An Overview of Operational Auditing*

Associate Professor Şaban UZAY**

Abstract

The increasing competition, emerging because of globalization, urged organizations to focus on efficiency. The assessment of the effectiveness and efficiency of organizations’ operations is called “operational auditing.” The USA is the country that has the most advanced operational auditing. Changes in both the management concept and internal auditing profession have had important role on the development of operational auditing. Operational auditing is mainly the work of internal auditors and governmental auditors. According to recent research, operational auditing composes 28 % of the total workload of internal auditors. Operational auditing may have different aims, since it is steered by the requirements of the management. Primary types of operational auditing are functional auditing, organizational auditing, and special tasks. In summary, operational auditing is composed of planning, collecting evidence, and reporting. However, the success of its application depends on the capabilities and experiences of the operational auditor. Operational auditing has a key role in profitability (therefore the future) for private-sector organizations; as well as transparency (therefore economic and social development) for the public sector with a sense of accountability to citizens, emerged as a result of the development of a social-state concept. Therefore, sufficient resources should be allocated to operational auditing and to auditors who perform this task.

Keywords: Operational auditing, performance auditing, phases in operational auditing.

1. Introduction

At today’s organizations, marketing and competition are global concepts that target the all world markets. Firms and organizations aim to reach at world-standard efficiency. The low exchange rates and relatively lower inflation, emerged after the 2001 crisis in Turkish economy, led firms to review their competition strategies. The increasing competition, has made it compulsory for firms to conduct operational auditing. The analysis of firms in terms of their effectiveness and efficiency is briefly called “operational auditing.”

In the literature, operational auditing is also named “management auditing” and “performance auditing”. In addition, it is called “comprehensive auditing” in Canada, “value-for-money auditing” in Britain (Flesher ve Zarzeski, 2002:93).

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** Erciyes University, Faculty of Economics and Administrative Sciences (E-mail: suzay@erciyes.edu.tr)
Operational auditing is one of the tasks of internal auditors at firms. If there are no internal auditors at a firm, this service may be delivered by financial managers or by outside auditing and consulting companies. Operational auditing of independent auditors is generally called “administrative consulting” service (Selimoğlu, 1999:196). If there exists sufficient demand for operational auditing and if the necessary personnel for this task exist, then, independent auditing companies can perform operational auditing as optional auditing.

The purpose of this study is to present general information about operational auditing. For this purpose, the description of operational auditing, its history, differences from other types of auditing, its types, the auditing phases, and its levels of application in Turkey are briefly but systematically presented below.

2. Description and Specifics of Operational Auditing

Extended description of the operational auditing is as follows (Moeller ve Witt, 1999:21-2):

“Operational auditing is an independent review including all aspects of an organization; its business functions, financial controls, and the supporting systems. It involves a systematic review of an organization’s activities, or a stipulated segment of them, in relation to specified objectives. The operational auditor has an overall objective to assess the quality of internal controls for an area, including its effectiveness and efficiency of operations, reliability of the financial reporting, and compliance with applicable laws and regulations”.

Financial auditing, mentioned in the description above, involve internal controls for the financial structure. On the other hand, operational controls involve financial controls and performance metrics of the operations over the assets. Because of its common use at contemporary firms, information-system controls should also be considered as a type of operational auditing.

The measurement and assessment of the operational efficiency may change from a firm to another, and in fact, it may change from a department to another department. Operational auditing, to a great extent, is subjective. Therefore, operational auditors, rather than presenting reports on the measurement of the current achievements, they submit reports to the top management that include their suggestions on how to improve these achievements (Güredin, 2006:19).

The USA is the leading country in the development of operational auditing. During the development of operational auditing in the USA, General Accounting Office published a book in 1972, entitled “Standards for Audit of Governmental Organizations, Programs, Activities and Functions”. This book, which is commonly referred as the “Yellow Book”, has caused substantial changes in governmental auditing. These arrangements classified the governmental auditing into three groups: a) financial and compliance, b) economy and efficiency, c) program results. The last two groups may be considered within the field of operational auditing (Flesher ve Zarzeski, 2002:96).

The changes in management and internal auditing profession also have had important contributions to the development of operational auditing. The role of internal auditing has substantially increased after the Second World War and, besides the financial auditing, operational auditing was adapted into its scope. The need for operational auditing emerged as the number of big firms increased in the USA. In the beginning, internal auditors were expected to protect the assets, and they were considered as the police of the firm. However, with the developments in business, internal auditor has become an inseparable part of the management process.
The Concepts of effectiveness, efficiency, and economical

It is useful to elaborate on the concepts of effectiveness, efficiency, and economy that are used in the description of operational auditing. Effectiveness means reaching a goal, whereas efficiency means the efficient utilization of resources to reach this goal. For example, production without defects is called effectiveness, and production with minimum cost is called efficiency. On the other hand, the concept “economical” is used for being thrifty, that is, avoiding unnecessary expenditures.

Before starting operational auditing, specific criteria regarding the effectiveness should be created. In a similar way, criteria for efficiency should be created. Because reducing the cost without curtailing the effectiveness is regarded as efficiency, it is easier to create auditing criteria for efficiency. Basic resources of an operational auditor to use during the formulation of special auditing criteria are: previous experience, comparison, taking advantage of engineering standards, meetings and discussions within the organizations. For this reason, it is very important that all employers should be able to present their complaints and suggestions about the operations to the management.

Samples of leading types of inefficiencies that are encountered during operational auditing are given below (Arens, Elder and Beasley, 2005:767):
- Purchase of products and service at a very high cost
- Unavailability of required raw material
- Unnecessary repetitions by employers
- Commiting pointless acts
- Hidden unemployment; overemployment.

purposes and types of operational audits

There are three basic goals for operational auditing. These are (Selimoğlu, 1999:197):
- Determining the operations
- Determining the opportunities for the improvement
- Developing the offers for the future.

Operational auditing can be classified into three groups. These are (Arens, Elder and Beasley, 2005: 769) :
- **Functional audits**: In this context, function means the classification of the operations. For example, production function, purchasing function etc.
- **Organizational audits**: Organizational auditing tries to assess to what extent the interaction of functions at a firm are efficient and effective.
- **Special assignments**: In the context of operational auditing, administration can assign specific jobs.

The work of the internal auditing department of a firm, let’s say the Firm X, can be classified into five groups: operations, conformance, financial, research, and information-system auditing. Most of the audits can be classified in one of these groups. However, some of them may be a combination of these groups as well. Main types of operational auditing performed at a firm are as follows (Internal Control Guide for Managers):

“These adres cost accounting issues, recharge centers/user fees, internal control effects of proposed systems/process changes, performance measurement, pricing of services, in-house vs. contracting out/outsourcing issues, operational controls/procedures, process flows, forms, integrity of management information, and opportunities for more efficient and effective use of...”
resources to fulfill the unit’s mission and objectives. Also, includes providing assurance that system/process problems were properly corrected and that action was taken to prevent recurrence."

The fields given above require close familiarity with the organization. In fact, with its historical development operational auditing appeared as an extension of internal auditing (Selimoğlu, 1999:196).

**The Place of Operational Auditing in Internal Auditing Services**

Given the historical development of internal auditing beginning from 1940’s, it can be seen that the development process extended from accounting to operational management. Therefore, the scientific-management understanding of the last century has had an important role on the strengthening of internal-control mechanisms. In the beginning, the internal auditing function helped the management for the development and assessment of the internal-control system. Even because of this, internal auditing has been seen as an important part of the control mechanism, and it has been considered as “the control over control.” In the next phase, internal auditing has focused on the direct assessment of organizational efficiency, and offering suggestions for the detected problems (Jin’e and Dunjia, 1997:193).

From these explanations, it should not be conceived that all operational auditing should be performed by internal auditors, or internal auditors should work only on operational auditing. However, internal auditors have certain advantages in operational auditing. Internal auditors:

- Are relatively familiar with the production and operation phases of the organization,
- More independent compared to employers of other departments,
- Other advantages are as follows: Reporting to top managers; having sufficient time for conducting the operational auditing, having sufficient information and skill for operational auditing, and having no restraint in doing his or her job.

**Differences Between Operational Auditing and Financial Auditing**

Financial auditors’ dealing with operational auditing is not something new. However, their level of involvement is not as comprehensive as that of internal auditors. In addition to auditing teams, big-scale auditing firms have generally a separate “management consulting” team that provides this service. Although there are many common concepts in both types of auditing such as auditing process, techniques etc., there are also main differences, which are listed below (Arens, Elder and Beasley, 2005:767):

- Purpose of the auditing,
- Distribution of the Reports,
- Inclusion of nonfinancial areas.

**The Relation Between the Operational Auditing and Internal Control**

Internal auditing is an inseparable part of an efficient internal control. Internal-control procedures are mainly created and administered by the management of the firm. However, if an internal auditing department exists at a firm, it is easier to create efficient internal control policies and procedures. The control system and operational auditing reinforces each other. The existence of an efficient internal-control system contributes to operational auditing, while the suggestions formed as a result of successful operational auditing strengthen the internal controls as well as help the management toward reaching the firm’s objectives.

**Factors that Affect the Success of Operational Auditing**

Operational auditing is different from other types of auditing in that it has a wider scope, its criteria are relatively abstract, and it lacks standards of application at departments of a
firm. Therefore, to conduct effective operational auditing and for concerned managers to objectively assess operational auditors’ reports, there exist some critical points: (Arens, Elder and Beasley, 2005:770; Jin’e and Dunjia, 1997:195; Reeve, 1981:40):

- Independence of operational auditors
- Competency of operational auditors
- Creating a methodology for operational auditing
- Financial auditing is critical
- Internal auditing should be adopted by the firm
- Reporting is critical
- Time is critical
- Meetings are essential
- Evidence must be collected
- Accentuating the positive sides
- Giving specifics in the reports.

3. Phases of Operational Auditing

Although operational auditing changes from sector to sector and from firm to firm, its operational phases are similar. Operational auditing consists of three phases: a) planning, b) collecting evidence and evaluation, c) reporting and follow-up. Although there are substantial differences between operational auditing and financial auditing, they are similar in some ways. The phases of operational auditing are shown in Figure 1.

![Figure 1: Phases in Operational Auditing](source: Whittington and Pany, 1998:757).
Brief information about the operation auditing process is given below (Whittington and Pany, 1998:757-758):

**Definition of Purpose:** Functional and operational assessment of a unit with a designated aim. Auditors must determine the custom policies and procedures about the specific aims of the firm. Operational auditing has a broad scope at a firm, and it is generally planned according to the goals listed below (Moeller ve Witt, 1999:21-5):

- Ascertaining the extent of compliance with the defined policies, plans, and procedures
- Reviewing and appraising the soundness, adequacy, and application of operating controls,
- Ascertaining the reliability of management data developed within the organizations,
- Appraising the quality of performance in carrying out assigned responsibilities,
- Recommending operating improvements,
- Accounting for and safeguarding assets.

**Familiarization:** The auditor starts with the investigation of organizational charts, documents of functions and responsibilities, management policies and rules, and operation policies and procedures. At the end of this phase, the auditor documents the familiarization with the functions and processes through surveys, flow charts, and notes.

**Preliminary Survey:** Depending on the preliminary investigations, the auditor summarizes his or her results about the potential problems and critical points of the operations. The auditor uses this survey also in the development stage of an auditing program.

**Program Development:** Each operational auditing has a special structure. The auditor develops a program that involves the required tests and analysis for the operational auditing. Due to the difficulty of auditing, both the assignment of a competent auditing team and conducting the work according to the timetable are critical.

**Field Work:** This stage involves putting the operational auditing program into action. Analysis is another important part of this phase. The real performance of the firm is assessed using various criteria (such as budgets, efficiency goals, and performance of other departments). The auditor will base his or her suggestions on this assessment and analysis.

**Reporting the Findings:** The auditor summarizes in the report the findings on the basic aims of the auditing. Operational-auditing reports are not submitted to third parties, therefore they do not have a specific format. However, respecting a style guideline may be asked in the public sector.

**Follow-up:** Follow-up is required to elaborate on the shortages mentioned in the auditing reports. Generally, someone from the internal auditing team is assigned to this task. Sometimes, a short investigation is performed to enhance the important suggestions.

### 4. Practice of Operational Auditing in Turkey

According to the Turkish laws; banks, brokerage houses, private pension companies, and portfolio management companies are required to form an internal control system and an internal auditing department. There is no such legal requirements for firms whose shares can be purchased at the stock exchange.

In Turkey, besides the financial sector, there exist real sector companies with internal auditing departments. These are generally holdings or international companies that form
internal auditing departments as result of benchmark against other firms or of the vision of their top management. Operational auditing is generally performed by these internal auditing departments at firms. In Turkey, operational auditing is the main task of internal auditing at firms or groups of a certain size.

Besides investigating the legality of public resources, accounting for appropriate, timely and economic usage of resources; correcting the mistakes in the process; determining those who are responsible are among the scope of performance auditing (Altuğ, 2000:15). In many countries, (i.e. England, New Zealand, Canada, Australia) performance auditing in the public sector and passing laws regarding this kind of auditing started in early 1970’s.

In our country, the performance auditing was included to the tasks Turkish Court of Accounts, which is a supreme audit organization, with the change of related laws (Law No: 832) in 1996. Although the performance auditing is not the only task of governmental auditors, it is really important for countries with scarce resources such as Turkey. Therefore, performance auditing is expected from governmental auditors along with auditors of the Turkish Court of Accounts. On the other hand, qualified and hard-working governmental managers also demand performance auditing.

5. Conclusion

Operational auditing is a costly and effort-intensive field because of its broad scope and abstract criteria. Furthermore, expected results from operational auditing can be obtained if it is performed by qualified and experienced auditors. Therefore, managers of organizations should allocate sufficient resources to internal auditing for qualified personnel, technological support, and wage policy. It is also essential for these managers to continuously strengthen and increase the independence of internal auditors.

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