

# Operationalizing the operational audit course

Mary Brady Greenawalt

**Highlights the significance of operational auditing and methods of exposing students to operational audits**

The internal audit function is broad, encompassing financial, compliance, and operational audits. The operational audit is a significant area in which internal audit (IA) frequently provides a unique service. Recognizing the importance of operational auditing, it seems appropriate that an internal auditing course should focus on operational audit aspects. In fact, Gavin *et al.*[1] voiced a well-articulated appeal for a prominent place for operational auditing in the auditing curriculum in general. The first two sections of this article discuss the importance of operational auditing and the crucial role of internal control in the audit process. The remainder of the article reviews ways of gearing an IA course towards operational auditing, i.e. of operationalizing an operational audit course. The article examines means of exposing students to operational audits in a wide variety of situations, including different ways of structuring an operational audit project.

## **The operational audit: the internal auditor's bailiwick**

Because of the focus on the efficiency and effectiveness of operations, internal auditors provide some of their most valuable services to the organization by performing operational audits. While the external financial auditors may place a degree of reliance on work performed by the internal auditors or may utilize the assistance of IA staff, the outside audit firm still has the responsibility for the attest function for the financial statements. Similarly, regulatory agencies or other organizations concerned with compliance typically either send in their own auditors or hire an external audit firm. IA staff are likely to have full responsibility for compliance audits related to the policies, procedures, and other guidelines that are

internal to their own organizations, such as a corporate code of conduct. This IA work, however, only supplements that of the outside auditors when dealing with legal and regulatory compliance. IA often plays a supplementary role in financial and compliance audits, but operational auditing is the primary, albeit not the exclusive, bailiwick of the internal auditor.

One author[2] attributes the beginnings of operational auditing to the US General Accounting Office (GAO) in the late 1960s. The *Standards for Audit of Governmental Organization, Programs, Activities and Functions*[3] (also known as the "Yellow Book") disseminated information about auditing for economy, efficiency, and effectiveness. Descriptions of, and techniques for, carrying out operational audits, still being described as relatively new, appeared in the late 1970s[2,4]. Flesher[5] advised CPAs in public practice to consider offering operational auditing services to clients. The editor's preface to that article indicated, however, that, although the term "operational auditing" might be fairly new, that type of service was already being provided without using that terminology. While CPAs can, and do, perform operational audits as outside contractors, the internal audit staff's presence in an organization still lends itself to IA being the primary provider of operational auditing services to management.

## **Internal control: the operational auditor's "Open Sesame"**

Using a memorable analogy to a scene from an *Arabian Nights* tale, Sawyer[6] likens internal control to the magic words "Open Sesame" by which Ali Baba gains entrance to a cave filled with treasure. The key to operational auditors gaining acceptance by management in various areas of an organization is their knowledge and understanding of internal control.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) has recently issued a four-volume study[7] also known as the “COSO report”. This report, which was jointly sponsored by the Institute of Internal Auditors (IIA), the American Institute of CPAs, the Financial Executives Institute, the American Accounting Association, and the Institute of Management, represents a major effort to provide a common, widely accepted definition of internal control. Furthermore, the COSO report provides a framework of internal control which can be used as a benchmark for assessing its effectiveness. Despite criticism of it by GAO official Don Chapin[8], the COSO report has been widely hailed as a landmark study (see, for instance, [9-12]). The COSO report defines internal control as follows (emphasis added):

...a process, effected by an entity's board of directors, management and other personnel, which is designed to provide reasonable assurance regarding the achievement of objectives in one or more categories:

- effectiveness and efficiency of operations
- reliability of financial information
- compliance with applicable laws and regulations[7].

The COSO definition emphasizes the importance of internal control as a process which is put into effect by people at all levels in the organization. Thus, internal control according to the COSO committee goes beyond the IIA concept, as stated in Guideline 300.06 of the *Standards for Professional Practice of Internal Auditing*, that a control is an “action taken by *management* to enhance the likelihood that established objectives and goals will be achieved” (emphasis added). The COSO definition acknowledges that both management *and* non-management personnel play a significant role in making the internal control process function.

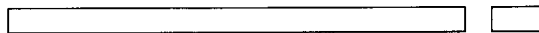
The COSO study identifies five interrelated components of internal control:

- (1) the control environment;
- (2) risk assessment;
- (3) control activities;
- (4) information and communication;
- (5) monitoring.

The underlying foundation of internal control, termed the control environment, is dependent on the people in an organization, their competence and attributes, including their ethical values. By the examples that it provides, management sets the tone at the top of the organization. In order to accomplish its goals and objectives, management must assess the risks that face the entity and devise mechanisms, such as control activities, to manage those risks. Information and communication

among people are vital links in allowing the control system to function. Monitoring of internal controls can be an ongoing process, such as managerial reviews, or periodic, such as an internal self-assessment or an audit.

The internal audit function fits into the COSO view of internal control as part of the monitoring process. Operational audits, of course, are those concerned with the objectives of efficiency and effectiveness. As Crockett[13] points out, however, a challenge that often confronts an auditor is that management has not formally specified its objectives. Such circumstances can require the auditor to deduce what have previously been implicit objectives and then ascertain that management is in accord with the objectives that have been identified.



## Understanding internal control functions is vital to the operational auditor

Whether internal control is viewed as the “Open Sesame” for the operational auditor, as per Lawrence, or operational auditing is viewed as a component of internal control, as per COSO, understanding how internal control functions is vital to the operational auditor.

### Exposing students to operational audits

In addition to textbook coverage, ways by which students can gain knowledge of operational auditing include the following:

- reading and reporting on journal articles;
- analysis of cases;
- comparison of audit reports;
- interaction with practitioners;
- writing case scenarios;
- performing an operational audit;

This section elaborates on these means of exposing students to operational auditing.

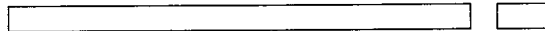
### Journal articles

Assigning students to select and report on articles pertaining to operational auditing exposes them to breadth of coverage of the professional literature. Selecting the articles may be accomplished, for instance, by browsing through hard copies of current auditing journals or by searching a database of business

periodicals for auditing topics. Either means allows the students to appreciate the variety of subjects addressed in the auditing literature. The writing assignment, which may be structured as a summary, a critique, a summary *and* critique, or a comparison of two or more articles, compels students to exercise their writing capabilities. By assigning short article reports early in the term, as the author does, the professor can discern which students need more work on their writing skills and send them to the campus writing centre for tutoring, if needed. Encouraging the students to present a brief oral report on the article provides each one with additional experience in oral communications, as well as introducing the class to a variety of articles about operational auditing.

### Cases

Case analyses are an excellent means of exposing students to operational audit situations and exercising their critical thinking skills. The "Roundtable" anecdotes which appear in each issue of the IIA's *Internal Auditor* often pertain to operational auditing, especially to efficiency findings. These can be viewed as mini-cases which show differing areas into which internal auditors delve. Additionally, these mini-cases can serve as exercises in which students can explicitly identify implicit efficiency and effectiveness objectives.



## "Roundtable" anecdotes often pertain to operational auditing

The IIA now has available two volumes of *Case Studies in Internal Auditing*[14,15], which are accompanied by instructor's guides. Since many of these cases deal with operational audits, they provide a good means of acquainting students with detailed information about various aspects of the audit process in different organizational settings.

### Audit reports

The US GAO makes its audit reports available to the public, thus providing a wealth of examples of operational audits to the interested professor and student[16]. Flesher[17] recommends assigning a project which involves each student comparing two or more audit reports from similar types of audit. After analysing the audit reports to determine how or whether they meet the criteria for effective reports, students present their

conclusions in oral form to the whole class and in written form to the instructor.

### Interaction with practitioners

Hearing an articulate, enthusiastic practitioner tell about his experiences with operational auditing is a good means of sparking student interest. Inviting the speaker to visit the classroom is an efficient way of exposing class members to the practitioner, and allowing time for student questions enables a dialogue to take place. While more time-consuming, one-on-one or small-group interviews at the auditor's place of work can also be valuable experiences. Interview sessions with practising auditors let students develop their interviewing skills and can provide the raw material for student-written cases.

### Student-written cases

Assigning students to write their own cases based on actual information challenges them in multiple ways[18]. Good interviewing techniques aid in eliciting "war stories" from internal auditors to serve as the basis for case scenarios. In writing up a case, the students need to understand both the case facts and the related IA concepts sufficiently to make them clear to the reader. Once the scenarios are critiqued by other students and revised, such student-written cases provide the basis for stimulating class discussions. Having someone who is quite knowledgeable of the context of the case situation, i.e. the case writer, is helpful so that additional details of the situation may be revealed, if desired. In addition, the case writer can, at the end of the discussion, disclose "the rest of the story".

### Performance of an operational audit

Once students have a basic understanding of internal audit concepts, gaining first-hand knowledge of the operational audit process provides valuable experiential learning. This experience may encompass performing an operational audit from start to finish, or it may be more limited in scope. In any case, learning by doing, via an audit project, is very beneficial, especially for students with limited work experience. Several articles have reported on their students' performance of full-scale internal audits while the professor acted in the role of audit supervisor. Brown[19] attended the opening conference with the auditee and student auditors and then kept up with the progress of student teams throughout the course of the audit by means of weekly status reports. Schwieger[20] provided feedback to his students after they conducted a preliminary survey and developed an audit programme. He then consulted with his student auditors as needed. Codori[21] related three separate instances in which her class of graduate students conducted an audit pertaining to attendance policies at their university.

All the audit projects described above used university departments or activities as audit subjects; in each case, the professor made preliminary arrangements with prospective auditees. Brown[19] and Schwieger[20] also dealt with outside auditees, either businesses or non-profit organizations, in the second year of supervising audit projects. Reports from the full-scale audits were presented to the auditees, and auditee reactions to the student audits were favorable. Brown's[19] three or four-person teams took up to 120 hours to complete their audits. Time reports prepared by Schwieger's[20] students showed that they worked 30 to 40 hours on the audit project.

### In a similar project MBA students carried out surveys

Greenawalt[22] described requiring teams of students to complete a preliminary survey, assess risks, and develop audit objectives using university activities as auditees. This more limited audit project assignment exposes students to the "real world" of internal auditing and related decision-making processes without requiring the same time commitment as would performance of a complete audit. In a similar project focusing on operational audits, individual MBA students in the author's class carried out preliminary surveys, often at their own place of work. The auditee's functions covered a wide range of topics, such as:

- purchasing procedures at a hazardous waste-recycling company;
- copier and fax services at a college;
- administration of user fees for recreational use of government-owned lake properties;
- shipment and disposal of radioactive material.

Another type of team-oriented project involves students in the assessment of controls of some aspect of the entity[23]. While less than a full-scale audit, control assessment for an actual client allows students to experience real-world aspects of the audit process.

Students at all the schools involved in audit-related projects responded very positively to the audit project assignments and recommended that future classes should be given the same type of opportunity. The hands-on, real-world experience provides students a laboratory in which to apply their internal audit knowledge and in

which to exercise their analytical, communications, and interpersonal skills[24]. Not only do such hands-on projects increase students' understanding of IA procedures, but also they heighten students' confidence about their capabilities, as shown by a student poll before and after audit project participation[19].

### Conclusion

Operational auditing is the bailiwick of the internal auditor, and it deserves special emphasis in the classroom. Students can be exposed to operational auditing by means of journal articles, reading and discussion of cases, and analysis of GAO audit reports. Using internal auditors as classroom speakers or having students interview internal auditors adds a personal dimension to the learning process, since a dialogue is possible. Carrying out part, or all, of an operational audit provides the student with valuable experiential learning, in which the audit process really comes to life for the participants. Whatever means are used by the instructor, operationalizing an operational audit course or course component can be of great benefit to the students and, ultimately, to the profession.

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Mary Brady Greenawalt is Associate Professor of Business Administration, at The Citadel, Charleston, South Carolina, USA.

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