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Internal Audit, Management and Operational Audit

Question 1

Mr. 'P' have been appointed as operational auditor of M/s Books & Magazine Ltd. and observed a totaling error in invoice of ₹ 1,000. He has not taken care of the same saying that this is out of scope of his work. Comment. *(3 Marks, May, 2014)*

Answer

Scope of Operational Audit: Operational auditing is a systematic process involving logical, structured and organized series of procedures. It 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 improvement in future.

The main objective of operational auditing is to verify the fulfilment of plans and sound business requirements as also to focus on objectives and their achievement objectives; the operational auditor should not only have a proper business sense, he should also be equipped with a thorough knowledge of policies, procedures, systems and controls, he should be intimately familiar with the business, its nature and problems, and prospects and its environment. Above all, his mind should be open and active so as to be able to perceive problems and prospects, and grasp technical matters.

In carrying out his work probably at every step he will have to exercise judgement to evaluate evidence in connection with the situations and issues; he will have to get the assistance of norms and standards in every operating field to be able to objectively judge a situation. The norms and standards should be such as are generally acceptable or developed by the company itself.

To a traditional internal auditor, a loss of ₹ 1,000 caused by a wrong totalling of invoice is important and this is that he looks for. But for an auditor engaged in the review of operations, carrying out of a proper maintenance programme of the machines is of greater importance because considerable production loss due to machine breaks down can thus be prevented. In both the cases, the auditor's objective is to see that the business and its profitability do not suffer from avoidable loss, but, nevertheless, there is a distinct difference in approach. But 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.

Hence, contention of operational auditor that totaling error in invoice of ₹ 1,000 is out of scope is not correct as operational audit is being carried out to ensure that all the management functions like planning, organizing, staffing, directing and controlling are working effectively and efficiently. Such kind of error is very much in scope because such an existence of error indicates that control system (controlling function) is not sound.

Question 2

The Managing Director of X Ltd is concerned about high employee attrition rate in his company. As the internal auditor of the company he requests you to analyze the causes for the same. What factors would you consider in such analysis? (4 Marks, May, 2013)

Answer

The factors responsible for high employee attrition rate are as under:

(i) Job Stress & work life imbalance.

(ii) Wrong policies of the Management.

(iii) Unbearable behaviour of Senior Staff.

(iv) Safety factors.

(v) Limited opportunities for promotion.

(vi) Low monetary benefits.

(vii) Lack of labour welfare schemes.

(viii) Whether the organization has properly qualified and experienced personnel for the various levels of works?

(ix) Is the number of people employed at various work centres excessive or inadequate?

(x) Does the organization provide facilities for staff training so that employees and workers keep themselves abreast of current techniques and practices?

Question 3

State the key differences between financial and operational audit. (4 Marks, May, 2012)

Or

What are the major differences between Financial and Operational Auditing?

(8 Marks, May, 2008)

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 4

Write a short note on General objectives of an operational audit. *(4 Marks, May, 2011)*

Or

Write a short note on Broad objectives of operational audit. *(4 Marks, November, 2006)*

Or

Briefly explain the objectives of Operational Audit. *(5 Marks, November, 2005)*

Answer

Objectives of Operational Audit: 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. Therefore, there is a possibility of operational auditing having different objectives to fulfil in different considerations. 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.

Question 5

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.

(5 Marks, November, 2010)

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 6

You are appointed statutory auditor of X Ltd. X Ltd. has a 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. *(8 Marks, June, 2009)*

Or

As the Statutory Auditor of a Manufacturing Company, what are the points you will consider to conclude "Whether the company has an Internal Audit system commensurate with the size of the company and its operations"? *(8 Marks, November, 2007)*

Answer

Internal Audit: As per Section 138 of the Companies Act, 2013, it is mandatory to have internal audit in case of–

(a) every listed company;

(b) every unlisted public company having-

  (i) paid up share capital of fifty crore rupees or more during the preceding financial year; or

  (ii) turnover of two hundred crore rupees or more during the preceding financial year; or

  (iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

  (iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(c) every private company having-

(i) turnover of two hundred crore rupees or more during the preceding financial year; or

(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

The auditor has to examine whether the internal audit system is commensurate with the size of the company and the nature of its business.

The following are some of the factors to be considered in this regard:

(i) What is the size of the internal audit department? In considering the adequacy of internal audit staff, it is necessary to consider the nature of the business, the number of operating points, the extent to which control is decentralised, the effectiveness of other forms of internal control, etc.

(ii) What are the qualifications of the persons who undertake the internal audit work? Internal auditing is reasonable to expect that the internal audit department should normally be headed by a chartered accountant and that, depending upon the size of the department, it employs other qualified persons.

(iii) To whom does the internal auditor report? In general, the higher the level to which the internal auditor reports, the greater will be his independence.

(iv) What are the areas covered by the internal audit? Internal audit can cover a large number of areas including operational auditing, organisation and methods studies, special investigations and the like.

(v) Has the internal auditor adequate technical assistance? This can be provided either by having full-time technically qualified persons in the internal audit department or by such persons being deputed to the internal audit department for specific assignments.

(vi) What are the reports which are submitted by the internal auditor or what other evidence is there of his work? Auditor should satisfy himself that an internal audit system is functioning effectively. He can do so by examining the reports submitted by the internal auditor.

(vii) What is the follow-up? It is necessary that there is an adequate follow-up system to ensure that the errors pointed out are corrected and remedial action taken on the deficiencies reported upon.

Question 7

State the important aspects to be considered by the External auditor in the evaluation of Internal Audit Function. *(4 Marks, November, 2008)*

Or

Enumerate, in brief, the important aspects to be evaluated by the external auditor in determining the efficiency and extent of reliance to be placed on the work and function of an Internal Auditor. *(6 Marks, May, 2005)*

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. As per SA 610 "Using the Work of Internal Auditors", factors that may affect the external auditor's determination of whether the work of the internal auditors is likely to be adequate for the purposes of the audit include:

(1) Objectivity

(i) The status of the internal audit function within the entity and the effect such status has on the ability of the internal auditors to be objective.

(ii) Whether the internal audit function reports to those charged with governance or an officer with appropriate authority, and whether the internal auditors have direct access to those charged with governance.

(iii) Whether the internal auditors are free of any conflicting responsibilities.

(iv) Whether those charged with governance oversee employment decisions related to the internal audit function.

(v) Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance.

(vi) Whether, and to what extent, management acts on the recommendations of the internal audit function, and how such action is evidenced.

(2) Technical competence

(i) Whether the internal auditors are members of relevant professional bodies.

(ii) Whether the internal auditors have adequate technical training and proficiency as internal auditors.

(iii) Compliance with the mandatory/ recommendatory Standards on Internal Audit (SIAs) issued by Internal Audit Standards Board of the Institute of Chartered Accountants of India (ICAI).

(iv) Whether there are established policies for hiring and training internal auditors.

(3) Due professional care

(i) Whether activities of the internal audit function are properly planned, supervised, reviewed and documented.

(ii) The existence and adequacy of audit manuals or other similar documents, work programs and internal audit documentation.

(4) Communication: Communication between the external auditor and the internal auditors may be most effective when the internal auditors are free to communicate openly with the external auditors, and:

(i) Meetings are held at appropriate intervals throughout the period;

(ii) The external auditor is advised of and has access to relevant internal audit reports and is informed of any significant matters that come to the attention of the internal auditors when such matters may affect the work of the external auditor; and

(iii) The external auditor informs the internal auditors of any significant matters that may affect the internal audit function.

The degree of reliance that a statutory auditor can place on the work done by the internal auditor is also a matter of individual judgement in a given set of circumstances. The ultimate responsibility for reporting on the financial statements is that of the statutory auditor. It must be clearly understood that the statutory auditor's responsibility is absolute and any reliance he places upon the internal audit system is part of his audit approach or technique and does not reduce his sole responsibility.

Question 8

K Ltd., requires you to organize a Management audit program. Briefly state a plan of action.
(8 Marks, May, 2007)

Answer

Organizing a Management Audit: 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.-

(i) Devising a statement of policy: In consultation with the top Management, a policy statement on Management should be issued. The policy should ideally cover the scope, objective, the authority of the management audit function. In short, the policy should be drafted to become a charter of Management Audit.

(ii) Location of audit function within the organization: The hierarchical status of the Management auditor and his team should be clearly defined.

(iii) Allocation of personnel: The Management audit team should comprise of personnel who have adequate experience on all the facets of the organization. Ideally, it should comprise of technical audit team.

(iv) Staff Training: In order to maintain qualitative standards, adequate and continuous training should be offered to the Management audit team.

(v) Time and other aspects: While planning management audit adequate consideration should be given to time & cost involved in conducting the audit.

(vi) Frequency of audit: Depending on the pace of change that happens in that industry, the frequency of the Management audit should be determined. This can be fixed in consultation with the top Management.

Question 9

You have been appointed Management Auditor of a large manufacturing company suffering from working capital crunch. Enlist and discuss the related areas which you would probe into to overcome the company's problem. (8 Marks, November, 2004)

Answer

Action Plan to Overcome Working Capital Crunch: Adequate working capital is required for liquidity and smooth operations of the company. To ensure an adequate flow of working capital to the manufacturing company, the following action plan may be considered-

(i) Working Capital Estimation: The company should start by preparing a statement of the projected working capital requirements. This should be based on the functional budgets in sales, production, expenses, capital expenditure and the Master Budget consisting of projected profit and loss and the Balance Sheet.

(ii) Cash Flow Statement / Cash Budget: Month-wise cash budgets showing inflows and outflows of cash heading-wise should be prepared to analyse the major inflows and outflows affecting the entity. At this stage any wasteful outflow can be traced and eliminated. Bank reconciliation should be undertaken periodically so that outstandings can be traced and acted upon. This is also necessary to reduce the float time.

(iii) Inventory / Stock Management: Raw materials and inventories should be classified properly to determine the level of stock of materials. The method of costing also needs to be looked at minutely. There is a need to establish linkage with the production pattern and work backwards accounting for time factor in receipt of material. This needs to be worked out carefully since at no cost, production schedule should be hampered. The caution also need to be exercised that there is not unused/obsolete inventory. The system of inventory management needs to be looked at so as to check the avoidable wastes/scraps generated during storage and handling. Just in time philosophy will enable the company to reduce processing time, stocks and related costs. The adoption of such a mechanism would bring down the cost to a considerable extent.

(iv) Credit Management: The company should lay down a proper policy for evaluating customers, determining the credit period and offering discounts for early payment. An age-wise analysis of debtors should also be prepared so as to avoid credit to defaulters. The sale department needs to be geared up so that realisation can be made in time. A careful analysis should be done of various customers according to pattern of sales so as to exercise control on their respective debit balances. The company should through its purchase department endeavour to avail the maximum credit period from its creditors. This would enhance the working capital of the company.

(v) Funds Flow Analysis: The company should prepare a funds flow analysis, distinguishing between long-term and short-term sources and applications.

(vi) Investment Management: The idle funds of the company, if any, should be invested in short-term securities to augment the income.

(vii) WIP Analysis: Minimum WIP should be monitored and for the purpose it is necessary to ensure that no bottlenecks develop at any stage during the production process.

Question 10

Explain in brief the behavioural aspects encountered in the management audit and state the ways to solve them. *(8 Marks, May, 2004)*

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 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.