



INTERNAL AUDIT, MANAGEMENT AND OPERATIONAL AUDIT

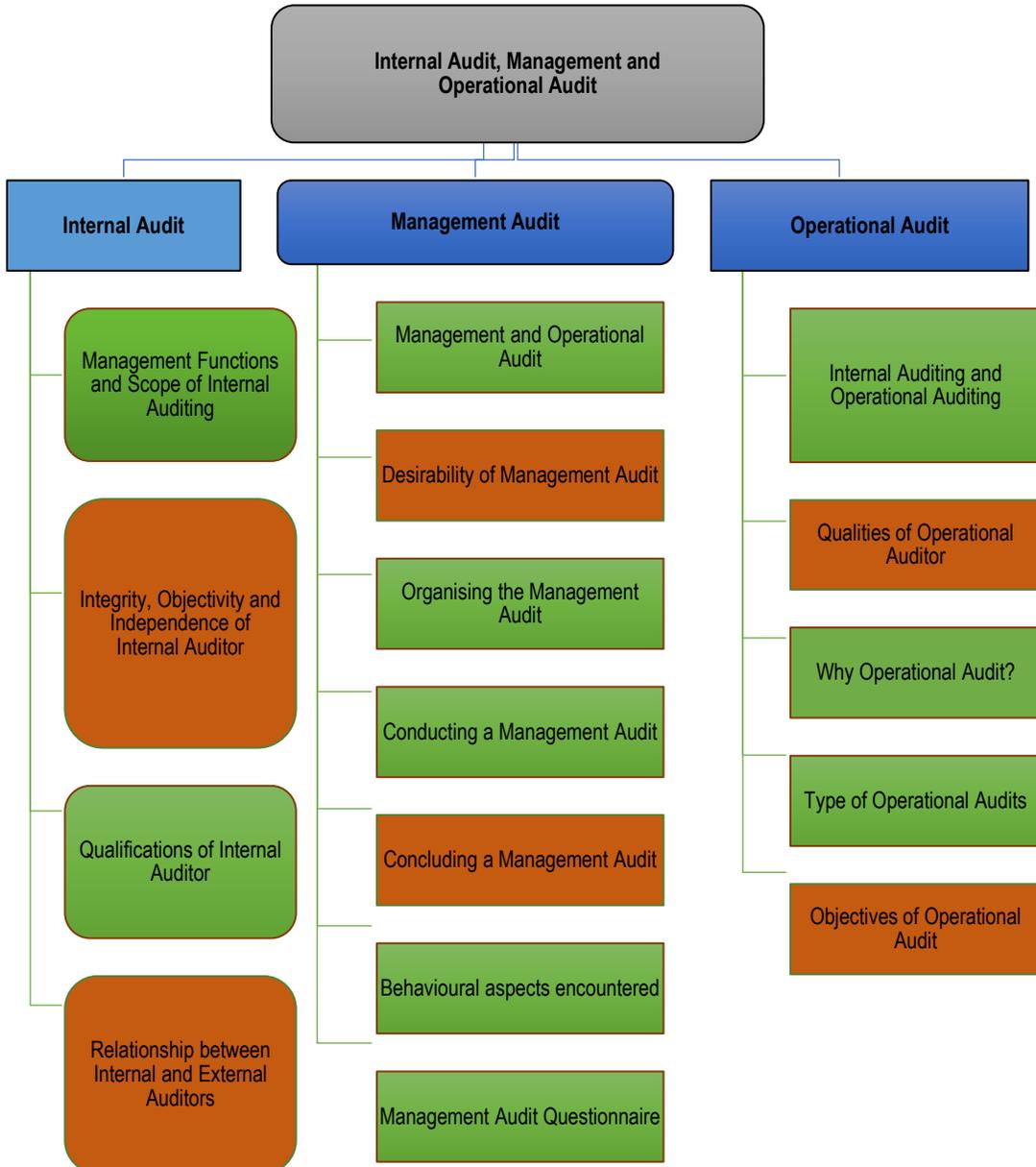


LEARNING OUTCOMES

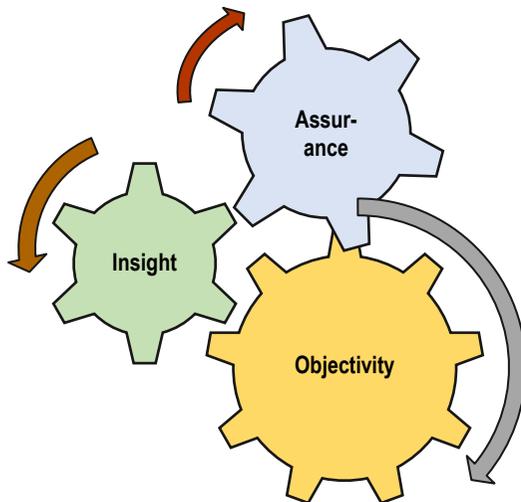
After reading this chapter student shall be able to:

- Know the meaning of Internal Audit, Management and Operational Audit.
- Gain the knowledge of the management functions and scope of internal auditing.
- Analyse the relationship between Internal and External Auditors.
- Understand the difference between Management Audit and Operational Audit.

CHAPTER OVERVIEW



1. INTERNAL AUDIT



Many modern enterprises have become huge and sophisticated. This has resulted in decentralisation of their activities and consequently the top management is remotely concerned with the day-to-day activities of the concern.

The Institute of Chartered Accountants of India has constituted a Committee on Internal Audit (CIA) as a non-standing committee on February 5, 2004. The CIA was constituted (now known as Internal Audit Standard Board) with the object of formulating Standards and Guidance Notes on Internal Audit.

As defined in scope of the Standards on Internal Audit, Internal Audit means “an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity’s strategic risk management and internal control system”.

The internal auditing need not to be confined to financial transactions and its scope may be extended to the task of reviewing whether the resource utilisation of the enterprise is efficient and economical. This would necessitate a review of all operations of the enterprise as also an evaluation of the effectiveness of management. We should not however lose sight of the fact that internal auditing is basically a service activity.

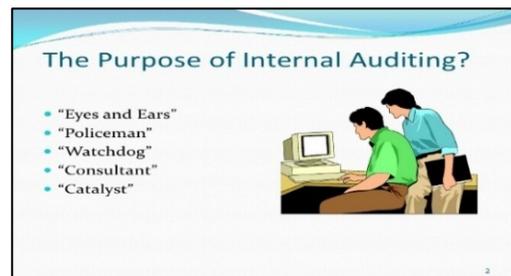


Fig.: Internal Audit*

The internal auditor should review and report, he is not expected to take upon himself functions of the operational managers.

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013, following class of companies (prescribed in rule 13 of Companies(Accounts)Rules,2014) shall be required to appoint **an internal auditor which may be either an individual or a partnership firm or a body corporate**, namely-

*Source: Slide Share

(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.

It is provided that an existing company covered under any of the above criteria shall comply with the requirements within six months of commencement of such section.

CASE STUDY

JKT Pvt. Ltd. having ₹ 40 lacs paid up capital, ₹9.50 crores reserves and turnover of last three consecutive financial years, immediately preceding the financial year under audit, being ₹ 49 crores, ₹ 145 crores and ₹ 260 crores, but does not have any internal audit system. In view of the management, internal audit system is not mandatory. Comment.

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013, read with rule 13 of Companies (Audit and Auditors) Rules, 2014, every private company shall be required to appoint an internal auditor or a firm of internal auditors, 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.

Conclusion: In the instant case, JKT Pvt. Ltd. is having turnover of ₹ 260 crores during the preceding financial year which is more than two hundred crore rupees. Hence, the company has the statutory liability to appoint an Internal Auditor and mandatorily conduct internal audit.

Who can be Appointed as Internal Auditor?

- As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be

decided by the Board to conduct internal audit of the functions and activities of the companies. The internal auditor may or may not be an employee of the company.

- To be effective, the internal auditor must be regarded as part of the management and not merely as an assistant thereto. He must have authority to investigate from the financial angles, every phase of the organisational activity under any circumstances.



AB Pvt. Ltd. company having outstanding loans or borrowings from banks exceeding one hundred crore rupees wants to appoint Mr. X who is a practicing cost accountant as internal auditor.

Provision & Conclusion: According to the provision given in section 138 of the companies Act, 2013, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies. Thus Appointment of Mr. X as internal Auditor of AB Pvt Ltd is valid.

His main responsibility, however, must be

- to maintain adequate system of internal control by a continuous examination of accounting procedures, receipts and disbursements and to provide adequate safeguards against misappropriation of assets.
- to operate independently of the accounting staff and must not in any way divest himself of any of the responsibilities placed upon him.
- Not to involve himself in the performance of executive functions in order that his objective outlook does not get obscured by the creation of vested interest.
- to observe facts and situations and bring them to notice of authorities who would otherwise never know them; also, they critically appraise various policies of the management and draw its attention to any deficiencies, wherever these require to be corrected.
- to associate closely with management and his knowledge must be kept up to date by his being kept informed about all important occurrences and events affecting the business, as well as the changes that are made in business policies. He must enjoy an independent status.

In addition, the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

It may also be noted that the Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.

(The Research Committee of the Institute of Chartered Accountants of India has brought out "General Guidelines on Internal auditing". The following discussion is based upon the above publication.)

IN check	CE check	Inspection type	Order status	Priority
✓	✓	Main inspection	Inspection in progress	Low
✓	✓	Main inspection	Certification finished	Low
✓	✓	Main inspection	Inspection order accepted	Low
✓	✓	Main inspection	Inspector's Infoportal	Low
✓	✓	Main inspection	Inspection order accepted	Low
✓	✓	Main inspection	Inspector's Infoportal	Low
✓	✓	Main inspection	Inspection order accepted	Low
✓	✓	Main inspection	Inspection in progress	Low
✓	✓	Main inspection	Inspection order accepted	Low
✓	✓	Main inspection	Inspection order accepted	Low
✓	✓	Main inspection	Inspector's Infoportal	Low
✓	✓	Main inspection	Inspection order accepted	Low
✓	✓	Main inspection	Inspection order accepted	Low
✓	✓	Main inspection	Inspection in progress	Low
✓	✓	Main inspection	Inspector's Infoportal	Low
✓	✓	Main inspection	Inspection order accepted	Low

*Figure: Internal Auditor and Inspection Assignment

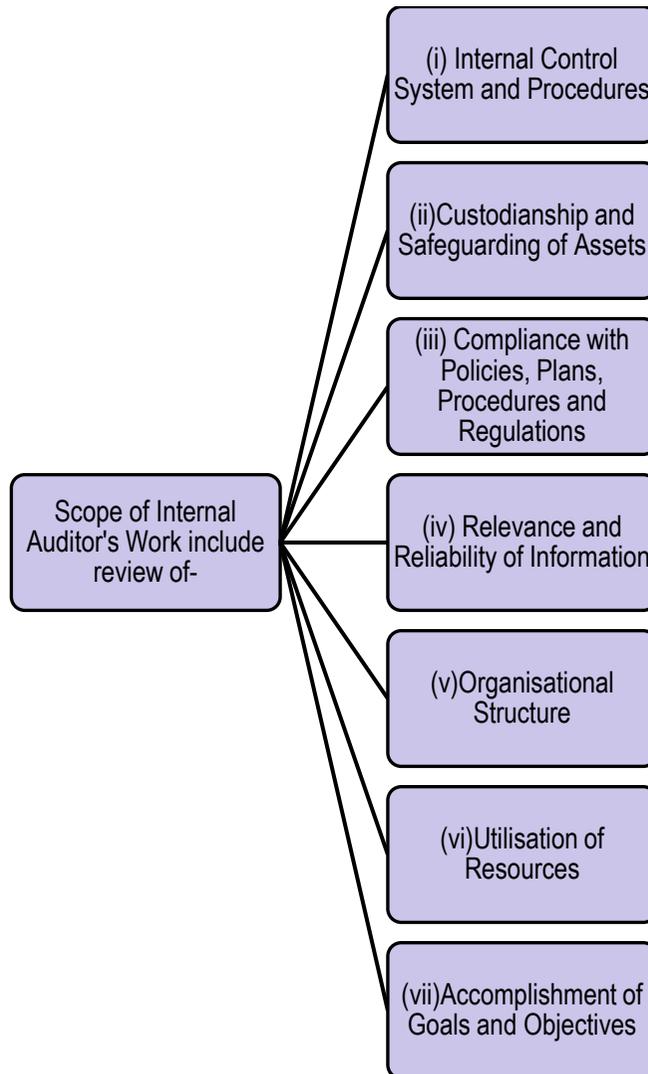


2. MANAGEMENT FUNCTIONS AND SCOPE OF INTERNAL AUDITING

Management is a process by which the affairs of an enterprise are conducted in such a manner that its goals and objectives are attained through optimum utilisation of all available resources, within the legal, social, economic and environmental constraints. To achieve optimum utilisation of resources management should determine the goals and objectives of the concern, quantify them to the extent possible, develop major policies and plans, implement them and exercise control over such implementation.

Each of the managerial functions should constantly be viewed by the internal auditor. The scope of internal auditor's work should include a review of-

* Source : Intact-systems.com



On the basis of such review, the internal auditor should in his report, highlight the weaknesses observed and give suggestions for improvement. We may now have a brief description on each of the above areas of review:

(i) Review of Internal Control System and Procedures -

- (a) The internal auditor should determine whether the internal control system is in consonance with the organisational structure. As far as possible, controls should be in-built in the operating functions, if they are to be cost effective.



The establishment of a separate credit control department would not be justified if the objective of reducing credit risk and minimising debt recovery period could be met through controls in-built in the accounting and sales systems especially in smaller and medium sized concerns.

- (b) Each control should be reviewed and analysed in terms of its costs and benefits. It should also be seen whether the internal controls were in use throughout the period of intended reliance. A break-down in internal controls for a specific portion of intended reliance would need special attention.
- (ii) **Review of Custodianship and Safeguarding of Assets -**
- The internal auditor should review the control systems to ensure that all assets are accounted for fully. He should review the means used for safeguarding assets against losses **e.g. fire, improper or negligent activity, theft and illegal acts etc.**
 - He should review the control systems for intangible assets e.g. the procedures relating to credit control. Where an enterprise uses electronic data processing equipment, the physical and systems control on processing facilities as well as on data storage should be examined and tested.
 - He should also verify the existence of the assets.
- (iii) **Review of Compliance with Policies, Plans, Procedures and Regulations -** It is essential that the various functional segments of an enterprise comply with the relevant policies, plans, procedures, laws and regulations so that the operations are carried out in coordinated manner. He should examine the system of periodical review of existing policies particularly when there is a change in the method and nature of operations of the enterprise. By combining the results of his review of the adequacy of the systems with the result of his compliance tests, the internal auditor should be able to evaluate the effectiveness of the former. He should point out specific weaknesses and suggest remedial action.
- (iv) **Review of Relevance and Reliability of Information -** The internal auditor should review the information systems to evaluate the reliability and integrity of financial and operating information given to management and to external agencies such as governmental bodies, trade organisations and labour unions. He should examine the accuracy and reliability of financial and operational records. The usefulness of the reports as well as of the records should be evaluated with reference to their costs. The internal auditor should examine whether the reporting is by exception i.e. the reports highlight the significant and distinctive features.
- (v) **Review of the Organisation Structure -** The internal auditor should conduct an appraisal of the organisation structure to ascertain whether it is in harmony with the objectives of the enterprise and whether the assignment of responsibilities is in consonance therewith. For this purpose:
- He should review the manner in which the activities of the enterprise are grouped for managerial control. It is also important to review whether responsibility and authority are in harmony with the grouping pattern.

- The internal auditor should examine the organisation chart to find out whether the structure is simple and economical and that no function enjoys an undue dominance over the others.
- He should particularly see that the responsibilities of managerial staff at headquarters do not overlap with those of chief executives at operating units. He should examine whether there is a satisfactory balance between authority and responsibility of important executives.
- The internal auditor should examine the reasonableness of the span of control of each executive (the number of sub-ordinates that an executive controls). He should examine whether there is a unity of command i.e., whether each person reports only to one superior.
- Where dual responsibilities cannot be avoided, the primary one should be specified and the specific responsibility to each senior fixed. This must be made known to all concerned.
- Finally, he should evaluate the process of managerial development in the enterprise. This is a vital aspect in a fast growing enterprise.

(vi) Review of Utilisation of Resources –

- The internal auditor should check whether proper operating standards and norms have been established for measuring economical and efficient use of resources.
- They should be detailed enough to be identifiable with specific operating responsibilities and should be capable of being used by operating personnel for monitoring and evaluating their performance.
- The internal auditor should review the methods of establishing the operating standards and norms. He should carefully examine the assumptions made while setting the standards to ensure that they are appropriate and necessary.
- Where there is a wide divergence between actual performance and the corresponding standards, reasons may be considered. As a part of evaluating resources utilisation, identifying the facilities which are under-utilized is an important function of the internal auditor.

For example: it may consist of under-utilized machines, unoccupied storage space, huge cash or bank balances, idle man power etc. While commenting on staffing, the internal auditor should pay special attention to non-productive work being performed. This would require an enquiry into the job descriptions of employees combined with an intelligent observation of the work being done.

- (vii) Review of Accomplishment of Goals and Objectives -** The internal auditor should review the overall objectives of the enterprise to evaluate whether they are clearly stated and are

attainable. The internal auditor should examine whether to the extent possible, objectives are expressed in precise quantifiable terms (both monetary and non-monetary) to facilitate detailed planning to be made for achieving them. Budgeting forms an important part of such planning. This will ensure that plans anticipate the problem areas. There should also be sufficient flexibility in the plans to permit such improvements in their implementation, as would benefit the enterprises as a whole.



3. INTEGRITY, OBJECTIVITY AND INDEPENDENCE OF INTERNAL AUDITOR

As per Standard on Internal Audit (SIA) 2, Basic Principles Governing Internal Audit, issued by the Council of the Institute of Chartered Accountants of India.

The internal auditor should:

1. be straightforward, honest and sincere in his approach to his professional work;
2. be fair and must not allow prejudice or bias to override his objectivity;
3. should maintain an impartial attitude. He should not only be independent in fact but also appear to be independent.
4. The internal auditor should not, therefore, to the extent possible, undertake activities, which are or might appear to be incompatible with his independence and objectivity.

For example, to avoid any conflict of interest, the internal auditor should not review an activity for which he was previously responsible. It is also expected from the management to take steps necessary for providing an environment conducive to enable the internal auditor to discharge his responsibilities independently and also report his findings without any management interference.

For example, in case of a listed company, the internal auditor may be required to report directly to those charged with governance, such as the Audit Committee instead of the Chief Executive Officer or the Chief Financial Officer. The internal auditor should immediately bring any actual or apparent conflict of interest to the attention of the appropriate level of management so that necessary corrective action may be taken.



4. QUALIFICATIONS OF INTERNAL AUDITOR

1.	The internal auditor should have the special expertise necessary for evaluating management control systems, especially financial and accounting controls.
2.	Accounting and finance functions provide basic data for management control of an enterprise. Therefore the internal auditor must have accounting and financial expertise to be able to discharge his duties.
3.	The internal auditor is also expected to evaluate operational performance and non-monetary, operational controls. This requires a basic knowledge of the technology and commercial practices of the enterprise.
4.	He should also have a basic knowledge of commerce, laws, taxation, cost accounting, economics, quantitative methods and EDP systems.
5.	An understanding of management principles and techniques is another essential qualification of an internal auditor as also the ability to deal with people.
6.	By his conduct the internal auditor should provide an assurance to the management that confidentiality of such information would be maintained.



5. INTERNAL AUDIT REPORT

As per Standard on Internal Audit (SIA) 2, Basic Principles Governing Internal Audit, issued by the Council of the Institute of Chartered Accountants of India, the internal auditor should carefully review and assess the conclusions drawn from the audit evidence obtained, as the basis for his findings contained in his report and suggest remedial action. However, in case the internal auditor comes across any actual or suspected fraud or any other misappropriation of assets, it would be more appropriate for him to bring the same immediately to the attention of the management.

Basic Elements of the Internal Audit Report: Basic elements of the internal audit report as per Standard on Internal Audit (SIA) 4, on Reporting issued by the Council of the Institute of Chartered Accountants of India. The internal auditor's report includes the following basic elements, ordinarily, in the following layout:

- | | |
|-----|---|
| (a) | Title; |
| (b) | Addressee; |
| (c) | Report Distribution List; |
| (d) | Period of coverage of the Report; |
| (e) | Opening or introductory paragraph; |
| (i) | identification of the processes/functions and items of financial statements audited; and |

- (ii) a statement of the responsibility of the entity's management and the responsibility of the internal auditor;
- (f) Objectives paragraph - statement of the objectives and scope of the internal audit engagement;
- (g) Scope paragraph (describing the nature of an internal audit):
 - (i) a reference to the generally accepted audit procedures in India, as applicable;
 - (ii) a description of the engagement background and the methodology of the internal audit together with procedures performed by the internal auditor; and
 - (iii) a description of the population and the sampling technique used.
- (h) Executive Summary, highlighting the key material issues, observations, control weaknesses and exceptions;
- (i) Observations, findings and recommendations made by the internal auditor;
- (j) Comments from the local management;
- (k) Action Taken Report – Action taken/ not taken pursuant to the observations made in the previous internal audit reports;
- (l) Date of the report;
- (m) Place of signature; and
- (n) Internal auditor's signature with Membership Number.

A measure of uniformity in the form and content of the internal auditor's report is desirable because it helps to promote the reader's understanding of the internal auditor's report and to identify unusual circumstances when they occur.

- (1) **Title:** The internal auditor's report should have an appropriate title expressing the nature of the Report.
- (2) **Addressee:** The internal auditor's report should be appropriately addressed as required by the circumstances of the engagement. Ordinarily, the internal auditor's report is addressed to the appointing authority or such other person as directed.
- (3) **Report Distribution List, Coverage and Opening or Introductory Paragraph:** There should be a mention of the recipients of the report in the section on Report Distribution List. The internal auditor's report should identify the systems, processes, functional lines or other items of the entity that have been audited, including the date of and period covered. The report should include a statement that the operation of systems, procedures and controls are the responsibility of the entity's management and a statement that the responsibility of the internal auditor is to express an opinion on the weaknesses in internal controls, risk management and governance (entity level controls) framework, highlighting any exceptions and cases of noncompliance and suggest or recommend improvements in the design and operations of controls based on the internal audit.
- (4) **Scope Paragraph:** The internal auditor's report should describe the scope of the internal audit by stating that the internal audit was conducted in accordance with generally accepted

audit procedures as applicable. The management needs this as an assurance that the audit has been carried out in accordance with established Standards. "Scope" refers to the internal auditor's ability to perform internal audit procedures deemed necessary in the circumstances. The report should include a statement that the internal audit was planned and performed to obtain reasonable assurance whether the systems, processes and controls operate efficiently and effectively and financial information is free of material misstatement. **The internal auditor's report, in line with the terms of the engagement, should describe the internal audit as including:**

- (i) examining, on a test basis, evidence to support the amounts and disclosures in financial statements;
- (ii) assessing the strength, design and operating effectiveness of internal controls at process level and identifying areas of control weakness, business risks and vulnerability in the system and procedures adopted by the entity;
- (iii) assessing the accounting principles and estimates used in the preparation of the financial statements; and
- (iv) evaluating the overall entity-wide risk management and governance framework.

The Report should include a description of the engagement background, internal audit methodology used and procedures performed by the internal auditor mentioning further that the internal audit provides a reasonable basis for his comments.

- (5) **Executive Summary Paragraph:** The Executive Summary paragraph of the internal auditor's report should clearly indicate the highlights of the internal audit findings, key issues and observations of concern, significant controls lapses, failures or weaknesses in the systems or processes.
- (6) **Observations (Main Report) Paragraph:** The Observations paragraph should clearly mention the process name, significant observations, findings, analysis and comments of the internal auditor.
- (7) **Comments from Local Management:** The Comments from Local Management Paragraph should contain the observations and comments from the local management of the entity provided after giving due cognizance to the internal auditor's comments. This should also include local management's action plan for resolution of the issues and compliance to the internal auditor's recommendations and suggestions on the areas of process and control weakness/ deficiency. **The management action plan should contain, inter alia:**

- (i) the timeframe for taking appropriate corrective action;
- (ii) the person responsible; and
- (iii) resource requirements, if any, for ensuring such compliance. Further comments from the internal auditor, in response to the auditee feedback, are to be clearly mentioned.

This paragraph should also contain the internal auditor's suggestions and recommendations to mitigate risks, strengthen controls and streamline processes with respect to each of the observations and comments made.

- (8) **Action Taken Report Paragraph: The Action Taken Report paragraph should be appended after the observations and findings and should include:**

- (i) Status of compliance / corrective action already taken / being taken by the auditee with respect to previous internal audit observations;
- (ii) Status of compliance / corrective action not taken by the auditee with respect to previous internal audit observations and the reasons for non-compliance thereof; and
- (iii) Revised timelines for compliance of all open items in (b) above and fixation of the responsibility of the concerned process owner.

- (9) **Date:** The date of an internal auditor's report is the date on which the internal auditor signs the report expressing his comments and observations.
- (10) **Place of Signature:** The report should name the specific location, which is ordinarily the city where the internal audit report is signed.
- (11) **Internal Auditor's Signature:** The report should be signed by the internal auditor in his personal name. The internal auditor should also mention the membership number assigned by the Institute of Chartered Accountants of India in the report so issued by him.

Further, the internal auditor should exercise due professional care to ensure that the internal audit report, inter alia, is:

- (i) clear
- (ii) factual – presents all significant matters with disclosure of material facts
- (iii) specific
- (iv) concise
- (v) unambiguous
- (vi) timely
- (vii) complies with generally accepted audit procedures in India, as applicable.

5.1 Essential Features of a Good Internal Audit Report

The contents of an internal audit report are influenced by various factors such as the nature of internal auditing function in the organisation, level of reporting, degree of management support and capabilities of internal audit staff. However, for preparing a good internal audit report, the following general rules may be observed:

- (i) **Objectivity** - To maintain the credibility of internal audit function the comments and opinions expressed in the report should be as objective and unbiased as possible.
- (ii) **Clarity** - The language used should be simple and straight-forward. As far as practicable use of technical terms and jargon should be avoided. Each draft of the report should be reviewed by a senior who should attempt to read it from the point of view of the users of the report.
- (iii) **Accuracy** - The information contained in the report, whether quantified or otherwise, should be accurate. Where approximation or assumptions have been made the fact should be clearly stated along with reasons, if material.
- (iv) **Conciseness** - Brevity is vital subject, of course, to the condition that important information should not be omitted.
- (v) **Constructiveness** - Destructive criticism should carefully be avoided in the report. The report should clearly demonstrate that the internal auditor is trying to assist the auditor in an effective discharge of his responsibilities.
- (vi) **Readability** - The reader's interest should be captured and retained throughout. For this, appropriate paragraph heading may be used.
- (vii) **Timeliness** - The report should be submitted promptly because if the time lag between the occurrence of an event and its reporting is considerable, the opportunity for taking action may be lost or a wrong decision may be taken in the absence of the information.
- (viii) **Findings and Conclusions** - These may be given either department-wise or in the order of importance. All the facts and data pertaining to the situation should be assembled, classified and analysed. Each conclusion and opinion should normally follow the findings. Tables or graphs may be used for the presentation of statistical data in appendices.
- (ix) **Recommendations** - An internal audit report usually includes recommendations for potential improvements. In order to enable the management to accept and implement the recommendations, the internal auditor should be able to convince the management that the conclusions are logical and valid and the recommendations represent effective and feasible ways of taking action.
- (x) **Auditee's views** - The auditee's views about audit conclusions or recommendations may also be included in the audit report in appropriate circumstances.
- (xi) **Summary** - A summary of conclusions and recommendations may be given at the end. This is particularly useful in long reports.
- (xii) **Supporting information** - The internal auditor should supplement his report by such documents and data which adequately and convincingly support the conclusions. Supporting information may include the relevant standards or regulations.

- (xiii) **Draft Report** - Before writing the final report, the internal auditor should prepare a draft report. This would help him in finding out the most effective manner of presenting his reports. It would also indicate whether there is any superfluous information or a gap in reasoning.
- (xiv) **Writing and issuing the Final Report** - The final report should be written only when the auditor is completely satisfied with the draft report. The head of the internal auditing department, may review and approve the final report. Before issuing the final report, the auditor should discuss conclusions and recommendations at appropriate levels of management. The report should be duly signed.

5.2 Follow-up

The internal auditor should review whether follow-up action is taken by the management on the basis of his report. If no action is taken within a reasonable time he should draw the management's attention to it.

Where the management has not acted upon his suggestions or not implemented his recommendations, the internal auditor should ascertain the reasons therefor.

Where the management has accepted his recommendations and initiated the necessary action, the internal auditor should periodically review the manner and the extent of implementation of the recommendations and report to the management highlighting the recommendations which have not been implemented fully or partly.



6. RELATIONSHIP BETWEEN INTERNAL AND EXTERNAL AUDITORS

- The scope and objective of internal audit are dependent upon the size and structure of the entity and the requirements of its management. As stated earlier the internal auditor operates in various areas such as review of accounting system and internal control; examination of financial and operating information for the benefit of management, examination of the economy, efficiency and effectiveness of operations including non-financial controls of various tangible assets of the entity. While operating in these areas, there is lot of overlapping between the work of internal auditor and external auditor.
- The work done by internal auditor has an important bearing on the work performed by the statutory auditor as evaluation done by the internal auditor in respect of internal controls, reliability of financial information, verification of assets etc. is also required to be done by the external auditor. The function of an internal auditor is an integral part of the system of internal control.
- It is statutory requirement too as per section 138 of the Companies Act, 2013 where the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting

the internal audit.

- However, it is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor. For the purpose, he should examine the Internal Audit Department of the organisation, the strength of the internal audit staff, their qualification and their powers.
- The extent of independence exhibited by the internal auditor in the discharge of his duties and his status in the organisation are important factors for determining the effectiveness of his audit.. But so far, the practice of audit being conducted jointly by the internal auditors is of great assistance to statutory auditors.
- The external auditor should, as part of his audit, evaluate the internal audit function to the extent he considers that it will be relevant in determining the nature, timing and extent of his compliance and substantive procedures. Depending upon such evaluation, the external auditor may be able to adopt less extensive procedures than would otherwise be required.

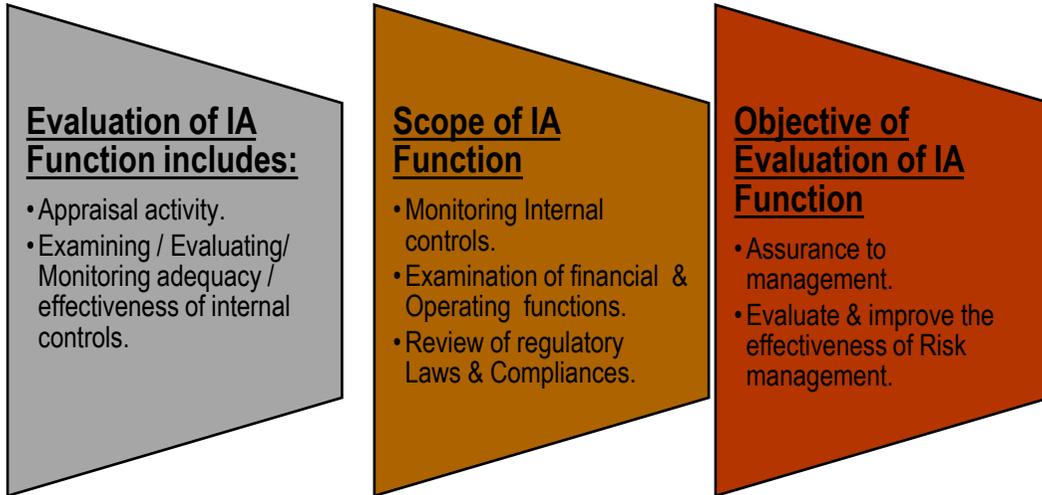
Difference Between Internal & External Auditors

BASIS FOR COMPARISON	INTERNAL AUDIT	EXTERNAL AUDIT
1. Meaning	It refers to an ongoing audit function performed within an organization by a separate internal auditing department.	It is an audit function performed by the independent body which is not a part of the organization.
2. Examination	Internal auditor examines the Operational efficiency of the organisation.	External auditor examines the Accuracy and Validity of Financial Statements.
3. Appointment	Internal auditor is appointed by the Management.	External auditor is appointed by the Members.
4. Users of Report	User of internal audit report is Management.	User of external audit report is Stakeholders.
5. Period	Internal audit is a Continuous Process throughout the year.	External audit is done once in a year.
6. Opinion	Opinion is provided on the effectiveness of the operational activities of the organization.	Opinion is provided on the truthfulness and fairness of the financial statement of the company.
7. Status of Auditor	Internal auditor is employee of the company, thus, less independent.	External auditor is an independent person.

SA 610 “Using the work of an Internal Auditor” deals with the relationship between internal and external auditors which is already discussed above.

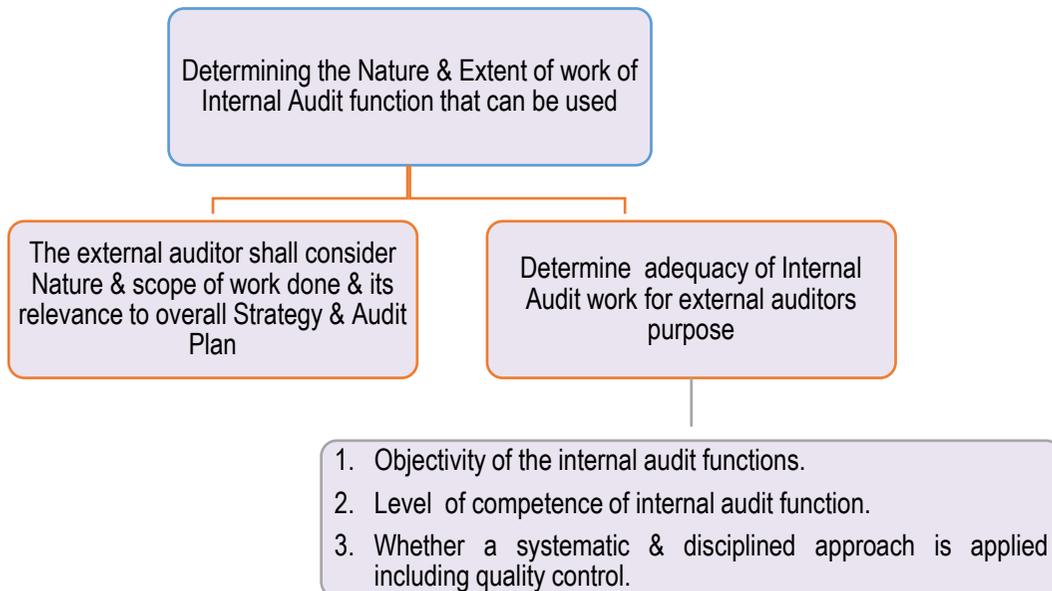
6.1 Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used

Evaluating the Internal Audit Function:

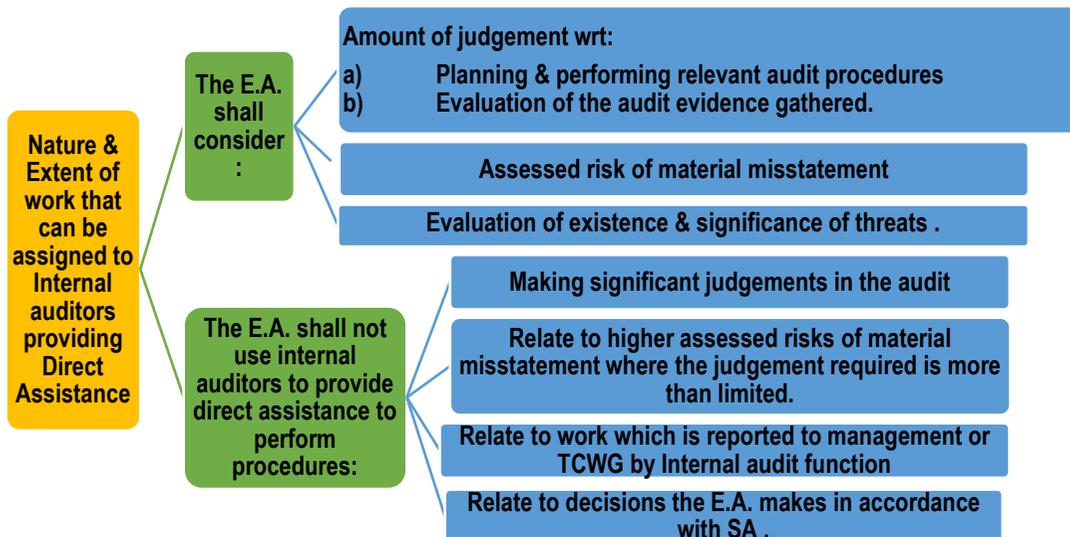


6.2 Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used

The external auditor shall not use the work of the internal audit function if the external auditor determines that the function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors; the function lacks sufficient competence or the function does not apply a systematic and disciplined approach, including quality control.



6.3 Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance



6.4 If the External Auditor uses Internal Auditors to Provide Direct Assistance on the Audit, the External Auditor shall include in the Audit Documentation

- (a) The evaluation of the existence and significance of threats to the objectivity of the internal auditors, and the level of competence of the internal auditors used to provide direct assistance;
- (b) The basis for the decision regarding the nature and extent of the work performed by the internal auditors;
- (c) Who reviewed the work performed and the date and extent of that review in accordance with SA 230 Audit Documentation;
- (d) The written agreements obtained from an authorized representative of the entity and the internal auditors; and
- (e) The working papers prepared by the internal auditors who provided direct assistance on the audit engagement.

Finally, in India even the statute has now recognised that internal audit is necessary for efficient running of companies. Thus, a review of the internal audit function in specified companies has become a statutory responsibility for the statutory auditor.

[Note: Student are advised to refer SA 610 Using the work of Internal Auditor for more details, SA 610 is reproduced in Auditing Pronouncements.]

Illustration

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?

Solution

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?

7. MANAGEMENT AUDIT

In recent years, the world has witnessed a rather new type of revolution viz. managerial revolution. This revolution has considerably changed the composition and outlook of management. Auditing has come to be viewed as an essential management tool, among others, for the efficient running of business and other economic activities. When we speak of auditing as a management tool, we give an extended coverage to the term auditing without, however, altering its basic concept. This extended concept of auditing includes operational auditing.

The emphasis of auditing has been changing over the years According to T.G. Rose, “The management audit would therefore concern itself with the whole field of activities of the concern, from top to bottom, starting, as always where management control is concerned, from the top, because we are primarily concerned with whether the general management is functioning smoothly and satisfactorily. If it is not, it may be due to the functional management being faulty and, therefore, we pass on to examine that in its turn, in order to find the missing or faulty link which is causing the trouble”.



Fig.: Auditors & Management Audit*

* Source: Money Matters

7.1 Management and Operational Audit

The concept of operational audit is discussed in detail later in the chapter. Operational audit is an audit for the management; it is undertaken at the instance of the management for providing it with information and appraisal of operations and activities. A parallel development in auditing is getting shaped as management audit. Management audit is an “audit of the management” also.

The scope and content of management audit. It should cover everything that we know as operational audit and, in addition it should also include review of the adequacy and competence of the objectives, plans, policies and decisions of the top management. However, as has been indicated above, unanimity is lacking on this aspect and management audit has become a subject of debate. John C. Burton, in the article “Management Auditing” (The Journal of Accountancy, May 1968) commented as follows:

“In a management audit, the auditor will look to see whether management is getting information relevant to the decisions and actions which it must take. This will require a much more intensive analysis of information needs and the efficiency of the existing system in meeting them. The auditor will not have to decide whether management is making the right strategic and operative decisions but rather whether management has available to it and is using the relevant information and techniques necessary to evaluate rationally the various alternatives that exist”. Management audits are concerned with appraising management’s accomplishment of organisational objectives; the management functions of planning, organising, directing, and controlling; and the adequacy of management’s decisions and actions in moving towards its stated objectives. Hence, the accent is on evaluating managers’ ability to manage.

Difference between Management Audit & Operational Audit

- Management audit is concerned with the “Quality of managing”, whereas operational audit focuses on the “Quality of operations”.
- Management audit is the “**Audit of management**” while operational audit is the “**Audit for the management**”.
- The basic difference between the two audits, then, is not in method, but in the level of appraisal. In management audit, the auditor is to make his tests to the level of top management, its formulation of objectives, plans and policies and its decision making. It is not that he just verifies the operations of control and procedures and fulfilment of plans in conformity with the prescribed policies.

7.2 Scope

From the authorities quoted above, it seems that the preponderant view about management audit is that it is wider in scope compared to operational audit.

The Two Audits are Complementary and Supplementary to One Another: In management audit, the auditor is to make his tests to the level of top management, its formulation of objectives, plans

and policies and its decision making. It is not that he just verifies the operations of control and procedures and fulfilment of plans in conformity with the prescribed policies. He is to reach the root i.e., the functions of top management which lay down objectives and policies, provide means and procedures of implementation and control and which actually engage in direction and control on a continuous basis.

In addition to what would normally be covered in an operational audit, management audit would also encompass the relevance and effectiveness of the aims, duties and decisions of management at various levels. Every aspect of the functions of Board of Directors should be in conformity with the objects set out in the constituting document. Similarly the managing director, if any, should act not only in accordance with the mandate he has received but he should ensure that the decisions he takes are in conformity with the objects of the company and the policies formulated by the Board. The effectiveness of management under the control of managing director and the various members of the Board including those incharge of finance, production, sales etc., should be subject to review of the management auditor.

From the point of view of the management auditor, knowledge about the following is essential:

- (i) Purpose for which the organisation has been created.

For example, purpose of a steel mill in the state sector may include:

- (a) production of steel to reduce imports of steel.
- (b) creation of reasonable employment opportunities.
- (c) development of backward areas.
- (d) providing staff welfare consistent with the needs for a proper living.

It should not be understood that such steel mill will not work for profit. Profit being one of the objects, should be properly balanced with other objects so that the purposes for which the organisation was created can be achieved.

- (ii) Management structure including delegation of authority, planning and budgeting.
- (iii) Reports required for a proper management and the reports actually received.
- (iv) Internal controls.
- (v) Nature of production of the business concerned in the broad way so that he can understand the flow and content of work leading to production and their mutual relationships. Some ideas about the techniques, formulas, raw materials and personnel requirement would be of direct assistance to the management auditor.
- (vi) Production planning.
- (vii) Factory layout, design and installed capacity.

- (viii) Personnel policy and personnel management including requirements, training, welfare, incentives and disincentives.
- (ix) Materials management including sources of important raw materials, receipt of materials of the quality and quantity needed, storage, supervision and safe custody, insurance and the procedure for issue of materials.
- (x) Sales management and sales planning including advertisement policy.
- (xi) Decision making process.
- (xii) Books and records including cost accounting records, cost accounting system and financial accounting policies.
- (xiii) Financial management of the organisation.

In view of the analysis made above which recognises management audit and operational audit as two identifiable exercises having a large area of overlapping jurisdiction, it may be convenient to consider them together to avoid duplication; and for this purpose the expression “management and operational audit” may be acceptable as a management audit which includes within its scope all the elements of operational auditing.

7.3 Desirability of Management Audit

Management Audit is a tool to improve management performance by recognising facts and information about management presented after appropriate examination, verification and evaluation, by professionally qualified and competent people. Management audit focuses attention on a comprehensive and constructive examination of the organisational structure, its components such as, divisions, departments, ventures, plans, policies, its financial control system, its method of operation, its appropriate use of human, physical and financial resources.

 **The principal reason** for undertaking a management audit is the need for detecting and overcoming current managerial deficiencies (and resulting operational problems) in ongoing operations. A management audit represents a more positive, forward-looking approach that evaluates how well management accomplishes its stated organisational objectives; how effective management is in planning, organising, directing, and controlling the organisation's activities; and how appropriate management's decisions are for reaching stated organisation objectives. This evaluation of managerial performance is achieved with the aid of a management audit questionnaire.

 In management audit, the managerial problems and related operational difficulties can be spotted before the fact rather than after the fact as with a financial audit. This forward-looking approach is analogous to the preventive maintenance concept found in production; that is, periodic management audits can pinpoint problems as they are developing from a small scale. In comparison, detecting the same problem at a later time, when they have generally increased in scope, results in higher costs to the organisation.

- ✎ The benefit of management auditing is that it represents another management tool to assist the organisation in accomplishing desired objectives. The capability of the management audit questionnaire to pinpoint important problem areas that are related to managing an organisation is a real plus factor for its use.
- ✎ Obviously, management auditing would be clearly helpful in the case of ailing industries, to isolate the problems and account for their ailments. It is especially important if such industries are either to be taken over by the government or to be heavily financed by financial institutions with a view to bring back vigor in them. Before committing public funds, like government funds or the institutional funds, it is important to properly diagnose the financial health and possibilities of a business undertaking and know the specific reasons that have caused or contributed to the decline of the business.

7.4 Organising the Management Audit

The establishment of a general programme for management audit requires management's approval to the plan. Unless the management's full support is available for the proposal, there may be lot of difficulties at later stages. Therefore, it is imperative to give consideration to a statement of policy which indicates therein the objectives and which reflects a definite plan to achieve the objectives while organising for management audit. The plan should also include the statement on personnel requirements, establishment of staff training programmes to improve the effectiveness of work and the basis of control over time and cost. These, being the basic features are discussed below at length with related matters.

1. 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.
- The statement must categorically say that the management auditor is capable of reviewing administrative and management controls over any activity within the company.

2. Location of audit function within the organisation –

- Some organisations depending upon their size and nature 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.

3. 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 emphasizes 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.

4. Staff training programme –

- A continuous training programme is necessary to achieve quality in performing audit assignments because the management auditor must keep 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.

5. Time and other aspects –

- 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.

6. 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?
- 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. In no case should the interval be allowed to exceed three years.

7.5 Conducting a Management Audit

Once top management has decided on the scope, the staffing, and the frequency of the management audit, the next phase is the undertaking of actual audit. This involves investigating and analysing the present facts through interviews as well as completing a management questionnaire so as to determine the problems confronting the organisation.

1. Getting the facts through interviews –

- To avoid waste of time and effort, adequate preparation is necessary in management auditing just as in financial auditing. The management auditors should know what information is desired, and they should be prepared to ask a number of direct questions to get the desired information. Reference can be made to the management audit questionnaire for specific questions.
- In the interview itself, the auditors should begin by stating the purpose of the audit. Emphasis should be placed on getting the facts that are essential to review and appraise the functional area(s) under study. The exchange between auditor and manager should be friendly and conducted in an open atmosphere so as to encourage a free exchange of ideas.

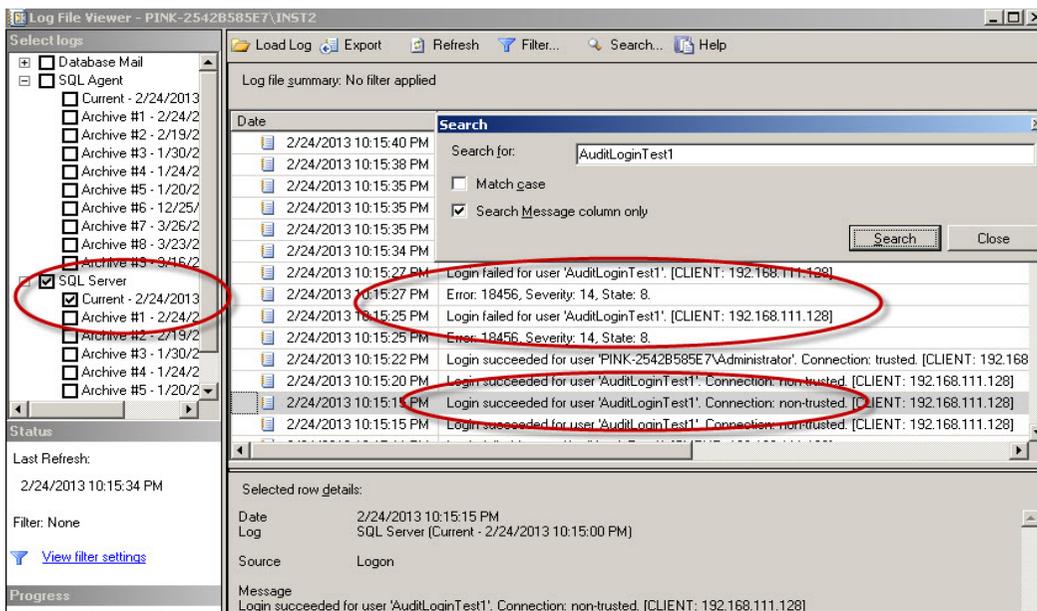
2. Measuring performance through the Management Audit Questionnaire –

- During the interview, the management auditors make a careful inquiry into important facts. The next step is to analyse this information, with the aim of measuring current performance. The best way to perform such an analysis is to utilise the sections of the management audit questionnaire that apply to the areas under study.
- By way of review, a management audit questionnaire aims at a comprehensive and constructive examination of an organisation's management and its assigned tasks.

- Overall, the questionnaire is concerned with the appraisal of management actions in accomplishing organisation objectives. Its primary objective is to highlight weaknesses and deficiencies of the organisation for possible improvements.
- 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. (Management Audit Questionnaire is discussed in later part of this chapter)

7.6 Concluding a Management Audit

The preparation of the management audit report that covers the details of the management auditor's findings and recommendations represents an important part of concluding an audit assignment.



***Figure: Management Audit and Audit Login Test**

- To assist in the preparation of the final report, the management auditors normally meet with management and other concerned personnel for the purpose of discussing freely any aspect or finding of the audit.
- This approach assists the independent third party in bringing together the important elements of audit as well as determining appropriate recommendations. It is far better to discuss alternative recommendations and feel out the possible consequences of

* Source mssqltalks.wordpress.com

recommended action. However, it should be noted that the type of report required varies with the level of investigation.

- Thus, a comprehensive investigation involves a report that is very broad in scope, while a smaller-scale investigation of one or two functional areas will result in a less comprehensive report.

Oral recommendations for improvement - From the management viewpoint, the main focus of audit is recommendations. Generally, there is an oral presentation of specific recommendations to members of the top management team who approved the audit. In some cases, the approval may have come from the board of directors, which then becomes the recipient of the auditors' oral recommendations. Upon completion of the presentation, oral recommendations become an integral part of the final report- the subject matter for the next section.

The auditors should back these recommendations with a cost/benefit analysis that indicates the expected return to the organisation from implementing them.

7.7 Management Audit Reports

The written report is the medium by which the comments, criticisms and recommendations of a management audit department are conveyed to the Board, to functional directors and to management in general. Management audit reports will inevitably cover a wide variety of subjects, reflecting the many and ever increasing ramifications of management audit departments. Broadly, however, reports may be divided into four main categories:

1. Reports prepared by the management audit staff after their visits to a unit.
2. Periodical reports prepared by senior members of management audit department which summarise the main audit findings and recommendations for the period under consideration and which afford a concise review of the department's activities for that period.
3. Reports on the results of special investigations and inquiries.
4. An annual audit report.

Types of Reports - The reporting of results covers a wide spectrum of types. We can describe the more important ones as follows:

1. **Oral reports** - In many situations, the reporting of results will be on an oral basis. To some extent, this is inevitable since a part of the actual audit effort is carried on in conjunction with company personnel. In other cases, it is a result of emergency action needs. It may also be a prelude to more formal written reports. To some extent, there will always be oral reporting as a means of later supplementing written reports, especially when individuals being served have special needs.

Oral reporting therefore, serves a useful and legitimate purpose, specially the matters covered by emergency oral reporting, should be followed up immediately by a written report giving reference to oral reporting.



A management auditor, if he has come across any embezzlement, should immediately inform the concerned management orally, so that steps may be immediately taken to prevent further embezzlement.

2. **Interim written reports** - In situations where it is deemed advisable to inform management of significant developments during the course of the audit, or at least preceding the release of the regular report, there may be some kind of interim written report.

This report may pertain to especially significant problems where there is a need for early consideration or the report may be of a progress nature. All in all, interim reports represent a type of reporting which, when used with judgement, can be a good device to improve the total reporting process.

3. **Regular written reports** - In the typical situation, the particular audit assignment will include the preparation of a formal written report. The form and content of such written reports will vary widely, both as between individual audit assignments and individual companies. They may be short or long. They may be presented in many different ways, including the extent to which quantitative or financial data are re-included. We will in the later pages discuss in more detail the organisation and planning of this type of report.

4. **Summary written reports** - These summary reports are also referred to as '**flash**' reports'. In a number of companies the practice has developed of issuing an annual (or sometimes more frequent) report summarising the various individual reports issued, and describing the range of their content. These summary reports in some cases are primarily for audit committees of Boards of Directors, but in other cases for higher level management. They are especially useful to top level managers who do not actively review the individual reports. They are also useful to the general auditor in seeing his total reporting effort with more perspective and on an integrated basis.

Organisation of the Written Report -

Format - Though it is difficult to lay down a format applicable to all situations, yet the following general guidelines may be observed:

- (i) **Title** - The management audit report should have a short but descriptive title so that its subject matter can be easily identified.
- (ii) **Objectives** - The management auditor may describe the objectives of the audit assignment.
- (iii) **Scope** - The management auditor may give a brief description of the activities audited by him.
- (iv) **Findings, conclusions and opinions** - These may be given either department wise or in the order of importance. All the facts and data pertaining to the, situation should be assembled, classified and analysed. Each finding should be discussed comprehensively and correlated

with other findings. Conclusions and opinions should normally follow the findings. Tables or graphs may be used for the presentation of statistical data in appendices.

- (v) **Recommendations** - A management audit report may include recommendations for potential improvements. However, care should be taken in making recommendations in order that the auditor's own objectivity may not become subject matter of question. He may point out defects and make recommendations in a broad manner on how to overcome them. He should avoid providing detailed procedures in the capacity of an auditor. Normally specifying procedures etc. should rest with consultants.
- (vi) **Auditee's views** - The auditee's views about audit conclusions or recommendations may also be included in the audit report in appropriate circumstances.
- (vii) **Summary** - A summary of conclusions and recommendations may be given at the end. This is particularly useful in long reports.

Brief Steps w.r.t Audit Report

Planning the Audit Report - Before starting the report, the auditor should ask himself, "What do I want to tell the reader about this audit? The answer will enable him to communicate effectively.

Supporting information - The management auditor should supplement his report by such documents and data which adequately and convincingly support the conclusions. Supporting information may include the relevant standards or regulations.

Preparing draft report - Before writing the final report, the auditor should prepare a draft report. This would help him in finding out the most effective manner of presenting his report. It would also indicate whether there is any superfluous information or a gap in reasoning.

Writing and issuing the final report - The final report should be written only when the auditor is completely satisfied with the draft report. The head of the management auditing department may review and approve the final report. Before issuing the final report, the auditor should discuss conclusions and recommendations at appropriate levels of management. The report should be duly signed and dated.

Follow-up of the audit report - The management auditor should review whether follow-up action is taken by management on the basis of his report. If no action is taken within a reasonable time, he should draw management's attention to it.

Action / Response of Management on Audit Report: Where management has not acted upon his suggestions or not implemented his recommendations, the auditor should ascertain the reasons therefor. In cases where he finds that non-implementation is due to a gap in communication, he should initiate further discussions in that matter. It also reflects management's attitude to audit. In any case, the auditor to retain the usefulness of audit function should ascertain from the management, preferably in writing, the reasons for non- implementation. It is possible that because of change in circumstances, the audit observation did not require any action on the part of the management.

7.8 Behavioral aspects encountered in a Management Audit

It has been experienced that one of the biggest difficulties involved during the course of management audit is that people working in the organisation do not wish to accept any change. While at the time of conducting interviews, it seems that people working in the organisation are amenable to change but at the time of actual implementation they come up with stiff resistance to proposals on account of various behavioural problems arising on this account. Such an unfortunate situation can be avoided by building up a positive approach to management audit and involving the various organisation personnel right from the initiation of the management audit.

Another fear which haunts executives working in the organisation is that the management auditors' recommendations may lead to their removal or reshuffling in the process. This problem may also be overcome by explaining to these executives that the management auditor is there to help them in achieving the results rather acting against their interests. Various problems arising on account of behavioural attitudes and solutions to overcome them during the process of management audit are discussed in the following paragraphs.

Financial auditors deal mainly with figures. Management auditors deal mainly with people. Management auditors in the normal discharge of their duty will come into contact with the following:

- (a) **Colleagues in their own department.**
- (b) **Staff of the department whose functioning they audit.**
- (c) **“Top management” who authorise them to perform audits.**

Therefore, management auditors must develop and maintain good relations with auditees to gain information and to ensure corrective action on audit findings.

In the following paragraphs, 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.

- (1) **Staff/line conflict** - The staff/line relationship is inherently prone to conflict. Management auditors are staff. And line people in the sense all members of other departments of the organisation are likely to regard the management auditor the same way as they regard other staff people. Management auditors being specialists in their field may think that their approach and solutions are the only answers.
- (2) **Control** - As the management auditor is expected to evaluate the effectiveness of controls, there is an instinctive reaction from the auditee to have certain amount of fear that his actions when reported are likely to cause adverse effect on those who receive the auditor's report, viz., top management. Therefore, the management auditor, being the part of control system and thorough evaluation of controls, leads to breeding of antagonism on the part of the auditees.

According to a research study, the causes of antagonism are as follows:



- (3) **Resistance to Change:** The other significant cause is that auditor's study of existing systems and procedures may give room for recommendations for changes of such systems. There is a certain built-in resistance to change. When a change is recommended by the auditor the resistance to change is transferred to the auditor's recommendations and the auditor. The auditor is looked upon as a likely instrument for recommending changes and auditees do not welcome the visits of auditors and much less their studies and their reports thereafter.

Solution to behavioural problems - The auditors, if they were to adopt the role of accuser or secret agency of the management to try upon the happenings of the auditee division, they would be unwelcome. Relations between the auditor and the auditee may improve if the auditor acts and is perceived as a professional advisor and consultant. In any event, there is a need to demonstrate to the extent possible that:

1. the audit is part of an overall programme mandated by higher- level authority to meet higher-level organisational needs for both protection and maximum constructive benefit.
2. the objective of the review is to provide maximum service in all feasible managerial dimensions.
3. the review will be conducted with minimum interference with regular operations of the operating personnel.

4. the responsible officers will be kept fully informed and have an opportunity to review findings and recommendations before any 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.

1. **Constructive criticism** - It is essential that the auditor should concentrate only on constructive criticism. He should also make obvious in his report the value of his comments in tangible terms. Only then would suggestions carry weight with the auditees and they will feel convinced that the auditor has been objective in his remarks in the report.
2. **Reporting methods** - To achieve this objective, the auditor has to make a concerted effort to convey effectively his role by adopting a friendly but firm tone in his report. It is always possible to disagree without being disagreeable, to criticise without being critical. The reports should concentrate on areas which need improvement rather than listing inefficiencies and deficiencies in performance of the auditee.
3. **Participative approach** - It is well established that auditor's reports have better acceptability if the improvements suggested are discussed with those who have to implement them and made to feel that they have participated in the recommendations made for improvements. On the other hand, it has been observed that either oral or written appreciation of the auditee's achievements not only encourages the auditees to develop a friendly attitude towards the auditors but look forward to their guidance in a more receptive fashion.

The participative approach to the internal audit process has proved to be success. Feelings of hostility disappear giving room to feelings of mutual trust. Team spirit is developed. Proposed recommendations are discussed with the auditee and such modifications as may be mutually agreed upon are incorporated.

Three cases are given hereunder to illustrate the practical aspects of behavioural problems.

Case-1: Auditor objective: Auditee offensive: Management's apathy - In Professional Organisation Ltd., the Management Auditor as part of his duty was expected to perform the audit function of the Consultancy Division of the organisation. The auditor in the normal functioning discovered lack of control and a further study revealed suppression of information regarding illegal procedures being followed by the department. His further in-depth examination of the books revealed that the division has been overstating profits, to justify its existence. These facts which had been in existence with the knowledge of manager of the Division had been left undetected. The auditor was totally professional. His attitude was not one of "policing". He had discussed the contents of his proposed report with the auditee. The auditee had to be defensive and hence decided to be offensive. Management had to face the predicament of appreciating the good job done by the management audit department without openly decrying the Divisional Manager. There was open "cold war" of hatred and hostility declared by the divisional Manager. The behavioural problems arose in spite of auditor's professional role. The auditee's reaction was instinctive as a corollary to being self-defensive. The management had a tough time. The problem was sorted out and the atmosphere of ill-feeling and hatred generated by the auditee could be smoothed.

Case-2 Auditee progressive: Auditor cantankerous: Management indifferent - In a large organisation, there was a long-standing problem of lack of coordination between marketing and production. The pressures of day-to-day problem, made the situation worse. Production and Marketing Managers were happy to have the services of the management, auditor to streamline procedures and monitor the implementation. It would have been ideal for the auditor to evolve a good system after a detailed study of the problems, have the key personnel of production and marketing departments participate in the discussion and to have introduced the proposed system with their co-operation. Instead the auditor took on his duty as a mission for fault finding and started submitting secret reports on the malfunctioning of the Production and Marketing departments. Management, having already the heavy load of coordination would seek explanations from Production and Marketing departments. The auditor's cantankerous behaviour and management's indifferent attitude inspite of auditee's very co-operative approach gave room for a series of behavioural problems. A participative approach, with the total curtailment of "policing" reports, with the correct guidance from the management would have avoided all behavioural problems.

Case-3 Auditor progressive- Auditee appreciative: Management objective - In a large organisation with operations spread all over the country the management faced sudden problems of lack of financial control, inspite of high levels of production and remarkable market demand. The organisation had an efficient and progressive management auditor with a good team. The auditees were individuals with professional attitude. Management was progressive and dynamic. Management called for meetings, explained the special assignment being given to management auditor of aiding management to get a grip over the situation. The auditee welcomed the auditor as an expert consultant. The auditor adopted an attitude of friendliness without descending to levels of too much familiarity. There was coordinated effort between the auditor and auditee. Management was kept informed of the problems and solutions being jointly worked out by the auditors and the auditees. Within a very reasonable time, what seemed an "out of control" situation was streamlined and the management got back the grip over the entire organisation.



8. OPERATIONAL AUDIT

Operational auditing is a systematic process involving logical, structured and organized series of procedures.

8.1 Relationship between Internal Auditing and Operational Auditing

To understand what operational auditing is, it would be better if we first understand internal auditing. It may be recalled that internal auditing is an activity carried on by the internal staff of an organisation to meet the management requirements of information. Internal auditing is an independent appraisal activity within an organisation for the review of operations as a service to organisation. Naturally, when an auditor is concerned with the appraisal of operations, he becomes an operational auditor. A function of internal auditing staff. 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.

IIA publication defines operational auditing as - Operational auditing is a systematic process of evaluating an organisation's effectiveness, efficiency and economy of operations under management's control and reporting to appropriate persons the results of the evaluation along with recommendations for improvement*.

On the basis of above definition operational auditing is a systematic process involving logical, structured and organized series of procedures. Operational auditing 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.

Illustration:

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.

Solution

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 discusses 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.

* Darwin J. Casler and James R. Crockett, *operational Auditing. An Introduction (Altamonte Springs, FL: The Institute of Internal Auditors, Inc., 1982). P 14.*

Difference between Internal & Operational Audit: There probably may not be much of difference in viewing operational audit as a review and appraisal of operations of an organisation carried on by a competent independent person. Auditing whether carried on by an internal staff or by an external person, should necessarily be an independent activity to maintain its objectivity and usefulness.

The difference in the approach of both these audits is illustrated below:

1. **Perception** - Traditionally, internal auditors have been engaged in a sort of protective function, deriving their authority from the management. They view and examine internal controls in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are not there; they check the accounting books and records to see, whether the internal checks are properly working and the resulting accounting data are reliable.

For example - when the auditor looks into the vouchers to see whether they corroborate the entries in the cash book or physically examines the cash in hand he is doing his traditional protective function. The moment he concerns himself to see whether customers' complaints are duly attended to or whether cash balance is excessive to the need, he comes to the operational field.

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 be interested in such matters as reorder policy, obsolescence policy and the overall inventory management policy. In pure administrative areas on stock, he will see whether adequate security and insurance arrangements exist for protection of stocks.

2. **Issues** - The basic difference that exists in conceptualisation of the technique of operational auditing is in the auditor's role in recommending corrections or in installing systems and controls. According to Lindberg and Cohn, such a situation would be in conflict with the role of operational auditor. In this connection, the views of the Institute of Internal Auditors, in the context of internal audit are relevant. According to that Institute, "the internal auditor should be free to review and appraise policies, plans, procedures and records; but his review and appraisal does not in any way relieve other persons in the organisation of the responsibilities assigned to them.

However, a further distinction should be observed between traditional internal auditing and operational auditing - this lies in the attitude and approach to the whole auditing proposition. Every aspect of operational auditing programme should be geared to management policies, management objectives and management goals.

3. **Objectives** - 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. The norms and standards should be such as are generally acceptable or developed by the company itself.

Performance yardsticks can be found 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.



The standards relating to objectives for a government company are quite different from those of a private sector company. Similarly standards of performance of a well equipped company which also adequately looks after the well-being of employees may be significantly different from a company which offers scanty welfare facilities or is ill-equipped.

Today, however, the concept of modern internal auditing suggests that there is no difference in internal and operational auditing. In fact, the scope of internal auditing is broad enough to embrace the areas covered by operational auditing as well. The modern internal auditing performs both protective as well as constructive functions.

8.2 Qualities of Operational Auditor

The operational auditor should possess some very essential personal qualities to be effective in his work:

1. In areas beyond accounting and finance, his knowledge ordinarily would be rather scanty and this is a reason which should make him even more inquisitive.
2. He should ask the who, why, how of everything. He should try to visualise whether simpler alternative means are available to do a particular work.
3. He should try to see everything as to whether that properly fits in the business frame and organisational policy. He should be persistent and should possess an attitude of skepticism.
4. He should not give up or feel satisfied easily. He should imbibe a constructive approach rather than a fault-finding approach and should give a feeling that his efforts are to help attaining an improved operation and not merely fault finding.
5. If the auditor succeeds in giving a feeling of help and assistance through constructive

criticism, he will be able to obtain co-operation of the persons who are involved in the operations. This will itself be a tremendous achievement of the operational auditor. He should try to develop a team comprised of people of different backgrounds. Involvement of technical people in operational auditing is generally helpful.

8.3 Why 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.

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. **The shortcomings of these sources can be stated as under:**

- (i) Executives and managers are too preoccupied with implementation of plans and achieving of targets. They are left with very little time to collect information and locate problems. They may come across problems that have come to surface but they are hardly aware of problems that are brewing and potential.
- (ii) Managers or their aides are generally relied upon for transmitting information than for booking for information or for analysing situations.
- (iii) The information that is transmitted by managers is not necessarily objective - often it may be biased for various reasons.
- (iv) Conventional internal audit reports are often routine and mechanical in character and have a definite leaning towards accounting and financial information. They are also historical in nature.
- (v) Other performance reports contained in the annual audited accounts and the routine reports prepared by the operating departments have their own limitations. The annual audited accounts are good as far as an overall evaluation is concerned in monetary terms.



Sales may be shown at a higher monetary value compared to the previous year and this may apparently suggest that the functioning of the sales department is satisfactory. But this may have been caused by a number of factors inspite of a really bad performance on the sales front. This fact may not be readily known unless one cares to analyse the sales data by reference to notes and explanations to the accounts and other related accounting data. Even a study of this nature may not fully reveal the weakness. It is quite possible that the established market for sales has been lost partly while some fortuitous sales have compensated the loss



The routine weekly production report may include production 'that is subsequently rejected by the quality control staff, or to avoid showing a bad production performance; even the partly produced goods may also be included. Remember, all this can happen inspite of specific management instructions about the basis on which the production report is to be made out.

Another important point may be noticed in the matter of routine departmental reports.. The busy management people, who can afford time only to glance over the performance reports, cannot be expected to make an integrated reading of several reports or to undertake an analysis of such reports. What they need is reliable, unmanipulated and objective report which they would like to look into to understand the situation.

- (vi) Operations of controls in a satisfactory manner cannot be relied upon to bring to light the environmental conditions. Controls are specific and their satisfactory operation is related to the specific situation under control. Also monitoring of the breakdown or non-operation of controls is a periodic phenomenon.
- (vii) Surveys and special investigations, no doubt, are very useful but these are at the best occasional in character. Also, they are costly, time consuming and keep the departmental key personnel busy during the period they are on. These are basically an attempt to carry out a post-mortem rather than to enlighten the management about the ways on improvement or for better performance or to give a signal for dangers and disasters to come.

8.4 Type of Operational Audits*

There are three broad categories of operational auditors: functional, organizational, and special assignments. In case, part of the audit is likely to concern evaluating internal controls for efficiency and effectiveness.

1. **Functional Audits** - Functions are a means of categorizing the activities of a business, such as the billing function or production function. There are many ways to categorize and subdivide functions.

For example, there is an accounting function, but there are also cash disbursements, cash receipt, and payroll disbursement functions. There is a payroll function, but there are also hiring, timekeeping, and payroll disbursement functions. As the name implies, a functional audit deals with one or more functions in an organization. It could concern, for example, the payroll function for a division or for the company as a whole.

A functional audit has the advantage of permitting specialization by auditors. Certain auditors within an internal audit staff can develop considerable expertise in an area, such as production engineering. They can more efficiently spend all their time auditing in that area. A

*Auditing and Assurance Services by Arens, Elder & Beasley; prentice hall publication, 2003 edition, page 740.

disadvantage of functional auditing is the failure to evaluate interrelated functions. The production engineering function interacts with manufacturing and other functions in an organization.

2. **Organizational Audits** - An operational audit of an organization deals with an entire organizational unit, such as a department, branch, or subsidiary. An organizational audit emphasizes how efficiently and effectively functions interact. The plan of organization and the methods to coordinate activities are especially important in this type of audit.
3. **Special Assignments** - In operational auditing, special assignments arise at the request of management. There are a wide variety of such audits. **Examples** include determining the cause of an ineffective IT system, investigating the possibility of fraud in a division, and making recommendations for reducing the cost of a manufactured product.

8.5 Objectives of Operational Audit

Like internal auditing, 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. 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:** The most significant gain an organisation can derive from operational auditing is probably in the area of appraisal of controls. Internal controls, because of their unobtrusive omnipresence in the organisation, provide the essential hinges to ensure proper performance in each functional or organisational area for accomplishing the desired organisational objective. Similarly, if controls are weak or breaking down, however well-equipped or well-manned the organisation may be, it will fail to operate effectively.
- (ii) **Evaluation of Performance:** In the task of performance evaluation, an operational auditor is heavily dependent upon availability of acceptable standards. Apart from this, 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.



When he walks through the factory floor, amongst others, he observes whether machines are idle or workmen not present in the post assigned to them or the accumulation of stores on the floors. All these have a bearing on the operation of controls. He can then go into the reasons of the failure of controls and bring these to the attention of the management for verification in the interest of proper working in future. He reviews internal control reports to ascertain whether they bring the performance, qualitatively and quantitatively to the notice of the management; also whether the organisation's policies and plans are being carried out.

- (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. He prepares his evaluation programme in such a manner that it will show how well or how poorly the department has fared by reference to applicable standards, procedures, rules, policies and plans. The principal basis of performance evaluation can be productivity, personnel, workload, cost and quality.

In the area of **productivity**, the operational auditor can undertake such tests as input-output ratios for materials and labour in quantitative terms.

Personnel is perhaps the most important factor in performance evaluation. Unless the organisation has a sound personnel policy consistent with its requirements, the facilities, materials and equipment that are available in the organisation may not be utilised properly to obtain optimum performance.

Work load measurement can be another significant area where operational auditor can be of use because of ready availability of quantitative data. There can be measures like volume or quantity of work handled and/or performed volume of new work, backlog of work, etc.

Quality of work is a matter which is not directly amenable to operational audit scrutiny. Nevertheless, it is an important aspect of performance of an organisation. Therefore, some quantitative measures are often devised to judge the quality of work. These can be number of customers' complaints, rejections by quality control department, number of workers' grievances, number of errors in invoicing or recording transactions, quantity of scrap and wastages, etc.

Cost is perhaps the most cogent indicator of performance. Costs are classified and recorded for a proper assimilation of their implications on performance.

- (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. Therefore, this is also another important area for appraisal by the operational auditor. In evaluating organisational structure, the aspects that may be considered by the operational auditor may be as follows:

- (i) Is the organisational structure in conformity with management objectives?
- (ii) Whether the organisational structure is drawn up on the basis of matching of responsibility and authority?
- (iii) Whether the line of responsibility from the top to the bottom is clearly discernible from the structure?
- (iv) Whether the delegation of responsibility and authority at each stage is clear and overlapping are avoided?



9. REVIEW OF SYSTEMS AND PROCEDURES

9.1 Systems

The word 'system' is commonly defined as "a set of objects, together with relationships between the objects and their attributes, connected or related to each other and to their environment in such a manner as to form an entire or integral whole".

The definition can be better understood with reference to a complex biological system of human beings which consists of various sub-systems, e.g. nervous system, digestive system, respiratory system, blood circulation system, reproductive system, etc. Each sub-system in turn, may be treated as a complete system in itself. **For example**, digestive system consists of various organs, say stomach, esophagus, intestines, etc. which are interdependent and interrelated, so that failure of any part will lead to failure of the digestive system. Thus, the essence of a system lies in the inter-relationship and inter-dependence of various parts and processes. Unrelated and independent parts can never constitute a system.

Similarly, it can be said that a business organisation also does not operate in a vacuum. Its various operations-manufacturing, purchasing, marketing, accounting and finance, research and development, personnel - comprise a system. These operations have to take into account and needs and operating modes of all the people, enterprises and governments that make up the environments in which it operates.

To accomplish an objective by means of a system entails three main steps:

1. Design a system to achieve the main objectives.
2. Operate the system.
3. Check that the system is operating and producing as intended by its design, i.e. that the stated objective is being achieved.

9.2 Procedures

Procedures are the means by which policies are implemented. Most often, procedures entail the use of documents in accordance with precise instructions or methods to be used. At lower levels in an organisation, formalised and authorised procedures become more numerous and of specific nature because of following factors:

1. There exists economic advantage of specifying precise uniform action to be taken by a large number of people and for repetitive jobs.
2. The need for more precise control over employees' activities which can only be achieved if there are detailed prescriptions of how things are to be done.
3. The element of discretion has to be reduced as far as possible.

Standard procedures go a long way towards making sure that pertinent information flows to the people who need it and that each person understands what he is to do with it.

9.3 Review of Systems and Procedures

The purpose of systems and procedures is to help management in the planning and accomplishment of organisational purpose, in communicating their requirements, and in assisting the personnel in carrying out the requirements. The review of systems and procedures is to improve the methods, to get away from the old ways and traditional routines and to reduce the cost in completing and processing the paper work - eliminating waste, duplication and inefficiencies. In reviewing any system or procedure, the management auditor must concern himself with its purpose as well as its design and then he must decide on its merits as the best serving the interests of the enterprise.

In the study of the systems and procedural functions, the auditor should ask himself:

1. Is the function properly located in the organisation?
2. Do the staff personnel have the necessary training and experience to perform the work?
3. Has a definite programme been established and has been taken for its attentive accomplishment?
4. Is productivity satisfactory?

The evaluation of a system or a procedure actually includes three separate considerations. **First**, is the system or procedure meeting all of the current requirements? **Second**, is it operating effectively? And **third**, what is the degree of effectiveness? **To determine whether system or procedure is meeting current requirements, the following among other things, should be considered:**

1. Is the system or procedure designed to promote achievement of the company's objectives, and is it accomplished effectively?
2. Does the system or procedure operate within the framework of the organisational structure?
3. Does the system or procedure adequately provide methods of control in order to obtain maximum performance with the least expenditure of time and effort?
4. Do the routines designated in the system or procedures indicate performance in logical sequence?
5. Does the system or procedure provide the means for effective coordination between one department and another?
6. Have all required functions been established?
7. Has the necessary authority been designated to carry out responsibilities?
8. Can any changes be made to improve effectiveness?

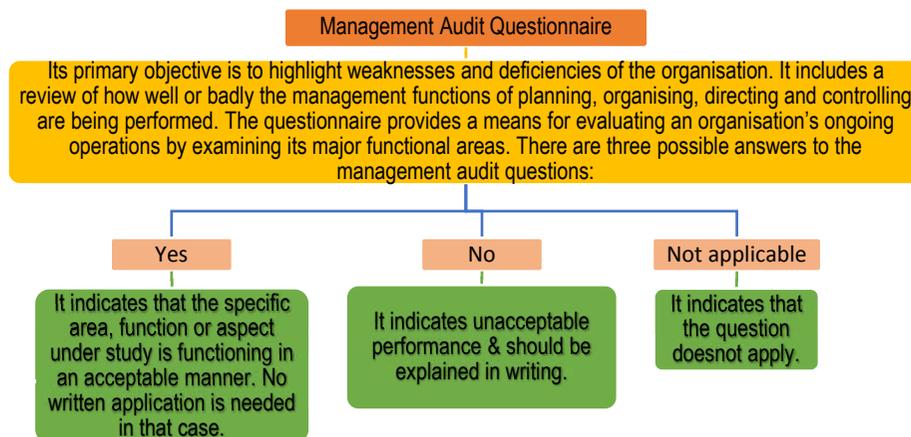
The important thing is to make sure that the system or procedure is designed to meet the desired results.

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.

10. 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.



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.

APPENDIX

The following Standards on Internal Audit are recommendatory in nature. The Standards shall become mandatory from such date as notified by the council:

SIA 1 : Planning an Internal Audit

SIA 2 : Basic Principles Governing Internal Audit

SIA 3 : Documentation.

SIA 4 : Reporting

SIA 5 : Sampling

SIA 6 : Analytical Procedures

SIA 7 : Quality Assurance in Internal Audit

SIA 8 : Terms of Internal Audit Engagement.

SIA 9 : Communication with Management

SIA 10 : Internal Audit Evidence

SIA 11 : Consideration of Fraud in an Internal Audit.

SIA 12 : Internal Control Evaluation

SIA 13 : Enterprise Risk Management

SIA 14 : Internal Audit in an Information Technology Environment

SIA 15 : Knowledge of the Entity and its Environment.

SIA 16 : Using the Work of an Expert.

SIA 17 : Consideration of Laws and Regulations in an Internal Audit.

SIA 18 : Related Parties.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. Write a short note on-Summary Written Report.
2. State the important aspects to be considered by the External auditor in the evaluation of Internal Audit Function.
3. AB Pvt. Ltd. company having outstanding loans or borrowings from banks exceeding one hundred crore rupees wants to appoint internal auditor. Please guide him for applicability of the same and who can be appointed as internal auditor and what work would be reviewed by him.

Multiple Choice Questions

1. The Board of Directors of Young Ltd., a listed company, appointed Mr. Old, a Cost Accountant (not in practice), to conduct internal audit of the functions and activities of the company. The job of Mr. Old would be of an independent management function, involving a continuous and critical appraisal of the functioning of the company with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the company, including the entity's strategic risk management and internal control system. However, some of the officers of the company are against the appointment of a Cost Accountant who is not in practice as an internal auditor. State whether those officers are correct or not in their view point by referring the provisions of the Companies Act, 2013?
 - (a) The view point of the officers are correct because as per section 138 of the Companies Act, 2013, the internal auditor shall be a chartered accountant.
 - (b) The view point of the officers are correct because as per section 138 of the Companies Act, 2013, the internal auditor shall a cost accountant in practice.
 - (c) The view point of the officers are correct because as per section 138 of the Companies Act, 2013, the internal auditor shall be an employee of the company.
 - (d) The view point of the officers are not correct because as per section 138 of the Companies Act, 2013, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be decided by the Board.
2. Employees of GIG Ltd. have to travel frequently for business purposes, so the company entered into a contract with a Simony Travels Ltd. for managing booking, cancellation and other services required by their employees. As per contract terms, Simony travels has to raise its monthly bills for the tickets booked or cancelled during the period and the same are paid by GIG Ltd. within 15 days of the bill date. The bills raised by Simony travels were of huge amount, so the management of GIG Ltd. decided to get an audit conducted of the process

followed for booking/ cancellation of tickets and verify the accuracy of bills raised by the travel agency. Which audit do you feel the management should opt for?

- (a) Internal audit, as it relates to examine the operational efficiency of the organisation.
- (b) Management audit, as it is an audit desired by the management.
- (c) Performance audit so as to assess the performance of the Simony travels appointed by the organisation.
- (d) Operational audit, as it is the audit for the management and involves verifying the effectiveness, efficiency and economy of operations done by the Simony travels for the organisation.

Case Study Based MCQs

1. RS Ltd was set up by Raj and Shanti in 1992. Initially the name of the company was Rajeev Private Limited. The company is currently into the business of aviation. The company has its head office at Chennai. The company has been in the same business since its incorporation but over the years had to shut down its business 3 times due to operational inefficiencies and resultant losses.

In the year 2012, when the company restarted its operations after shutting that down third time, the company got funding from foreign investors. The management of the company increased its focus on the processes of the company and various checks and controls to improve the efficiency of the operations. This gradually resulted in improving the overall business culture of the company and gradually company started earning profits.

In the year 2016, the company got converted into public company and got its name changed to RS Ltd. After that the company also tried to get listed on the New York Stock Exchange but the market was not favourable and the company instead got listed in India.

The company kept increasing its focus on operational efficiencies which was also extended to all other processes of the company, most importantly, financial reporting which was not focused earlier by the management.

The company also appointed a large firm of Chartered Accountants, KB & Co, as its internal auditors, who have had specialization in the same sector so that they can help the company to fill the gaps in the processes, wherever required.

The company also appointed other consultants to improve on the operations and management functions.

During the financial year ended 31 March 2018, the internal auditors of the company raised some observations which were discussed in detail with the management, primarily because the management was not agreeing to some of the points of the internal auditors.

Subsequently in the financial year ended 31 March 2019, the management decided to set up its in-house internal audit function along with the CA firm, KB & Co. The idea was to do the work in-house and over the period, KB & Co can move out once the management is confident of the in-house internal audit function.

Considering the above mentioned facts, please provide your suggestions in respect of the following:

- (i) The Standard Operating Procedures (SOP) for logistics process was not defined from the point of vehicle request received from the sales marketing department up to the bills verification. The management explained that part of this process was developed and remaining part was expected within next 3 months.
 - (a) This is more of a documentation and hence not relevant for the management.
 - (b) Auditor should highlight and report this matter in his report.
 - (c) The matter which is already under development should not be considered by the auditor.
 - (d) Management needs to demonstrate the development process further and get this issue closed.
- (ii) It was noted that during a particular period, cash in hand balance was higher than actual cash requirement at some locations. Ratio of cash expenses to closing cash balance during that period ranged from 7 to 84 times. Further the insurance cover was also not taken for the cash in hand kept at some locations. The management explained that this occurred only during a specified period and the insurance coverage plan was in place for the next year.
 - (a) Auditor should report this matter in his report.
 - (b) The management needs to explain the amount involved and if that is low then the auditor should ignore this.
 - (c) The cash balance should not be looked at by the internal auditor as this is more relevant from financial reporting.
 - (d) Internal auditor should only report about not availability of the insurance coverage to the management.

- (iii) On review of procurement process, it was observed that the system was not enabled to show pending delivery of same material while raising a subsequent purchase order and the guidelines were not defined for review of open purchase orders and long pending orders.

Management explained that this was due to lead time, locking in quantity/price, lead time to shipment, delays in delivery due to rake unavailability, failure of vendors to supply material as per timelines or quality etc and they will explore how system driven reporting can be done.

- (a) This was an operational challenge and hence out of the purview of internal auditor.
- (b) This related to some system constraints and hence may be ignored by the internal auditor.
- (c) The internal auditor needs to highlight this in his report.
- (d) The management should draw a proper plan to take care of this. In any case there doesn't appear to be any financial impact due to this and hence the same should be ignored.
- (iv) It was observed that the credit limit assessment was not being performed for all the customers which could result in possibility of credit being given to customers with weak financial credibility leading to bad debts/ financial losses to the company.
- Management replied that they started the process of updation of credit limit in their ERP package which shall be completed in a month's time for major customers and for customers wherever temporary credit limit was defined. This would cover majority of exposure.
- (a) Since the management has already taken remedial action, the internal audit should drop this point.
- (b) Since this matter related to financials, this should be covered by the statutory auditors and not the internal auditors.
- (c) The management said that statutory auditors have also raised this point and hence internal auditors should drop this.
- (d) Internal auditors should report this irrespective of the fact whether statutory auditors covered this or not.

- (v) The management's plan to phase out the CA firm by building up in-house internal audit team has been questioned by the statutory auditors saying this is not acceptable.
 - (a) Statutory auditors are correct.
 - (b) Statutory auditors should observe this for a period and if that is working fine then they should have no concern regarding this.
 - (c) The management has a discretion regarding this and hence statutory auditors are not correct.
 - (d) The management should take approval from relevant authority like MCA and then statutory auditors would have to accept this.

Answers to Theoretical Questions

1. **Refer Para 7.7.**
2. **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.

3. **Applicability of Internal Audit:** Section 138 of the Companies Act, 2013 states that every private limited company is required to conduct internal audit if its 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.

In view of above provisions, AB Pvt. Ltd. is under compulsion to conduct internal audit as its loans or borrowings are falling under the prescribed limit.

Who can be appointed as Internal Auditor- The internal auditor shall either be a chartered accountant or a cost accountant, whether engaged in practice or not, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies.

The internal auditor may or may not be an employee of the company.

Work to be reviewed by Internal Auditor- Refer Para 2.

Answers to Multiple Choice Questions

1. (d) 2. (d)

Answers to Case Study Based MCQs

1. (b) 2. (a) 3. (c) 4. (d) 5. (c)