AREAS OF MANAGEMENT AUDIT

3.01 Management Audit according to American Institute of Management concentrates upon the following areas of management function in the Corporation:

   i) Economic function
   ii) Corporate structure
   iii) Health of earnings
   iv) Service to stock holders
   v) Research and Development
   vi) Directorate analysis
   vii) Physical policies
   viii) Production efficiency
   ix) Sales vigour; and
   x) Executive evaluation.

It is to be emphasised that these 10 categories are not exclusive mutually. They broadly cover the various functions of management. These areas are further explained below.

3.02 Even in the approach to management audit of these areas there is a two stage analysis.

   i) Compilation of data for analysis and evaluation; and
   ii) Analysis of information obtained.

3.03 For the purpose of compilation of data, detailed questionnaires are used that cover management performance in each of the audit areas

mentioned above and relevant to the context, over a number of years. These questionnaires and their construction will be discussed later.

The information thus obtained is amplified by holding interviews with the concerned corporate and field managers, directors and a wide range of others. Naturally, this will include employees, managers, suppliers, customers, stock holders and even creditors. Besides this, additional material is to be assembled from other companies in the same industry. This is for an inter-firm comparison. The same approach can be adopted in the case of a service enterprise as well as in a manufacturing enterprise. But, the significance of audit areas may vary between the two.

3.04 The auditor has to develop a methodology for collecting information from within the organisation and also from other corporations within the subject industry. It may be added that the success of the second stage and its utility depends on the thoroughness and correctness with which data are collected during first stage.

3.05 In the second stage, collected data of first stage are analysed in great detail, to develop appraisal conclusions on each of the individual categories of management activity. From these categorywise appraisal conclusions, overall performance evaluation of management is developed. One can say that this is the most critical phase of management audit. Even if the data collected are complete, if it is not properly evaluated and scientifically analysed, proper findings cannot be arrived at. However much one may be sincere and syst
in management audit, it is to be stressed that ultimately subjective 
judgement enters into the appraisal and as such the auditor has to 
be personally experienced and skilled.

3.06 Wider the base of data on which findings are arrived at and 
wider the collection of data and comparison, lesser will be subjective 
element in the audit finding. Findings are based on uniform and 
general conceptual foundation. The concept underlying the system 
is that the management, in final analysis, is nothing but purposeful 
and effective action. As such, management audit is perhaps the best 
technique so far developed to measure the correctness and effective-
ness of the actions taken by the management or to identify the action:
that should have been taken or should be taken in future. It could 
also make SWOT analysis with reference to the auditee company and 
come up with suitable findings. In fact, the only limit for manage-
ment audit is the limit of time, energy and funds that could be spent on 
that, keeping in view the economic return.

3.07 It may be appropriate now to look at the above 10 audit areas 
of management audit and identify their scope and applicability.

Economic function:

3.08 This function involves management's continuing responsibility 
for the enterprise's position or importance to the economy. This 
can also be called the public value of the corporation. This is based 
on its products and services and how it functions in the legal and 
ethical environment. Naturally, it comprises such intangibles as 
reputation of the company and management's interpretation of the 
purpose of the enterprise.
3.09 The public purpose or the public value referred to above includes not merely consumption of the company's products or services or its share-holders or employees but also others with varying interests, who are, in one way or another, affected by the activities of the company and the way the company seeks to satisfy them. These others could be suppliers, distributors, the local community, the state or even the country as a whole in which the company operates.

3.10 Economic function has to be considered as a cumulative evaluation factor. Until a company has gone through series of yearly cycles, met with competition over a period, established its reputation in the area, in the community or industry in which it operates and has developed and replaced its management teams and has built up an image or reputation for itself it is difficult to establish or assess its economic value. This takes time. This means track record or trend analysis, to enable measurement and assessment as to whether it has or has not served the economic purpose. The recent controversy in this country concerning certain public enterprises or even Government services, regarding their public purpose, social objectives, eligibility to continue and to tap the public funds, centres round the economic function, the economic achievement and even their right to exist. Hence, in their context management audit of their economic function is the most appropriate and scientific technique of determining whether they should continue, whether they have served the purpose and whether they have got a future or a right to continue to serve.

Corporate structure:

3.11 This area covers the effectiveness of corporate structure, built
up by the management and through which it seeks to achieve its aims, goals and objectives. The corporate structure specifies the areas of responsibility and authority of the various levels of management and the emphasis is on the top executives. It must not only facilitate their execution but also ensure that these decisions are adhered to. They must also have effective control over the enterprise. In this regard, the formal structure and informal structure should be studied. It is the legitimate function of management audit.

3.12 Often the formal organisation chart differs from the ground conditions and they are to be identified by actual management audit. Some times, the formal organisation chart is of little use to a management auditor. This must be kept in view while appraising the corporate structure. Vast difference may also highlight the urgent need for restructuring the corporation.

While considering the corporate structure, other issues like the level of decentralisation, the need for decentralisation, delegation of authority, etc., should also be looked into by the management auditor. Generally, decentralisation follows the lines of authority. There could be exceptions also. In some large corporations, decentralisation has far exceeded the lines of authority and has resulted in breakdown of the exercise and acceptance of authority. As such, need for decentralisation, delegation of authority and accounting for responsibility are be gone into.
Health of Earnings:

3.13 This aspect concerns historic record of earnings of the Corporation and its prospects for the future. It is concerned with not only the quantum of income, but also with the corporate income formation. The audit is to determine whether the full profit potential of the Corporations in the selected field of activities has been realised. Assets may take many forms. But it is the management function to employ these assets for full utilisation of their potential. As such, the question should be not how much profit was made, but how much profit could have been made. To make this evaluation, study must be made of the potential in the market outside and of the risk assumed in the employment of the resources and the actual return by way of profit by their employment. This makes it necessary to give proper consideration to the nature of, value and distribution of the assets among various categories and the turnover of stock, capital etc. Industrial activities are eminently suitable for this type of analysis. Yet, in ascertaining or fixing the value of certain types of assets such as patents, licences and processes, there may be problems. Similarly, in determining the potential while applying these assets also, there may be practical problems. Even then, management audit should attempt to assess the cause of their selection, their current book value, their percent return and their potential return.

3.14 Information regarding book value of the assets will be available in published accounts. The returns from the assets will also be available from the certified statement of accounts, furnished by
the Statutory Auditors. The management auditors, experienced and intelligent, will be involved in assessing the potential in their application.

**Service to Stock Holders:**

3.15 In this audit area, management audit appraises how far the management team has discharged the mandate or direction given by the stockholders and how far they served the stockholders sincerely and suitably. How well the management has fulfilled its mandate can be said to determine the quality of service to stockholders.

3.16 The mandate from stockholders to the management will fall under three parts (a) amount invested shall not be expended for unnecessary requisitions (b) value of the principal must be increased as much as possible, through effective use of corporate, undistributed profits; and (c) stockholders shall receive a reasonable return on their principal in the form of dividends or other pre-emptive rights. In short, these will fall under security, growth and return. Management audit would look into all these three divisions of the mandate of stockholders. It may be mentioned here that this is not applicable only to the private sector. It is equally applicable to public sector as well, wherein the public as a whole are the stockholders. Government is their representative. As such, Government is entitled to expect from management of public enterprises security, credit and return on the capital entrusted to them. This is dealt with in greater detail later.
3.17 In addition, management audit would also review how well the shareholders are kept informed so that they can evaluate the progress of the corporation as to its soundness, its management and also participate in vital decisions that may have a real effect upon their investment and which can be taken only by the stock holders.

Giving stock holders expectations due importance, management shall think of generation of surplus which is important. The sound relationship between the management and stockholders is the basic foundation of the entire structure of corporate arrangement.

3.18 It may not be possible for the management auditor to theoretically have any hallmark or optimum dividend return to judge the performance of management. Similarly, it is very difficult to judge the competence of management from dividend returns and growth of security. Ultimately, management performance has to be judged by the sum total of all the three categories. As such, the judgement has to be well reasoned but composite. It cannot be based upon any one current factor and must be measured over a period of time.

3.19 In the case of public sector enterprises, due application of assets is very special because of social obligations they undertake and also because of their control over prices. As such, while judging the performance of their management, purely based on financial books of accounts and from dividend returns paid or not paid, all the relevant factors should be kept in view and a considered opinion arrived at. Any unilateral or rigid approach will more often than not end in incorrect and some times hazardous conclusions.
3.20 It may be well said that scientific research alone can assure the corporation stability, growth and enhancement in its competitive position. Management audit, to evaluate the totality of function of management should take into its ambit the corporation's policies on research and development. Larger corporations, in every field, have recognised the importance of research as an essential and continuing activity. However, programmes of research and the need for research vary from industry to industry. In fact, many small and intermediate companies may not have any research infrastructure. Research requires to be based on clarity of objective and affordability. Moreover, research is based on expectations in future and an element of risk is always present. As such, research itself is bound to be a calculated risk and management audit helps to analyse the effectiveness of that expenditure. The whole approach helps to maintain proper balance between investment in research and expected or probable return on that investment.

3.21 Research must be examined both comparatively and historically on such matters as amount spent, ratio of research cost and staff to other expenses and costs and the results of research and the benefits flowing from these by way of increased turnover, reduction in cost, increased profit, etc. There could not be any standard cost. Invariably the management auditor goes by the previous experience or record. Many companies establish their own thumb rule of 5%
on research or something like that. This will also be based on the previous experience and it is upto the management auditor to examine these thumbs rules and their reliability. However, this thumb rule cannot be interpreted as an unbreakable rule. In fact, according to American Institute of Management, there is no simple formula for the analysis of research. The emphasis is on determining what part of the company's progress can be legitimately identified as the result of research and how the present research projects are preparing the company for the future.

3.22 More important than even the expenditure or findings of research, it is the utilisation of results of research by the management that shall be examined in greater detail. After all, benefits of research could be reaped only if they are put to use. What is primarily necessary is the willingness on the part of management to accept the results of research, develop new products or new markets or modify the existing products. Management must take all steps necessary to realise the potential of the results of research. Evaluating the willingness of the management and the efforts made by the management is very essential for the management auditor.

**Directorate Analysis:***

3.23 Under corporate set up, the entire authority of management is vested in the Board of Directors. It has the power to appoint and remove every executive, in the interests of the ultimate owners
and the public. As such, the effectiveness of the directors must be assessed through management audit. For this purpose, the following issues have to be looked into:

(a) the qualification and experience of each director and the contribution he or she makes to the Board.

(b) The integral set up of the Board and whether the Board acts as a single entity. The directors should complement and stimulate each other instead of dividing the Board. This is very important as the Board is expected to act as a group with necessary internal understanding and compromise. Any internecine criticism among them will affect the working of the company.

(c) How well the Directors act as trustees for the assets of the company and discharge the responsibility may also need analysis.

3.24 While examining discharge of responsibility by the Directors, it is important to analyse areas in which conflict of interests exists between the corporation's business, its executives, its owners and the public. These areas of conflict may involve particular directors. How the Board has handled these issues and how the Directors have reacted will indicate how far the concept of trusteeship has been carried out.

3.25 It is also important to measure the effectiveness of the Board as a group. Almost every Corporation has got an audit committee, management committee, etc. These committees are expected to meet more frequently than the Board of Directors and facilitate decisions taking. They are expected to save delay in decision making. The functioning of these committees and their effectiveness should also be gone into by the management auditor. The qualification of the members of the committee and the contribution and new thinking they are able to bring to the decisions of the executives
will indicate the utility of these committees. The management auditor should go through the constitution, working and minutes of meeting of the committee of directors on important issues, analyse their discussions, decisions and the follow up action.

**Fiscal Policies:**

3.26 Apart from the record of earnings, the fiscal policies will cover past and present financial policies of the corporation. The key areas to be audited herein are providing, controlling and applications of funds. The three important areas of study would be:

(a) evaluation of capital structure of the corporation;
(b) evaluation of its internal organisation for developing fiscal policies and controls and application of the policies and controls in the various areas of corporate activity.

**Operational Efficiency:**

3.27 Every one recognises that operational efficiency in areas like production, etc., is important in appraising the overall success of the corporation. What is important to notice is that operating efficiency is of importance not only for manufacturing companies but also for all types of activities. This includes banking, finance, insurance, communications, transportation, utilities or any field in which the product may or may not be a tangible output.

3.28 The principle is that virtually all corporations that are not merely agents for others must have input of resources, process the inputs and deliver goods or services and even market them. This is the cycle of overall operations. The efficiency with which
the corporation performs this cycle is evaluated through operating efficiency. It is important while analysing operating efficiency that it must be recognised there are areas for looking as indicators of efficiency, which will however vary from activity to activity. For example, in a manufacturing enterprise, this will include consumption of raw materials, energy, labour productivity, conversion ratio and output. It will include management of machinery and raw materials. Their relative importance may again vary from industry to industry, depending on the cost structure and nature of activities. Similarly for non-manufacturing activities various inputs and outputs have to be identified and evaluated. Only when both inputs and outputs are analysed, the entire gamut of operating efficiency would have been gone into.

Sales:

3.29 The importance of marketing and sales can vary materially from industry to industry and even for a corporation from product to product. Each market or product or corporation may require different marketing strategy. As such, while evaluating marketing efficiency or marketing performance, these factors must be kept in view. The best method is to make a comparative appraisal by having the review encompass the performance of marketing wing over a length of period. Wherever possible it can be compared with other sections of the corporation or even with other corporations. While appraising marketing policies, sales vigour should also be looked into. However, such an appraisal must give proper consideration to the product or service marketing goals set by the company or the marketing goals under each/
The review must first determine or identify these goals and then appraise the performance vis-a-vis the goals. The appropriate goals for each sector as well as for the entire organisation should be properly distinguished. Sometimes trade off between various activities and goals may also become necessary and this must be thoroughly evaluated.

Executive evaluation:

3.30 Finally, management audit should evaluate the performance of the team of executives and individual executive. While all the others look at one section of the executives or one section of their activities, this one will be the summation of all those activities. It appraises net result of the total thinking and action of management in the various categories. Broadly, important goals of this analysis could be listed as under:

(a) evaluating the quality of executives;
(b) appraising the management philosophy of executives;
(c) appropriateness of the findings and conclusions in relation to overall performance of the organisation under review;
(d) recommendations to make the executives more effective.

Naturally, such a review will evaluate their ability, industry, integrity and imagination. This is the sum total of management audit.