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COMMITTEE III (1ST SESSION)

SUMMARY OF SIGNIFICANT ISSUES RAISED IN THE PAPERS ON SUBJECT III

"Management or Operational Auditing -- An Extension of the Scope of the Work of Supreme Audit Institutions"

PRESENTED BY

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<u>MANAGEMENT OR OPERATIONAL AUDITING</u>

I think it would be well to start with a few comments about the terminology of the subject we are talking about. It has been our experience that the terms "management auditing" and "operational auditing" have no generally accepted meaning. Viewpoints vary greatly as to what the nature and scope of such audits embrace. We have another term in the United States which is also frequently used. That term is "performance auditing."

All of these terms are likely to be used whenever there appears to be a need to establish a distinction between "financial auditing" and auditing which goes beyond financial transactions and accounting records and examines into the operating, managerial, or administrative performance of an organization.

The suggested definition sent to the Supreme Audit Institutions as a basis for discussion of this subject at this Congress reflects this distinction. It defines "management audit" as "a constructive assessment of future alternatives available to an organization." These alternatives are in turn further interpreted as being those based on "analysis of stated objectives, past management activities and current problems."

This definition is quite broad. In fact, it strikes me as so broad as not to be really definitive as to what the objectives of a "management audit" should be.

For purposes of discussion here, I would like to suggest that we consider the total audit job as consisting of financial auditing, management auditing, and program auditing.

Financial auditing would be concerned primarily with financial transactions, accounts, and financial reports.

Management (or operational or performance) auditing would be concerned primarily with the efficiency and economy with which resources are managed and consumed.

Program auditing would be concerned mainly with inquiring into the results or benefits being achieved by an organization and evaluating whether programs are meeting the objectives set by the legislature or other authorizing bodies.

Each of these types of audits would include checking into compliance with applicable laws and regulations. A complete audit would embrace all three types and could be considered as a comprehensive audit of an organization's overall performance.

Another observation that I would like to introduce early in this discussion is one of a cautionary nature. The office which I head--the United States General Accounting Office--has accumulated much successful experience in management auditing. However, we have learned how to accomplish this only gradually, and to a considerable extent by trial and error--some efforts being more successful than others.

I believe that management or operational auditing to be successful must start modestly and expand slowly. There must be a gradual development built on experience gained--the auditor must walk before attempting to run. That gradual development and transition from purely financial or fiscal type auditing calls for an increased involvement of staff members who have some acquaintance with such fields as administration, engineering, economics, etc. This is needed for a good understanding of operational problems. In examining into management or operational problems, and the effectiveness of governmental programs, the financial auditor is no longer on his home ground. He is in the territory of the manager who knows that territory much better than he does. Therefore, it behooves the auditor who is expanding his efforts beyond financial and accounting matters to develop his competence gradually but surely.

From a careful reading of the papers distributed by 35 Supreme Audit Institutions before this Congress convened, it is quite evident that the extension of auditing practice beyond financial matters varies greatly among our members.

Twenty of the thirty-five papers received on Subject III indicated that they had--I repeat, they did have--legal authority for such extended auditing practice. Fourteen of these twenty countries also reported that they conducted management audits as a regular practice and reported on the results to their legislative or parliamentary authorities. Thirteen others noted that such auditing was conducted only occasionally. In seven cases, it was reported that no authority has been provided to conduct such audits.

An interesting observation made in one paper relates to the definition of the scope of management auditing suggested as a basis for discussion at this Congress. That paper raised the basic question of whether management auditing as a constructive assessment of future alternatives available to an organization was a logical extension of financial auditing. It argued that this was a responsibility of management itself and not that of the independent auditor. The paper stated further that if the auditor finds that the job is not being done, he should point that out and suggest that it be done but he is neither entitled nor qualified to do it himself.

None of the other papers raised the question quite this sharply but I believe it is a good question and it suggests that we might want to recommend changes in the proposed definition.

Another country stated that it was undecided as to whether management auditing "in the full sense" should be undertaken and was looking forward to learning the views of other Supreme Audit Institutions on the question. This reservation also suggests a question about the scope of the so-called management audit as suggested in the definition submitted as a basis for discussion here.

Management Auditing Concepts

At this point, I think it would be appropriate to outline the approach to management auditing we follow in the United States General Accounting Office. Basically, our general approach is not really much different than that we would follow in an audit confined to financial matters. The following broad steps would be performed for almost any type of audit:

1. A preliminary survey of the activity being examined should be made to obtain necessary background and other working information for use in making the audit. I would like to add here simply that what this amounts to is that, to save time in the long run, we can be more selective and thus avoid situations where we

would be chasing rabbits when we might be chasing elephants or bears.

2. The basic charter or assignment of responsibility for the activity being examined should be studied to ascertain the authorized purposes and related authorities of the activity and any applicable restrictions or limitations. In this respect, we need to involve legal staff in questions of legal authority. Also, to examine the legislative history to determine the full intent of the legislature authorizing the expenditure or program we are auditing.
3. The management system should be examined by studying the policies established to govern the activities under examination, testing the effectiveness of specific operating and administrative procedures and practices followed, and fully exploring any important problem areas or weaknesses encountered.
4. Reports on results of the audit work performed should then be prepared and submitted to those responsible for receiving or acting on the auditor's findings and recommendations.

In identifying problem areas to examine into, the auditor has several techniques available. Here are some techniques that are employed by auditors in my office:

Making surveys	By obtaining and studying information on how an activity is supposed to be carried out or how a procedure is supposed to work, key features or procedures can usually be identified that appear difficult to control or to be susceptible to abuse.
Reviewing management reports	These can be valuable sources of information on possible problem areas for the auditor to look into.
Reviewing internal audit or inspection reports	These are invaluable sources of information. Of particular interest to the external auditor are those which bring to light important findings on which the management has not acted.
Making physical inspections	These can be very useful ways to observe possible inefficiencies or problems that should be analyzed and studied. Examples of such problems would be large accumulations of supplies or materials; idle or little used equipment; idle employees; disposal of apparently good and usable materials; and the like.
Making test examinations of transactions	This is a very useful way to obtain a practical working insight into the efficiency of procedures and their effectiveness in assuring that things are done in the way and with the results intended.
Holding discussions with agency officials and employees	Frank and open discussions with such persons can provide the auditor with much valuable information. The degree of

<u>Holding discussions with agency officials and employees (continued)</u>

success in obtaining useful information in this way is greatly dependent on the auditor's reputation for independent and constructive inquiry. If he is regarded with fear because of overly critical reporting in the past, this source of information may not be productive.

When the auditor finds a problem area that he believes he should examine into, his job becomes one of obtaining all pertinent evidence and doing an adequate amount of analytical work to:

1. Identify specifically what the problem is, that is, what is deficient, what is defective, what is in error, and the like.
2. Determine whether the condition is isolated or widespread.
3. Determine the significance of the deficiency in such terms as increased or unnecessary costs, loss of revenues, loss of property, ineffective performance of work, or other effects.
4. Ascertain the cause or causes for the condition.
5. Identify the persons in the organization responsible for the deficiency.
6. Determine possible lines of corrective or preventive action and formulate constructive recommendations.

The auditor should review his findings with management officials responsible for the operations being examined so that he will have the opportunity to obtain as much information as possible that bears on the problems and to formulate his conclusions in the light of the detailed knowledge of the officials responsible for the performance being reviewed.

The auditor must consider all pertinent factors in appraising performance. Also, to be effective and to be accepted as a constructive force, he must be fair, objective, and realistic. For example, he must use a different standard when evaluating a new program from that used to evaluate one that has been in existence for a long time. Above all, he must avoid making judgments and conclusions on performance based solely on hindsight.

If these concepts are followed and if the auditor considers all significant factors bearing on a problem, he can make reasonable judgments concerning the discharge of specific kinds of management responsibilities. These judgments can be of value in promoting desirable improvements in management performance and they can be useful to third parties in connection with their evaluations of such performance.

Some of the papers submitted raise the question as to whether it is appropriate for auditors to engage in management or operational audit, citing the fear that this type of auditing interferes with management's operations. Our experience has been that when properly conducted, audits of management performance need not--and certainly should not--result in interference. They should always be conducted with a view towards not only identifying problems or weaknesses, but also with a view towards assisting management in improving its operations. We have much testimony that many of our reports have been useful to managers who have accepted our recommendations with resultant financial savings and improved operations. Another point to be emphasized is that neither the external nor the internal auditor should participate directly in management decisions.

Relationship Between Internal And External Audit

In commenting on the relationship between internal audit and the external audit, the papers submitted showed widely varying views. In many cases, the work of internal auditors is given consideration in fixing the scope of the external audit and effective cooperation exists. In other cases, the roles and responsibilities of the two groups are considered to be quite separate and there is no particular interrelationship or coordination.

In a few cases, it was noted that government departments have no internal audit but it was also brought out that there is interest in establishing such systems. I believe this is a most important point. A strong internal audit system is an essential part of a good management system. Because of this, the external auditor should do all he can to promote the establishment and development of good internal audit systems. Such systems not only aid managers in improving their operations but they make it easier for the external auditor to concentrate his audit efforts on those problem areas most demanding of attention from the standpoint of efficiency and economy in the use of scarce public funds.

This is the view we have embraced in the United States General Accounting Office and I think it important enough to dwell on it a little more. To the fullest extent possible, the external auditor should utilize available internal audit work rather than directly performing all of the work himself. He should also be familiar with the operations and findings of any other internal review activities, such as inspection, investigation, appraisal, or management analysis, that may exist in large organizations.

Normally, there should be little duplication between the work of the external and internal auditors. The internal auditor should be performing his work as part of the management's system of operation and control. In contrast, the audits made by the external auditor are <u>independent</u> appraisals of

(1) the manner in which government agencies discharge their responsibilities and, (2) the effectiveness of their control system, including internal audit.

The external auditor should maintain a close working relationship with the agency internal auditors. He should receive copies of internal audit work plans and the internal audit reports. In turn, he should inform the internal audit organization about the areas in which he plans to work.

It should be the responsibility of the government agency head to establish and maintain satisfactory accounting systems and related internal controls pertaining to the custody and use of public funds and other resources. His internal auditor should include in his audit program an examination of financial transactions, including both the receipt and disbursement of funds, to the extent necessary to evaluate:

--The adequacy of the agency's prescribed policies and procedures relating to such transactions.

--The adequacy of internal controls over such transactions.

--Compliance with prescribed agency policies and procedures and applicable laws and regulations.

In recognition that the basic responsibility for proper accounting and internal control is that of each government agency, the external auditor in his examination of financial transactions and accounts should place major emphasis on the adequacy and effectiveness of the agency's accounting and internal controls and he should test the adequacy of the agency's procedures and the work of the internal auditors to establish the extent to which such work is satisfactorily performed.

Thus, internal auditors, in addition to their primary role of serving the managers of their organizations, can have a very significant impact on the scope and effectiveness of the work of the external auditors. The more reliable the internal auditor's work is with respect to financial operations, the more opportunity the external auditor has to delve into other problems, including efficiency and economy in the use of funds and what is accomplished with the use of those funds. For example, as a result of improved internal audits of financial transactions in our Government, we have been able to reduce the effort of the General Accounting Office to the point where its financial auditing now represents less than 10 percent of our audit program.

Training

Training is another important aspect of the whole question of extending the auditor's role in examining into problems of management performance. Where and how does the auditor develop his competence to inquire into such matters in a knowledgeable manner and with the necessary maturity and judgment to evaluate performance and make sound recommendations for improvement?

The answer is intense and continuous training--both formal training in classrooms and on-the-job training under competent, experienced supervisors. This need is no different than what is required for the auditor who concerns himself only with auditing financial transactions and accounts. But for the auditor who is extending the scope of his examinations into management performance, adequate training is even more important. There are those who will question his qualifications, his competence, and his ability to effectively analyze and evaluate such matters. The only answer to this questioning is demonstrated competence and that competence comes through conscientious adherence to the generally accepted auditing standard that auditors must be adequately trained and properly supervised in all of their work.

I realize that training auditing staffs was a major part of Subject I which was discussed yesterday. However, it is such a vital part of developing and maintaining a good and acceptable audit system that some of the key principles can bear repetition.

The comments in the papers submitted reflect some variation in views on this subject. Some did not specifically mention the subject in relation to management auditing on the basis that it was dealt with in Subject I. Others described their practices at some length and showed a serious concern with the importance of the subject.

I was very much interested in some of the different ways in which broad training and familiarization with government operations are carried out in some countries. For example, one approach is to give staff auditors temporary assignments in government corporations to provide them realistic financial and operating experience. Another practice is to provide in-house training in such subjects as civil engineering. One country requires considerable advance preparation for its audit staff such as 2½ years of intensive training in its national school of administration and getting into the school in the first place requires an advanced degree or 5 years of public service experience.

One auditor general recently established a fiscal control school in order to train audit staffs in new techniques in order to achieve broader and more effective audits, particularly those where operational efficiency is to be evaluated. The school is operated by the auditor general, and the teaching staff is comprised of officials from his office, university professors, and other competent officials. Seminars, conferences, and training courses specializing in auditing and fiscal control service will be conducted. In addition, cultural extension courses are included in order to improve the overall intellectual and cultural backgrounds of audit staff.

In the General Accounting Office, we use large numbers of persons who have concentrated in the study of accounting and who, through in-house training and on-the-job training, become quite capable of conducting management and program audits. In recent years, we have also added to our staff large numbers of college graduates who have concentrated in such subject areas as economics, business, public administration, engineering, mathematics and statistics. We also have added staff members who are expert in systems analysis, computer science, and actuarial work. A broadened base of expertise is essential to the external audit organization that wishes to broaden its scope of operation into management problems.

No matter what their major area of university study may have been, beginning auditors need close direction, supervision, and training if they are to develop rapidly into good management auditors.

Initially, training programs should emphasize the technical aspects of management audits to assist new staff members in adapting to the work required. More advanced training programs can then emphasize the development of (1) supervisory and management skills, such as planning, audit decisionmaking, communicating, and delegating, and (2) special skills, such as systems analysis, statistical sampling, and automatic data processing.

Formal classroom training programs should be designed to (1) improve management auditing skills and technical competence that can be applied on the job, (2) prepare each staff member for greater responsibility, and (3) inform the staff of new ideas and practices in management operations.

All staff members should be encouraged and be given incentives to continue their professional development throughout their professional careers. Each staff member must grow throughout his career if he and the organization are to remain responsive and useful.

An effective staff development program requires an effective career planning and evaluation system which will help each staff member identify his strengths and weaknesses as well as his opportunities for growth. Such a system permits him to use his existing strengths while developing new strengths and correcting any weaknesses. The audit organization should provide regular performance appraisal and counseling programs to assist its staff members in assessing their strengths and potentials and in planning programs which will enable them to develop the maximum of their potential.

Use of Consultants

I might add another thought here on the point of expanding the competence of the audit organization. Because of the very wide range of activities of modern governments, it is doubtful if any organization can efficiently acquire all of the expertise needed to make management audits. To supplement the staff, expert consultants in various specialized fields should also be employed. In this way, an audit organization has available to it the special knowledge and competence needed for a particular audit at the time needed without having to maintain such specialists on the staff all of the time.

In the General Accounting Office, we have made good use of expert consultants in our audits of the programs concerned with elimination of poverty, manpower training, control and abatement of water pollution, and review of complicated weapons systems procurement. Our intentions are to increase our use of consultants in order to expand our overall capabilities to audit government programs.

The Expanding Role of the Auditor

I would like to conclude these remarks with a few observations about the expanding role of the auditor.

First, it is my belief that the responsibility of the independent, external governmental auditor should embrace the following three aspects of management accountability:

--fiscal accountability, which includes fiscal integrity, disclosure, and compliance with applicable laws and regulations;

--managerial accountability, which is concerned with the efficient and economical use of personnel and other resources; and

--program accountability, which is designed to assess whether programs are achieving their intended objectives and whether the best program options have been selected to achieve these objectives from the standpoint of total cost and outputs.

An accountability system should embrace all three elements. There must be public confidence as to fiscal integrity in the spending of public funds; there must be assurance that waste does not occur through mismanagement; and, there must be an assessment of whether programs are accomplishing their intended objectives with the least cost and maximum results.

I do not intend to imply that the auditor has an exclusive responsibility for management and program evaluation. Other analytical staffs and other systems of review are also available to government administrators and legislators. Too frequently, however, such staffs have been primarily concerned with budget formulation and program planning and not sufficiently with whether authorized programs are achieving their intended results. This is the area to which I strongly believe the auditor has a major and increasingly important contribution to make. He has a tradition of making and reporting his findings independent of operating officials. He should be increasingly equipped with special skills which go far beyond that required for financial audits alone. And most importantly, he should be increasingly looked to by legislatures and by the executive officials for examinations and recommendations on all three aspects of accountability.