit plan must be focused on what matters the most, it is important to be careful about the way that each assignment is resourced. One head of audit explained:

"We are being more flexible but also more challenging on the amount of time we spend on assignments. We will accept a more diverse range of how much time we will spend, the aim being to more closely match assignment lengths to the likely value add"

Assignment planning:

One interviewee explained:



“Planning an assignment is key because when I see things going wrong, including delays in delivery, it is often because we didn’t think enough up front. It can be as simple as not recognizing a key contact is travelling or on holiday for 2 weeks during the assignment.

Unless people have really thought about what they want and sufficiently planned and been rigorous in engaging the business, problems will arise”.

Another interviewee explained:

“Good audit departments put a lot of effort into thinking about and agreeing the scope of their audits so they are addressing important points; and as a result key findings will then be meaningful to the organization”.

Testing:

One of my interviewees explained:

“IIA Standards say that you need to gather sufficient evidence and have sufficient relevant information to be confident about what you are concluding and in order to be able to express an opinion.

The basic principle is clear: you've got to do enough work and gather enough information and interpret and analyse that information to form a view.

That's often translated into a whole load of advice about how many records you need to look at and how many tests you need to do to substantiate everything, when, in point of fact, when we are focusing on risk and adding value it should be different from that.

It's wrong to stick to sample requirements in a rigid way”.


Root cause analysis:

With the time saved from more intelligent testing, additional added value can be derived from a solid root cause analysis. One interviewee commented:

“I think that reporting the findings in terms of symptoms and then stopping is ridiculous. If you just report the reconciliations are not being done, without asking five or six more questions that may be needed to identify the root cause, the issues don't go away. You're actually not curing the patient. You're just pointing out the problem”.

Reporting:

One senior auditor explained:



“Before we put pen to paper and waste our time, let's write up a list of findings and first of all decide whether we agree these are all important.

After that we can look at the findings and the proposed corrective actions and start to see whether there are patterns, so that they can be combined.

This approach makes sure that audit reports are more focused, with less need of rewriting. It also helps you to combine points making reports as concise and readable as possible, and also helping stakeholders better judge the relative significance of what is being found”.

The key message is to think carefully about what is key in the audit report and to focus on that, avoiding the demotivating and wasteful practice of rewriting audit reports.

Final reflections

Many more detailed practices and insights are contained within the lean auditing book. These have given me encouragement that there is a considerable body of progressive, value adding, practice in the internal audit profession across a range of countries and sectors. However, it is clear from my research that many audit functions can do more to improve their value add contribution and/or improve their efficiency and will therefore gain benefit from the practices outlined in the book.

Of course making progress in driving forward more progressive audit practices requires leadership and judgment from heads of audit and auditors. As one head of audit explained:
“It takes confidence and courage to say no, I'm not doing any more audit work. It takes confidence and experience to say I'm not going to drill down any further. I've got my point. Management have said yes, we agree, we've got an issue, we need to do something about it.”

My hope is that the greater understanding of lean principles can help us as a profession to become more confident in making these judgments, without feeling like we are “cutting corners”. Of course this will also require stakeholders to better understand what progressive audit practices are like, and therefore at the end of each chapter in the book I have prepared some key messages for senior managers and board members as well, which I hope will help them see the benefits of a more progressive, value added role for internal audit.

Writing this article has felt like squeezing a gallon into a pint pot, and may have opened up as many questions about lean auditing as it has answered. However, I hope that those reading this article are curious to learn more, whether through their own research, by attending a lean auditing course, or even buying the book! (Lean Auditing – ISBN 9781118896884). You can also contact me on: jcp@riskai.co.uk.