

# Comparative analysis of basic paradigms in internal audit development

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**Abstract**—the article considers the comparative analysis of the three paradigms of evolutionary development of the internal audit (supporting, system-oriented, risk-oriented) on such characteristics as - target. Task object, character, type, and thrust of the recommendations of the auditor, which allows more to articulate the basic features of the modern paradigm of internal audit.

**Index Terms**—comparative analysis, internal audit, internal audit paradigm.

## I. INTRODUCTION

Increased risk organics and strengthening of competition within the external economic environment alternate the requirements towards the quality of corporate management, as well as towards the volumes of disclosed information and the number of parties concerned for the corporate subjects, which does not only change the external audit parameters but also transforms the essential traits and functions of the internal audit. A functional direction of the internal audit is becoming more and more extensive and is not being limited merely to the verification of financial reports and compliance to the legislation in effect. The internal audit is being integrated into the managerial and informational functions of the corporate management for economic entities. The new kinds of internal audit activities concerning the risks assessment, corporate management quality assessment, managerial decision-making, evaluation of prognostic financial information, etc., appear and develop. [1] All these are a reflection of an evolution of internal audit which has undergone several development paradigms, not only for the Russian Federation but for the developed countries as well. In R. Dodge's opinion, the following three "evolution stages may be detected in the audit procedures: the first being a supporting audit, the second stage – system-oriented audit, and the third and the final stage – risk-based audit" [2]. In the course of supporting audit, a special attention is paid to verification of primary accounting documents and registers. A system-oriented approach to the audit implies an observation of control systems of an entity subject to audit. Application of the risk-based audit procedures means an emphasis of the auditor's effort on the areas in which the risks of mistake and fraud from the partakers of corporate management are higher. The three types of audit (supporting, system-oriented and risk-based) are pointed out at in the works by V.I. Podolskaya [ 3], V.D. Andreyev [ 4], I.N. Bogataya, N.T. Labyntsev and N.N. Khakhonova[ 5], I.N. Dmitrenko[6]. With this, as R.A. Alborov [7] puts it, the former two types of audit are connected with the alternation of goals and functions of audit aimed at the verification

optimization: cost reduction for auditor's services, acceleration of audit. From the viewpoint of O.V. Kovalev and Y.P. Konstantinov [8] all the three mentioned types of audit are different in the methods of verification and not in the goal or structural characteristics. The influence of the three main paradigms of the internal audit development has also been reflected in the diversity of methodological approaches to the research thereof that convey the nature and the goals of the internal audit. Thus, the internal audit has been made equal to the system of internal control itself by one of the authors [9], while the other authors [10] consider the internal audit as a variety of external audit having its own specific goals and tools. The third group of the authors [11] position the internal audit as an independent element of management system which doesn't merge with the internal control area as it "provides not only the information about the activities of an organization but also confirms the correctness and confidence of the managers' reports". From the viewpoint of the fourth group of the authors, the attention is concentrated on independent and advisory activities of internal audit in the spheres of corporate management, risks management and control of business processes in the organization [12]. Each of the three paradigms of the internal audit has played a dominant role in a different period, and has altered the goals, the objectives and the structure and nature of the procedures, as well as the implementation methods of the procedures, interconnection grade with the business of the entity, etc. Against this background it is expedient to accomplish a comparative analysis of the said evolutionary paradigms of the internal audit development which will help to characterize the trends and the factors of the modern stage of internal audit development more precisely. A supporting paradigm of internal audit was dominant as long as up to 1940-ies, and concentrated on the verification of fiscal (accounting) reports; its goals were to execute the auditor's function – prevention and detection of abuse. At this stage, the main audit client was the line management, and the internal auditor was directly subordinated to the chief accountant; the audits were held irregularly. Within the framework of this paradigm, the main objective of internal audit was to conduct fiscal (accounting) reporting. Aside from the confidence verification of fiscal (accounting) reports, the system-oriented paradigm aimed the internal audit on the efficiency of the internal control system. On the modern stage, the main internal audit clients are the Directors' Board (audit committee at the Directors' Board). This provides for a complete independence of the internal auditors from the line management of the organization. This paradigm has occupied the leading positions due to the unification processes in the requirements system for the

internal audit which has been taking place in the USA since 1985. This paradigm is connected to the activities of self-regulated organizations for internal audit. This paradigm has further developed in 1992 into a General Control Integrated Concept known as COSO. Compliance to the COSO principles was not an obligatory requirement for the commercial organizations although this model and its principles underlie every control system that has been offered afterwards. The risk-oriented paradigm of the internal audit consists in an accent of auditor's attention on detection of risks in the activities of an entity subject to audit which risks may affect the distortion of fiscal (accounting) reports and affect the control tools used by an entity subject to audit in order to withstand such risks and by the auditor to plan and to implement against such risks. As the detection of the risks and the management of the risks have become the integrate elements of a corporate management system, a new approach has been facilitated. This approach allows the auditor to rely on an effective counteraction against the risks taken by the entity under audit with a certain measure of founded sureness. These measures include a detection of risks by the entity, application of appropriate control tools and monitoring of efficiency of these tools by the internal audit services. The risk-oriented paradigm of internal audit that has been actualized since the beginning of a new millennium extended sufficiently the sphere of its activities, having added the rank of its problems with a wide range of issues in the area of corporate management, risks management and control of company's business processes. Within the framework the risk-based paradigm, internal audit is based on consolidation of the responsibility for financial services, operational processes and the inherent risks of the line (operative) leaders on every level of management. It is based on the recognition of broad access to the corporate information by the top managers, shareholders and stakeholders who set the level, the nature and the direction of the company operation risks. Despite the fact that the risk - oriented paradigm of the development of internal audit is at the present stage a dominant and a structure-forming paradigm, the conceptual boundaries of this direction are not unambiguous for the foreign researchers. Thus, some authors believe that a risk-based audit involves the expansion of prospects of the internal audit through the use of all methods of risk management, not only the internal control methods [13], the others emphasize the warranting character of the internal risk audit, especially for the managers of organizations, inasmuch that all risks should be adequately controlled [14], and the third group of the authors emphasizes the methodological integration of the internal risk audit into the risk management system of the enterprise [15], the fifth group pays attention to the independence and professional nature of the internal auditor's opinion about whether the risks are being managed according to the level adopted by the management or not. [16] The table 1 [17] represents a comparative analysis of the evolutionary paradigms of internal audit development. In general, it can be remarked that the modern concept of

risk-oriented control has incorporated the best features of the previous evolutionary stages of the internal audit development, and is based on the following elements:

- rejection of the canonical approach to planning of the control procedures not taking into account the different levels of risk and based on the formal requirements of regulations and rules (which are required but are often a result of a compromise and not the absolute truth);

- Implementation of an approach based on the identification and monitoring of the level of risk which is acceptable for the organization;

- Transition of a responsibility for risk identification and assessment onto all levels of management and all units, and "embedding" the control processes helping to mitigate the risk into business processes;

- Transfer of functions of providing warranties and independent evaluation of the effectiveness of internal control and risk management process to the internal audit.

The risk-oriented concept of internal audit has been further developed in the documents of Basel Committee dealing with the operational risk management. Many new ideas stated in the latest COSO lay-out titled "concepts of Risk Management for an Enterprise" (2004) were partially reflected in these documents. The said lay-out represents a further development of COSO model in connection with the increased threat of terrorism and high-profile events of international companies' bankruptcies caused by an incorrect financial reporting and internal audit implementation. The modern integrated development concept of internal audit reflects the convergence of national corporate management models that predetermine the nature, direction, scope and purpose of corporate reporting to the owners, top managers, Board of Directors and other stakeholders. The contemporary paradigm of internal audit development has been affected significantly by the specificity of the national corporate management models reflecting the grade of a conflict between the parties of corporate management, the degree of information exposure of the public companies, the nature of equity, the power and the methods of opportunism of the top managers influencing the risks of distorting of fiscal (accounting) reports, etc. In other words, the international audit standards represent not only a certain concept of its development, but also the risk ogenetics and competition levels in the external economic environment, the convergence grade between the internal and external mechanisms of the national corporate management principles within the framework of which the modes of action and fulfillment of internal audit and control are being formed. This aspect is especially crucial for the Russian companies provided a strong differentiation in the course of the Russian public companies' development which is reflected in a vast number of small and middle stock companies with unsatisfactory parameters of corporate management quality as well as in a powerful impact of the state corporations [18] which lead the way for the national corporate management model. For the smaller corporations, the costs of internal

audit within a risk-oriented paradigm are too high and thus they focus on the supporting audit, and only a small part of the middle-sized Russian joint stock companies are able to apply systems-based audit effectively, and an effective risk-based internal audit is only available for the large Russian companies. Thus, a comparative analysis of the internal audit evolutionary paradigms has demonstrated that all three paradigms of the internal audit are not entirely mutually exclusive but are to some extent complementary to each other as they constantly improve and influence each other allowing to characterize the modern development paradigm of internal audit as an “integrated” and “mixed” one, with the *dominant* functional role of risk-oriented paradigm of internal audit development which is a system-forming factor transforming the goals, objectives, object, structure, methods and procedures, as well as the quantitative and the qualitative thrusts and nature of the development of national guidelines for the internal audit development for the large corporate structures.

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**Table1: Comparative analysis of the evolutionary paradigms of internal audit development**

Feature	Internal audit paradigm		
	Supporting	System-oriented	Risk-oriented
Period of domination	Before 1941	From 1950 till 1996.	From 1999–presently
Independence of audit	none	Gradually increases	Prominent
Goals of audit	Verification of fiscal (accounting) reports; control of assets	Verification of fiscal (accounting) reports; verification of efficiency of an internal control system as one of the organization management subsystems	Increase of efficiency of organization’s functional management alongside with the reduction of entrepreneurial risks, business process management and corporate management
Objectives of audit	Verification of fiscal (accounting) reports; Inspection of material and technical assets soundness	Verification of fiscal (accounting) reports; inspection of the internal control system; operational efficiency assessment	Improvement of risks management processes, improvement of control over operational and strategic organization management
Main clients	Top	Top managers,	Top

	managers, line management	line management	managers, Audit committee, Board of Directors, and other parties concerned (stakeholders)
Audited entity	Fiscal (accounting) reports	Fiscal (accounting) reports; internal control system	Risks management, corporate management quality of the internal control system for business processes
Types of audit	Fiscal audit	Compliance audit Operational audit	Strategic audit of the entire organization and its structural units
Nature of audit	Single-time, periodic	Constant short-term	Constant long-term, integrated monitoring advisory audit
Thrust of the final recommendations of audit	Confidence and control over fiscal reports	Efficiency of the internal control system (cost reduction of control procedures, increased efficiency of control tools)	Economic risks management strategies (assumption, insurance and prevention), business processes management, corporate management quality control

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- [17] Compiled by the author based on the research materials.
- [18] As a rule, the state corporations do not undergo an internal audit as their activities are regulated by specific federal laws.

#### AUHTOR'S PROFILE

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