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Operations auditing, a study of the newest phase of internal auditin

Russell William Miller

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OPERATIONS AUDITING
A STUDY OF THE NEWEST PHASE
OF INTERNAL AUDITING

A Thesis
Presented to
the Faculty of the School of Business Administration
The University of Richmond

In Partial Fulfillment
of the Requirements for the Degree
Master of Science in Business Administration

By
Russell William Miller

August 1957

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CHAPTER I

THE PAPER, DEFINITION OF TERMS USED, THE LITERATURE AND HISTORICAL BACKGROUND OF INTERNAL AUDITING CONCEPTS

American management has seen the magnitude of its operations multiplied to tremendous proportions in the short span of seventeen years (1940-1957). In this period the nation went from depression to a gigantic war economy and on to an even greater post-war economy. The process of national economic expansion was directly responsible for tremendous pressures on the management control function of many business enterprises. For example, many companies dispersed their plants over vast geographical areas. A major problem of management control was thus created by the miles separating the home office from the sites of operations. Top management had to rely chiefly on reports prepared by field (line) personnel. But were the reports themselves reliable and useful?

"Diversification" became a widely-practiced business principle. As a result, top management found itself charged with responsibility for the success of "subsidiary companies" engaged in widely-varied activities. Reports sent to top management by the subsidiaries were major control tools.

Once again, top management had to know whether the reports accurately and completely stated facts and were therefore reliable and useful. Top management did personally visit field activities to look, listen, question and recommend. But, it couldn't be out in the field all the time. These were pressing problems at headquarters: funds for capital investment in "automation" were needed; direct and indirect taxes were taking larger amounts of the income; and employee "fringe benefits" and higher pay scales were making increasingly heavy demands. Top management needed more "eyes and ears" to keep in close contact with "operations."

At the beginning of the war, there were already internal auditing departments in some large business enterprises and in the federal government. Far-seeing members of these internal auditing groups felt that their organizations could fill management's pressing need for timely and unbiased information about operations.¹ They envisioned the broadening of internal auditing programs from that of merely verifying financial accounts and statements to the observation and evaluation of operations. Thus, internal auditors were to serve as top management's "eyes and ears" through the appraisal of operations from a "management viewpoint."

¹Arthur H. Kent, "The Development and Application of a New Concept of Internal Auditing," The Internal Auditor, XIV (March, 1957) p. 7.

"Operations Auditing" was the logical outcome of internal auditors' attempts to meet management's need for information.

I. THE PAPER

Purpose of the paper. The Statement of Responsibilities stipulates:

Internal auditing is an independent appraisal activity within an organization for the review of accounting, financial, and other operations as a basis for service to management. It is a managerial control, which functions by measuring and evaluating the effectiveness of other controls. . . .The internal auditor therefore should be concerned with any phase of the business activity wherein he can be of service to management. [*Italics mine.*]²

With this formal statement the Institute of Internal Auditors expressed the "still broader concept of internal auditing, which it holds today." (See Appendix "B" for the original 1947 "statement.") Thus, the leading members of the internal auditing profession have stated their convictions that internal auditing is capable of assuming the responsibility for a major management function: the managerial control function of measuring and evaluating the effectiveness of other controls by reviewing accounting, financial, and other operations. Further, that the internal auditor should be concerned with any phase of the business activity wherein he can be of service to management.

² Statement of Responsibilities of the Internal Auditor (New York: Institute of Internal Auditors, 1957) See Appendix "A"

It is the purpose of this paper to propose that properly-qualified internal auditing staffs should assume the responsibility for "operations auditing." ("Operations auditing" being the term used in this paper to identify the new, "managerial viewpoint," constructive phase of modern internal auditing.) The paper approaches "operations auditing" through (1) the description of its nature, scope and methods; (2) the study of the application of operations auditing methods and consideration of the results of some actual operations auditing cases; and (3) the review of factors vital to the success of operations auditing.

Significance of the paper. Operations auditing has grown to sizable proportions in large-scale business enterprises which are instituting, or augmenting, internal auditing staffs.³ Each major bureau and/or department of the federal government either has, or will soon have, an internal auditing department.⁴ These departments have as one of their major activities the appraisal of operations from a "management viewpoint" similar to that utilized in operations auditing as practiced by internal auditors.

³The Field of Internal Auditing (New York: The Institute of Internal Auditors, 1956) p. 4.

⁴Eric L. Kohler, Howard W. Wright, Accounting in the Federal Government (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1956) p. 205.

Many large, national public accounting firms have offered a wide variety of "management" services to their clients for many years. Medium-sized, local firms have started to provide "management" services to their clients also.⁵ These "management services" provided by public accountants include some of the same approaches that operations auditing includes in internal auditing. They are both performed as a service to management.

(Public accountants' traditional role is to serve the stockholders and other non-management interests.) Thus, business firms unable to maintain full-sized internal auditing staffs can look to some public accounting firms, as well as to management consultants, for the vital type of information an internal audit staff could provide by operations auditing.

Considerable amounts of money, talent and time have been invested in bringing the operations auditing concept to its present stage of development in American business and government.

⁵ American Institute of Certified Public Accountants - Research Department. "Management Services - A Survey," Journal of Accountancy, (June, 1957) p. 42.

II. DEFINITIONS OF TERMS USED

Three vital terms are defined in this section:

"Internal auditing", "operations auditing", and
"comprehensive audit."

"Internal auditing" is a major management control function; "operations auditing" describes a process within that function. A complete definition of the major function has been included to illustrate the framework within which "operations auditing" works.

"Operations auditing" is the term used throughout this paper to denote the operations appraisal process based on the "broad audit" concept--a concept which has greatly changed internal auditing since World War II. Many terms synonymous with "operations auditing" are currently in use within the internal auditing profession, for example: "operations audits," "audits of operations," "operational audits," "operational auditing," and "management auditing."

"Comprehensive audit" is a term used within the federal government to describe a type of audit which goes beyond the financial records and views operations in order to evaluate their efficiency and economy. The process of operational evaluation that the comprehensive audit implements is the same process of operational evaluation

that is termed operations auditing by internal auditors. The term was originally applied solely to the United States General Accounting Office's "broad audit" program, initiated in 1949. Recent references to a "comprehensive audit" approach are found in literature concerning internal auditing activities within federal agencies and bureaus. Thus it would seem that "comprehensive audit" has become a government-wide phrase connoting a "broad audit" which encompasses considerably more than financial audits.

Internal auditing. Throughout this paper the definition of "internal auditing" set forth by the Institute of Internal Auditors in the Statement of the Responsibilities of the Internal Auditor (Revised 1957) prevails.⁶ The definition is as follows:

Internal auditing is an independent appraisal activity within an organization for the review of accounting, financial and other operations as a basis for service to management. It is a managerial control, which functions by measuring and evaluating the effectiveness of other controls.

The over-all objective of internal auditing is to assist all members of management in the effective, discharge of their responsibilities, by furnishing them with objective analyses, appraisals, recommendations and pertinent comments concerning the activities reviewed. The internal auditor therefore should be concerned with any phase of business activity wherein he can be of service to management. The attainment of this over-all objective of service to management should involve such activities as:

⁶ Statement of Responsibilities of the Internal Auditor (New York: Institute of Internal Auditors, 1957)

Reviewing and appraising the soundness, adequacy and application of accounting, financial and operating controls.

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

Ascertaining the extent to which company assets are accounted for, and safeguarded from losses of all kinds.

Ascertaining the reliability of accounting and other data developed within the organization.

Appraising the quality of performance in carrying out assigned responsibilities.

Operations auditing. Many sources have been consulted in a search for a complete definition of "operations auditing" for this paper. The Statement of Responsibilities of the Internal Auditor (1957) was a principal definition source. The Institute of Internal Auditors 1947 statement was revised in June, 1957 because:

THE INSTITUTE. . . believes it advisable at this time to issue a Revised Statement, which shall express the still broader concept of internal auditing which it holds today.

As admirable as the "revised statement" is, it can not serve as the only source for the definition of a highly personalized group of human activities and objectives called "operations auditing." What is needed is the animating warmth of personal experience and interpretation. Personal discussion with experienced internal auditors has been a remarkably rewarding source of information. Moreover,

⁷Ibid.

The Internal Auditor, the Institute of Internal Auditors' quarterly publication, has been found to be replete with articles on the "broad audit" concept. Many of these articles have been written by prominent executives in some of the nation's largest companies; men who are almost daily involved in "operations auditing." Appendix "A" contains several pertinent quotations used in the preparation of this paper's definition of "operations auditing."

Operations Auditing. Operations auditing is the phase of modern internal auditing that renders constructive services to management in the form of objective analyses, appraisals, and recommendations about operations within the whole organization.

Operations are examined from a management point of view, when and where they are occurring. Control systems and procedures are appraised as to efficiency and economy. Standards are evaluated for their reasonableness. The accuracy with which performance data are developed and standards are applied is studied in the light of their effectiveness and practicality.

The paramount objective of operations auditing is the accomplishment of the "real" objectives, or goals, of the institution being served. All operations and controls reviewed and appraised are accordingly reviewed in

relationship to their worth as contributors to the real objectives of the institution. To properly carry out his operations auditing responsibilities, the auditor requires the objectivity and independence which comes from management's acceptance and support. Further, he requires exemption from participation in "line" activities which he might review and appraise later.

Operations auditing penetrates into every phase of activities where it may be of service to management; but the possibility is recognized that situations involving extremely technical problems may arise. In such instances, specialists (from within and without the organization) are consulted.

Some of the methods of traditional financial auditing are utilized: most activities have some form of original documents and statistical summaries relating to their work. These can be appraised for reliability and soundness. However, the most important method of operations auditing is the personal observation of activities as they occur. The auditor sees whether the controls (such as policies, standards and operating procedures) set down on paper are being utilized; if they are relevant to the actual situation; and are helping to achieve expected performance.

Personal observation is made of the general environment of the operation being audited. The initiative, imagination and total background of the auditor are challenged to the fullest in this "creative" part of the operations audit. The ability to talk with operators and supervisors is of great significance. Through his "practical" observation of the total situation, the auditor can bring to light important weaknesses or strengths which formal audit work programs would rarely, if ever, uncover.

Since operations auditing takes the internal auditor into virtually every activity of the organization, the "communications" service that the internal auditor may render is recognized as a potent means of direct contact between the home office and field operations. The auditor can be the salesman of ideas and information to the field by discussing interpretations of central office communications. He can carry back to headquarters his considered opinion about the morale and general climate of the installations visited.

Effective operations auditing recognizes that "management is getting things done through people." Thus, a spirit of enthusiastic "team play" is necessary. The recognized goal is improvement in the future, not retribution for past mistakes. Since the auditor is in a staff relationship he makes recommendations and suggestions;

top management and local management make the decisions. In its highest sense, operations auditing is performed by competent and imaginative people who are devoted to the betterment of the whole organization.

Comprehensive Audit. The General Accounting Office Policy and Procedures Manual for Guidance of Federal Agencies serves as the source of the definition which is used throughout this paper for "comprehensive audit."

Although the term "audit" is a general term normally applied to the process of examining accounting records and documents, the term "comprehensive audit" is not restricted to accounting matters or to books, records and documents . . . A comprehensive audit is an analytical and critical examination of an agency and its activities.⁸

III. THE LITERATURE

Operations auditing is still in its formative stage. Complete codification of its nomenclature and methods has not yet come about. Therefore, articles in current periodicals form the largest fund of information about this developing "broad audit" concept. These articles resemble the reports on individual experimentation and thought contributed to professional journals by physical scientists. In the business periodicals, operations

⁸General Accounting Office Policy and Procedures Manual for Guidance of Federal Agencies (Washington: Government Printing Office, 1957) p. 3. GAO 2020.30 See Appendix "A" for abstract from manual.

auditing experiences within specific companies are described; hypotheses are suggested; and tentative conclusions are set forth. Since all internal auditing work is done for the benefit of a particular business firm or government organization complete unanimity of nomenclature and methods will probably never be attained. The literature about operations auditing reflects this fact. A variety of terminology and methods is evident. Throughout the literature, however, there is a dominant and constantly repeated theme: internal auditing has joined the management team; it now has a broad audit concept which includes "operations" in its scope.

Institute of Internal Auditors' Publications. The chief source of material for this thesis is the publications of the Institute of Internal Auditors. The Institute of Internal Auditors holds a position of leadership in internal auditing comparable to the American Institute of Accountants' leadership in the field of public accountancy. The Institute of Internal Auditors' Statement of the Responsibilities of the Internal Auditor (1957 revised edition) is the present, formalized, professional concept of the nature of internal auditing. The "statement" presents a picture of the whole internal auditing function, of which operations auditing is the newest phase.

One of the earliest books published by the Institute of Internal Auditors was Internal Auditing Philosophy and Practice, published in 1944. It is one of the most revealing and searching considerations made of the internal auditing concept. The Institute of Internal Auditors has sponsored, throughout the years, many other books dealing with internal auditing theory and practice.

Since September, 1944, a quarterly periodical, The Internal Auditor, has been published regularly. Articles in The Internal Auditor are written by leading personalities in the fields of internal auditing, business, and education. The chief value of this quarterly publication is that it portrays the unfolding picture of developments in internal auditing theory and practice as they occur.

Federal Government Publications. The United States Government Printing Office has made material available regarding the activities of the United States General Accounting Office. Under the dynamic leadership of Lindsay C. Warren, Comptroller General of the United States, 1940-1954, a new broad audit concept--the "comprehensive audit"--was instituted by the General Accounting Office in 1949. In its review and evaluation of agency policies, procedures, practices, and operations, the General Accounting Office employs operations auditing techniques. The "management evaluation" (Operations auditing)

techniques of the General Accounting Office comprehensive audits are inherent in many agency internal auditing programs.

Recognition of the similarities in the General Accounting Office comprehensive audits and operations auditing was made in a recent address, by the Assistant Comptroller General when he said, "The comprehensive-type audit is not unique to the General Accounting Office. There is a similar development in internal auditing."⁹ General Accounting Office literature has, accordingly, been utilized in this paper as a major source of information.

The Government Printing Office also publishes congressional committee reports. Chief among these publications consulted are the reports of Senate and House Committees on government operations. The "Hoover Commissions' reports" have also been studied for "background" value.

Miscellaneous Literature. The American Institute of Accountants publishes the Journal of Accountancy monthly. This publications has been used as a minor source for this paper since it is primarily concerned with the field of certified public accountancy. The Federal

⁹ Frank H. Weitzel, "How the General Accounting Office Looks at Auditing in the Government" (address before the Federal Government Accountants Association at the sixth Annual Symposium, Oct. 30, 1956) p. 28. (Mimeographed)

Government Accountants Association publishes a quarterly review of current developments and trends in federal accounting. The periodical, The Federal Accountant, contains articles written by top officials in government and education as well as reports on symposiums it has sponsored. The Accounting Review, published by the American Accounting Association, primarily contains articles by and for accounting professors and teachers. Theoretical considerations are given exhaustive treatment in "Review" articles.

IV. HISTORICAL BACKGROUND OF INTERNAL AUDITING CONCEPTS

Three broad, evolutionary stages in internal auditing concepts have been defined by A. H. Kent as follows:

1. The verification of mathematical accuracy. Particular attention to cash matters, reconciliation of bank accounts, payrolls and check of approvals on documents.
2. Verification of accuracy and propriety of company accounts and financial statements. This was more detailed, but very similar to the same type of audit performed by Certified Public Accountants.

3. The adoption of top management point of view, rather than a strictly accounting one, in all areas under examination. The logical effect of this change of viewpoint was to extend gradually the scope of verification, inquiry and appraisal into areas of business beyond those usually designated as accounting.¹⁰

Two significant dates divide the three stages of development in concepts: December 7, 1941 and December 9, 1941. Japanese treachery on December 7, 1941 instantly united the productive skills and energies of American labor and management to the task of winning a war. Two days later, December 9, 1941, twenty-four men met in New York City, after months of preparation, and elected the first officers and directors of the Institute of Internal Auditors.

The impact of bombs on battleship decks and the dignified chartering of a professional organization, both had a profound effect on internal auditing. Stage "3", the contemporary "broad audit" era, is generally recognized to have received its impetus from the accelerated demands of all-out war and its continuity from the steady and guiding influence of the Institute of Internal Auditors. Stages "1" and "2" in the evolution of internal auditing concepts largely belong to the pre-World War II, pre-Institute of Internal Auditors era.

¹⁰ A. H. Kent, "The New Internal Auditing and the Need for Specialized Preparatory Training," The Accounting Review, XXX (October, 1955) p. 639.

Old Internal Auditing Concepts. Pre-World War II concepts of internal auditing were largely concerned with the protective functions and verification aspects of financial auditing. The typical method of operation in that era was the "centralized voucher audit." Carloads of documents were shipped to central audit offices where vast, detailed, "paper-mill" operations were employed. This included the totaling of control accounts, comparison of disbursing checks and vouchers against invoices, and other "accountability" verification. A fallacious impression of "management control" was thereby created. Actually, only bookkeeping accuracy and the legality of disbursements was proven.¹¹

In the same period "traveling auditors" were not unknown in large business firms. Their functions, however, were on the whole, just as restricted as the centralized voucher audit. They counted cash, verified bank balances and receivables, and examined documents for approvals. Most operating managers saw little reason for the auditors' existence, since their activities added little of a constructive nature to the business of making profits. However, despite their limited objectives, they did

¹¹ Arthur H. Kent, "The Development and Application of a New Concept of Internal Auditing," The Internal Auditor, XIV (March, 1957) p. 71.

contribute something of value: the knowledge that auditors would examine transactions served as a stimulus towards proper bookkeeping.¹²

New Internal Auditing Concepts. During the period of the 'thirties, some internal auditors scattered in various parts of the country were beginning to see the possibilities of greater service to their companies. Time and earnest thought developed this nebulous idea until it assumed a clear shape and form. The potentialities and possibilities were intriguing.

The germ of the new concept of internal auditing was found in the often expressed viewpoint that the difference between internal auditors and outside auditors was that the internal auditor worked on behalf of management, and the outside auditor represented the stockholders.¹³

The idea began to develop that the internal auditor could serve management most completely by extending the scope of his audits. One of the pioneers of this idea was Victor Z. Brink, the author of the first nationally-recognized study of internal auditing. Dr. Brink's book, Internal Auditing, written in 1941 when he was an associate

¹² Ibid.

¹³ Ibid. p. 8.

professor of accounting at Columbia University, summarized the then-present status of internal auditing and looked forward with great imagination to an almost limitless future. Typical of Brink's vision is a statement he made on page 38. He saw internal auditing serving the needs of management by means of "the appraisal of existing rules, procedures and policies relating to accounting and financial and associated activities, together with constructive recommendations which are directed toward the improvement of general company welfare."¹⁴

Even more visionary, was his contentions that internal auditing should give:

Other services to management of a direct nature in the way of providing an effective means of contact with field operations and an impartial reporting agency; the provision of personnel for executive positions; and the furthering of the efficiency and economy of the outside audit.¹⁵

The words of men like Victor Brink stirringly pointed towards the management role internal auditors might attain. The way towards operations auditing was clearly shown.

Nevertheless, the verification of figures and determination of the propriety of transactions was, and still is, an important phase of internal auditing since

¹⁴ Victor Z. Brink, Internal Auditing (New York: The Ronald Press Co., 1941) p. 38.

¹⁵
Ibid.

management is thereby assured of the integrity of financial accounts and controls within the organization. However, today's internal auditor does not live at a desk. He visits the site of the audit and personally observes operations in progress. When he checks records he uses modern sampling techniques. His chief responsibility is the appraisal of controls, but he looks at all phases of the work going on around him. He is more than just a competent technician: in the eyes of field personnel, from top local management on down, he has become a home office representative.¹⁶

¹⁶ Elmer Johnson, "Becoming More Than Just A Competent Technician," The Internal Auditor, XIII (March, 1956) p. 13.

CHAPTER II

NATURE, SCOPE AND METHODS OF OPERATIONS AUDITING

A process providing service and information primarily to top management and secondarily to all levels of management and delving into every activity of the institution being served must of necessity be complex. Operations auditing can cover just such a broad scope. The underlying concept is that of appraising control systems to insure efficient and economical performance. Records and performance standards are reviewed and operations are personally observed where and when they are occurring. The objective of operations auditing is to promote the over-all objective of the institution served.

I. NATURE OF OPERATIONS AUDITING

In considering here the nature of operations auditing, the factors reviewed are: comparison to financial auditing; appraisal of operations; standards; objectives; and auditor's viewpoint. The briefest possible description of the nature of operations auditing is: Operations auditing is an analytical appraisal of a business activity.

The United States General Accounting Office has made this statement, "A comprehensive audit is an analytical and critical examination of an agency and its activities."¹ The comprehensive audit utilizes operations auditing techniques to accomplish its "management evaluation" objectives.

Thus, by definition, the techniques and audit activities termed "operations auditing" and "comprehensive audits" are primarily analytical in nature. The techniques and activities involved delve into areas first pioneered by "management engineers."

Operations auditing compared to financial auditing. A comparison between operations auditing and financial auditing brings to light some of the fundamental differences in the nature of these, the two major phases of internal auditing.

Financial auditing is concerned primarily with the verification of financial statements, both as to mathematical accuracy and adherence to recognized accounting principles. It is most typically performed by certified public accountants, who represent ownership and are primarily concerned with the fairness and accuracy of the financial statements. It must be re-emphasized, however, that financial auditing is still one of the major phases of internal auditing.

1

General Accounting Office Policy and Procedures Manual for Guidance of Federal Agencies (Washington: Government Printing Office, 1957) p. 3 GAO 2020.30

The Statement of the Responsibilities of the Internal Auditor includes these financial auditing objectives of internal auditing:

Ascertaining the extent to which company assets are accounted for, and safeguarded from losses of all kind.

Ascertaining the reliability of accounting and other data developed within the organization.²

Thus the financial auditing responsibility is strongly set forth in the profession's formalized statement. The operations auditing activities are outlined in the same statement as follows:

Reviewing and appraising the soundness, adequacy and application of accounting, financial and operating controls.

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

Appraising the quality of performance in carrying out assigned responsibilities.³

The true nature of operations auditing becomes more apparent after comparing the relatively limited viewpoint of financial auditing with the broadly-conceived operations auditing activities of reviewing and appraising. The very nature of the words "reviewing" and "appraising" is personal and active. The auditor is seen to be actively and personally reviewing and appraising not only financial and statistical data but also the soundness, adequacy and,

² Statement of Responsibilities of the Internal Auditor
(New York: Institute of Internal Auditors, 1957)

³ Ibid.

application of accounting, financial, and operation controls. Furthermore, he is seen appraising the quality of performance. Inherent in his reviewing and appraising work is the actual observation of operations where and when they occur.

The importance attached to on-the-site observation of operations is one of the major characteristics of the modern broad-audit concept. It is interesting to note that two professors of scientific management had this to say about the value of personal observation in this era of scientific techniques:

In any preoccupation with the devices of managerial control, one should never overlook the importance of control through personal observation... Management is, after all, getting things done through people, and, while many scientific devices aid in making sure that people are doing that which the manager has hoped and planned for them, the problem of control is still one of human relations.⁴

The full resources of the individual auditor are called upon in the process of personal observation. His entire fund of skill, knowledge, past experience, imagination and ability to reason are challenged to the utmost. It is this activity that results in the achievement of "creative" appraisal and which ultimately determines the quality of operations auditing.

⁴ Harold Koontz and Cyril O'Donnell, Principles of Management (New York: McGraw-Hill Book Co., Inc. 1955) p. 567.

Appraisal of controls. The principal result of the auditors analysis of records and observation of operations is an appraisal of controls. H. B. Lichtenberger, Chief Field Auditor, Reynolds Metals Company, in a discussion with the author of the thesis recently said, "The appraisal of control systems is internal auditing's field."⁵ His brief description of the evaluation of the controls over an operation is:

Does a formal system of controls over the operation exist?

If so--is it enforced?

If enforced -

Adequate?

Valid?

If not being enforced--why not?

Obsolete?

Misunderstood?

Negligence?

Deliberate obstruction (possibly fraud involved)?

If no formal controls exist--Why?

What kind of informal controls exist?⁶

Lichtenberger's concise description recognizes that there is some kind of control system involved in every activity--be it formal or informal. If formal policies or procedures have been designated, the question of enforcement occurs. Where no formal policies or procedures are found, the determination of the nature of the formal

⁵Statement by H. B. Lichtenberger, personal interview. Permission to quote secured.

⁶Ibid.

controls becomes the auditor's concern. As was pointed out earlier, the appraisal of control systems is "internal auditing's field." The fundamental assumption being that operations carried on under proper control systems will probably be successful operations.

There is a possibility of confusion in the overly-simplified idea that proper controls systems will probably result in successful operation. It is necessary to remember that "proper controls systems" are not limited to the evaluation of actual performance against "expected" or "pre-determined" standards. Rather, there should be included in proper controls systems a method of measuring the pre-determined standards themselves. The internal auditor's reports themselves provide information which management can use to reappraise the wisdom of its planning (which set-up the procedures and expected performance standards.)⁷

Standards. Inherent in the appraisal of controls is the use of "yardsticks" or "standards." How can the internal auditor hope to "measure" the effectiveness of controls in the multitude of operating situations he faces? Must he be an "expert" in every type of activity he attempts to evaluate? Bradford Cadmus, Managing Director of the Institute of Internal Auditors, has answered this in part

⁷ George Albert Smith, Jr. Policy Formulation and Administration. (Homewood, Illinois: Richard D. Irwin, Inc., 1954) p. 11.

by pointing out that control requirements differ with every auditing situation. Such things as the management policies of the company, nature and abilities of the executives and the cost of control measures will determine the standard of control appraisal. He knows that it would be very convenient if there were a "fixed standard" for every operation. He feels that it is fortunate both for business and the internal auditor that such a situation does not prevail.⁸

Thus, a widely-experienced auditor recognizes the fact that operations auditing is not a simple matter of "check-listing" against standards.

A professional internal auditor has expanded this point further by noting the multiple meanings of the word "standards." The objective in mind must be considered. The internal auditor is personally observing the operation as a whole, from the viewpoint of management. He has had a "briefing" on the operation under audit; has tested whatever records and reports exist; and probably has talked with "local" management about it. He does not perform "industrial engineering"--stop-watch-in-hand. Rather, his objective is to make an over-all evaluation based on all the facts and observations at his disposal. His standard and objective is--does there seem to be a reasonable system of control

⁸Bradford Cadmus, "Auditing the Purchasing Department," The Internal Auditor, XII (September, 1955) p. 8.

in operation? It must be remembered that any suggestions or recommendations he may make will be discussed thoroughly at the local level.

In summary, the "standards" may be well-defined and easily applied but more-than-likely they will largely depend upon the skill, intelligence and experience of the auditor. His function is not to "split hairs" but to raise a question where improvement seems possible.

Objective of operations auditing. As already stated, the overall objective of operations auditing is the promotion or furtherance of the interests of the organization. The Institute of Internal Auditors sees the overall objective of internal auditing as that of assisting management in "achieving the most efficient administration of the operations of the organization."⁹

The broad scope and personal nature of operations auditing have been depicted earlier in this paper. Equally broad objectives are associated with the new audit concept. This results from the broader management viewpoint necessary to the successful accomplishment of operations auditing.

A simplified, but reasonable definition of internal auditing objectives was proposed by D. S. Grubbs:

⁹ Statement of Responsibilities of the Internal Auditor
(New York: Institute of Internal Auditors, 1957)

1. See that people are doing the things they were told to do; i.e., following authorized policies and procedures.
2. Ascertain if the authorized policies and procedures provide adequate protection against loss at a reasonable cost.
3. Observe opportunities for increasing profits.¹⁰

Simple as the above definition seems, it effectively summarizes operations auditing objectives. All of Grubbs' audit objectives are ultimately directed towards the accomplishment of the over-all objective: promoting the organization.

Auditor's viewpoint. A very important element in the accomplishment of operations auditing is the internal auditor's viewpoint. Throughout the literature consulted a consistently recurring theme was found: the auditor who is to perform effective operations audits must have the viewpoint of a representative of management. That is to say, he is no longer merely a "colorless figure checker" but rather, combines the skill of a technician with an understanding of business procedures and the outlook of top management.

To be really effective, the auditor must also work from a viewpoint of impartiality brought about by his independence from intimidation. Furthermore, it is felt that the auditor's viewpoint should be rooted in the enthusiastic

¹⁰
D. S. Grubbs, "Internal Auditing Objectives,"
The Internal Auditor, XIV (March, 1957) p. 29.

notion that he is a "salesman of ideas and information." This means that he must know himself to be a "member of the management team."¹¹

It is emphasized by many professional internal auditors that individuals with an air of "policemen" and those who give the impression they are waiting to "trip someone up" are not going to be effective in the highly personal field of operations auditing.¹² A spirit of objectivity and teamwork, looking towards future improvement, rather than backward upon past mistakes, is the viewpoint indicated for successful operations auditing activities.

II. SCOPE OF OPERATIONS AUDITING

Operations auditing can encompass the agency or organization as a whole. The extent of the detailed examination work is largely governed by the evaluation of the effectiveness of controls. Where adequate and effective controls have been exercised by management over its operations, detailed examination is proportionately reduced.

F. E. Mints, Resident Internal Auditor, Lockheed Aircraft Corporation, has made some pertinent comments about

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Victor Z. Brink, "The Internal Auditor Joins the Management Team," The Internal Auditor, XIV (June, 1957) p. 14.

12

Arthur H. Kent, "The Important Factors of A Successful Internal Auditing Program," The Internal Auditor, X (June, 1953) p. 12.

the scope of "operational auditing." He has pointed out that audits of his company's operations are sometimes conducted on a purely functional basis, and at other times on an organizational basis. A combination of the two is much more common, however. An example would be the examination of a function or group of functions within an organizational unit.

It was further pointed out by Mr. Mints that broad, general reviews are frequently broken down into smaller pieces. He cited a specific instance:

In studying material management, we might have a series of eight or ten projects, each covering some phase of the activity, such as: the determination of what, how much, and when to buy materials; the actual placing of the order or buying function; the paper-work and follow-up involved in a purchase and the payment of the invoice; the receiving of the material; its handling in stores; the eventual disbursement of the materials to the shops, and so forth. ¹³

The General Accounting Office has performed many of its comprehensive audits on a "segmented" or "piece" basis. This is because of the tremendous size of many of the activities audited. Moreover, there might be certain activities and functions which have presented control difficulties in the past or are suspected of having weaknesses in them, or are so vital they must be reviewed.

Management consultants. Since writers in the field of internal auditing indicate an extremely broad scope in

¹³ F. E. Mints, "Operational Auditing," The Internal Auditor, XI (June, 1954) p. 34.

operations auditing activities, the question arises as to where the management consultant, or engineer, fits into the scheme of things. If internal auditing were to live up to the prediction of the first president of the Institute of Internal Auditors it would become "intra-company management engineering." ¹⁴

Mr. C. Oliver Wellington, former president of the American Institute of Accountants and The Association of Management Consultant Engineers, writing in an early Institute of Internal Auditors publication, undertook to suggest the role of the private management consultant in a large business firm along with a complete internal audit staff. Specifically, he thought that management consultant engineers should be called in to direct or supplement the work of the internal auditors. His reason was that the independent management engineers have a broader variety of experience in their backgrounds.

Another circumstance pointed out by Wellington was the lack of time for the internal auditing staff to accomplish needed operations auditing. Thus, he saw the consultants as a supplementary work force, brought in when activities are at a peak but which is not "carried" on the payroll throughout the year.

¹⁴

John B. Thurston, "The Past, Present and Future of Internal Auditing," Internal Auditing Philosophy and Practice (Stamford, Connecticut: Brock and Wallston, 1944) p. 242.

Another justification for hiring management consultants, given by Wellington, involved the solution of specialized problems. He recognized that problems would probably be encountered requiring specialized knowledge and skill to solve. Thus he saw the several management consulting firms as a source of specialists which could be drawn upon for expert advice in areas outside the capabilities of the resident staff.

From the background of his own broad, practical experience, Wellington observed that there are areas in which only the "outsider" can say things that "must" be said--areas in which "personalities" are involved. In these cases, although the internal auditing staff's appraisal and conclusions may be right, the consultant can collect the facts "objectively" and make suggestions not subject to the charge of "partiality."

In summing up, Wellington contended that a maximum benefit could be derived at a minimum cost by having the internal auditing department include the bulk of the work in its scope and look upon the management consultant both as a busy-season reserve force and as specialists and impartial agents in matters involving personalities.¹⁵

¹⁵ C. Oliver Wellington, "The Relationship of Internal Auditing to Management Engineering," Internal Auditing Philosophy and Practice, pp. 88-97.

The author of the thesis feels it necessary to point out that Wellington is primarily a management consultant and his remarks should be considered accordingly. His idea that management consultants should "direct" the work of the internal auditors because the independent consultants have a "broader variety of experience" should not be accepted without qualifications. If the internal auditing staff is competent, "outside" consultants directing their work would pose a serious threat to their organizational prestige. Also, the use of "outside" consultants to say things that "must" be said can not be accepted without comment. Although such a situation is conceivable it must be recognized that top management must approve the hiring of the consultant in the first place. With dictatorial management this might be the only way, but most managements would probably feel better if the internal auditing members of the management team would frankly state what the difficulty is rather than hire an expensive intermediary.

III. METHODS OF OPERATIONS AUDITING

Some of the techniques and methods of traditional financial audits are utilized in operations auditing. However, operations auditing cannot be confined to the examination of records and statistical data. Personal

observation and conversations at the site of the audit are important. Specialization in large staffs is common. There are alternative means within and without the organization by which management can receive the information developed by operations auditing.

Examination of records. The point of departure in most audits can be the examination of records. In almost any type of activity some original documents and work summaries are found. These documents can be stated in terms of dollars, quantities, time, percentages of completion, or other denominators of human activity. The denominator, whatever its nature, can be audited as to its integrity.¹⁶

Another familiar method that is applicable in operations auditing is the seeking out of source data to see whether it substantiates summary reports such as status of work, flow of operations, labor utilization statistics and similar operating data.¹⁷

Personal observation and conversation. Eventually the auditor who is attempting to apply the appraisals, perspectives and tolerances of management will be forced into methods more suitable for arriving at judgements than the rigid methods of financial auditing.

Personal contact with operating levels of management and labor will produce much valuable information. Therefore,

¹⁶ Arthur H. Kent, "The Development and Application of a New Concept of Internal Auditing," The Internal Auditor, SIV (March, 1957) p. 11.

¹⁷ Ibid.

personal observation and conversation will become one of his most important methods.

Another deviation from traditional auditing is the free use of common sense and imagination that forms one of the most important methods in operations auditing. The auditor must be constantly asking why things are done in a certain way. This questioning is most effective when imaginatively applied. However, common sense can save a great deal of lost motion if it enables the auditor to recognize the practicality of the way certain things are done.

As imaginative as some of the "methods" used in operations auditing seem, it is interesting to note that the Resident Internal Auditor of the Lockheed Aircraft Corporation firmly maintains that operations auditing consists of 80% or more practical analysis and only 20% or less special technical know-how.¹⁸

Specialization. The structure of internal auditing departments varies in different organizations. The internal auditing function is largely a centralized function carried on in decentralized organizations. John B. Thurston, a founder and the first president of the Institute of Internal

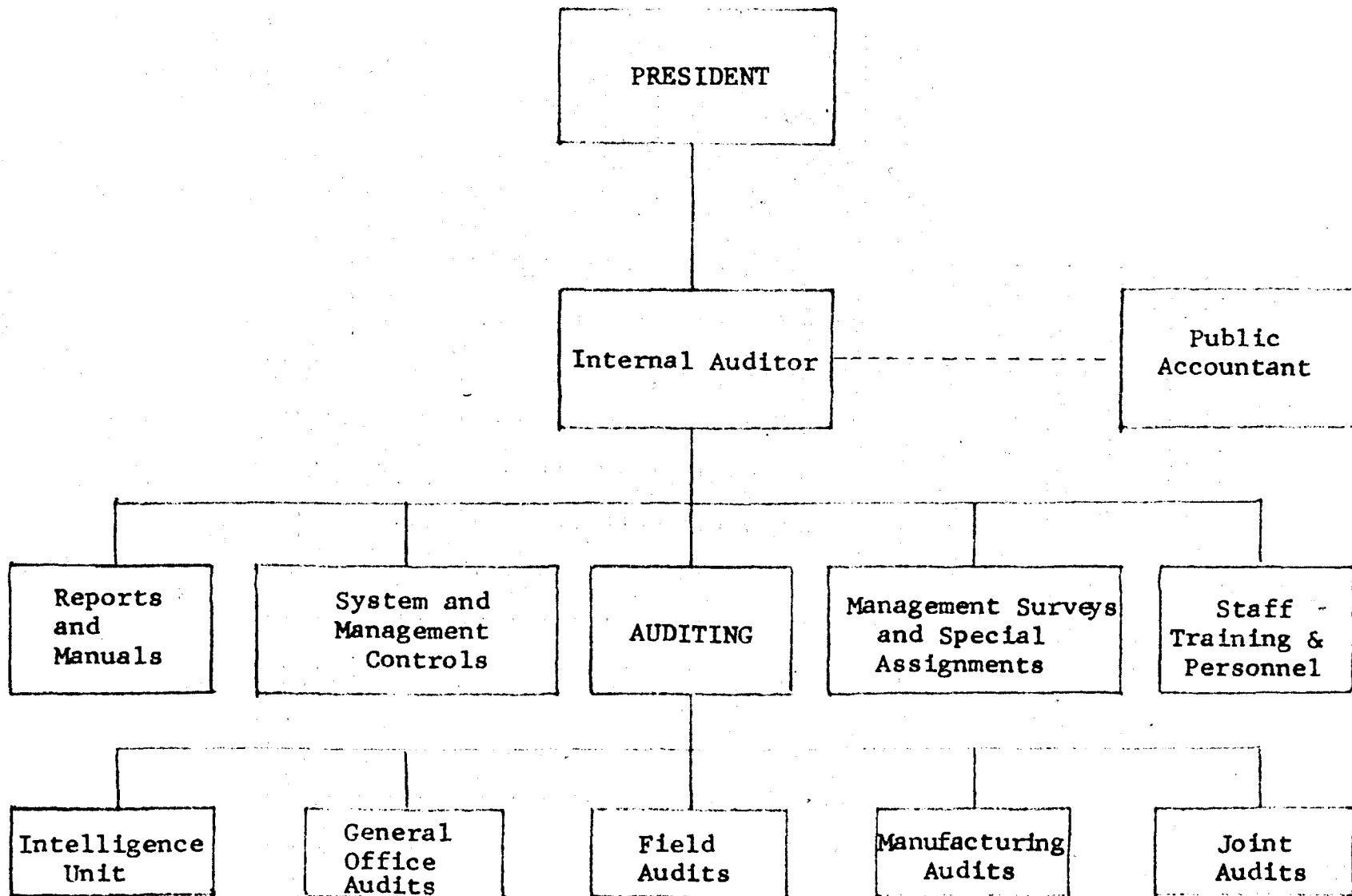
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F. E. Mints, "Operational Auditing," The Internal Auditor, XI (June, 1954) p. 45.

Auditors, indicated the degree of specialization which may occur within a large internal auditing group.¹⁹

Figure 1 illustrates the organization of a forty man staff of a company with large central office, a limited number of manufacturing divisions and distribution outlets located throughout the country. The "Internal Auditor" designated on Thurston's chart might be designated "Vice President-Management Controls." The dotted line to the public accountant indicates that all auditing details are cleared through the internal auditor. It does not preclude the public accountant from presenting his final report to the stockholders, board of directors or president.

Alternatives to operations auditing. Inherent in any organized human activities is a control function. Activities must be observed and appraised in the light of actual performance versus planned or expected performance. Management must have general information which can also be used to make adjustments in plans and procedures. Operations auditing is the performance by internal auditors of a process which gives management timely information and evaluations of operations. It also recognizes problems and



ORGANIZATION OF A LARGE, SPECIALIZED INTERNAL AUDITING STAFF

Figure 1

makes recommendations for their correction. There are alternative ways of accomplishing this process. Within the organization, top management can gather the information personally. The impracticality of this is immediately evident: geography and time rule this out. Line reports are a possible alternative within the company. Also, central control groups such as the "Koppers" idea might be used. Both of these have the weakness that they put such great reliance upon reports originated by "the operators." There are tendencies to "tone-down" unfavorable aspects in these reports. Personal observation is still the best method of evaluation known. Thus the operations auditing process is not replaced by "paper reports" because it uses on-the-site personal observation and conversation as its chief method.

"External" to the organization are management engineering firms and public accounting firms. Both of these groups may perform "studies" and "surveys" which supply the same information operations auditing does. The principal drawback here is the considerable costs involved. Heavy "non-productive time" of their staffs have to be "absorbed" by the client. Internal auditing staffs are with the company throughout the year and their time can be constantly productive. Also, the internal group is familiar with company

procedures and personnel and therefore doesn't lose as much time merely becoming acclimated.

The function has to be performed. It can be performed by top management, line management, management consultants and qualified public accounting firms. Operations auditing, by internal auditing groups, is the best means because it relies upon unbiased personal observation at the site of operations; and it is a continuous year 'round activity with little or no unproductive "between jobs" overhead.

CHAPTER III

PROCEDURAL STEPS IN OPERATIONS AUDITING AND HIGHLIGHTS FROM SELECTED ACTUAL AUDITS

The procedural steps used in operations auditing directly parallel those found in financial auditing. They are the: pre-audit survey; preliminary audit program preparation; on the site activities; and preparation of reports containing "findings" and "recommendations." Here the similarity ends. The financial audit report is full of columnar tables and formal presentations of accounts. The operations auditing report is largely narrative; it is in essence the result of a management study. The reports differ because their objectives differ and the auditing methods used in their preparation differ. The financial audit is based on a program intent upon determining if the company's financial statements "present fairly the financial position of the company and the results of its operations for the period audited." The operations auditing program is based on a broadly conceived program which, if effectively carried out, will:

Provide the administrator and his subordinates . . . with an objective appraisal of the manner in which policies and procedures have been carried out, along with recommendations for improvement.¹

I. PRE-AUDIT SURVEY

Organizational background study. Prior to the audit the senior in charge makes a study of the background of the organization under audit. This study involves the review of organizational manuals and charts, applicable policies, methods of operation and (in the case of governmental audits) the pertinent legal regulations and congressional intent as to activities and functions. He also considers the organizational responsibilities and may, in the course of his study, actually visit the site and talk with various echelons of management for clarifying any questions he may have about the material studied.²

The purpose of his background study is to obtain a broad over-all viewpoint of the organization to be audited. The extent of the study is dependent, to a certain degree, upon whether or not it is an initial audit. The study also serves the purpose of familiarizing the

¹. U. S. General Accounting Office, "Statement of Accounting Principles and Standards for Guidance of Executive Agencies in the Federal Government" (Washington: Government Printing Office, November 26, 1952) p. 5.

²Bradford Cadmus, "Auditing the Purchasing Department," The Internal Auditor, XII (September, 1955) p. 10.

auditor with any special technical problems and nomenclature which may be encountered.

Examination of previous audit reports, special studies, and intra-company correspondence. Concurrently with the organizational background study, the senior and members of his staff will refer to any existing work papers, special studies and intra-company correspondence on file pertaining to the organization to be audited.

Areas of past weaknesses in the organization's activities, as noted in prior reports, will be considered for particular examination to ascertain if corrective measures have been taken. New areas that pose potential control difficulties will be included as "sensitive items" in the over-all estimate of the organizational survey. Thus, an estimate will have been obtained of areas where the greatest audit activity might have to be concentrated.³

II. PRELIMINARY AUDIT PROGRAM PREPARATION

As a result of the estimate obtained through the background study and examination of prior reports, broad objectives will be brought to focus into specific audit objectives.

The preliminary audit program must be flexible in its nature and scope. Areas that loomed large in the

³ F. E. Mints, "Operational Auditing," The Internal Auditor, XI (June, 1954) p. 35.

pre-audit survey may be found upon actual investigation to be insignificant. The program also should be so devised as to make expansion of scope possible when actual audit conditions indicate greater attention to a particular phase is necessary. One widely-used approach to the preparation of a preliminary audit program is for the auditor to set up questions which management would, or should, be likely to ask.⁴ The purpose of operations auditing is to render a service to management. Therefore, if management has not asked specific questions regarding the operation to be audited, the "programmer" assumes the manager's viewpoint. It is interesting to note, in this respect, that the General Accounting Office comprehensive audits give meticulous attention to "Congressional intent." Laws, authorities and records of congressional hearings are studied to determine what Congress intended the agency to do and how to accomplish it.

Less abstract matters than policy intent are also involved in the preparation of the audit work program. Tentative man-hour time budgets must be worked up which break the audit down section-by-section as to estimated work time and also assign the work to specific members of the staff.

⁴ Ibid.

III. AUDITORS' ON THE SITE ACTIVITIES

Preliminaries. It is customary for the audit staff to have a conference, upon arrival, with local management personnel. The meeting serves a dual purpose: formal introductions; and local management's cooperation is made evident to everybody. Following the meeting, a "walk-around" is made of the installation to familiarize the auditors with locations and give them a picture of all the operations being carried on at the audit site.

Records examinations. The examination and testing of records and reports of the operation being audited usually begins the "work program" phase of the audit.⁵ This process helps the auditor to become familiar with the way performance data are developed and summarized; their accuracy and timeliness; and their relation to existing standards of performance.

Personal observation. The value of personal observation is very great in operations auditing. The auditor has had a certain amount of "orientation" by the time he really takes a look at the work going on. This is the part of operations auditing dividing "figure checkers" from "management-minded" professional internal auditors.

⁵ Arthur H. Kent, "The Development and Application of a New Concept of Internal Auditing," The Internal Auditor, XIV (March, 1957) p. 11.

The auditor sees whether "paper controls" are utilized and appear to be effective. He looks at the way things are being done and raises the question--Why? He recognizes that controls theoretically sound on paper may not necessarily translate into highly efficient operations. In this respect, he makes a practical appraisal of standards. Do they seem practical from a quantity and quality consideration? He also looks at the surrounding environment. Do things look well kept? A general impression of business-like practices? In conversations with lower management and the workers, is high employee morale evident? The program planner knows it is possible that all of his work may be of no consequence if the individual auditor lacks the imagination, initiative, and intelligence to eventually put his work program down and look around.

Reports. Reports should state all the pertinent facts fairly and completely. If exceptions are noted, the views of local management should be included along with recommendations made and corrective measures agreed upon.⁶ The timeliness of a report is a major attribute. This was recognized by Congress, when it noted that some of the General Accounting Office's comprehensive audits reports were "... too late reaching the Congress to be of maximum

⁶ R. C. Tyson, "What Management Looks for in an Internal Auditor's Report," The Internal Auditor, X (September, 1953) p. 46.

aid in taking corrective action. The Congress. . . can regard these reports only as historical documents of limited interest."⁷

Format. The auditor is expected to prepare a report that is "usable" by operating management. Simple, direct narrative, in plain words--not schedules and masses of figures is what the operating manager wants.⁸

The typical report submitted as a result of the operations auditing process is almost completely narrative. Certain elements are "common" to this type of report but there is no universally-accepted format. Each internal auditing staff prepares reports in the format that has been found most usable by its company's management.

Some generalizations can be made about the format of the reports: (1) There is usually an "introductory" or "summation" section which recites as briefly as possible what the subject of the audit is and what the major "findings" (deficiencies) were. (2) A "recommendations" section briefly states the recommendations made to local management

⁷United States Congress, Seventeenth Intermediate Report of the Committee on Government Operations. The General Accounting Office. A Study of its Organization and Administration with Recommendations for Increasing its Effectiveness. 84th Congress, 2d Session, House Report No. 2264, June 6, 1956 (Washington: Government Printing Office, 1956) p. 6.

⁸Arthur H. Kent, "The Profession of Internal Auditing," The Internal Auditor, VIII (September, 1951) p. 22.

by the auditing personnel. (3) The "body" of the report is cross-indexed with the "recommendations" and "findings" sections and "supports" them in detail. The "support" sometimes includes formal accounting statements and/or statistical compilations but the major portion of the supporting material is concise narrative. This narrative may indicate: the degree of reliability of records; what was personally observed; how detailed the observation was; conversations--with whom and what they said; areas observed outside the present audit's scope which seem to require later study; local managements' remarks concerning recommendations made and immediate or promised remedial actions; and other descriptive information which adequately reports what the "eyes and ears" of top management found out.

A qualified internal auditing group is admirably "fitted" to the task of preparing reports of this type. Not only because of their "technical" qualifications but also because they are "businessmen" and "members of the firm." Although they are well-grounded in "scientific management" theory, they can "talk the language" of their company with local management. Internal auditors also have the advantage of being full-time employees of the organization; they know its "informal" attitudes as well as its codified policies. Thus, they possess several important advantages which any "outsiders" would rarely, if ever, attain.

In their personal contact with local management any findings or recommendations are discussed. This is in keeping with the "Principle of Decentralized Decisions," as stated by Davis:

A decision should be made at the lowest level in the organization that has the requisite competence, authority, and prestige.⁹

If the major discrepancies are found top management is immediately notified so that immediate action may be taken. But the usual procedure is to suggest corrective measures to local management for its decision and report to top management: the problem recognized; the recommendations made; and local management's response.

IV. HIGHLIGHTS FROM SELECTED ACTUAL AUDITS

Much has been said of an abstract nature about the qualities of operations auditing. Some actual audits have been gleaned for highlights which illustrate some applications of internal auditing's newest phase. A phase which, on the whole, puts less emphasis on the comparison or analysis of records and stresses such techniques as personal observation of work being performed and personal interviews with employees.

⁹ Ralph C. Davis, The Fundamentals of Top Management (New York: Harper & Brothers, Publishers, 1951) p. 307.

Employment departmental operations audit - Lockheed Aircraft Corporation. The Lockheed Corporation employs 35,000 workers in its California Division. It has to conduct extensive interviewing of applicants for jobs since there is a high turnover of employees in the industry. It is important to know if the interviewing function develops the applicant's qualifications sufficiently to permit informed decisions as to his: general suitability for employment; desirability for technical qualification tests; and placement in a particular job. Management also wants to know if interviews are conducted in a reasonable time and if they result in good public relations.

The auditors first had discussions with department heads and supervisors who make the requests for workers. The object of the discussions was to get a clear picture of what these managers' policies and standards were in regards to the hiring of new employees. The next important step in the operations auditing process was to personally observe interviews being conducted. Several experienced auditors "sat in on" interviews being conducted.

Discussions were had with training department people and foremen to get their opinions as to how well the employment people had done. Statistics giving the average interview time and costs involved were considered. Also,

an inspection was made of the physical environment of the hiring process. Items considered were: efficient use of space available; proper facilities for preparing applications; and pleasant appearing soundproof interview booths.¹⁰

In the brief information given by Mints no definite conclusions can be drawn about the audit in question. A question can be raised as to whether the auditors thoroughly checked the job standards to see if they were correct. The extensive use of personal observation and discussion is readily apparent in this case. It would seem that a more subtle method of appraising interviews could have been devised. The "normal" two-person interview situation could not exist with a third party in the room.

The internal auditors have not participated in evolving any of the employment procedures so they can give an unbiased opinion--which personnel people might not have been able to do had they performed the audit.

Selected illustrative examples - Capitol Airlines.

The General Auditor of Capitol Airlines recently showed how his staff has been delving into operations in ways that some might not consider "proper" audit functions.

¹⁰ F. E. Mints, "Operational Auditing," The Internal Auditor, XI (June, 1954) pp. 43-44.

However, cost-savings have resulted.

Cash accounts. The usual "financial verifications" of cash are performed. But the internal auditors now go beyond the records and study the "cash management policies" in effect and how well they are carried out. That is, is temporarily-unemployed cash adequately and properly invested?

Confirmation of accounts receivable. Not only is the accuracy of amounts confirmed, but special attention is given to comments and criticisms written on confirmations returned by customers. "Following up" some of these comments and criticisms leads to corrective action which can improve entire operations.

Special departmental surveys. The two preceding illustrations showed the operations auditing process originating in the normal financial auditing phase. In the departmental survey the internal auditing staff goes directly into operations as a result of top management's request. The personal interview of employees within the department is one of the chief methods used in these surveys. Employees are encouraged to give their opinions as to what they consider wrong with the organizational set-up, supervision, procedures, office management, general working conditions, and other matters. It is interesting to note that the auditors were looking for potential supervisors as they conducted the interviews. The results of one survey was a

reorganization of the department surveyed with an improvement of supervision and a \$25,000 saving was made possible in annual salary expense.¹¹

Norfolk and Charleston Naval Shipyards. A General Accounting Office comprehensive audit of the shipyards presents an excellent illustration of the "problem recognition" function. Instances were noted where work on ships had been cancelled due to the lack of design plans. A recommendation was made to the Bureau of Ships to have design work at all shipyards brought to a current status. This suggestion was adopted and a report was initiated to estimate design personnel needed to eliminate bottlenecks caused by lack of design plans.¹²

U. S. Army, Corps of Engineers - Synchronomatic Accounting Machine System. In 1952 a synchronomatic accounting machine system was installed by the Corps at a cost of \$767,000. The purpose of the system was to prepare reports showing the status of funds, by appropriations, for each district office. After a year of testing; the Corps was unable to prepare an accurate summary of funds in a reasonable length of time.

¹¹ O'Ferrell Estes, "The Audit of Operations," The Internal Auditor, XIII (December, 1956) pp. 7-8.

¹² United States Congress, Senate, Committee on Government Operations, Review of Audit Reports of the Comptroller General, 84th Congress, 2d Session, Report No. 1572, February 23, 1956, (Washington: Government Printing Office, 1956)

The General Accounting Office recommendation was to abandon the system. The recommendation was approved and the system was abandoned.

Questions as to the planning function could be raised in this case. Was there a real necessity to have such fund status reports so readily available that over three-quarters of a million dollars would be invested in it? Secondly, had there been an adequate preliminary study made of the capabilities of the system? Was it impossible to predict that the system could not produce the desired results?¹³

In the brief examples of operations auditing that have been considered a wide range of interests is noted. "Personnel" audits were performed; important public relations facts were found by the examination of comments and complaints written on customers' confirmations. The recognition of a "bottleneck" holding up major operations and the recognition that a costly piece of accounting machinery was not "worth the money"--all of these show that many auditors are not restrained by stereotyped ideas about their "proper" functions. Rather, they are delving into operations and performing valuable services to their organizations.

¹³
Ibid. p. 79.

CHAPTER IV

FACTORS VITAL TO THE SUCCESS OF OPERATIONS AUDITING

Internal auditing's new phase has been variously described and defined in this paper. This chapter considers the factors vital to the success of operation auditing in the hope that a study of its basic "success" elements will further reveal its essential nature.

In 1953 a poll was conducted by the Institute of Internal Auditors. The purpose was to get representative members of the institute to rate (in order of importance) the factors they considered most important to successful internal auditing. A comprehensive picture of the internal auditing function can be seen by considering the results of the study. The more important elements indicated will be expounded upon in this chapter. Before doing this, however, we give the complete rankings of factors indicated by the poll:¹

¹ Arthur H. Kent, "The Important Factors of A Successful Internal Auditing Program," The Internal Auditor X (June, 1953) p. 11.

<u>Factor</u>	<u>Position</u>
Competency and characteristics of Staff members	1
Acceptance and support of management and supervision at all levels	2
Organizational status	3
Audit program concepts	4
Staff policies	5
Selection of Staff	6
Audit reports	7
Training of Staff	8
Administration of Staff	9
Audit planning (schedules)	10
Conferences--prior to report issuance	11
Outside accountants	12
Miscellaneous	13

I. COMPETENCE AND CHARACTERISTICS OF THE AUDIT STAFF MEMBERS

This factor drew the most votes, and more comments than any other category. A good picture was presented of what internal auditors themselves consider important in the staff man. A brief resumé of qualities cited includes: experience and professional competence; constructive thinking ability; command respect by reason of fairness; thoroughness and speed; ability to think in terms of management at all levels; avoidance of "policeman," "ivory tower" or "superior creature" attitude; and the ability to express ideas clearly "in terms of the particular audience." The last-mentioned attribute--that of being able to adjust effectively to the level of the audience--was thought to be particularly important to supervisors and managers. That is,

those who deal with top-management, middle-management and operating management.²

The importance held by competence is well illustrated by a letter sent to Senator McClellan, Chairman of the Senate Committee on Government Operations, by D. O. Beasley, Assistant Secretary of the Department of the Interior, about a recent General Accounting Office comprehensive audit. A recommendation had been made as to a more proper overall organization of the department's three major bureaus. Some of Beasley's remarks were:

We believe that many of the recommendations of the auditors pertain to fields of administration outside the competence of the auditors to evaluate. . . . We feel that our people who are responsible for making policy and who have years of background experience in this field, should not be expected to change sound and proven policies, procedures and organization alignment because an auditor feels that it should be done some other way...An accountant is not ordinarily qualified--either through professional training or broad administrative experience--to determine the scope and pattern of a complex organization.³

Beasley's letter is quoted because it represents an adverse management reaction to "operations auditing." The competence of the auditor is the first factor questioned when adverse findings have been stated. The "accountant's" qualifications (training and management experience) are considered inadequate. No valid conclusions can be drawn as to

² Ibid., p. 12

³ United States Congress, Senate, Committee on Government Operations, Review of Audit Reports of the Comptroller General, 84th Congress, 2d Session, Report No. 1572, February 23, 1956, (Washington: Government Printing Office, 1956)

the justice of Beasley's charges, because all of the facts are not known. Any adequate defense of the audit recommendations would largely revolve around the competence of the individual auditors who participated in the audit in question.

It is obvious that Beasley has been thinking in generalities. He questions the competence of "auditors" to make evaluations in the field of administration and maintains that "accountants" are not ordinarily qualified through training or experience to determine the scope and pattern of a complex organization.

It seems to the author of this thesis that some of the most crucial points are illustrated here in the acceptance of the internal auditing staff as organization-wide controls evaluation function. The old connotations of the words "accountant" and "auditor" are seen as decided restrictions to Beasley's understanding of the new, managerial-viewpoint auditing. It is impossible to state the case definitely, but it would seem that Beasley is not aware of the fact that internal auditors now make a strong distinction between themselves and accountants. They see accountants as compilers of historical data and auditors as evaluators and interpreters.

The auditors in the Department of the Interior case obviously failed to win management approval of their

recommendations. The auditors must "sell" their new function as an objective program if they are to gain the confidence and cooperation of operating management. In this instance, management seems to be hostile. This hostility may have been provoked by auditors who lost sight of the fact that their function is to recommend and not command. Or top management (Congress) might have impeded the objectivity and cooperation needed for effective operations auditing through the use of "findings" as a punitive bludgeon.

Some rather grave questions have been raised in a Canadian business periodical about "the accountant" as management material. The fact was conceded that many top executives were originally accountants but "the accountant" as a type was thought to be such a child of precedence and so suspicious of non-figure facts that he would be "incapable of creative thinking."⁴ Further, "The solid atmosphere around the ledgers is not conducive towards developing an understanding of human nature."⁵ Although the article concluded that accountants could become executives by extraordinary effort, its chief effect was to generalize about "accountants" as a type (in a manner similar to Secretary Beasley.)

⁴ Article in The Accountant's Digest--XIX (June, 1954) p. 215. "Can Accountants be Made Into Executives?" A digest of an editorial in Cash and Management, Canada, February, 1954.

⁵ Ibid.

"Type" generalizations about "accountants" and "auditors" in the opinion of this paper's author, are manifestations of the present-day penchant to fit not only "pegs" but also "people" into neatly-compartmented slots. It has not been demonstrated that all accountants and auditors are completely introverted, narrow, unimaginative and incapable of creative thinking and successful relations with other people. Neither has it been demonstrated, to this writer's knowledge, that all successful managers are completely extroverted, broad, imaginative, creative thinkers and completely effective in their relations with others. There are many successful auditors and managers who do not fit such a "pat" description.

"Accountants" and "auditors" capable of broadened horizons do exist. Roger Wellington, partner in the firm of Scovell, Wellington and Company, commented recently:

Men develop into management consultants only after years of learning and experience; but they usually begin in a relatively narrow, specialized field. From this starting point, they gradually broaden out until they possess qualifications of a general nature.⁶

A recent survey of moderate-size local accounting firms was made in order to discover what "management services" these accounting firms were rendering. (It is a well-known fact that many of the large, national accounting firms have

⁶Roger Wellington, "The Development of Management Service," Journal of Accountancy, (June, 1956) p. 57.

performed management services for many years.) The survey included firms with one owner to fourteen partners and averaged six partners. Twenty-three states were represented; seven firms being the largest number included from any one state. An "activity index" was incorporated in the tabulation of the results and the management services were "grouped" into ten major categories as follows:

MAJOR GROUPS OF MANAGEMENT SERVICES RENDERED BY CPA'S
RANKED AS TO ACTIVITY

	<u>Activity</u> <u>Index</u> *
Finance	79
General Management and Administration	74
Office Management	71
Purchasing	64
Other Professional Services	50
Personnel	36
Research and Development	21
Traffic and Transportation	20
Production	18
Sales	16

*The activity index would be 100 if each accounting firm had rendered all of the types of service in each group.⁷

A detailed listing is given of specific activities within the ten major "groups." Some of these specific activities are presented here to show the scope of management work being done by public "accountants" and "auditors." They are shown in the following paragraphs under major group headings. The examples used were

⁷"Management Services - A Survey," AICPA - Research Dept., Journal of Accountancy (June, 1957) p. 43.

selected here because they are more in the area of "operations" than in the traditional "financial" areas. (Activity indexes are in parentheses.)

General Management and Administration. Specific activities of this group included: Surveys and design of internal reporting systems (73); surveys of management policies and rendering advice as to business expansion or contraction (62); and surveys of internal organization (53).

Office Management. Some specific activities under this group heading were: Surveys of office organization; analyses of office personnel workloads; and personnel evaluations (72).

Personnel. Some of the activities grouped in the "personnel" heading had low activity index factors but they are included here to indicate the scope of the work these medium size firms have undertaken as follows: Advice as to compensation for various types of work, advice as to wage incentive and employee benefit programs (70); preparation of job classification (31); advice as to safety and health programs (21); and advice as to labor union contracts and preparing evidence as to "ability to pay" wage increases in labor union negotiations (9).

Production. Some of the activities reported under the production heading fall directly in the category of "industrial engineering." Activities mentioned include:

Development of inventory controls and survey of production records (26); and time and motion studies; development of production standards, and survey and evaluation of production methods (10).

Sales. The conducting of market research for products and services had an activity index of (7).⁸

The great diversity of management services indicated by the above-cited study is found in medium size public accounting firms. It is true that many of these firms have hired "management engineers" but it is also true that many of the auditors have become involved in the newer phase of the business. This point was made clear recently by Louis A. Ryan, partner in Andrews, Burket and Co. of Richmond, Virginia. When a medium sized firm decides to embark upon the provision of management services Ryan suggests a:

Thorough review should be made of the education, experience, aptitudes and personalities of all the partners and staff to determine which persons in the group are best equipped to satisfy the client and bring esteem to the work."⁹

Ryan thus implies that the accountants and auditors of the existing organization should be considered as source

⁸ Ibid., pp. 44-45.

⁹ Louis A. Ryan, "Organizing For Management Services," Journal of Accountancy, (February, 1957) p. 46.

material for the management service work. There is also a tacit recognition of the importance of the whole man to the proper accomplishment of this "dynamic" service.

II. ACCEPTANCE AND SUPPORT OF MANAGEMENT

The Statement of Responsibilities of Internal Auditors formally recognizes the fact that the service rendered to management by the internal auditor is directly affected by "acceptance." Kent points out that the real difference between old internal auditing (checking and verification of accounting documents) and the modern concept (management service) is bound up in "Acceptance."¹⁰

J. M. Sullivan of the General Accounting Office put the importance of management acceptance very well when he said:

It is only with the enthusiastic support of management that any financial management device can prove successful . . .¹¹

General Electric Company furnishes an outstanding example of management acceptance and support of internal auditing. The audit program reaches all of the company's operations and has played a major role over the years. The internal audit work has been of such a high standard that

¹⁰ Arthur H. Kent, "The Important Factors of A Successful Internal Auditing Program," The Internal Auditor, X (June, 1953) p. 13.

¹¹ Joseph M. Sullivan, "Are Working Capital Funds the Answer?" (paper read at the Financial Management Roundtable Washington, D. C., April 24, 1956) p. 5. (Mimeographed)

the independent auditors accept a very large part of the findings. In fact, the internal auditing program is closely coordinated with the work of the outside auditors.¹² The internal auditing staff is the keystone of the financial management training program. The "most promising recruits" are sent into the internal auditing staff so they can have the opportunity to:

Strengthen their business background, supplement their business knowledge, develop their initiative judgement and broaden their understanding of the Company audits problems."¹³

"The internal auditor has joined the management team" an ever-growing reality. Victor Z. Brink, Executive Assistant to the Vice President and General Manager, Lincoln Division, Ford Motor Co., has pictured what is meant by "joining the management team." He maintains that the internal auditor does not merely furnish data but is "actually participating in management activity and positively contributing in a constructive manner to the solution of significant management problems."¹⁴

This raises a problem involving auditors' independence, in the opinion of the writer of this thesis. If the

¹² R. L. Knight, "The Internal Audit Aspect of the General Electric Training Program," The Internal Auditor, XIII (June, 1956) p. 37.

¹³ Ibid.

¹⁴ Victor Z. Brink, "The Internal Auditor Joins the Management Team," The Internal Auditor, XIV (June, 1957) p. 13.

internal auditor is to be "positively contributing" to the "solution" of management problems, might it not weaken his claim to "impartiality" in the review of operations affected by "solutions" in which he participated?

III. ORGANIZATIONAL STATUS

The common view of "organization status" is that the internal auditor must be rigidly understood to be in a "staff capacity" and therefore not to be expected to prejudice his position (independence) by working as an operator.¹⁵ There are also human relations considerations involved. If the internal auditing organization is to have sufficient prestige, it must report high up the ladder. A practical matter of auditor morale is also involved. Continued disregard or lack of action on audit findings and recommendations eventually have a disheartening influence upon the morale of the internal audit staff.

Ralph C. Davis has formulated "The Principle of Staff Independence" as follows:

¹⁵ Kent, op. cit., p. 14.

The extent to which the responsible line executive receives competent, frank advice and assistance from staff subordinates depends on their ability to recommend or take whatever staff action is demanded by the situation without fear that conflict of ideas between a staff executive and his line superior will jeopardize the former's position."¹⁶

Thus, the internal auditor's "frank advice and assistance" to line superiors is shown as being dependent upon a freedom from fear of retaliation. The "level" at which the auditor reports is a vital factor in this "independence," in the opinion of the author of this thesis. The "backing" he can expect to receive is usually related to the status of the official reported to. Experience in the military made this quite clear. A captain, for example, who is the representative of a lieutenant general can expect full cooperation from officers many ranks his senior. Were he representing a full colonel the cooperation would diminish appreciably. A somewhat comparable situation exists regarding the internal auditor. If the internal auditing staff is reporting to a high level they are in a situation analogous to the officer representing a lieutenant general.

Since most internal auditing staffs do work out of central headquarters they have the prestige which attaches to those who are "from the home office." If they have the

¹⁶ Ralph Currier Davis, The Fundamentals of Top Management (New York: Harper & Brothers, Publishers, 1951) p. 454.

full support of top management they are in a better position than any "line" personnel (other than top management itself) to receive the active cooperation throughout the organization.

IV. AUDIT PROGRAM CONCEPTS

'Make it broad in scope and company-wide.'" "Base it on providing management with information as to conditions in various company activities." "Direct efforts to controls, trends and conditions." "Don't get too deep into technical subjects, unless you have auditors equipped to do so." These were some of the comments made on replies to the Institute of Internal Auditors' poll.¹⁷

The audit program concept is of utmost importance if operations auditing is to be carried on, it seems to the writer of this thesis. Unless the program goes beyond financial auditing, a modern concept of internal auditing is not present.

17

Kent, loc. cit.

CHAPTER V

SUMMARY AND CONCLUSIONS

SUMMARY

Until the year 1941 not one book was available in the United States devoted exclusively to the subject of internal auditing. In that year, Victor Z. Brink published his famous book and in that same year the Institute of Internal Auditors was founded.

In the ten years since the Institute of Internal Auditors issued their first formal Statement of the Responsibilities of the Internal Auditor (1947), a whole new idea has swept through many of America's largest business enterprises and the federal government. With the awareness of the top-management need for current and accurate information about business operations, Internal Auditing Departments have advanced from relative obscurity to great importance. The "broad audit concept" advocated by the Institute of Internal Auditors has been translated into "operations auditing." Internal auditing's emphasis is now on constructive service to management with the auditor himself a member of the "management team."

Although the modern internal auditor's work emphasis has changed from financial auditing to the observation of practically every operation in the organization, he has retained some financial auditing approaches. He has recognized that most work activities generate statistical data to record performance. The data might be stated in terms of dollars, work units produced, man hours of service rendered or other measurements of human activity. The auditor is familiar with mathematically-stated accounting records; statistical operating data is stated in mathematical terms. Thus a starting point for operations auditing was available.

The auditor's inherent human abilities to observe, reason, compare and arrive at judgements was also a starting point. "Management" pioneers such as Taylor, Harrington, Gilbreth and others prepared the way for objective analysis of human work activities. This was another starting point.

With businesses and government constantly getting larger and more widely dispersed, home office control and knowledge of what was occurring in the field has become increasingly more difficult. The idea was conceived that in the internal auditing staff there was a ready-made group of individuals who were familiar with the control concept.

They had observed most of the organization's activities on an informal basis at one time or another. Also, many internal auditors were students of "scientific management" procedures and they felt that they and their staffs should be given a chance to prove themselves. Top management in many large-scale businesses and the federal government listened to what the internal auditors were saying. The work of the Institute of Internal Auditors was of inestimable value. Thousands of reprints of the 1947 Statement of Responsibilities were sent to federal government activities and businesses throughout America. As a result, many internal auditing groups received top management approval to broaden the scope of their work to include operations auditing. Today most large-scale business enterprises and federal agencies maintain internal auditing staffs which are regularly performing some degree of operations auditing in addition to their still-vital financial auditing responsibilities.

Thus, internal auditors are now concerned that the policies, plans, and procedures being used in operations result in efficient and economical performance.

CONCLUSION

In consideration of the facts presented in this paper, it is concluded that operations auditing is a legitimate and logical function of internal auditing. The validity of this conclusion is dependent upon certain qualifications: (1) There must be a competent internal auditing staff which represents a wide range of technical abilities and practical experience. Those in supervisory capacities should possess superior "financial" and "management" auditing skill and broad business experience which are utilized to review staff members' work; actively train junior auditors; and plan and coordinate the work of the internal auditing group. Field auditors should be sufficiently qualified to be able to accomplish the work assigned to them. The ability to meet and work with other people in a cooperative manner should be one of their chief personal characteristics. Another personal characteristic of great importance that must be present is a broadness of background that enables them to look at operations from an over-all management viewpoint. Imagination, initiative, an inquiring mind, and common-sense on the part of auditors are vital to the success of operations auditing; without them the audit is merely a verification of mathematical balances. (2) Management must

wholeheartedly accept and support the internal auditing staff's operations auditing endeavors and make it evident that the auditors are full-fledged members of the "management team." (3) The internal auditing group must work strictly in a "staff" capacity. They should be relieved of "line" responsibilities so that they may retain impartiality. The auditors' independence must be protected by guaranteeing freedom from intimidation. (4) Broad audit work programs must be in effect--programs which encourage the individual auditor to exercise imagination and initiative. (5) It must be understood at all levels of the organization that the primary purpose of operations auditing is to provide forward-looking, constructive service to management and not to serve as a "police force" intent upon punitive-measures against individuals responsible for past mistakes. (6) There must be a high morale spirit within the auditing group as a result of fair and effective staff management policies which recognize the unique contribution each individual auditor can make. (7) There must be a real enthusiasm among the auditors for the idea that their "mission" is to help improve the organization by serving as management's "eyes and ears." (8) The auditors must understand that management bears the responsibility for the success of the organization; it therefore makes the decisions. It must

be recognized that management will not always accept the auditors' suggestions. If this happens frequently the staff must be capable of self-examination to see where it has failed.

If the foregoing qualifications are met in a reasonable degree, the internal auditing staff will be qualified to review and appraise operations from management's viewpoint because: (1) They are technically qualified to trace the complex buildup of accounting and statistical data from its sources of origination to the "cost" or "control" centers where actual performance is compared to expected performance standards. (2) Their training in the principles of management plus the broad experience they receive through seeing most of their company's activities enables them to relate "paper" standards, procedures, and controls to the facts revealed by tests of recorded data and personal observation of operations. Thus they are able to make "practical" appraisals, from an over-all management viewpoint. (3) They are intimately acquainted with the "informal," as well as the "formal," procedures and objectives of their company. (4) They possess an "independence" and "impartiality" of viewpoint which "line" personnel would find difficult, if not impossible, to maintain. (5) There is an ever-growing body of technical literature available

to internal auditors in the publications of the Institute of Internal Auditors. In addition there is an active professional program being carried on by local chapters of the Institute. Some of the keenest minds in American business are daily adding to the store of knowledge available to internal auditors concerning methods and techniques that have been found to be successful in implementing their new role as "members of the management team" in the reviews and appraisal of operations. (6) They have proven themselves capable in many business enterprises and have won management's continuing support because of the valuable service they have rendered.

Therefore, it is the considered opinion of the author of this thesis that operations auditing presents the most practical method for top management of large-scale enterprises to obtain timely and unbiased reports about the efficiency and economy with which operations are being conducted. Also, to obtain information and constructive recommendations about actual, or potential, weaknesses in operational plans, policies, and procedures within the organization.

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APPENDIX "A"

APPENDIX "A"

PERTINENT QUOTATIONS CONSIDERED IN PREPARING
THE DEFINITION OF "OPERATIONS AUDITING"
USED IN THIS PAPERDefinitions.

An operations audit may be described as an analytical survey of a business activity, to determine and inform management whether that activity is being performed in such a way as to comply with management's policies and insure that management's objectives will be met.

By: F. E. Mints, Resident Internal Auditor, Lockheed Aircraft Corporation

In: The Internal Auditor, XI (June, 1954) p. 32.

An internal audit is an analytical survey of various business activities, which in general uses as its base or entree, the various records--original or summarized--of the company.

Such a definition suggests two phases of the survey:

- (1) The verification of the reliability of the figures from which analyses will be made, and conclusions drawn....no analysis of business operations can be entered into without assurance that the basic data are accurate.
- (2) This verification, however, while important in itself, also becomes a prelude to the really distinctive phase of internal auditing. That phase is the analytical survey, the scrutiny of the operations themselves through the eyes

Definitions.

of management in which we use our training and experience in the realm of figures.

By: Arthur H. Kent (Formerly General Auditor, Standard Oil Company of California)
 In: "The Profession of Internal Auditing," The Internal Auditor, VIII (September, 1951) pp. 16-17.

Specific Areas.Constructive Service.

At this point, it may be advantageous to consider briefly the main tenets of what is generally described in North America as management auditing. It is a service to management which, through appraisal of all aspects of business performance and evaluation of the facts revealed, provides information on weaknesses existing in the organization, or important events, trends, their causes and effects, together with appropriate recommendations for improvements.

By: G. D. Bunce, Chartered Accountant, London, England
 In: "Auditing for Management," The Internal Auditor, XIV (March, 1957) p. 46. (Reprinted from The Accountant April 14, 1956 issue)

Basically then, the new look in objective, centers around the constructive rather than the protective phase of auditing. To be specific it is the phase which allows the auditor to review and appraise: policies and plans in the light of related data; internal records and procedures in terms of adequacy and effectiveness and, performance under policies, plans and procedures, ultimately to further the interests of the organization. Make no mistake however, that such an objective is to be attained to the complete exclusion of the fundamental protective phase with which you are already familiar.

By: David J. Dawson, Boston Edison Company
 In: "The New Look in Internal Auditing," The Internal Auditor, XII (December, 1955) p. 44.

Constructive Service.

This being the case, the internal auditor must make the most of his other class of service to management--constructive service. This might be defined as the service which leads directly to the reduction of costs or to an increase in revenue, thereby increasing profits. This does not mean that it will be necessary for the internal auditor to engage in systems work. It is the internal auditor's job merely to point out things that require corrective action and make whatever suggestions occur to him and to have others do the systems work.

- By: William J. Lehmann, General Auditor, Lockheed Aircraft Corporation
 In: "How to Assist Management to Increased Profits Through Internal Auditing," The Internal Auditor, XI (December, 1954) p. 7.

Management Viewpoint.

How can you supply constructive service to management? How can this best be done? In attempting to do this it is imperative that the internal auditor approach his work in the right way; that he attain a management viewpoint. He must think like a manager.... And how does he do this? Just try to put yourself in the manager's place and try to determine what you would have the auditors do if you were the manager.

- By: William J. Lehmann, General Auditor, Lockheed Aircraft Corporation
 In: "How to Assist Management to Increased Profits Through Internal Auditing," The Internal Auditor, XI (December, 1954) p. 7.

They [operating management] are interested in efficiency and economy. They are interested in relationships both inside and outside. They are vitally concerned with supervision and with people. They are correspondingly interested in profit and loss, salvage and waste. These are the things that consume the time of operating management; and these are the things on which they will enthusiastically accept aid and assistance.

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Management Viewpoint.

If operating management is to develop a hunger for the service of the internal auditor, we must first let them taste the wares. In every audit let your thinking clearly embrace the needs of the operating management as well as the financial verification. As you analyze and verify, ask these questions--"What are the operating aspects?", "Who will be interested in this?", "How can it be presented?".

By: E. F. Ratliff, Eli Lilly & Company
 In: "Extending Auditing Into Operations," The Internal Auditor, XI (September, 1954) p. 15.

The internal auditor's work and interest in his business will follow organization lines--the way that the business is organized and operated. He is interested in controls and procedures as much as or more than in the end results. If controls are correctly developed and properly operated, the end results will have to be right...The internal auditor is interested in the effectiveness of operation, in how individuals perform their work, how the operation and control of one office compares with a similar office elsewhere in the organization. The internal auditor is always interested in improving the operation, improving control and increasing profits--and has a definite responsibility for this. p. 5.

The internal auditor will be one of the very few who goes into all departments and works in them sufficiently to know how they operate and just how they mesh into the whole structure of his business. p. 7.

As the internal auditor is concerned with the welfare of his business above all, he must have a well-developed sense of proportion and values--or business sense as it is called. In his work, he must be able to separate the trivial from the important. . . The internal auditor cannot be a 'hair-splitter'. p. 9.

.....Must be able to get on well with others; he must have 'contact ability'. This does not mean that he should be a complete extrovert but it does

Management Viewpoint.

mean that he cannot be secretive and intolerant of the opinions and actions of others. He must be a 'square-shooter', fair and tolerant, yet with determination to follow through without fear or favor.

p. 9.

By: The Institute of Internal Auditors
 In: The Field of Internal Auditing. Pamphlet, 1956.

His mind has been taken out of the books, and has been directed into all except the most scientific and technical aspects of his company's affairs. He has turned into a businessman, in the broader definition of the term. He has had to become a salesman of ideas and information.

By: Elmer Johnson, Staff Assistant to General Auditor, Standard Oil Company of California
 In: "Becoming More Than Just a Competent Technician," The Internal Auditor, XIII (March, 1956) p. 12.

Independence.

The auditor today must have more than a sense of knowing what is right or wrong in the recording of financial transactions: he must also have a knowledge of the better technique or procedure in accounting for these transactions. He must be constantly aware that one of his functions is to challenge policy.

By: Donald J. Bevis, Partner of the firm of Touche, Niven, Bailey & Smart.
 In: "Recent Developments in Auditing Techniques," The Federal Accountant, VI (March, 1957) p. 50.

Communications.

Actually, an internal auditor, particularly one of the traveling kind in the larger corporations, is a roving ambassador. He is attached to one of the stronger cables used by top home office management to bind the organization together. In the eyes of field personnel, from top local management on down, he is a home office representative; in fact, usually he spends more time in their area than any other Home Office staff man.

By: Elmer Johnson, Staff Assistant to General Auditor, Standard Oil Company of California
 In: "Becoming More Than Just a Competent Technician," The Internal Auditor, XIII (March, 1956) p. 12.

The internal auditor can materially aid in effecting this better relationship [better human relationships among employees] by demonstrating his interest in these programs [employee training], and by carrying back to management the interest of employees in the enterprise, and by suggesting how the intensity of human interest in industry may be enhanced.

By: Glenn T. Bodman, Assistant Controller of the Continental Oil Company
 In: "Human Relations With Management," The Internal Auditor, VIII (September, 1951) p. 55.

Timeliness.

It is worthy of emphasis that control information should be much more than a gathering of historical data. Rather, it must be a gathering and using of live, 'still-happening' data, so that a timely, usable basis is provided for reappraising, in the light of newly unfolding events, the wisdom of original analysis and plans and the effectiveness of the organization's actions.

Timeliness.

If the boss finds that the expected results are being achieved, it is probable (although not absolutely certain) that the size-up and the program were of good quality and that the organization is efficient... Very often the expected results are not being achieved. Then the boss is put on notice that there were weaknesses or breakdowns in one or two, or all three, of the areas: size-up, planning, taking action. If the control information is good, it will help him to discover where the actual or potential trouble seems to lie, and will thus indicate where corrective or, preferably, preventive steps should be taken.

By: George Albert Smith, Professor of Business Administration, Graduate School of Business Administration, Harvard University.
 In: Policy Formulation and Administration, (Richard D. Irwin, Inc., Homewood, Illinois, 1954) p. 11.

Control.

If you keep in mind the functions of control--that of seeing whether an organization is achieving its purpose and obeying the rules--you will find a definition of the basic job of an internal auditor. The most common means of control (defined as here) is internal reports, whether from the comptroller or the internal auditor. You are a part of the control staff, charged to investigate adherence to company procedure and policies and to submit reports thereon to higher management. You are charged to provide data on which higher management can revise its planning, its organization, its command and its coordination. As auditors, often times as the only head-office person who spends much time in remote parts of an organization, you are being used to check measurable facts and to report opinions on an increasing range of specified topics.

By: E. D. McPhee, Director, School of Commerce, University of British Columbia
 In: "Scientific Management Control," The Internal Auditor X (March, 1953) p. 25.

Scope.

While often limited to the auditing of accounts, in its most useful aspect internal auditing involves the appraisal of operations generally, weighing actual results in the light of planned results. Thus, the internal auditors, in addition to assuring themselves that the accounts properly reflect the facts, might also appraise policies, procedures, use of authority, quality of management, effectiveness of methods, and other phases of operations.

By: Harold Koontz and Cyril O'Donnell, School of Business Administration, University of California, Los Angeles
 In: Principles of Management, p. 567.

If our work is to be of value, we must go beyond the mere verification of accounts and enter the field of inspection and appraisal of operations.

By: O'Ferrell Estes, General Auditor, Capitol Airlines
 In: "The Audit of Operations," The Internal Auditor, XIII (December, 1956) p. 7.

Many of our managements have been brought into the picture, to the point that they have learned that their internal auditing staff is an ideal group to aid in keeping their organization functioning, by on-the-ground investigation of many matters which have little or nothing to do with accounting, but have a great deal to do with keeping the business healthy and profitable.

By: Elmer Johnson, Staff Assistant to General Auditor, Standard Oil Company of California
 In: "Becoming More Than Just A competent Technician," The Internal Auditor, XIII (March, 1956) p. 12.

Scope.

For example, our [Lockheed Aircraft Corporation] statement of functions and responsibilities says that we shall "review and appraise the performance of the various accounting, control, custodial, and other units to determine whether these activities are carried on in accordance with management's directives and in a manner expected to achieve management's objectives." We interpret the phrase "control activities" to include planning, scheduling, inspecting, recording, budgeting, and safeguarding.

By: F. E. Mints, Resident Internal Auditor, Lockheed Aircraft Corporation
In: "Operational Auditing," The Internal Auditor, XI (June, 1954) p. 34.

Personal Observation.

In any preoccupation with the devices of managerial control, one should never overlook the importance of control through personal observation... Management is, after all, getting things done through people, and, while many scientific devices aid in making sure that people are doing that which the manager has hoped and planned for them, the problem of control is still one of human relations.

By: Harold Koontz and Cyril O'Donnell, School of Business Administration, University of California, Los Angeles
In: Principles of Management, p. 567.

STATEMENT OF THE
RESPONSIBILITIES OF THE INTERNAL
AUDITOR



THE INSTITUTE OF INTERNAL AUDITORS
120 Wall Street
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STATEMENT OF RESPONSIBILITIES OF THE INTERNAL AUDITOR

FOREWORD

In 1947, THE INSTITUTE OF INTERNAL AUDITORS published for the first time a "Statement of Responsibilities of the Internal Auditor." In the Foreword to that Statement recognition was given to the fact that "new conditions and needs, and further development in the professional stature of the internal auditor might well warrant in future years some revision of the Statement."

Over the period of nine years since the Statement was published, there has been a continuing development of the profession. THE INSTITUTE, therefore, believes it advisable at this time to issue a Revised Statement, which shall express the still broader concept of internal auditing, which it holds today.

NATURE OF INTERNAL AUDITING

Internal auditing is an independent appraisal activity within an organization for the review of accounting, financial and other operations as a basis for service to management. It is a managerial control, which functions by measuring and evaluating the effectiveness of other controls.

OBJECTIVE AND SCOPE OF INTERNAL AUDITING

The over-all objective of internal auditing is to assist all members of management in the effective discharge of their responsibilities, by furnishing them with objective analyses, appraisals, recommendations and pertinent comments concerning the activities reviewed. The internal auditor therefore should be concerned with any phase of business activity wherein he can be of service to management. The attainment of this over-all objective of service to management should involve such activities as:

- Reviewing and appraising the soundness, adequacy and application of accounting, financial and operating controls.
- Ascertaining the extent of compliance with established policies, plans and procedures.
- Ascertaining the extent to which company assets are accounted for, and safeguarded from losses of all kinds.

- Ascertaining the reliability of accounting and other data developed within the organization.
- Appraising the quality of performance in carrying out assigned responsibilities.

AUTHORITY AND RESPONSIBILITY

Internal auditing is a staff function rather than a line function. Therefore the internal auditor does not exercise direct authority over other persons in the organization, whose work he reviews.

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 organization of the responsibilities assigned to them.

INDEPENDENCE

Independence is essential to the effectiveness of the internal auditing program. This independence has two major aspects:

- (1) The organizational status of the internal auditor and the support accorded to him by management are major determinants of the range and value of the services which management will obtain from the internal auditing function. The head of the internal auditing department, therefore, should be responsible to an officer of sufficient rank in the organization as will assure a broad scope of activities, and adequate consideration of and effective action on the findings or recommendations made by him.
- (2) Since complete objectivity is essential to the audit function, internal auditors should not develop and install procedures, prepare records, or engage in any other activity which they normally would be expected to review and appraise.

GENERAL ACCOUNTING OFFICE
WASHINGTON 25

May 1, 1957

PURPOSES AND OBJECTIVES OF COMPREHENSIVE AUDITS

As an agent of the legislative branch of the Government, the Comptroller General has from time to time been given extremely broad statutory authority to review the activities of executive agencies. Important among the various statutes are sections 312(a) and 313 of the Budget and Accounting Act, 1921, section 206 of the Legislative Reorganization Act of 1946, section 206(c) of the Federal Property and Administrative Services Act of 1949, and, most recently, sections 111(d) and 117(a) of the Budget and Accounting Procedures Act of 1950. Auditing on a comprehensive basis was instituted by the Comptroller General of the United States in 1949 as a means of more effectively discharging the audit responsibilities placed on him by law.

Purpose of the comprehensive audit

Stated as simply as possible, the purpose of the comprehensive audit is to determine how well the agency or activity under audit has discharged its financial responsibilities. Financial responsibilities in this case are construed as including the expenditure of funds and the utilization of property and personnel in the furtherance only of authorized programs or activities and the conduct of programs or activities in an effective, efficient and economical manner.

Authority

Congressional authority for audits with this objective clearly exists in the legislative history of the Budget and Accounting Act, 1921, and the Accounting and Auditing Act of 1950.

Section 312(a) of the Budget and Accounting Act, 1921, states:

"The Comptroller General shall investigate, at the seat of Government or elsewhere, all matters relating to the receipt, disbursement, and application of public funds." (42 Stat. 24, 31 U.S.C. 71.)

Section 117(a) of the Accounting and Auditing Act of 1950 provides that:

"Except as otherwise specifically provided by law, the financial transactions of each executive, legislative, and judicial agency, including but not limited to the accounts of accountable officers, shall be audited by the General Accounting Office in accordance with such principles and procedures and under such rules and regulations as may be prescribed by the Comptroller General of the United States. In the determination of auditing procedures to be followed and the extent of examination of vouchers and other documents, the Comptroller General shall give due regard to generally accepted principles of auditing, including consideration of the effectiveness of accounting organizations and systems, internal audit and control, and related administrative practices of the respective agencies." (64 Stat. 837; 31 U.S.C. 67.)

Audit objectives

In order that the full responsibility of the General Accounting Office in the audit of a Government agency may be discharged, the following determinations must be made:

1. That the agency is carrying out only those activities or programs authorized by the Congress and is conducting them efficiently and in the manner authorized.
2. That expenditures are made only in the furtherance of authorized activities and in accordance with the requirements of applicable laws and regulations, including decisions of the Comptroller General.
3. That the agency collects and accounts properly for all revenues and receipts arising from its activities.
4. That the assets of the agency or in its custody are adequately safeguarded and controlled and utilized in an efficient manner.
5. That reports by the agencies to the Congress and to the central control agencies, such as the Bureau of the Budget, disclose fully the nature and scope of activities conducted and provide a proper basis for evaluating the agencies' operations.

Nature of the comprehensive audit

In order to make these determinations and to take the actions which may be necessary, the comprehensive audit includes:

1. A study of the pertinent laws and legislative history to ascertain congressional intent as to the purposes of the activities engaged in by the agency, their intended scope, the manner in which they are to be conducted, and the extent of the agency's authority and responsibility.
2. A review of the policies established by the agency (and to the extent applicable, by the central control agencies) to determine whether (a) they conform to the intent of Congress, and (b) they are designed to carry out the authorized activities in an effective and efficient manner.
3. A review of the procedures, practices, form of organization (particularly as to the segregation of duties and responsibilities), and system of reporting, review, and inspection as well as other elements of internal control to determine whether (a) provide reasonable assurance of control over expenditures, receipts and revenues, and assets, (b) assure the accuracy, reliability and usefulness of financial data, including the budget statements and supporting data presented to the Budget Bureau and the Congress, (c) promote operational efficiency, (d) result in adherence to prescribed policies, and (e) assure compliance with the requirements of applicable laws, regulations, and decisions.
4. A review and analysis, by activities, of receipts and revenues, expenditures, and the utilization of assets together with all related control processes as a basis for evaluating the effectiveness with which public funds are applied and property utilized. This will include comparisons of performance with budget estimates and with results of prior periods and evaluation of costs of performance in relation to accomplishments.
5. The examination of individual transactions, the confirmation of balances with debtors, creditors, and depositaries, and the physical inspection of property, to the extent necessary to determine whether (a) transactions have been consummated in accordance with applicable laws, regulations, and decisions, and have been correctly

classified, (b) resources and financial transactions have been properly accounted for, and (c) control processes of the agency are functioning effectively.

6. The exploration and full development of all important deficiencies encountered and the presentation of appropriate recommendations for corrective action by the Congress, where needed, agency heads, or the control agencies such as the Bureau of the Budget, the Civil Service Commission, and the General Services Administration. This will include the reporting of any programs undertaken or transactions completed without authority of law disclosed during the audit as well as the stating of exceptions against accountable officers and the making of collections resulting from illegal or otherwise improper expenditures.

The satisfactory completion of this type of audit, in addition to fulfilling the audit responsibilities imposed on the Comptroller General, will enable the General Accounting Office to furnish assistance to the appropriation committees and to the Bureau of the Budget in connection with their consideration of annual budget estimates and to furnish more satisfactory comments to the Congress on substantive legislation affecting the operations of the various agencies.

Deviations from laws, regulations, and established policies and procedures, and other deficiencies noted in the audit by the General Accounting Office together with any suggestions for corrective action will be discussed promptly with the agency officials responsible in order to obtain their views and assure a fair and accurate reporting of the findings.

While General Accounting Office auditors are not empowered to direct changes in policies, procedures, and functions, they do observe opportunities for improving efficiency and for obtaining better results. When warranted, they will make recommendations for simplifying and developing more effective operating procedures and eliminating those procedures which involve duplication or which do not serve a purpose commensurate with the costs involved.

Although the term "audit" is a general term normally applied to the process of examining accounting records and documents, the term "comprehensive audit" is not restricted to accounting matters or to books, records and documents. The term is descriptive of those audits in which all the above-listed steps are performed. A comprehensive audit is an analytical and critical examination of an agency and its activities. While the goal is an evaluation

of the discharge of the agency's financial responsibilities, the scope of the comprehensive audit extends to all of an agency's operations and activities and to all of their aspects. The existence of good accounting records and sound accounting procedures is not a condition precedent to making a comprehensive audit. The accounting function is a management responsibility, the discharge of which is subject to audit review in the same manner as any other financial responsibility.

The comprehensive audit of a Government corporation will include the performance of all work deemed necessary to keep the Congress informed of the operations and financial condition of the corporation as required by law. When practicable, this will include an examination of accounts and financial statements to the extent necessary to obtain and express an opinion as to the fairness with which the corporation's financial statements present its financial position and operations.

Differences from commercial-type audit

The comprehensive audit may be contrasted with the usual annual audit of business enterprises made by independent public accountants. Although the term "commercial-type audit" has sometimes been used synonymously with "comprehensive audit" and although commercial audit techniques are used to the utmost, there are some important differences between the comprehensive audit and normal annual audits made by independent public accountants.

In the first place, the General Accounting Office stands in a uniquely independent relation to the agencies being audited because it is responsible solely to the Congress, a third party. Public accountants are generally responsible directly to their clients and only indirectly to third parties.

Other differences exist in the objectives of the two types of audits. Usually the annual audit of a business enterprise is made primarily for the purpose of arriving at an opinion as to the fairness with which the financial statements present the financial position and results of operations of the enterprise. The opinion of the independent public accountant as to the financial statements is an end result and is of importance to creditors, investors, and regulatory bodies. As already stated, the objectives of comprehensive auditing require the making of determinations on a number of matters in addition to the reliability of reported financial data.

Government agencies are generally financed by congressional appropriation rather than by investors and creditors, and such agencies are preponderantly of the nonbusiness and non-revenue-producing type. Also, the

Congress circumscribes in great detail the manner in which funds may be used or expended. For example, fixed amounts may be appropriated for specific programs and additional limitations placed upon the amounts available for various phases of a program and for specific types of expenses such as travel or salary. In addition, the manner in which the funds may be obligated and expended may be specified; e. g., prohibiting negotiated purchases, providing salary scales and the precise manner in which pay may be earned, and designating the manner in which travel may be performed. The comprehensive audit is sufficiently broad in scope and enough individual transactions must be examined to provide a basis for an opinion as to the agency's compliance with all these legal requirements as well as many others imposed by Executive direction, regulations of other agencies, and decisions by the Comptroller General.

Another difference exists in the responsibility of the General Accounting Office to examine into areas of inefficiency and waste in the administration and expenditure of public funds. Because of the manner in which a Government agency is financed and circumscribed in its activities, the stewardship concept in the handling of public funds is of great importance and must receive extended audit treatment. Similar conditions do not exist in many private enterprises and except in special cases, these matters normally are not explored by independent public accountants in making an annual audit leading to an expression of opinion of financial statements.

A fundamental difference also exists in the authority and responsibility of the General Accounting Office to adjust and settle accounts after audit. In the case of most Government agencies other than corporations, the General Accounting Office possesses and exercises the power to refuse credit to accountable officers for payments made illegally or improperly. In substance, this means that the auditors have the responsibility to disallow credit for and to enforce recovery of money improperly paid out by action against the accountable officer or his surety. This relationship is, of course, materially different from that between the independent public accountant and his client.

Differences from centralized voucher audit

The comprehensive audit also differs in a number of significant respects from the centralized voucher audit, the type of audit applied in the past to most of the agencies of the Government other than corporations.

The centralized voucher audit consists of the examination, at some central location, of expenditure and collection vouchers and related documents

submitted periodically in support of financial transactions of Government officers having personal accountability for public funds. The main objectives of this type of audit are to determine whether expenditures are made legally and solely for the objects for which appropriations were made. The extent of detailed voucher examination in this type of audit is not regulated by the effectiveness of operating or administrative controls exercised by an agency over its financial transactions except indirectly based on past audit experience.

In contrast, the comprehensive audit is performed at the site of operations, its scope encompasses the agency as a whole and its activities, and the extent of detailed examination work is governed by the adequacy and effectiveness of the controls exercised by the management over its operations, as determined by a study and testing of those controls.

Site audits

Another term sometimes used is the so-called site audit. All comprehensive audits are performed at the site. However, an audit performed at the site is not necessarily a comprehensive audit. The distinction between site audits and comprehensive audits lies in the objectives established in each case. Site audits include in varying degrees certain phases and objectives of the comprehensive audit, but when the term is used it means that all the objectives of the comprehensive audit are not present. For example, in a specific audit assignment it may be that because of lack of availability of personnel to accomplish the necessary review of vouchers to settle the accountable officer's account, documentation may continue to flow for a period of time to one of our central audit branches for audit review. However, one, two, or three persons may be assigned to the activity on the site to make a preliminary survey or to inquire into certain specific areas of activity. In these cases we might use the term "site audit."

Agency responsibilities

The primary responsibility for establishing and maintaining adequate systems of accounting and internal control, including internal audit, is vested by the Budget and Accounting Procedures Act of 1950 in Federal Government agencies themselves. In addition, the establishment of effective controls is required from the standpoint of sound fiscal management practice. However, systems of accounting must conform to the principles, standards, and related requirements prescribed by the Comptroller General pursuant to the Budget and Accounting Procedures Act of 1950.

APPENDIX "B"

STATEMENT OF THE
RESPONSIBILITIES OF THE INTERNAL
AUDITOR



THE INSTITUTE OF INTERNAL AUDITORS

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RESPONSIBILITIES OF THE INTERNAL AUDITOR

FOREWORD

This statement of the Responsibilities of the Internal Auditor was prepared by the Research Committee and approved by the Board of Directors of THE INSTITUTE OF INTERNAL AUDITORS, INC., at its meeting July 15, 1947. In taking this action the Board was desirous of lending its full support and that of THE INSTITUTE to the Statement. It was not intended, however, that the treatment of the various matters in the Statement was considered in any sense to be final or fixed. Rather it was recognized that the principles and concepts relating to internal auditing are evolving constantly. The approval therefore represented essentially an endorsement of what the Board believes to be a fair and considered statement of the responsibilities of the internal auditor at its present stage of development. The Statement is therefore subject to such further modification in the future as may appear to be warranted in the light of new conditions and needs and through further development in the professional stature of the internal auditor.

NATURE OF INTERNAL AUDITING

Internal auditing is the independent appraisal activity within an organization for the review of the accounting, financial, and other operations as a basis for protective and constructive service to management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of control. It deals primarily with accounting and financial matters but it may also properly deal with matters of an operating nature.

OBJECTIVES AND RELATED ACTIVITIES

The overall objective of internal auditing is to assist management in achieving the most efficient administration of the operations of the organization. This total objective has two major phases, as follows:

- (1) The protection of the interests of the organization, including the pointing out of existing deficiencies to provide a basis for appropriate corrective action.

The attainment of this objective involves such activities of the internal auditor as:

- (a) Ascertaining the degree of reliability of accounting and statistical data developed within the organization.
- (b) Ascertaining the extent to which company assets are properly accounted for and safeguarded from losses of all kinds.

- (c) Ascertaining the extent of compliance with established policies, plans, and procedures.
- (2) The furtherance of the interests of the organization, including the recommendation of changes for the improvement of the various phases of the operations.

The attainment of this objective involves such activities of the internal auditor as:

- (a) Reviewing and appraising the policies and plans of the organization in the light of the related data and other evidence.
- (b) Reviewing and appraising the internal records and procedures of the organization in terms of their adequacy and effectiveness.
- (c) Reviewing and appraising performance under the policies, plans and procedures.

SCOPE OF AUTHORITY AND RESPONSIBILITY

Internal auditing is a staff or advisory function rather than a line or operating function. Therefore the internal auditor does not exercise direct authority over other persons in the organization.

The internal auditor should be free to review and appraise policies, plans and procedures but his review and appraisal does not in any way relieve other persons in the organization of the primary responsibilities assigned to them.

INDEPENDENCE

Independence is basic to the effectiveness of the internal auditing program. This independence has two major aspects, as follows:

- (1) The head of the internal auditing department should be made responsible to an officer of sufficient rank in the organization as will assure adequate consideration and action on the findings or recommendations. The organizational status of the internal auditor and the support accorded to him by management are major determinants of the range and value of the services which management will obtain from the internal auditing function.
- (2) Internal auditing should not include responsibilities for procedures which are essentially a part of the regular operations of a complete and adequate accounting system or of a properly organized operating department. In some instances management may assign current operating responsibilities to the internal auditing department, but in such cases the execution of the current operating responsibilities should be performed by separate personnel and be subjected to the same review and appraisal as is accorded other operations.