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THE OPERATIONAL AUDITING FUNCTION AND ITS PLACE IN THE BANK STRUCTURE

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Many executives in financial management believe that operational auditing is a major new technique for improving the quality of both the independent and the internal audits. In the judgment of others, external and internal auditors do not have the imagination and training to undertake an operational audit effectively. Others are confused as to what operational auditing is all about.

In substance, operational auditing may be viewed as an approach to evaluating the effectiveness of operational controls and procedures. While it borrows much from financial auditing, it does require different attitudes, methods and skills.

Before we begin a discussion of operational auditing, it may be desirable to review the different objectives of the internal audit and the external audit by independent accountants. Traditionally, the internal audit is conducted to assure compliance with a bank's policies and procedures–conformity of the mechanics of recording and processing transactions with established procedures and, therefore, compliance with the predesigned system of internal accounting control. The examination of financial statements by independent accountants, however, has as its objective the reporting on the fairness of presentation of financial statements. It is true that the external auditor makes tests of the operation of the system of internal accounting control as a basis for relying thereon, but his principal objective is reporting on financial presentation.

In recent years, we have witnessed the services of internal audit staffs being expanded to include acquisition audits or businessman's reviews of banks or other finance-oriented companies to be acquired by holding companies. In my judgment, this expansion of services by bank internal audit departments represents a significant development–for it moves the internal auditor into top management decision-making circles. The undertaking of management or operational audits by bank internal audit departments likewise represents a significant thrust by internal auditors into a top management role. It requires talented staffs, of course, to implement these expanded services, and I will discuss the staffing of an operational audit team later.

THE CONCEPT OF OPERATIONAL AUDITING

Operational auditing is frequently defined as the analysis and evaluation of the working processes within an organization for the purpose of increasing earnings. A closer look at some of the key words in that definition would be meaningful.

First, an operational audit is an analysis and evaluation of all the working processes—the operational activities—in a given organization structure, whether the organization is a section, a division, a department or the bank as a whole. (The operational audit is concerned with the human aspects of the way work gets done—the way managers manage.) The other part of the definition, however, really provides the key and establishes direction and objectivity for an operational audit: The purpose of an operational audit must ultimately result in increased earnings for the organization unit. Without this direction, an operational audit creates a lot of wheel spinning, but no concerted action.

An operational audit would be expected to include at least four areas of analysis, each of which requires answers to certain questions:

1. *Organization*. What are the strengths and weaknesses of the organization? Does everyone understand his or her assigned responsibilities? Have employees been made aware of their responsibilities, or do they determine their own jobs and schedules? Is supervision effective? Is the basis for training an understood set of objectives, or are personnel assumed to be trained after two weeks of "observing"? Is there a schedule for cross-training?

2. *Policies.* Have necessary policies been developed to guide the activities and decision-making processes? If so, are they understood? For example, in the loan area, what kind of loan policies exist? In the tellers' area, how extensive are the teller policies governing their authority, disposition of balancing differences, absenteeism, etc.?

3. *Procedures and work flows.* How efficient are the procedures? How effectively are people and machines utilized to perform the overall activities? Are forms designed for optimum efficiency and control?

4. *Reports.* Are reports meaningful, providing the data needed for both operating and top management? What information should be reported but is not, and, conversely, what information is reported but not really needed?

The objectives of the operational audit relate specifically to improving earnings by eliminating duplication of effort, improving procedures and forms, centralizing work functions, and implementing production control and scheduling. It should be used primarily as a support tool to determine why certain responsibility centers are falling short of their contribution to earnings and to provide the reasons for that responsibility center's results. By digging into the cause of the problem with an operational audit, it is possible to find out why the problem exists, determine a solution and install a system for controlling it. These control systems may be in addition to the financial control offered by the profit plan and can be as simple or as complex as the particular problem requires. They may include formal policy restraints, increased training programs, compensation incentive awards, or, more frequently, the establishment of performance standards or production controls for measuring clerical utilization and effectiveness.

STAFFING THE OPERATIONAL AUDIT TEAM

As noted above, in their traditional roles both the internal and the outside auditor are principally concerned with reviewing and reporting on transactions that have occurred in the past. Managers of operating departments are often of the opinion that we are in the privileged position of "second guessers," reporting on and evaluating what happened in the past. Their world, however, is the present and the future—the business of improving the working processes within the bank for the purpose of increasing earnings. Perhaps it is because so many auditors have carried out their principal audit objectives with tunnel vision that management considers them not qualified to evaluate the working processes within an organization. Nevertheless, in my years of public accounting, I have yet to meet with an audit committee of the board of directors that failed to ask the independent accountants' opinion on the effectiveness of the working processes within the organization. Frequently such a question is also posed to the general auditor of the bank or company as well.

This brings me to the premise that there is nothing in the concept of operational auditing per se that precludes it from being performed by an internal audit staff. However, perhaps more in banks than in other enterprises, we must exercise caution to assure ourselves that the internal audit staff does not become identified with operational management at the expense of the traditional internal audit function of testing compliance with authorized procedures. I would suggest that the leader of the operational audit team be a well-trained analyst, probably someone recruited from outside the internal audit department and the bank. The key concern is that the analysis of the OA be objective and free from historical biases. (This is one reason why qualified outside consultants have been so effective in operational audits.) He or she should be a talented and imaginative individual, one with sound analytical ability. I cannot stress too strongly the need to keep the audit staff objective! This is a good reason for using staff members other than those who have been part of the operation for years. Trainees, if guided by experienced analysts, frequently are good for this sort of thing.

An operational audit program could also be implemented by using qualified outside firms to perform projects as assigned or a combination of in-house staff and consultants. In the latter situation, the outside consultants may be used to get the program started, perhaps in one or two key problem areas, using and training in-house people on those initial projects. After the completion of those projects, an in-house staff can continue to function as needed in other areas or can periodically review the progress being made in implementing needed improvements.

Here it may be appropriate to note that banks vary in their approach to assigning responsibility for the function of operational auditing. In the past, the function was generally exercised in either the controller's or the operations department. Recently, probably as a result of programs such as the seminars and workshops sponsored by the Bank Administration Institute, the American Management Associations and others, the function is being assumed by more internal audit departments in banks. In the situations of which I have direct knowledge, the general auditors have recruited special personnel from outside the department to oversee the program. In my experience with commercial enterprises, as contrasted with financial institutions, the operational audit function has more frequently been housed within the controller's department.

CONDUCTING THE OPERATIONAL AUDIT

Each operational audit should be designed for the special situation. A simple checklist of the general steps for successful completion of an operational audit is often helpful, particularly in the initial stages of conducting operational audits. Such a checklist would generally include the following:

1. Define the purpose and scope of the audit.
2. Interview the supervisors and employees.
3. Research and evaluate published material relating to the matter being studied.
4. Document and flowchart existing procedures.
5. Install basic activity counts or other preliminary measurement techniques.

6. Analyze and evaluate the strengths and weaknesses of the existing procedures and the alternatives.
7. Prepare the detailed recommendations.
8. Review the recommendations with management.
9. Implement the improvement and control techniques.

Generally, operational audits should be conducted as a continuing process. Unless procedures are reviewed with an eye toward their improvement or elimination, established time standards and clerical utilization reports may show a department to be efficient at performing inefficient tasks.

PARAMETERS OF OPERATIONAL AUDITING

Each operational audit will differ from the others. The audit objective may be concerned with long-range planning; budgeting, both operational and capital; management control and responsibility reporting; the cost accounting system; general accounting systems; cash management; production planning and control; marketing planning and control; data processing organization and operation; marketing and production planning relationships; etc. In carrying out the nine general steps of an operational audit listed above, the operational audit frequently serves as an objective information-reporting system, particularly as to the effectiveness and scope of internal controls, in areas where breakdowns of functional responsibilities occur, in areas where cost reductions can be implemented and on how executive controls relate to corporate policy and profit objectives.

INTERFACE WITH MANAGEMENT

Who initiates the operational audit? In the definition proposed above—namely, the analysis and evaluation of the working processes within an organization, performed for the purpose of increasing earnings—the purpose of an operational audit as ultimately resulting in increased earnings was stressed. It could be said, therefore, that the profit plan identifies the problem areas within a bank from the standpoint of low earnings contribution. Accordingly, a close working relationship with the controller's department is likely to exist where there is a successful operational audit team.

The operational audit function, if it is to be effective, must be placed high in the bank management structure and the support of top management communicated to all levels of operating management. The operational audit can dramatically strengthen the overall impact of the profit-planning function on a continuing basis and also have a substantial positive impact on net earnings of the bank. •