CHAPTER 19

Internal Audit, Management and Operational Audit

Question 1

Internal Audit said to be an "Independent appraisal activity within an organisation for review of accounting, financial and other operations as a basis of service to the organisation, it is a managerial control which functions by measuring and evaluating the effectiveness of other controls". Explain briefly.

Answer

Traditionally, the expression, 'internal audit' refers to an audit conducted on behalf of the management to ensure that the existing internal controls are adequate and effective; the financial accounting and other records and reports show results of actual operations accurately and promptly; and each unit of the organization follows the policies and procedures as laid down by the top management. Thus, during initial stages, the internal auditor's significant emphasis was on detection of errors and frauds focused on financial aspects of the enterprise.

Over a period of time, the participation in non-financial areas increased rapidly since the business scene was changing very fast. Pressure on the managements was building up due to enormous growth of organisations in size and operations. The complexity of business activities and voluminous transactions led to increasing dependence on large number of people. It was in this context that the management recognised the possibility of utilising the services of internal audit department in a much more effective manner. And this was possible with only a little extra expenditure. It was strongly felt that the expertise built by the internal auditor in financial operations should be equally useful for non-financial operation of the enterprise as well. This is how in the expression given in the question all three words viz. "accounting", "financial" and "other operations" stand on equal importance. The Statement of Responsibilities of Internal Auditor issued in 1971 by the Institute of Internal Auditors, USA cut the umbilical cord to the books of account and simply defined internal auditing as, Internal auditing is, "the review of operations as a service to management". With this revision of definition, it was made clear that accounting activity is also one of the operational areas of the entity like production, research and development, personnel, marketing, etc. In 1981, the definition was modified as under:

"Internal auditing is an independent appraisal function established within the organization to examine and evaluate its activities as a service to the organisation. It is a managerial control

which functions by measuring and evaluating the effectiveness of other controls."

With this, internal auditing came to be recognised as a management resource- an important part of the total internal control system for which management is primary responsible. Today, the total range of services rendered by the internal auditor covers both protective needs and constructive needs stressing on performance and operations. Specifically, the range of activities as outlined in the Statement of Responsibilities of Internal Auditors is as follows:

(i) Reviewing and appraising the soundness, adequacy and application of accounting, financial, and other operating controls, and promoting effective control at reasonable cost.

(ii) Ascertaining the extent of compliance with established policies, plans and procedures.

(iii) Ascertaining the extent to which company's assets are accounted for and safeguarded from losses of all kinds.

(iv) Ascertaining the reliability of management data developed within the organisation.

(v) Appraising the quality of performance in carrying out assigned responsibilities.

(vi) Recommending operating improvements.

A close examination of those services help us in identification of primary protective services viz second, third and fourth, and those that are primarily directed to further improvement in operations (i.e. the first, fifth, and sixth).

The modern concept of internal auditing suggests that internal auditing need not be confined to financial transactions and that its scope may be extended to the task of reviewing whether the resource utilisation of the enterprise is efficient and economically. This would necessitate a review of all operations of the enterprise as also an evaluation of the effectiveness of management. In this sense, the internal auditor performs what is known as 'Operational audit' or 'Management audit'. Thus, the expression makes it clear that the scope of activities of internal auditor is not restricted to financial areas but extends to non-financial areas as well.

(Note: Recently, the Institute of Internal Auditors itself has revised the definition of Internal Auditing. The revised definition is:

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

Question 2

Briefly explain the objectives and scope of Operational Audit.

Answer

Objectives of Operational Audit: The need for operational auditing has arisen due to the

inadequacy of traditional sources of information for an effective management of the company where the management is at a distance from actual operations due to layers of delegation of responsibility, separating it from actualities in the organisation. Specifically, operational auditing arose from the need of managers responsible for areas beyond their direct observation to be fully, objectively and currently informed about conditions in the units under control. Operational audit is considered as a specialised management information tool to fill the void that conventional information sources fail to fill. Conventional sources of management information are departmental managers, routine performance report, internal audit reports, and periodic special investigation and survey. These conventional sources fail to provide information for the best direction of the departments all of whose activities do not come under direct observation of managers.

Operational auditing has filled a very significant vacuum; it has come to provide the management with inexpensive, continuous and objective appraisal of activities, operations and controls to inform the management about achievement of standards and, if otherwise, to inform the management about what has gone wrong and how it has gone wrong. Also, it enlightens the management about possible dangers, constraints and opportunities that may be of immense value to the management.

The scope and quality of operational auditing is predominantly dependent upon management attitudes. An open minded management with broad vision, can appreciate the need of operational auditing and to give it the necessary freedom and sanction to perform what it is capable of performing. Also, the qualities and the sense of perspectives of the operational auditor can mould operational audit in the right shape. Without a combination of these two, operational auditing may not be able to show its distinctively and advantages to the organisation. Therefore, there is a possibility of operational auditing having different objectives to fulfil in different organisations. Generally, operational audit objectives include:

(i) Appraisal of controls: Operations and the results in which management is interested are largely a matter of control. If controls are effective in design and are faithfully adhered to the result that can be attained will be subject to the other limiting constraints in the organization.

(ii) Evaluation of performance: In the task of performance evaluation, an operational auditor is heavily dependent upon availability of acceptable standards. The operational auditor cannot be expected to possess technical background in so many diverse technical fields obtaining even in one enterprise. Even when examining or appraising performance or reports of performance, the operational auditor's mind is invariably fixed on control aspects.

(iii) Appraisal of objectives and plans: In performance appraisal, the operational auditor is basically concerned not so much with how well technically the operations are going on, but with accumulating information and evidence to measure the effectiveness, efficiency and economy with which the operations are being carried on.

(iv) Appraisal of organisational structure: Organisational structure provides the line of relationships and delegation of authority and tasks. This is an important element of the internal control design. In evaluating organisational structure, the operational auditor should consider whether the structure is in conformity with the management objectives and it is drawn up on the basis of matching of responsibility and authority. He should also analyse whether line of responsibility has been fixed, whether delegation of responsibility or authority is clear and there is no overlapping area.

Question 3

What are the Management Audit Questionnaires? Give a sample questionnaire for Audit of Inventory.

Answer

Management Audit Questionnaire: A management audit questionnaire is an important tool for conducting the management audit. It is through these questionnaires that the auditors make an inquiry into important facts by measuring current performance. Such questionnaires aim at a comprehensive and constructive examination of an organisation's management and its assigned tasks. Overall it is concerned with the appraisal of management actions in accomplishing the organisation's objectives. Its primary objective is to highlight weaknesses and deficiencies of the organisation. It includes a review of how well or badly the management functions of planning, organising, directing and controlling are being performed. In addition it evaluates how effective the decision-making process is accomplishing the stated organisation objectives. Within this framework, the questionnaire provides a means for evaluating an organisation's ongoing operations by examining its major functional areas. There are three possible answers to the management audit questions: "Yes", "No" and "N.A.", (not applicable). A "Yes" answer indicates that the specific area, function, or aspect under study is functioning in an acceptable manner; no written explanation is needed in that case. On the other hand, a "no" answer indicates unacceptable performance and should be explained in writing. Questionnaire comments on negative answers not only provide documentation for future reference, but, more important, provide background information for undertaking remedial action. Those questions that are not applicable and should be ignored in the audit are checked in the "N.A." column. The management audit questionnaire does not give answers, but simply asks questions. If all questions are answered with a 'yes', operations are proceeding as desired. On the other hand, if there are one or more 'no' answers, difficulties are being experienced and must be explained in writing. If the question does not apply, the N.A. (not applicable) column is checked. Thus, management audit questionnaire for this part of the audit not only serves as a management tool to analyse the current situation; more importantly, it enables the management auditors to synthesis those elements that are causing organisational difficulties and deficiencies.

Audit of Inventory

A management audit questionnaire for audit of inventory is given below

Questionnaire	*Yes*	*No*	*N.A.*
INVENTORY			
A. Long-range plans:			
1. Is inventory management sufficiently qualified to meet long-range company objectives?			
2. Are long-range inventory management plans coordinated with:			
a. production?			
b. purchasing?			
c. finance?			
3. Is inventory properly and efficiently stored so as to provide a minimum of:			
a. obsolescence?			
b. deterioration?			
c. pilferage?			
4. Is there an adequate inventory system under management control to plan inventory in the long run at optimum levels?			
5. Is there an effective physical inventory system to obviate any surprises in loss or value?			
6. Are inventory plans and procedures audited periodically by:			
a. internal auditors?			
b. external auditors?			
B. Short- or medium-range plans:			
1. Is inventory management sufficiently qualified to meet short- or medium-range company objectives?			
2. Are short-range inventory management plans an integral part of-			
a. production?			
b. purchasing?			
3. Are inventories under control as to:			
a. type?			
b. amount?			

4.	Is there an adequate inventory system to:			
	a. plan current inventory at optimum levels?			
	b. compare physical to perpetual inventories?			
	c. detect theft?			
5.	Are lead times figured into inventory levels for:			
	a. purchasing?			
	b. manufacturing?			
6.	Is the concept of safety stock employed as a protection against stock-outs?			
7.	Are inventory levels coordinated with reorder points?			
8.	Are bills of materials utilized to determine inventory requirements?			
9.	Do short-range inventory plans include "make" versus "buy" decisions to lower costs?			
10.	Is receiving and inspection of inventory items adequate?			
C.	Organisational structure:			
1.	Is the inventory department under the direction of a capable manager?			
2.	Are inventories and their in-plant movements organised and reported by their basic types:			
	a. raw materials?			
	b. work in process?			
	c. finished goods?			
3.	Are inventories maintained at their optimum level by their basic types: a. raw materials?			
	b. work in process?			
	c. finished goods?			
4.	Is there an effective system of physical inventory to disclose any irregularities or losses?			
5.	Is inventory organised around the ABC method of classifying materials, i.e., by high, medium, and low-value items?			
6.	Is inventory integrated within an information system?			
7.	Are modern materials-handling methods used for transportation and storage of materials?			

D.	Leadership:			
	1. Does inventory management exert the necessary leadership to keep inventory under control?			
	2. Is inventory management capable of giving the leadership necessary to minimise the investment in:			
	a. raw-materials inventories?			
	b. work-in-process inventories?			
	c. finished-goods inventories?			
	3. Is inventory kept at a minimum that is consistent with efficient production planning?			
	4. Does inventory management have the necessary clout to store inventories properly in order to minimize losses caused by spoilage, obsolescence, or depreciation?			
	5. Is inventory management sufficiently progressive to employ the most modern materials-handling methods for transportation and storage of inventories?			
E.	Communication:			
	1. Is there an information system utilised that employs efficient management, methods and techniques to control inventories and to prepare periodic inventory reports that are of great value to management?			
	2. Is there an effective communication system designed to assist in, keeping the inventory turnover rate high?			
	3. Is there good managerial control over movement of work-in-process materials so that this inventory is kept at a minimum?			
	4. Is the level of work-in-process materials consistent with an efficient manufacturing cycle?			
	5. Is there a procedure for highlighting excess inventory quantities and bringing this condition to management's attention in order to return them to their proper levels?			
	6. Is there an effective inventory system for keeping any surprises in inventory losses to minimum?			
F.	Control:			
	1. Are inventory management control reports, methods, and techniques integrated with:			
	a. production?			
	b. purchasing?			

2.	Are inventories effectively controlled as to:			
	a. type?			
	b. amount?			
3.	Are inventories properly stored to provide a minimum of.			
	a. obsolescence?			
	b. deterioration?			
	c. pilferage?			
4.	Have inventory levels been reduced by profitable disposition of obsolete or excess items?			
5.	Is inventory control integrated with:			
	a. economic order quantities?			
	b. reorder points?			
6.	Is the concept of safety stock employed to protect against stockouts?			
7.	Are lead times figured into inventory levels?			
8.	Have steps been taken to balance the cost generated by too small an inventory against the cost of carrying excessive inventories to determine an optimum inventory turnover?			
9.	Are bills of materials utilised to determine what items should be retrieved from inventory?			
10.	Is there adequate management control over the receipt of raw materials and parts from vendors?			
11.	Is there adequate management control over the receipt of work-in- process items for the manufacturing departments?			
12.	Is there adequate inspection of items received into inventory as to:			
	a. type?			
	b. number?			
13.	Are inventory items physically counted to make sure that perpetual inventory records are accurate?			
14.	Is inventory controlled through the use of the ABC concept (A = high-value items, B = medium-value items, C = low-value items)?			
15.	Is there an effective management control system for receiving materials that are not on a purchase order, i.e., products returned by customers?			

16. Are materials available when needed for the start of production?			

Question 4

"Operational auditing is not different from internal auditing." Discuss.

Answer

Internal auditing is an activity carried out by the internal staff of the organisation to meet the management requirements of information. The definition of internal auditing as given by the Institute of Internal Auditors of New York, in fact, is so wide in its scope that it covers both operational and management auditing. According to the Institute of Internal Auditors, "the overall objective of internal auditing is to assist all members of management in the objective discharge of their responsibilities, by furnishing them with objective analysis, appraisals, recommendations and pertinent comments concerning the activities reviewed. The internal auditor, therefore, should be concerned with any phase of business activity wherein he can be of service to organisation". According to the definition, the overall objective of internal auditing is to assist all members of management in the objective discharge of their responsibilities, by furnishing them with objective analysis, appraisals, recommendations and relevant comments concerning the activities reviewed. The internal auditor, therefore, should be concerned with any phase of business activity wherein he can be of service to the organisation. Naturally, when an auditor is concerned with the appraisal of operations, he would be performing the role of an operational auditor. Another important point that this definition throws up is that operational auditing is essentially a function of internal auditing staff. Traditionally, the internal auditing was concerned with the financial transactions only. It was during early 1940's, the concept of operational auditing came into existence. According to Cadmus "operational auditing is not different from internal auditing, it is merely an extension of internal auditing into operational areas. It is characterised in both financial and operational areas – by the auditor's approach and state of mind". The main objective of operational auditing is to verify the fulfillment of plans and sound business requirements as also to focus on objectives and their achievement as against the performance yardsticks evident from in the management objectives, goals and plans, budgets records of past performance, policies and procedures. Industry standards can be obtained from the statistics provided by industry, associations and government sources. It should be appreciated that the standards may be relative depending upon the situation and circumstances; the operational auditor may have to apply them with suitable adjustments. It might appear from the above that an internal auditor is not concerned with operational aspects and operational auditor is, not concerned with financial aspects which is not so. Because traditionally, internal auditors had been engaged in a sort of protective function, deriving their authority from the management. They examined internal controls in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are not there; they checked the accounting books and records to see, whether the internal checks are properly working and the resulting accounting data are reliable. They also looked into the aspect of safety of the assets and properties of the company. Some element of operational

auditing could be found even in these traditional functions of internal auditors, specially in the context of fraud, wastage and loss. Internal auditors emboldened by their ability to appraise financial and accounting control gradually started extending their field to cover non-accounting control as well. On the other hand, it should not be assumed, that, since an operational auditor is concerned with the audit of operations and review of operating conditions, he is not concerned with the financial aspects of transaction and controls. A point has already been made that the special expertise acquired by the operational auditor, that enables him to view the controls and operations from the management point of view, can be carried back to his review of the financial areas. In the matter of cash transactions, the operational auditor will look into such aspects as the quantum of cash in hand (by relating it to the requirement of cash to be held) carried generally or the use of cash not immediately required. Also he will review the operational control on cash to determine whether maximum possible protection has been given to cash. Similarly, in the audit of stocks, he would have management policy. In pure administrative areas on stock, he will see whether adequate security and insurance arrangements exist for protection of stocks.

Thus, over a period of time, the scope of internal auditing was widened to cover not only accounting and financial operations but other operations such as marketing, personnel, production, etc. As per the modern definition of internal auditing, there is no difference between the two. However, still some auditors believe that there might exist difference between the two on account of perception as far as scope of the two is concerned which in fact is not true as evident from the foregoing analysis.

Question 5

Explain in brief the behavioural aspects encountered in the management audit and state the ways to solve them.

Answer

Behavioural aspects encountered in Management Audit: Financial auditors deal mainly with figures. Management auditors deal mainly with people. There are many causes for behavioural problems arising in the review function of management audit. Particularly, when management auditors performs comprehensive audit of operations, they cannot be as well informed about such operations as a financial auditor in a financial department. Operating processes may be unfamiliar and complex. The operating people may be speaking a language and using terms that are foreign to the auditor's experience. The nature and causes of behavioural problems that the management auditor is likely to face in the discharge of the review function that is expected of him and possible solutions to overcome these problems are discussed below:

(1) Staff / Line conflict: Management auditors are staff people while the members of other departments are line people. Management auditors tend to discount the difficulties the line staff may face, if called on to act on the ideas of management auditors. Management

auditors are specialists in their field and they may think their approach and solutions are the only answers.

(2) Control: The management auditor is expected to evaluate the effectiveness of controls, there is an instinctive reaction from the auditee that the report of the auditor may affect them. There is a fear that the action taken based on the management audit report will affect the line people. It breeds antagonism. The causes are as under:

(i) Fear of criticism stemming from adverse audit findings.

(ii) Fear of change in day to day working habits because of changes resulting from audit recommendations.

(iii) Punitive action by superior prompted by reported deficiencies.

(iv) Insensitive audit practices.

(v) Hostile audit style.

Solution to behavioural problems: The following steps may be taken to overcome the aforesaid problems:

(i) To demonstrate that audit is part of an overall programme of review for protective and constructive benefit.

(ii) To demonstrate the objective of review is to provide maximum service in all feasible managerial dimensions.

(iii) To demonstrate the review will be with minimum interference with regular operation.

(iv) The responsible officers will be involved in the process of review of the findings and recommendations before the audit report is formally released.

It is essential to create an atmosphere of trust and friendliness so that audit reports will be understood in their proper perspective.

Finally, it needs hardly any emphasis that there should be right management culture, enlightened auditees and auditors of the right calibre. May be to expect a combination at all times of all the three is asking for the impossible. But, a concerted effort by the management, auditors and auditees to achieve a more acceptable climate would go a long way to achieve the goal.

Question 6

K Ltd., requires you to organize a Management audit program. Briefly state a plan of action.

Answer

Organizing a Management Audit for K Ltd.: The key requirement for a successful Management audit program would be the approval and support of the top management to initiate. Accordingly the following shall be the matters that should be considered while

organizing the Management Audit of K. Ltd.

Devising the statement of policy - The management's support must be reflected clearly and categorically in the company's highest policy statement. The policy statement should be quite specific. It should spell out clearly the scope and status of the management/operational auditing within the enterprise, its authority to carry out audits, issue reports, make recommendations, and evaluate corrective action. The statement of policy should lay down in clear terms the scope of activities to be performed by the management auditor. The scope of activities is the most basic requirement for building up a successful management audit programme both for small as well as a large organisation. Thus, a comprehensive statement of policy provides definite understanding to management concerning the nature of audit to be performed and the scope and details of audit work to be carried out. This then will become the charter under which the management auditor should operate. In this charter, will be set forth, for the rest of the company to see, how executive management regards the purpose, mission and authority of the function of management auditor within the company. The statement must afford the auditor all the authority he needs yet does not assign responsibility which he cannot conceivably carry out. The statement must categorically say that the management auditor is capable of reviewing administrative and management controls over any activity within the company. However, he should not be expected to extend his activities to the evaluation of performance of professional and technical activities calling for specialised knowledge and skills and suggest remedies unaided by people competent to undertake such evaluation.

Location of audit function within the organisation - Some organisations depending upon their size and nature of have established a separate department of audit specialists where the head of the department reports directly to the top executive. In certain cases, the audit group may be a part of the activities of management services department, administrative control department or some other unit of organisation. The more important question, however, is that the function should be as entirely independent as possible of pressure from various groups in the enterprise. The greater the independence, greater is the freedom to work effectively. Therefore, it is better to place the auditing function quite high in the organisation. The minimum requirement for the auditing organisation is to report to an officer whose status is such that he can command prompt and proper consideration of the auditor's opinion and recommendations. Preferably that officer should be a member of the Board. One of the controversies that is usually raised is whether the management auditor should report to the finance director, to whom he may be administratively responsible or to the managing director where he has no administrative responsibility. A third opinion would like the auditor to report to an audit committee, comprising of senior executives of the company who are preferably Board members. A different school of thought would like auditors to report to both the finance director and the audit committee. Though the controversy rages and no definite solution can be arrived at, it is felt that the controversy regarding which of these persons the management auditor should report to is not much substance where independence exists. Independence of the management auditor is not necessarily related to the person/persons he reports. His independence is entirely dependent on the management's attitude towards audit, the

credibility the management auditor has with the management and the management's positive will to listen to criticism for self betterment.

Allocation of personnel - Whatever be the size of the enterprise, it is important that all persons selected and assigned to audit possess a good understanding of auditing theory, a thorough knowledge of the fundamentals of both organisation and management, the principles and effective methods of control, and the requirements for conducting scientific appraisal. "General Guidelines on Internal Auditing" issued by the Institute also emphasise these qualifications for an auditor whose area extends beyond the review of financial controls. As the management auditor is expected to evaluate operational performance and non-monetary operational controls, he should possess basic knowledge of the technology and commercial practices of the enterprise, an enquiring, analytical, pragmatic and imaginative approach and a thorough understanding of the control system. The management auditor should also have a basic knowledge of commerce, law, taxation, cost accounting, economics, quantitative methods and EDP systems. Knowledge in these areas would be adequate for him to identify problems and to determine steps to be taken when a problem is identified. It does not mean that management audit should be assigned to engineers, computer experts and others. Rather persons having sound accounting background alongwith general knowledge of other relevant disciplines are best suited to perform this job. Because the profession of accountancy basically teaches a systematic and analytical approach to a problem, it is this methodical approach which is the guiding note to an audit function of review of controls. In personal characteristics individuals assigned to the job should have an inclination towards analysis, a high degree of imagination and an ability to write and express themselves clearly and logically.

Staff training programme - A continuous training programme is necessary to achieve quality in performing audit assignments because the management auditor must keep a breast of new ways to improve auditing standards. An effective training programme enables staff to assume additional responsibilities and advancements in the organisation. Thus the programme acts as an incentive for drawing capable people into the department and keeping them.

Time and other aspects - The time required to carry out a management audit will vary, depending upon the extent and nature of assignment. For example, the time required to perform an audit of the entire activities of an organisation's purchasing department might take a few weeks, while an audit of the entire business could take several months. Much depends upon the size of the activity. An appraisal of a plant's standard cost system might also simultaneously include an appraisal of the departmental budgetary control system. In a study of the results of sales contacts and selling efforts in the field, one might find it feasible to study the expense reports and other costs incurred in making contacts. In the evaluation of the method of scheduling production in a plant, one might well take a good look at the sales department's method of compiling and preparing the sales forecast. The time and cost will vary for each assignment, depending upon the nature of the assignment, the number of auditors assigned to perform the work, and whether or not more specialists in a particular field are required. An audit of a production planning and control department, for example because of its size and other factors, could require an audit staff of several persons and, in addition, a

specialist in production planning and one in production control. If an assignment is one which requires technical assistance of a nature unavailable within the audit group, it might be advisable to seek a qualified outside consultant to perform the work.

Frequency - Having specified various approaches to management audit, including its scope and its staffing requirements the last item that should be considered before undertaking such an audit is its frequency. Prime consideration should be given to the nature of the organisation. Is the company in a fast-changing industry where there is great accent on the latest technology in the company's products and/or services? When the organisation is subject to rapid change or the total resources utilised are expensive, the frequency of management auditing should be greater than when it does not undergo rapid changes or the resources employed are not high in value. In essence, management audits should be made often enough to provide protection against growing problems. On the other hand, they should not be so frequent as to lead to repetitious results of questionable value.

To get an idea of the optimum frequency of such an audit, it might be worthwhile to look at financial audits. Customarily, financial audits are conducted annually. They are highly programmed, since an internal control questionnaire is utilised to attest to accounting methods and procedures. By contrast, a management audit should be considered from a longer time frame. For an organisation, that is subject to rapid changes or consumes a great amount of high-cost resources, a two-years basis might be adequate to protect it from managerial and operational problems becoming entrenched or too large. For those organisations in a relatively stable industry, the frequency of audit can be every three years. In no case should the interval be allowed to exceed three years.

Question 7

What are the major differences between Financial and Operational Auditing?

Answer

Differences between Financial and Operational Auditing - The major differences between financial and operational auditing can be described as follows:

(i) Purpose - The financial auditing is basically concerned with the opinion that whether the historical information recorded is correct or not, whereas the operational auditing emphasizes on effectiveness and efficiency of operations for future performance.

(ii) Area - Financial audits are restricted to the matters directly affecting the appropriateness of the presented financial statements but the operational auditing covers all the activities that are related to efficiency and effectiveness of operations directed towards accomplishment of objectives of organization.

(iii) Reporting -The financial audit report is sent to all stock holders, bankers and other persons having stake in the Organisation. However the operational audit report is primarily for the management.

(iv) End Task - The financial audit has reporting the findings to the persons getting the report as its end objective, however, the operational auditing is not limited to reporting only but includes suggestions for improvement also

The main objective of operational auditing is to verify the fulfillment of plans, and sound business requirements. Operational auditing is considered as specialized management information tool. Operational auditing is essentially a function of internal auditing staff. Operational auditing is a systematic process of evaluating an organisation's effectiveness, efficiency and economy of operations under management control and reporting to appropriate persons, the result of the evaluation along with recommendations for improvements. Operational audit concentrates on effectiveness, efficiency and economy of operations and therefore it is future oriented. It does not end with the reporting of the findings but also recommends the steps for improvements in future. Operational auditing is not different from internal auditing; it is merely an extension of internal auditing into operational areas.

While in financial auditing, the concentration is more in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are minimized or removed. In financial auditing, an auditor is called upon to review the financial statements of an enterprise to ascertain whether they reflect true and fair view of its state of affairs and of its working results. He may analyse the operations of an enterprise to appraise their cost effectiveness and also he may seek evidence to review the managerial performances.

Question 8

State the important aspects to be considered by the External auditor in the evaluation of Internal Audit Function.

Answer

Evaluation of Internal Audit functions by external auditor.: The external auditor's general evaluation of the internal audit function will assist him in determining the extent to which he can place reliance upon the work of the internal auditor. The external auditor should document his evaluation and conclusions in this respect. The important aspects to be considered in this context are :

(a) Organisational Status - Whether internal audit is undertaken by an outside agency or by an internal audit department within the entity itself, the internal auditor reports to the management. In an ideal situation his reports to the highest level of management and is free of any other operating responsibility. Any constraints or restrictions placed upon his work by management should be carefully evaluated. In particular, the internal auditor should be free to communicate fully with the external auditor.

(b) Scope of Function - The external auditor should ascertain the nature and depth of coverage of the assignment which the internal auditor discharges for management. He should also ascertain to what extent the management considers, and where appropriate, acts upon internal audit recommendations.

(c) Technical Competence - The external auditor should ascertain that internal audit work is performed by persons having adequate technical training and proficiency. This may be accomplished by reviewing the experience and professional qualifications of the persons undertaking the internal audit work.

(d) Due Professional Care - The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented. An example of the exercise of due professional care by the internal auditor is the existence of adequate audit manuals, audit programmes and working papers.

Question 9

You are appointed statutory auditor of X Ltd. X Ltd. has an internal audit system and reports for the same are given to you. Mention the factors you will consider to ensure that the said system of internal audit of X Ltd. is commensurate with the size of the company and nature of its business.

Answer

As per SA 610 (Revised) "Using the Work of Internal Auditor" the statutory auditor has to consider the following before placing reliance on the same".

(i) Organizational status – whether the same is done internally or by an external agency.

(ii) Scope of work – What is the nature and depth of the coverage of the assignment.

(iii) Technical competence – Whether the internal auditor is technically competent to do the work i.e. having adequate technical training and proficiency.

(iv) Due professional care – Whether his work and reports appear to be properly planned, supervised reviewed and documented.

(v) Audit Evidence - Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;

(vi) Conclusions - Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and

(vii) Response to unusual matters - Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

If the above factors are not satisfactory, the statutory auditor will have to modify his audit program and increase the verification to be carried out.

Question 10

Write a short note on - Summary Written Report.

Answer

Summary written reports: These are known as flash reports. They are significant highlights for immediate attention of top management. Generally suspected defalcations are reported briefly to the appropriate management official on the 'flash' basis, often ending up in referral for criminal investigation and legal action. It is common practice in number of companies of issuing a report quite frequently summarising the various individual reports issued and describing the range of their contents in a very brief and comprehensive manner where only important points are highlighted. Such reports are primarily issued for audit committees of Board of Directors and for other top level managers who do not have sufficient time to go through the elaborate reports and matters which are required to be brought to their notice for immediate action.

Question 11

XYZ, a manufacturing unit does not accept the recommendations for improvements made by the Operational Auditor. Suggest an alternative way to tackle the hostile management.

Answer

Alternative way to tackle the hostile management : While conducting the operational audit the auditor has to come across many irregularities and areas where improvement can be made and therefore he gives his suggestions and recommendations.

These suggestions and recommendations for improvements may not be accepted by the hostile managers and in effect there may be cold war between the operational auditor and the managers. This would defeat the very purpose of the operational audit.

The Participative Approach comes to the help of the auditor. In this approach the auditor discuses the ideas for improvements with those managers that have to implement them and make them feel that they have participated in the recommendations made for improvements. By soliciting the views of the operating personnel, the operational audit becomes co-operative enterprise.

This participative approach encourages the auditee to develop a friendly attitude towards the auditors and look forward to their guidance in a more receptive fashion. When participative method is adopted then the resistance to change becomes minimal, feelings of hostility disappear and gives room for feelings of mutual trust. Team spirit is developed. The auditors and the auditee together try to achieve the common goal. The proposed recommendations are discussed with the auditee and modifications as may be agreed upon are incorporated in the operational audit report. With this attitude of the auditor it becomes absolutely easy to implement the proposed suggestions as the auditee themselves take initiative for implementing and the auditor do not have to force any change on the auditee.

Hence, Operational Auditor of XYZ manufacturing unit should adopt above mentioned participative approach to tackle the hostile management of XYZ.

Question 12

Write short note on general objectives of an operational audit.

Answer

General objectives of operational audit: It include

(i) Appraisal of Controls.

(ii) Evaluation of performance.

(iii) Appraisal of objectives and plans and

(iv) Appraisal of organizational structure.

(i) Appraisal of controls: Operations and the results in which management is interested are largely a matter of control. If controls are effective in design and are faithfully adhered to the result that can be attained then they will be subject to the other limiting constraints in the organization.

(ii) Evaluation of performance: In the task of performance evaluation, an operational auditor is heavily dependent upon availability of acceptable standards. The operational auditor cannot be expected to possess technical background in so many diverse technical fields obtaining even in one enterprise. Even when examining or appraising performance or reports of performance the operational auditor's mind is invariably fixed on control aspects.

(iii) Appraisal of objectives and plans: In performance appraisal, the operational auditor is basically concerned not so much with how well technically the operations are going on, but with accumulating information and evidence to measure the effectiveness, efficiency and economy with which the operations are being carried on.

(iv) Appraisal of organisational structure: Organisational structure provides the line of relationships and delegation of authority and tasks. This is an important element of the internal control design. In evaluating organisational structure, the operational auditor should consider whether the structure is in conformity with the management objectives and it is drawn up on the basis of matching of responsibility and authority. He should also analyse whether line of responsibility has been fixed, whether delegation of responsibility or authority is clear and there is no overlapping area.