

## 19. Internal Audit, Management and Operational Audit

### Important Point of this chapter

1.

### 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.

### Scope of Internal Audit

Each of the managerial function should be constantly be viewed by the auditor. Translated into more concrete terms, the scope of internal auditor’s work, should include a review of

- a. Internal control system and procedures.
- b. System regarding the custodianship and safeguarding of assets – monetary and non-monetary of enterprise.
- c. Compliance by the various segments with the policies, plans and procedures of the enterprise as well as with the relevant regulations and laws.
- d. Organisational structures of the enterprise and its congruence with its objectives.
- e. Efficient and economical use of available resources tangible as well as intangible.
- f. Various operations.

### Integrity, objectivity and independence of internal auditor

As per SIA 2, Basic principles governing internal audit, issued by ICAI, the internal auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain a impartial attitude. He should not only be independent in fact but also appear to be independent.

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.

### Qualification of Internal Auditor

- The IA should have the special expertise necessary for evaluating management control systems, especially financial and accounting controls.
- The IA 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.
- The IA should also have basic knowledge of commerce, laws, taxation, cost accounting, economics, quantitative methods and EDP systems.
- An understanding of management principles and techniques is another essential qualification of an internal auditor as also the ability to deal with the people.
- The IA should have the integrity and detachment of a professional. He often comes across confidential and sensitive information. By his conduct the IA should provide an assurance to the management that confidentiality of such information would be maintained.

## Internal Audit report

- 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. Objective paragraph – statement of the objectives and scope of the internal audit engagement;
- g. Scope paragraph:
  - i. A reference to the generally accepted audit procedures in India.
  - 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 techniques used.
- h. Executive summary, highlighting the key material issues, observations, control weakness and exceptions.
- i. Observations, findings and recommendations made by 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.

## Essential features of good internal audit report:

- i. *Objectivity*: comments and opinions expressed in report are objective and unbiased as possible.
- ii. *Clarity*: the language used should be simple and straight forward.
- iii. *Accuracy*: the information 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 be avoided in the report.
- vi. *Readability*: the reader's interest should be captured and retained throughout. For this appropriate heading should be used.
- vii. *Timeliness*: the report should be submitted promptly because if the time lag between the occurrence of the 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 information.
- viii. *Findings and conclusions*: this may be give either department-wise or in the order of importance.
- ix. *Recommendations*: 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 recommendation represents effective and feasible ways of taking action.
- x. *Auditee's reviews*

- xi. *Summary*
- xii. *Supporting information:* report submitted with accurate document also
- xiii. *Draft report:*
- xiv. *Writing and issuing the final report:* the final report should be written only when the auditor is completely satisfied with draft report.

### **Relationship between integral 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, and verification of assets etc. is also required to be done by the external auditor.
- While external auditor holds responsibility for his report and for the determination of nature, timing and instant of the audit procedures, much of the work of the internal audit function may be useful to him in his examination of financial information.
- The role of the internal audit function within an entity is determined by management and its prime objective differs from that of the external auditor who is appointed to report independently on financial information.
- The external auditor should, as part of 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.
- By its very nature, the internal audit function cannot be expected to have the same degree of independence as is essential when the external auditor expresses his opinion of the financial information.

### **Management Audit**

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 satisfactory. If it is not, it may be due to the functional management being faulty and, therefore, we pass on to examine than in its turn, in order to find the missing or faulty link which is causing the trouble.

Management audits are concerned with appraising management's accomplishment of organisational objectives; the management functions of planning, organizing, directing, and controlling; and the adequacy of management's decisions and actions in moving towards its stated objectives. Hence, the accent is on evaluating manager's ability to manage.

### **Scope**

- The auditor is to take his testes to the level of top management, its formulation of objectives, plans and policies and its decision making.
- Management audit also encompass the relevance and effectiveness of the aims, duties and decisions of management at various levels.
- From the point of view of management auditor, knowledge about the following is essential:
  - i. Purposes for which the organisations have been crated.
  - ii. Management structures including delegation of authority, planning and budgeting.
  - iii. Report 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 relationship.
- vi. Production planning
- vii. Factory layout, design and installed capacity.
- viii. Personnel policy and personnel management including requirements, training welfare, incentives and disincentives.
- ix. Material management including sources of raw materials, receipt of materials of the quality and quantity needed.
- x. Sales management and sales planning including advertisement policy
- xi. Decision making process.
- xii. Financial management of the organisation

### **Benefit of management audit**

1. The principal benefit is the need for detecting and overcoming current managerial deficiencies in ongoing operations.
2. A second important benefit of MA is that it represents another management tool to assist the organisation in accomplishing desired objectives.

### **Organising the management audit:**

1. Devising the statement of policy: the main and important step is this for conducting MA in entity. First the high or top management should make necessary policy for MA and it is also state the scope and other related criteria for conducting MA.
2. Location of audit function within the organisation.
3. Allocation of personnel
4. Staff training programmes
5. Time and other aspects
6. Frequency: when the organisation is subject to rapid change or the total resources utilised are expensive, the frequency of Management auditing should be greater than when it does not undergo rapid changes or the resources employed are not high in value.

### **Conducting a Management Audit:**

1. Getting the facts through interviews
2. Measuring performance through management audit questionnaire

### **Management Audit report**

*MA report 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 member of management audit department which summarise the main audit findings and recommendations for the period under considerations and which afford a concise review of the department's activities for that period.
3. Reports on the results of special investigation and inquiries.
4. An annual audit report.

*Types of reports*

1. Oral reports
2. Interim written reports
3. Regular written reports
4. Summary written reports

## **Behavioural 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.
- 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 management audit.
- Solution to overcome behavioural problem: the auditors, if they were to adopt the role of accuser or secret agency of the management try upon the happenings of the auditee division, they would be unwelcome. Their presence will give rise to problems of personnel relationship. In any event, there is a need to demonstrate to the extent possible that:

- i. The audit is a part of an overall programme mandated by higher-level authority to meet higher-level organisation needs for both protection and maximum constructive benefit.
- ii. The objective of the review is to provide maximum service in all feasible managerial dimensions.
- iii. The review will be conducted with minimum interference with regular operations of the operating personnel.
- iv. The responsible officers will be kept fully informed and have an opportunity to review findings and recommendations before any audit report is formally released.

## **Operational Audit**

Operational auditing is a systematic process involving logical, structured and organised series of procedures. In other words, we can say that, Operational auditing is a systematic process of evaluating an organisation's effectiveness and economy of operations under management's control and reporting to appropriate persons the results of the evaluation along with recommendations of improvement.

### **Why operational Audit?**

- The need for operational auditing is 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.
- Operational audit has filled a very significant vacuum; it has come to provide the management with inexpensive, continuous and objective appraisal of activities, operations and controls to inform the management about achievement of standards and, if otherwise, to inform the management about what has gone wrong and how it has gone wrong.

### **Type of operational Audit**

1. Functional audit
2. Organisational audit
3. Special assignments

### **Objective of special Audit**

1. Appraisal of controls
2. Evaluation of performance
3. Appraisal of objectives and plans, and
4. Appraisal of organisational structure.