

# Management Audit in Small & Medium Enterprises: Balancing a Watchdog and a Strategic Partner Role

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## **Abstract**

*Small & Medium Enterprises (SME) always confronts with limited resources, so that the effectiveness, efficiency and economy issues become really important to study. Management Audit function will help management to manage those issues by identifying business risks, developing internal control system and monitoring transactions. The focus of management audit, as literature suggest, now has evolving from becoming a watchdog toward a strategic partner. This paper, therefore, will study the management audit roles in real situation. We conducted case study over three SME's, which outsource management audit function, in period of June 2009 to March 2010. The Companies are Company A, a start up Company with annual sales of Rp5 billion, Company B, 5 years old company with annual sales of Rp30 billion, and Company C, 20 years old company with annual sales of Rp50 billion. We collected the data by conducting interviews, direct observation and reviewing financial statements. The findings confirmed the management audit roles in identifying internal control weaknesses and developing internal control systems. Management audit also successfully initiate some major changes. We suggest that the management audit function keeps balance of watchdog role and strategic partner role, and maintain full support from owner and senior management.*

*Keywords: Small and Medium Enterprises, Management Audit, Strategic Role, Key Success Factors*

## **1. Introduction**

Small and Medium Enterprises (SME) in Indonesia contribute significantly to Indonesian Economy. By 2008, the total SME in Indonesia is amounted to 51.26 millions units and represents 99.99% of business unit in Indonesia. Its contribution to Indonesia GDP in 2003 was 56.7% and employ 99.6% of Indonesia workforce (Brata, 2003). Hence, the SME roles in employment and national economics growth are substantial.

Berry et al, 2001 outlined three reasons why developing countries should pay attention to SME, (1) SME's performance is better on creating productive labor, (2) the productivity increase through investment and changing technology (3) SME's has more flexibility than big companies. Similarly, Kuncoro suggested that SME in Indonesia plays important roles in absorbing employment, increasing unit of business and supporting family income (2000).

However, there are still some problems that limit the potential of SME in Indonesia to grow. Those problems are lack of financial resources, lack of competent employee, lack of channel and distributions, lack of raw material supply, lack of technology, lack of access to banking system, lack of quality system and many more (Rahmana, 2008).

Therefore, this paper will explain how management audit can help the SME's management in achieving the Company's goal. The discussions then will be divided into three main issues:

1. What is the need and expectation of SME in using management audit?
2. What is the role of management audit in SME day to day business?
3. What are the key success factors of management audit in SME?

The remainder of this paper will be arranged as follow, the second section will discuss the literature reviews and previous studies on management audit, third section will discuss the methodology, the fourth section will discuss our data collection and analysis and the last section will discuss the conclusion of this study.

## 2. Literature reviews and previous studies

Management audit can be defined as a systematic process to evaluate management and the organization's functioning and performance with respect to economy, efficiency, effectiveness of operating areas, activities and results (Burrows and Perrson, 2000). Sawyer gives similar definition as the comprehensive review of unit activities, systems and controls within an enterprise to reach economic, efficiency, effectiveness or other objectives (2001). Kumar & Sharma added that management audit is the periodic assessment of company's managerial planning, organizing, actuating and controlling to norms of successful operation (2006).

Management audit is significantly different with financial audit or general audit performed by an independent accountant. Some of key differences are depicted in Table 1.

Table 1. The difference between financial and management audit

Financial Audit	Management Audit
1. The objectives is to give opinion on financial statements	1.The objectives is to give opinion on business operations
2.The criteria is Generally Accepted Accounting Principles (GAAP)	2. The criteria are effectiveness, efficiency, economy
3. Criteria used is	Auditor mus design

given by standard setter	and select criteria by benchmarking, best practices and company target as criteria
3. The analisis basically using quantitative approach	3. The analisis combines quantitative and qualitative approach
4. Must be done by an independent accountaant (public accounting firm)	4. Might be done internally or outsourced.
5. Done annually	5. Done continuously or anytime when necessary
6. The report is mainly for outsider, such as investor,	6. The report is mainly for insider / management

The concept of management audit is relatively new and often intertwined with concept of internal audit and operational audit. They do have many similarities but also have some difference. The internal audit is conducted by internal auditor appointed by management to "highlight the weak areas in the organization". Operational audit, "generally reviews the performance of an organization at middle and supervisory levels of management". Management audit, on the other hand, is concerned with examination and evaluation of management process as a whole. (Kumar & Sharma, 2006)

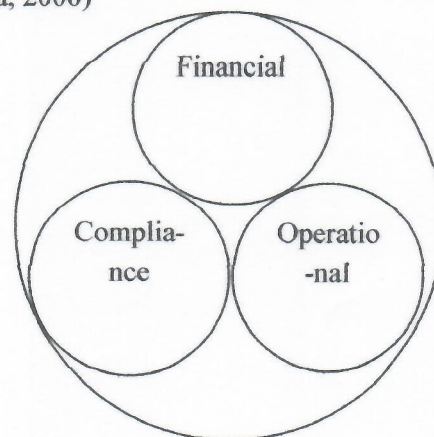


Figure 1. Scope of internal audit

Hence, the scope of management audit are ranging from evaluation of effectiveness, efficiency and economy of the Company business process. Some researchers said that the management audit is part of internal audit function (Kumar & Sharma, 2006, Sawyer, 2001)

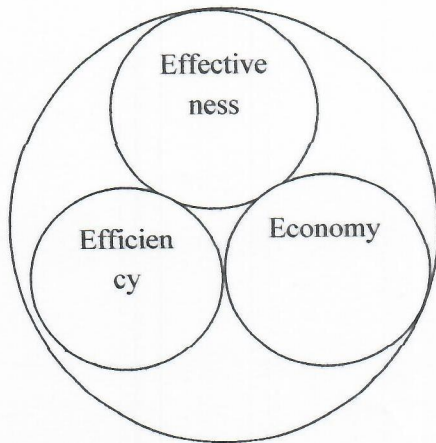


Figure 2. Scope of management audit

Effectiveness means that the Company can reach its goals; efficiency means that the Company in reaching its goals using minimum resources and economy means that the company buys the asset in cheapest alternatives available.

Hence, some examples of management audit activities to achieve those goals are (Kumar & Sharma, 2006):

- 1) Appraised the managerial performance at all levels
- 2) Enhance operational profitability
- 3) Improve organizational efficiency
- 4) Spotlight the decisions or activities, which are not in conformity with organizational objectives
- 5) Ascertain that organizational objectives are properly understood at all levels
- 6) Discover weaknesses or irregularities in the internal control system and suggest measures to get best possible results

- 7) Evaluate plans and policies.
- 8) Review the company's organizational structure, i.e assignment of duties and responsibilities and delegation of authority
- 9) Facilitate performance evaluation of different resources

McDafee and Selim (1998) study on internal audit functions suggest that internal audit or management audit focus on risks rather than controls of transactions. The risks are something that obstacles for organizational success. They criticize auditor focus on controls over transactions because it will bury the internal auditor in details of the past, limiting the value of any information derived (1998). The focus on risk is known as a new paradigm of internal audit. The new paradigm has major support from the Institute of Internal (IIA) Audit, which continuously suggests the use of IT and focus on risk to enhance the quality of internal audit. As management audit can be grouped into internal audit services, so that the new paradigm also can be applied in the management audit practices.

### 3. Research Model

#### 3.1 Case Study Approach

This study uses case study approach to answer the three questions as outline in first section. Case study is "an empirical inquiry that investigates a contemporary phenomenon within its real-life context; when the boundaries between phenomenon and context are not clearly evident; and in which multiple sources of evidence are used (Yin, 1984, .23).

The study of management audit in SME often faces with limited data. The practices of management audit in SME is also limited, therefore the case study approach is suitable approach.

We conducted the study mainly use participant observation method. The

Companies below hired us to be their internal audit.

### 3.2 Sample of Study

Based on Law No 20/2008 on Micro, Small and Medium Business in Indonesia, the small business criteria are (1) net asset other than land and building is range between Rp50.000.000 to Rp500.000.000, (2) total sales around annually around Rp300.000.000 to Rp2.500.000.000. The medium business criteria are (1) net asset other than land and building between Rp500.000.000 to Rp10.000.000.000, (2) and total annual sales between Rp2.500.000.000 to Rp50.000.000.000.

The sample of this study consist of three companies which represents the characteristics of SME in Indonesia, which are start up companies, small company and middle company. Due to confidentiality matter, hereafter, the companies will be called as Company A, Company B and Company C.

Company A is an IT and printing company which established on 2006. It was founded by two young men with two difference talents, a marketer and a programmer. This company enjoyed a rapid development due to some contracts from major companies to print out their member cards. In the peak of order, the Company can produce and deliver almost 600,000 cards per month. The IT divisions also gain a good reputation among customers. Their services are not only build a website but also doing consultation on how to run internet business for their client. The main problem of this company was lack of support from finance and administration staff.

Company B is a computer hardware trading companies which directly imported some products from Taiwan and sell to local computer dealer. This company started in 2002, and now become one of major player in Yogyakarta. The average sales of this company annual sales of is Rp30 billion with total assets of Rp10 billion. This company considered an

efficient company with strong network and distribution channel. The main issue of this company is in inventory.

Company C is a major dealer of Honda in Yogyakarta and Jawa Tengah. With the total revenue almost Rp50billions in 2008 and total asset, other than land and building, of Rp 40 billions, this company might be considered as medium company. The company had expanded very quickly with more than 3 branches. The total employee of this firm is almost 300 people. The rapid development created many problems, such as low commitment and low motivation of the employee since the believed they are underpaid, less capable person to hold a more complex business, span of control become too broad, so it is hard for management to cope.

Summary of selected company characteristics is shown in table 2.

Table 2. The characteristics of sampled companies

Characteristics	Company A	Company B	Company C
Net Assets	5 bn	10 bn	40 bn
Annual Revenues	5 bn	30 bn	50 bn
Employees	32	27	150
Branches	-	2	3
Divisions	4 units	1 units	2 units
Age	5 years	7 years	20 years

### 3.3 Data Collections and Analysis

We collected the data through direct observations, interviews and document reviews. The data are mainly qualitative data. We documented the data in working papers and analysis them by sorting, coding categorizing and finding the red line.

We analyzed the data focusing in answering the three questions as outline in the first section. To make easier to answer how management audit can help SME's, we discussed the issues surrounding the management audit process and then use the evidence or finding to answer the three questions.

#### 4. Management Audit Process

In order to help management to achieve the company's goals, the management audit team must perform management audit effectively. Effective audit mean the audit will produce the intended result (Ramli, Ramli, Yusof, 2010), which is in the case of management audit are effectiveness, efficiency and economic business process. In order to achieve the intended result various factors must be considered. Audit must have a feasible objective so that it is attainable and everyone understand and accept it. This paper suggest the framework to conduct an effective management audit, based on our observations in the three selected companies, as follow

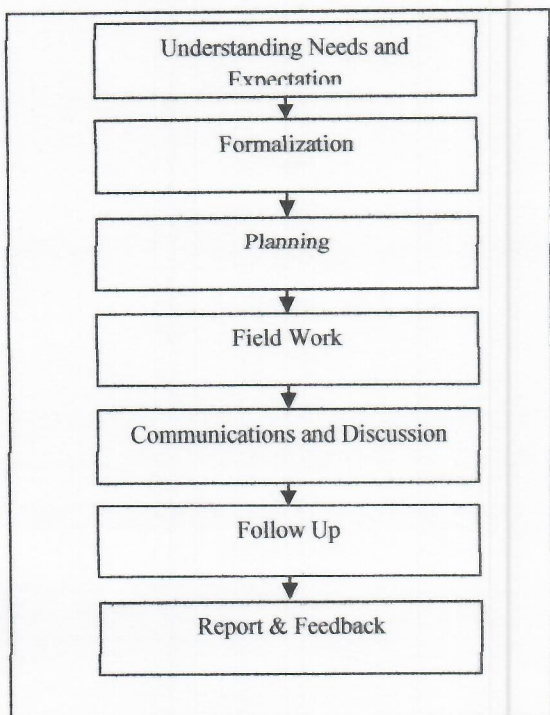


Figure 3. A Model of Management Audit Process

#### 4.1 Understanding SME's Needs

To deliver high quality and effective management audit, we need to understand deeply to the needs and expectation of management. It is different with general audit, which the scope and procedures are standardized, in management audit the scope and procedures is designed to meet the needs of expectations of clients. Since the needs and expectations are vary and sometimes subtle, management auditor must have high communication and analytical skills and deep understanding to the industry where the SME's operate.

The best practice to cope with this issue is conducting a kick off meeting in the beginning attended by owner, directors, managers, management audit providers and other important stakeholders, if any. This meeting's objectives are to clarify and confirm the understanding of what SME's needs currently and what SME's expectation of the service s and benefits of management audit.

The companies we selected as samples of our study pose a different needs and expectations. This is partly because they initially came to the decisions to outsource management audit for different reasons. The Company A has a problem of high turnover including in administration and finance staff. Within the same year before we come, they have twice resignation from finance staff. They thought that this problem might alter their operation and they also worry with the work of previous finance staff, because they admitted that they do not paid much attention and control to her works. The Company B felt that the competition in computer hardware trading

become tighter and the company had tremendous growth for the past three years. The management felt that their staff capabilities, especially in finance department, are not enough to cope with the challenge. The management often had difficulties to find data and information to support their decisions. The management also felt that the data on their stock is inaccurate and out of date. The Company C had a special need. The management felt that there was fraud in one of their business units.

We had documented the needs and expectations of the client. But we understand that the initial information does not represent the real needs and expectations. However, by documenting the information, at least, we have a basis to formulate the service offer.

#### **4.2 Formalizations**

The management audit team then discussed the information from the kick-off meeting to outline the contracts, terms of reference (TOR) and audit charter. The contracts will specify the scope of services, the deliverables or output, and the management audit fee. For a detail, we attached the terms of reference that outline the responsibilities of both parties, regarding the planning, collection of data, analysis, reporting and recommendations. By presenting the management audit team's understanding of client needs and expectations in forms of legal documents, we expect that the misunderstanding of both parties will be limited.

We found the problem in Company C, it seems that the management does not read carefully or do not fully understand what is written in the contracts. So there are a lot of things being asked for that are outside the scope of work. This causes a complicated situation,

because if we agree to what they asked for, it will alter the main jobs, but if we do not agree then they will be disappointed and do not cooperate in collecting the data and information. We deal with this problem by having an intense discussion with the owner and ended by splitting the task into two projects, management audit and consulting.

Other than contract and TOR, we also proposed to have an audit charter which is the formal document to explain what is our position and role in the organizations. This is important, since we as an outsider but doing internal management audit, work not on a project basis, but doing regular activities. So our presence must be known for the entire organizations. The selected companies have different approaches. Company A issued a management decree ('Surat Keputusan/SK') mentioning our positions as in charge Finance Manager. Company B did not issue any formal decree, and only mentioned our presence in the general assembly and provided us with a Surat Tugas during if we need to go to branch or perform special examination. Company C officially appointed as audit committee and reported directly to the owner.

We believe that the position and formalization of our position in the organization have an impact on the effectiveness of management audit role. We often have a problem on suggesting a recommendation in Company B staff. One of the staff told our staff "who are you, why you told me to do this and that". We brought this issue to the management, and reached the conclusion that the recommendations and evaluation should be reported directly to the management and they will do the follow-up. This approach created a new problem. Some staff think that our role is like a watchdog that monitors and reports the

mistake to the owner. Although this is true that one of our function is performing monitoring, in some occasions this resulted less respects and cooperation of staffs to us.

### **4.3 Management Audit Planning**

Management audit Planning is crucial. Lack of management audit planning might resulted audit failure (Ramli, Ramli, Yusof, 2010). Management audit planning is different with general audit planning due to its scope and period of audit. The general audit is one-off audit usually performed in year end, but management audit performed continuously through the year. Therefore, the team should plan the audit carefully. The resource of the team should be allocated wisely.

The management audit team performed preliminary survey to gather some data and information as basis for audit planning. The steps in the preliminary survey are checking legal & formal documents, observation to Companies' business operations and interview to some key persons.

In the selected Companies, the team use risk based approach to analyze the preliminary survey result to formulize audit plan. The approach required the team to identify and measure the business risks, inherent risks and control risks. The business risks is the risks that hinder the companies to achieve its business goal, the inherent risks is the risks that embedded in the area or accounts and the control risks is the mistake or misstatement due to lack of internal control. The team should focus on the high risk area.

We found that the high risk areas in Company A are the sales and receivables, inventory and cost of good sold in Company B, and loan and payables in Company C. We,

therefore, put more resource and time on those areas. Later, we recommend to the management to put more control on those high risk areas.

The result of the planning is audit areas, assignment schedule, staff assignments, deadlines and deliverables and audit program. The formal audit planning is signed by the management audit team leader and the owner or director.

### **4.4 Field Work**

The field work objective is to collect the evidence to support management audit team opinion and suggestion. Management audit team conducted field work based on the audit program outlined in planning stage. The team focused on looking for findings, which are the discrepancies of the real conditions and agreed criteria. The criteria in management audit are less standardized than in general audit. To determine effectiveness criteria, we derived from the company objectives, targets, benchmark, standard ratios and the industry best practices. For the efficiency criteria we used the standard ratios and target of the company. We also doing routine financial audit for the selected Companies monthly reports to check the accuracy and consistency with the Standard Operating Procedures (SOP). For compliance audit we only compare the company and employee practice with its SOP.

We documented all of our work done and findings in standardized working paper. The working paper will functions as reference, monitoring and coordinating media among of the team.

Our procedures consisted of checking documents (vouching), interviewing, direct

observations or inspections, analytical reviews and confirmations.

#### **4.5 Communications and Discussions**

We brought the findings during our field work during our weekly meeting with the management. We presented our findings in the format of background, the criteria, discrepancies, consequences and recommendations.

Often there was tight discussion in the weekly meeting. The management of Company A, B, and C challenged our findings and recommendations. Therefore, it's very important to present the evidence during this session, because the evidence speaks for itself.

We documented the weekly meeting into minutes of meeting (MoM), so we have tools to track the progress and development of the projects. Often our initial understanding is difference with the findings from the fieldwork, resulted the modification or change of scope in the audit.

The management of Company A, B, C valued the weekly meeting, since they can have the up to date of the project and the picture of their company. Other than weekly meeting, we conducted quarter meeting that invited larger attendees.

We were not only presented the problems that we had found but also the recommendation on how to solve the problems. The problems that the team successfully identified were lack of coordination and monitoring in all of selected companies, lack of internal control, the absence of SOP in high risk areas, no clear job descriptions and target among employees, some inefficiencies in Company A, errors in handling inventory in Company B, wrong calculation of cost of good sold in Company B,

and fraud amounted to Rp1.1 bn in Company C that then successfully recovered.

#### **4.6 Follow Up**

The implementations or follow up of the solution is the management responsibilities. The management audit in this case will give technical support and monitoring.

In general we have suggested the company to restructure its organization structures, detail job description of each employee, set some SOP's on financial reporting, implement cash centralization, introduced standardized management reports and map the needs of companies of new system.

The management audit's recommendation also had initiated some major changes in the selected Companies. In Company A, the finding of lack coordination among divisions resulted the restructuring of organization structure and legal forms. The management also conducted in house training for its manager, since based on the management audit findings; the managers did not fully understand the role and responsibilities of a manager. Management of Company B, hired two new staff so the segregation of duties follow good internal control standard. Company B also initiated the developments of computerized systems to overcome the problem of its inventory and cost of good sold. Company C also restructure its organization structures and appointed a general managers to oversee all of unit business. Management C also initiated some new SOP's and development of computerized system to one of its business unit.



#### 4.7 Report & Feedback

The management audit report mechanism much affected by the position of management audit team in the organization, as discussed in point 4.2. The direct link to owner or top management helps management audit team to have support and suggestion immediately if they face any problem. The direct link also important to build image that the management audit function is strategic and powerful. The image will help the management audit in collecting the data and information from the staffs.

Other than continuous meeting and communications, the management audit team also published a formal report quarterly to signify the audit process and findings. The report was circulated among senior and top management. *This regular meeting is important to support continuous improvement driven by management audit. As pointed out by Barthelemy and Zairi (1994), the audit should evolve from compliance audit to continual improvement, thriving, ultimate and total audit.*

The management audit also asked for feedback from the management regarding the audit process and finding. Surveys of employee satisfaction were circulated among employee to measure the perceptions of employee to several initiatives post management audit project initiated. A majority of employees felt the management audit functions help them to solve the problem they faced. They also can freely give feedback and criticism of the organization and top management to management audit team. They feel that the management audit team can play as a mediator between them and top management. So the employee perceived the management audit team as a partner, rather than 'top management representative'.

The management feedback also important to evaluate whether our audit approach and techniques in management audit is effective. The feedback also can be used to scale down or scale up the scope of management audit so it meets Client need and expectation.

*Figure 4 Proposed Effective Management Audit Model*

## 5. Conclusion

### 5.1 The need and expectation of Management Audit

Based on the above explanations, we can conclude that the need of SME to have management audit are:

- increased complexity of organization and business as company grow

- suspicion or indication of any fraud incident
- the high turn over of staff, especially in finance department
- the need to build a standardized system on management and finance

The management's expectations toward management audit are:

- better management control, so that top management can spend more time to develop business and think strategic issues
- perform fair and proper performance management
- be a partner of management in identifying and solving problems

## 5.2 The Roles of management audit

The roles of management audit can be grouped into two different approaches, the watchdog approach versus a strategic partner approach. Based on our observation the management audit functions in each approach are as follow:

### Watch Dog Roles

- Accounting staff supervisions
- Transaction verification
- Management reports review
- Fraud investigations

### Strategic partner

- Develop SOP's or new systems
- Develop performance measurement system
- Involve in budgeting process
- Give input for strategic planning

Most of SME still in developing phase, so the balance of the two approaches would be suitable in this context. What the literature suggest that Management Auditor should focus to be a strategic partner, does not mean that the management audit

## 5.3 The key success factors

Based on the observations and interviews, we conclude that some of the factors below are considered key success factors of management audit in SME

- Obtaining Strong and consistent supports from owner and top management
- Drafting a detail contract and term of reference to minimized over expectation of management
- Performing continuous and regular update of findings and progress of audit
- showing tangible result early, small evidence and some quick wins are important to gain the management confidence at the beginning
- Make a balance of monitoring (a watchdog) and developing systems (a strategic partner)

Those findings are consistent with the previous studies, which founded that typical audit problems or failures are due to lack of audit preparation, audit criteria elements or checklist driven, auditor skills and knowledge, commitment from the management, and bureaucratic reporting (Askey & Dale, 1994; Karapetrovic & Willborn, 2002; Barthelemy & Zairi, 1994).

In conclusion, performing management audit in SME will lead to some positive changes but the management auditors have to take the SME characteristics into account to deliver the service effectively.

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