

# 14

## C H A P T E R

# MANAGEMENT AUDIT

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### Relationship between internal auditing, operational auditing and management auditing

**14.1** *Internal auditing*, as already discussed, refers to a service function established within an organisation to examine and evaluate its activities. It may focus on financial reporting, compliance with policies, procedures, laws or regulations, fraud detection or improvement in efficiency and effectiveness. It may be noted that efficiency and effectiveness, as used here are distinct terms. *Efficiency* is an input measure. It relates to cost control and is concerned with performing recurring functions at a minimum cost to the entity. *Effectiveness* is output oriented and is a measure of productivity in utilising the firm's resources. *For example*, issues such as cost overruns, low rate of return on products, direct material usage exceeding standard are related to assessment of *efficiency* of operations while problem areas such as unfilled customer back orders, inability to meet production quotas, declining market share of a particular product, etc. are related to issue of effectiveness of operations.

*Management auditing* is concerned with review of operations and performance of management to improve efficiency and effectiveness of the organisation. It is, thus, an extension of internal audit function. Some authors use the terms management auditing and operational auditing interchangeably because of the close resemblance of methodology employed. But it may be noted, although operational auditing is also concerned with review of operations of an entity, management auditing, in addition to it also includes review of managerial performance. Secondly, the frame of reference of a management audit is derived, generally, from the expectations of the external participants and not of organisation's management as in case of operational auditing.

## Definition of management audit

14.2 A comprehensive definition of management audit has been given by *Sherer and Kent*<sup>1</sup>. They state,

*"A management audit is an independent review and investigation which is concerned with the identification of those functional and operational areas where management has failed to achieve the required external standards of performance and with evaluation of management decision making with the aim of monitoring and improving the total efficiency and effectiveness of the organisation".*

The following features of management audit are clear from analysis of the above definition—

- (i) Management audit is a comprehensive and critical review of managerial performance against external standards.
- (ii) Operational areas which have or may have problems are identified to locate waste and deficiencies and to ensure optimum utilisation of human and physical resources.
- (iii) It aims at improving the efficiency and effectiveness of the organisation by evaluating managerial decisions. Management auditor may suggest better system of quality and inventory controls and format of performance appraisal to improve the efficiency of the organisation. He may also help the management in its search for improved methods for better and more effective operations such as search for techniques of sales forecasting, changes in organizational structure, system of purchasing raw materials, changes in capital budgeting system, etc.

## Process of management audit

14.3 Management audit is a complex task and usually involves the following steps :

- (i) **Identifying the objectives of the business** - The auditor should identify the objectives of the business and examine whether they are clear, specific and reasonable. He should also assess the adequacy of objectives for earning reasonable profit, growth and survival of the business and fulfilling social obligations.
- (ii) **Segregation of overall objectives** - The overall objectives of the organisation are broken down into detailed targets and plans for various segments.
- (iii) **Review of organisational structure** - The auditor must examine whether the organisational structure is adequate to effectively achieve the overall objectives and detailed targets and plans.
- (iv) **Identification of responsibility centres** - In order to locate the probable weak points and develop/suggest control measures, the auditor should identify the various areas of managerial control within the firm. One possible classification would be as follows :

1. Sherer, Michael and David Kent, *Auditing and Accountability*, Pitman Books Limited, London, 1983.

- (a) *Planning and information systems*
  - Long range planning
  - Cost accounting systems
  - Cost controls
- (b) *Asset management*
  - Liquid asset control
  - Credit and receivable control
  - Inventory control
  - Capital budgeting system
- (c) *Marketing system*
  - Product planning
  - Market research
  - Sales forecasting
  - Sales analysis
- (d) *Production system*
  - Production planning
  - Quality control
  - Labour relations
  - Purchasing and procurement.
- (v) **Review of performance of each responsibility centre** - The performance of each responsibility centre is examined and, if possible, should be expressed in measurable terms. It is compared with set targets. Various procedures which are most significant in improving the quality of managerial controls are identified.
- (vi) **Reporting** - The auditor on the basis of the above review prepares a report on the overall performance of the organisation. The auditor may give recommendations to improve the efficiency and effectiveness of organisation. Management should try to implement suggestions as far as possible.

### Importance of management audit

**14.4** The demand for some impartial evaluation of management performance beyond that implicitly provided by financial reports led to the development of the concept of 'management audit'. It is undertaken for various reasons. Some of them are as follows :

- (i) **Improving efficiency and effectiveness of the organisation** - Management audit entails the review of managerial policies and actions. Such a review helps to identify managerial deficiencies and operational problems which may arise as a result. The management may take appropriate corrective actions in time to reduce the effect of these problems. Besides identifying deficiencies, management audit makes important suggestions with regards to various controls and techniques to be adopted for better and more effective operations.

(ii) **Assessing the efficiency of management** - In case third parties propose to commit funds for the business, they assess the efficiency of management through management audit. Examples of such situations are mentioned below :

- (a) *Granting loan or participation in equity* - A bank or a financial institution may get a management audit conducted before advancing loans or before agreeing to participate in the equity capital of an undertaking. This helps in avoiding the probable loss on account of inefficient management.
- (b) *Reviving sick units* - Many times the Government gives financial assistance to revive sick units. In order to ensure proper utilisation of such resources the Government may examine the efficiency of the management of the unit by conducting management audit.
- (c) *Foreign collaborations* - Foreign collaborators, prior to investment into the concerned unit, may arrange to conduct the management audit. Even after collaboration, they may like to get management audit conducted periodically in order to assess the managerial performance.

It can, thus, be seen that management audit serves as a tool for attesting the effectiveness of management's stewardship and control in many situations. This, in turn, leads to improvement in efficiency and effectiveness of the organisation

## Appointment of management auditor

### Who appoints the management auditor

**14.5-1** Management audit is not compulsory under law. The shareholders or board of directors may appoint the management auditor.

### Who should be appointed as the management auditor

**14.5-2** No specific qualifications have been prescribed for the management auditor. Generally, chartered accountants are appointed as the management auditor. In order to conduct management audit, the auditors should have sufficient knowledge about techniques to review management controls, methods to conduct intensive analysis of information needs and assessing the efficiency of the existing system in meeting them; conducting financial analysis and so on. To put it simply, a management auditor should have sufficient knowledge of accountancy, financial administration and management.

### Terms of appointment

**14.5-3** The terms and conditions of appointment, the scope of audit work, the period to be covered, the time frame of the submission of audit report and similar issues are settled through the letter of appointment of the auditor.

## Audit report

**14.6** The audit report should be clear and unambiguous. Although there is no set format of management audit report, generally, it is divided into three basic sections—

- (i) the first section describes the scope and nature of examination;
- (ii) the auditor evaluates, and compares the past and present performance in the second section; and
- (iii) in the third section the auditor evaluates the current management procedures and suggests improvements. However, the suggestions offered should be backed by factual evidence.

### Management audit in relation to cost audit

**14.7** Both management audit and cost audit try to locate waste and deficiencies. But these are two different concepts altogether. The main points of difference are as follows:

- (i) **Definition** - Management audit is a *comprehensive and critical review* of all aspects of management process but cost audit is *verification of correctness* of cost accounts and of the adherence to cost accounting plan.
- (ii) **Scope** - Management audit is *not a statutory requirement* and the management auditor critically examines the policies and objectives of management, reports on their suitability and may give suggestions. Cost audit, on the other hand is a *statutory requirement* in case of certain companies. It is narrower in scope since the cost auditor confines himself to check cost accounts only.
- (iii) **Period under audit** - Management audit covers wide area of management activities and may be for *more than one financial year* while cost audit is conducted for *every financial year* separately.
- (iv) **Appointment of auditor** - The management auditor is appointed either *by board of directors or shareholders*. The cost auditor, on the other hand, is appointed *by board of directors* with the prior approval of the Central Government.
- (v) **Qualifications of auditor** - Management auditor's qualifications are *not prescribed by law*. But he must be a person having wide experience and knowledge in field of accountancy, management and financial administration. The cost auditor must possess certain requisite qualifications as per provisions of the *Companies Act, 2013*.
- (vi) **Submission of audit report** - Management auditor is required to submit the *audit report to the management* within the time period mutually agreed upon. While cost auditor has to send his report to *the BOD*.

### 14.8 Management audit and statutory audit

	Management audit	Statutory audit
(i) Definition	Comprehensive and critical review of all aspects of management process	An audit which is authorised, governed and made compulsory under any statute
(ii) Scope	Determined by engagement letter	Determined by the statute

## KEY POINTS

	<i>Management audit</i>	<i>Statutory audit</i>
(iii) Period under audit	More than one financial year	Only one financial year
(iv) Appointment of auditor	Board of directors or shareholders	As per statute's provision
(v) Qualification of auditor	Not prescribed by law	Laid down under statute