

Contributions to Management Science

Plamena Nedyalkova

Quality of Internal Auditing in the Public Sector

Perspectives from the Bulgarian and
International Context



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Quality of Internal Auditing in the Public Sector

Perspectives from the Bulgarian
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Plamena Nedyalkova
University of Economics Varna
Varna, Bulgaria

ISSN 1431-1941 ISSN 2197-716X (electronic)
Contributions to Management Science
ISBN 978-3-030-29328-4 ISBN 978-3-030-29329-1 (eBook)
<https://doi.org/10.1007/978-3-030-29329-1>

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The registered company address is: Gewerbestrasse 11, 6330 Cham, Switzerland

Acknowledgement

My heartfelt thanks to the support of the entire Springer team, SPi Global, India, involved in the production of this book, particularly Philipp Baun and Irene Barrios-Kezic M.A. (Senior Editorial Assistant), Abinay Subramaniam P. (Project Coordinator—Books), and Mahalakshmi Rajendran (Project Manager).

Introduction

Internal audit identifies both the weak points in the financial management and control system and the potential opportunities for improving the organization's performance. Considered as a controlling process that has objectives, scope, functions and tasks, internal audit is the actual, real factor, affecting the achievement of the strategic and operational plan of the public sector organizations. The main challenge in the practical application is not to clarify the importance of internal audit but to determine whether it has accomplished its purpose—to improve the organization's performance by covering all the units in the unit under review and establishing the actual, factual state of the object under review.

The methodological aspects of internal audit quality assessment are still a topic, relevant to the current conditions. The relevance of the selected research problems is confirmed by numerous scientific forums, devoted to the issues of the quality and effectiveness of internal audit. On a global scale, each newly formed government faces the commitment to create, ensure and maintain an effective and quality internal control, in order to prevent frauds, mismanagement and misuse of public funds. The state mechanisms for the implementation of these commitments are both normative and legal, with the adoption or amendment of normative acts, as well as organizational and managerial ones, such as establishing a methodology for conducting an internal audit in the public sector. The implementation of one or another mechanism, or the combined application of multiple mechanisms, depends on the long-term strategic objectives, set to be achieved.

Changes in plan development and changes in organizational and management structure of a public sector organization are sometimes a consequence of the final results that are presented and established by internal auditors. Therefore, the correct application of methods, approaches and criteria for assessing the quality of internal audit is not an end in itself; it is a necessity and an important condition for the creative development of the organization. For this reason, the aim of the research is to explore the methodological aspects of the quality assessment of internal audit in the public sector, focusing on quantitative and qualitative methods of internal audit quality assessment, which have their prognostic and informational significance for

improving the organization's performance. Considering this aim, the main practical issues in assessing the quality of internal auditing for public sector organizations should be outlined.

Based on this goal, the following tasks should be addressed:

1. Identifying the nature of internal audit assessment and its distinction from the evaluation processes.
2. Presenting criteria for assessing the quality of internal audit.
3. Proposing a new approach to quality assessment and defining the state of internal audit in public sector organizations, other than the established and known to date approaches.
4. Making a comparative analysis between the established practice in Bulgaria and the foreign experience regarding the assessment of the quality of internal audit in the public sector.

Subjects of research are the evaluation approaches, used to assess the quality of the internal audit in public sector organizations, by making a comparative analysis between them.

Objects of study are the municipalities, which are public sector organizations in Bulgaria and, in particular, the municipalities that have a well-established and functioning Internal Audit Unit in Bulgaria, according to the requirements of the Public Sector Internal Audit Law.

This work presents **the thesis** that the assessment of the status and quality of internal audit is a complex and multilayered process that aims to determine its independence, on the one hand, and aims at identifying the benefits and improving the performance of the organization, on the other hand.

Based on the main thesis, the following working **hypotheses** are set out in this paper:

- H1:** Validating a unified approach to assessing the quality of internal audit creates an opportunity for effective comparability among public sector organizations on their implemented internal audit.
- H2:** The value-added indicator of internal audit is considered as a metric indicator to determine the quality of the internal audit activity.
- H3:** Organizations with a long history and practice in internal auditing have significant gaps and problems in assessing the quality of internal audit.
- H4:** Forming a final assessment of the quality of internal audit is not only a necessary result for the management of the relevant public sector organization, but it is also essential information for various outside persons and organizations, helping them make decisions regarding the public sector.

The chosen methodological approach and the tools of the research derive from the formulated thesis, as well as being consistent with the purpose, the tasks and the submitted hypotheses that need to be proved. The basic method of the study is dialectical and focuses on the theoretical development of internal audit and the understanding of the objective reality of the research objects from the public sector. A system of general methods such as methods of induction and deduction, analysis and synthesis and mathematical and statistical methods (descriptive statistics,

evaluation of hypotheses—parametric and nonparametric indicators, dependency studies, etc.) are applied; an abstract-logical approach is also applied.

The empirical study is for the period 2011–2016, with the following **information sources**:

1. Consolidated annual reports on the internal audit in the public sector in the Republic of Bulgaria, prepared by the Ministry of Finances for the period 2011–2016.
2. Audit reports from the Court of Auditors for the period 2011–2016 for audits of compliance in financial management.
3. Research reports of the Balkan Investment Consulting Agency (BICA).
4. The studies of the Institute of Internal Auditors in Bulgaria concerning the assessment of internal audit.
5. Researches by the International Institute of Internal Auditors (the Institute of Internal Auditors Inc.).
6. The Internal Audit Reports of the surveyed 25 municipalities, submitted by the Ministry of Finances.

The following **limitations** are included in this research:

1. We believe that the term “evaluation” is wide-ranging from a meaningful point of view. On the one hand, this is due to the diversity of the assessed objects and, on the other hand, to the diversity of assessment approaches that exist in the current practice. For this reason, the theoretical nature of this concept can be considered by an ethnological aspect, psychological aspect, social aspect, engineering and technical aspect, political aspect, medical aspect, economic aspect, accounting aspect as well as financial-control aspect. Following these goals and objectives, this work will focus on the differentiation of the term “evaluation” from etymological, economic and financial-control point of view.
2. The terms “control”, “audit” and “internal audit” are not within the scope of this study. We assume that, for the purposes of our research, in a broad sense, control should be seen as a public attitude that arises and develops irrespective of the changing political and economic conjuncture. Control should be considered as a process aimed at revealing the features and specifics of the controlled object, requiring preventive measures to eliminate diversions, frauds, violations and misappropriations by applying control means and techniques. The organization of control, as a function of governance, “has as its object the creation of an order in the functioning not only of the control but also of the management system in general” (Dinev 1989).

Regarding the concept of “internal audit”, this work accepts the meaning of the Institute of Internal Auditors, as it is endorsed in the Standards of Professional Practices on Internal Audit, namely being “an independent and objective activity that provides confidence and consultations, designed to contribute to adding value and improving the organization’s performance. Internal audit helps the organization achieve its goals by implementing a systematic and disciplined approach to assessing and improving the effectiveness of risk management,

control and management processes” (Institute of Internal Auditors 2014). Internal audit is directed at all the structural units that build up the organization; its main objective is to improve the performance of the overall organizational and structural unit by means of timely organization and consistent implementation of audit activities.

3. In the normative acts regulating the control practice, or the internal audit activity (the Law of Internal Audit in the Public Sector, the International Standards of Supreme Audit Institutions, etc.), they use the term “organization” rather than the generally accepted term “enterprise” as regulated by the Accountancy Law. The scope of this work, the set out objectives and tasks determine the direction of the examined problems, which implies that the long-standing and unconfirmed ideas of what should be considered under the terms “commercial company”—according to the Commerce Law, “enterprise”—according to the Accountancy Law, and “organization”—according to a number of normative acts—do not fall within the scope of this research. In this study, we assume that the terms “organization” and “enterprise” are synonyms, regardless of the normative act in which they are regulated.
4. The examination of the two main issues, namely the process of evaluating and issuing a final assessment to determine the state of internal audit, is considered from the internal and external departmental control point of view. The scope of the internal departmental control covers the implementation of the internal audit in the respective organization, in addition to all the structural units of the respective organizations and the approved forms of administrative activity. External control, in particular the specialized one by the Court of Auditors, carried out as a financial audit in the form of an audit on all the public sector organizations, is aimed at verifying the financial management and control systems, including internal audit and management decisions in relation to the organization, planning, management, reporting and control of the budget and other public funds and activities of the audited entity, in order to comply with the requirements of the norm acts, internal acts and treaties.

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Part I

Theoretical Aspects of Assessment and Evaluating as an Internal Audit Process

Abstract Chapter One presents the theoretical aspects of the terms “evaluation” and “assessment”. A brief characterization of the types of control assessments, including types of internal audit assessments, is made. The types of assessment bases are presented which are specific and characteristic only for the internal audit. A comparison was made between the types of assessment bases in the accounting and the internal audit. Different criteria are proposed for grouping the types of assessments in the control practice, including the types of internal audit assessments. Assessment is considered as a process that is part of the auditors’ internal auditing activities. The assessment can be performed by the organization’s own internal auditors, but also the assessment of the internal audit can be an evaluation, made by external auditors or external persons.

Chapter 1

Essential Characteristic of the Control Assessments, Incl. Internal Audit Evaluation



The problem of specifying and making a precise and categorical assessment of an internal audit in a public sector organization has always been a question of present interest, for the time being. The possible double-aspect assessment, in terms of its subjective and objective definition, on the one hand, and, on the other hand, the variety of nuances in the content side of this term is a prerequisite for a more detailed examination of the intrinsic characteristic of internal audit assessment.

The importance of this issue, regarding the exact defining of internal audit assessment, is also confirmed by the Institute of Internal Auditors (IIA) through the definition of internal audit presented in the Standards for Internal Audit in the Public Sector, the Internal Audit of the Public Sector Law (PIU), the Code of Ethics of Internal Auditors, and other normative acts, namely: “internal audit is an independent and objective activity of providing confidence and counseling designed to benefit and improve the organization’s performance. Internal audit helps the organization achieve its goals by implementing a **systematic and disciplined approach** to **assessing** and improving the effectiveness of risk management, control and management processes” (Ministry of Finances 2006).

Following the principles of the deductive approach, it can be assumed that from the so given definition of internal audit, the assessment is considered as:

1. Evaluation process, implemented through a systematic and disciplined approach.
2. Evaluation is considered as an idea, and even more precisely, as a guideline for establishing the end result of the performed internal audit.
3. The evaluation is presented through a systematic approach to developing models to promote understanding of the emerging events. It is a prerequisite for building and validating patterns of behavior as a result of the established results.
4. An entity’s internal control activity cannot benefit if the systematic and disciplined evaluation approach is not implemented in a timely manner and in such a way as to provide the best possible information that brings value to the object being evaluated (American Evaluation Association Guiding Principles For Evaluators 2014).

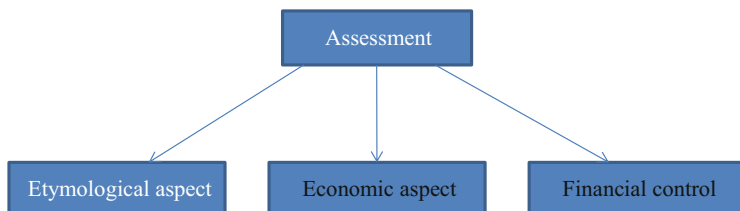


Fig. 1.1 Exploration aspects of the term “assessment”

Within the internal audit, the need for an ongoing evaluation of its quality is emphasized, when the key valuation indicators become a means of generating revenues for the relevant parties concerned.

Following the scope of this work, the objectives and tasks set, the essence of the term “evaluation” is examined in three aspects: from an etymological point of view, from an economic point of view and from the aspects of financial control. With the help of Fig. 1.1, the three aspects of exploring the concept of “assessment” are illustrated.

From the **etymological point of view**, the term “evaluation” derives from the Latin word *taxātiōnem* and means: determining the value of something; the amount of the value under certain conditions; an opinion about the qualities of someone or something, judgment; a note about the success of a student (Dictionary 2010). Also, under the definition “assessment” is meant “valuation” or “value determination”. In the Anglo-Saxon countries, the term is modified to “evaluate” and means “accept”, “evaluate”, or “qualify”. According to T.G. Kasjianenko, the terms “appraisal” and “valuation” are used to evaluate different types of property in the USA, and in Europe they use “valuation” (Kasjianenko 2014).

For convinience, we propose that the divergent **economic views** on the nature of the assessment should be systematized into four groups, according to the economic content of the term. *According to some authors*, the complex actions of the evaluators form a reasoned opinion on the value of the object to be evaluated at a certain date and in monetary terms (Gryaznova 2002), i.e. evaluation is a process of determining the value of the object.

The second group of specialists emphasizes the role of evaluation in making management decisions (Valdaytsev 1995). The importance of assessing the good corporate governance is proven through the modern **Value Based Management** concept (VBM). The concept was created in the 1980s when the US economy began recovering after a long period of high inflation and slow economic growth. Later, the concept was established in Europe and Asia. According to **M. Bozhinova, Sv. Ilyichovski and T. Filipova**, “The VBM concept is now a symbol of adopting the latest advances in management technology and, at the same time, a modern financial management tool that effectively targets, controls, and guides the company’s actions to achieve economically justifiable goals” (Bojinova et al. 2010). **Value based management** considers companies as an opportunity to create value and bring wealth to their owners (their shareholders). In order to assess the

capabilities of a company, along with the operational and strategic management decisions taken, VBM applies models to measure the value added of the respective business unit (enterprise) over a given time period and models (approaches) to determine the value of the surveyed enterprise at a given time point.

The third group of specialists considers the assessment according to the properties of the object. The objects are varied, according to their shape, size, mass, and consistency. The cumulative structural elements that each object possesses determine its quality characteristics. As a result of the manifestation of the qualitative properties of the object, as well as the necessity of the individual to meet a corresponding need, it acquires the relevant utility or inappropriateness. Very often the objects are considered only with regard to the impact they have on the individual. Not so often, they are evaluated against the impact they have on other objects or their relation to other economic objects (Kolesov 2006).

The fourth group of specialists adheres to the definition of the assessment, presented with different legal acts. For example, according to the Independent Assessors Law, an object assessment is an independent evaluator's opinion on the value of the object for a particular purpose, at a given time and under the conditions of a particular market, in the form of a written report, signed and stamped. The opinion of the independent evaluator is not obligatory for the contracting entity (Independent Evaluators Law 2011).

According to **the International Valuation Standards (IVS)**, assessment requires the use of skills and judgment by the assessor. The word "assessment" means the estimated value (assessment conclusion) or the development of the estimated value (evaluation process). According to the requirements of the IVS, when there is a risk of confusion and a distinction between the evaluation process and the assessment itself, additional denoted words are used in the standards to give clarity to the assessor.

The Accounting Law, as well as the accounting standards, are the main normative acts that should be applied strictly by the accountants. In these normative acts, which are the normative pillar of the accounting profession, the valuation issue is presented in terms of the accounting objects and above all in terms of the items presented in the financial statements. According to Art. 26, para. 1(9) of the Accounting Law, "the valuation of positions, recognized in the financial statements, is done according to the acquisition price, which may be a purchase price or prime cost or other method, required by the applicable accounting standards" (Accounting Law in Bulgaria 2018). In terms of the accounting aspect, which is part of the economic aspect, the issue of valuating the accounting objects and positions in the financial statements is also topical and controversial. The consensual application of the accounting standards and the Accounting Law is confirmed in Art. 12 para. 1, where point 2 specifies that the valuation methods should be retained and applied consistently in the subsequent reporting periods in order to achieve comparability of the accounting data and indicators of the financial statements. By observing the principle of precaution, the Accounting Law requires assessment and reporting of the suspected risks and expected losses in the accounting presentation of the reported entities, in order to obtain a real financial result. Therefore, it can be assumed that

from the accounting point of view, according to the timing of the assessment, the assessments are current and periodic (Filipova and Genov 2005).

In an accounting aspect, the valuation is always related to the value of the object, through the value measure. The accounting assessment allows for a summary of the objects, for which a generic characteristic could be obtained, using the value measure. For this reason, the assessment is considered as a method of accounting.

Therefore, from an economic point of view, the term “evaluation” represents the utility, value, and cost of what is being evaluated. The final evaluation of the value and usefulness of the object being analyzed is subject to a number of difficulties. A precondition for this is that the values change over time, and the utility arises from the necessity and satisfaction of the used resource. According to N. Kostova, “utility and value are quality features of the object. They have a quantitative measuring by value and price” (Kostova 2013).

From a macroeconomic point of view, assessment is one of the pillars for governance and economics regulation by the state; the valuation is particularly important in the management of state property. Market mechanisms and factors such as market conjuncture, competition, profitability deviations from its average value, etc. are influenced by it.

If the assessment is considered from **the financial control point of view**, there are different definitions of the terms “**control assessment**”, “**assessment of the control process**” and “**assessment of internal audit**”. The three concepts represent the distinctive and different aspect of the control as a theory and as a practical activity. Proof of this is also the statement that “the essence of the control, including the financial control consists of the following dimensions—comparison, evaluation and presentation” (Sarychev and Shiryayev 2008). From *the theory of control* point of view, including the financial control theory, *the control assessment* is considered as *an element of the control process* (defining the control object, choice of the control norm, measurement and evaluation of the actual state of the control objects, comparison and detection of deviations in the behavior and the result of the object, according to the norm that regulates them), and *the evaluation* itself is a means of control. Assessment is a process for establishing the actual state of the object through continuous analysis and research (Donev 2010). The assessment of the controlled object gives a quantitative and qualitative expression of its condition. The object of evaluation in the control practice can be everything that relates to the current financial and economic activities and realized current results, but also future actions and results can be an object of evaluation. Using Table 1.1, we present the main differences between *evaluations in accounting and control* (including financial control):

In addition to differences in accounting and control evaluations, a number of similarities have been observed as a result of the essential characteristics of the assessment as a resultant indicator, namely:

1. The two assessments are based on the judgment of the persons involved in the evaluation process. This determines their subjective nature.

Table 1.1 Differences between accounting evaluations and control evaluations

Differences	Accounting evaluations	Control evaluations
Value (monetary) measure	The evaluation of facts, occurrences and processes is related to the use of the value measure	The assessment of the objects in the control practice can be deduced by the application of the monetary (value) measure, but also another measure can be applied
Object of assessment	Accounting objects	Objects to be controlled. This extends the scope of the types of objects that can be evaluated, as both accounting and non-accounting items can be controlled
Evaluation bases	Historical cost Current value Realizable value Present value	In the control practice, the term “assessment base” is not used. The control assessment is based on a combination of features (criteria), characterizing the specific types of control assessments
Assessment approaches	Recommended approach Eligible alternative approach	Systematic approach Disciplined approach Another approach
Moments of evaluation	Pre-evaluation Current evaluation Subsequent evaluation	During the control processes (activities), i.e. currently Preliminary—In the preliminary control Subsequent—in the subsequent control
Persons	Accountants, auditors, others	Inspectors, internal auditors, external auditors

2. Evaluations, both in the accounting and the control, can evaluate future actions and results.
3. For both evaluations (i.e. both for accounting and controlling) a certain relativism is inherent. Accounting evaluations are “a sign of the entity’s relation to the subject of the valuation” (Alexandrova 2003). Control evaluations also represent a relationship, but this relationship is between the controlling subject and the controlled object.
4. The control assessment and the accounting assessment express the different properties of the object being assessed, namely: the utility of the object, its location, the quantitative specifics of the object under consideration, the current state and the time.

The distinction of the control assessments (including the assessment of the control process itself) from *the internal audit assessment* also has its theoretical and practical significance, since the improper handling of the conceptual arrangement is a prerequisite for making essential practical mistakes, that have their impact later. According to **Kenneth A. Smith**, the assessment of internal audit plays a significant role in identifying the test results obtained, to which audit procedures should be limited. The assessment of internal audit should be applied in the proper creation of the statistical samples to analyze the information (Smith 1972). The poor results of

internal audit, according to **Kenneth A. Smith**, are due, on the one hand, to the incorrect assessment of internal audit and, on the other hand, to the inaccurate statistical sample of information on which the audit process is based.

According to a research of **Ernest & Young**, the assessment of the overall effectiveness of internal audit is determined by comparing the results of the start and the end of the audit process. Because of the dynamic business environment, different internal and external factors influence the audit, which is a prerequisite for the different auditing approaches (Ramos 2004). Therefore, internal audit and the financial management and control systems should respond to the changes that have been made and are continuously improved in order to undertake adequate and timely control actions.

From financial control point of view, according to Prof. Dr. **K. Donev** “the evaluation is in close connection with the processes of knowledge and reflection, and therefore with the quality of the information as well. It is not an element of existence. The object of the assessment, in the terms of control, can be everything existing in the objective reality” (Donev 2010). Consequently, any economic, social, geopolitical object in the form of operations, actions, results, events and procedures that fall under the scope of control is covered by the control assessment.

The assessment of internal audit can be explored through its essential characteristic. Unlike internal control, which is a management function, internal audit is focused on the processes, i.e. on the evaluation activity. The role of internal audit is “to assess the internal control system according to the criteria developed in advance, by advising the operational management on matters both for the control and for the development and assessment of the risks related to the operational activity” (Dimitrova 2014). In this regard, **Taylor and Glezen** define the meaning of internal audit as “an independent assessment function set up within an organization to examine and evaluate its activity as a service to the organization itself” (Taylor and Glezen 1991).

M. Dinev broadens the scope of the examined matter and presents the assessment of internal audit not only as a measuring tool but raises questions on the definition of the evaluation approaches. According to M. Dinev, “in the system of control should be applied such approaches, which predict the possible deviations, establish the conditions, the prerequisites, the factors that give rise to the negative results, measure and determine the tendencies and the regularities in the different deviations, in the social development in general” (Dinev 1989). Therefore, the organization of the internal audit assessment is a complex process that requires the establishment of appropriate mechanisms, sufficiently available and quality information about the controlled entities, which build the common organizational unit.

The responsibility for the final assessment of the quality of internal audit belongs to the manager of the organization and the manager of internal audit (IAM), in accordance with the Internal Audit Law of the Public Sector (IALPC) and the International Standards for Professional Practice in Internal Auditing. According to the regulations, the Head of Internal Audit is committed to producing a final annual report on its activities. The final annual results of the internal audit activity

should be determined in accordance with a program, providing the quality of the internal audit. The manager himself develops this program.

Regarding all presented above, we assume that the internal audit evaluation is an expert assessment of an expert, based on the main features of the control profession. The expert assessment of the quality of the internal audit is actually done through the knowledge, skills and experience, possessed by the expert in the field of internal audit. It is based on a system of descriptions, but its purpose is the formation of individual internal auditing assessments of individual objects and prescriptions. In this regard, the main problem in assessing the quality of internal audit is to make a logical expert conclusion from the assessment itself. The formed internal audit assessment expresses both the experience of the expert evaluator and his/her professional development while determining it.

The basis for the internal audit assessment is the comparison and benchmarking, which requires the establishment of a benchmark or criteria to form the generic nature of the assessment. The assessments in economic terms are aimed at determining the value, and in the internal audit activity, we believe they target the measuring. As a result of this measuring, audit conclusions should be made on the quality of the internal audit work and on the necessary actions that need to be taken to improve it. For this purpose, the Head of Internal Audit shall prepare action plans, including measures, deadlines and responsible persons. The main aspects of the internal audit assessment are: to be useful, correct, relevant and accurate (Table 1.2).

Given the above, the following distinction can be made between the assessments made by the internal audit and the ones made by the control process itself, namely:

Taking into account all of the above, the following conclusions can be drawn, namely:

1. Evaluation, as a term, can be explored in various aspects, but from a control point of view, it is a means, a tool, a reflection, as well as a determining factor for the content side of the controlled object. The control assessment, and in particular, the assessment of the internal audit reflects the evaluator's cognitive qualities, as well as his objective and subjective approaches. At the core of the control assessment is always the comparing of all the information. The ongoing and periodic nature of control evaluations is observed in controlling processes with different time ranges.
2. The economic value of the controlled object and also its specifics, variations and deviations from its expected state, are defined with the help of the control assessments, and in particular, through the internal audit evaluations. The control assessment is a resultant indicator and a prerequisite for determining the effectiveness and quality of the control performed in the respective controlled unit. It is prepared by experts with the necessary skills, knowledge and professional experience.
3. On the one hand, the internal audit assessment measures the performed audit engagements, and on the other hand, the performance of the internal audit functions. The assessment is based on a set of criteria and indicators that determine the level of performance of the audit work, the proper functioning of

Table 1.2 Difference between internal audit assessments and control assessments

Criteria for differences	Evaluations derived from a control process	Evaluations derived from internal audit
Objects	The objects, which can receive evaluations from controlling processes, are numerous. This is determined by the specifics of the type and form of control	The objects, which receive evaluations from a performed internal audit, are more limited. This is determined by the specifics and the nature of the internal audit process
Moment of evaluating	In conducting the control processes, usually the evaluation is at the end of the control process—upon completion. This evaluation can be used to predict the organization's pre-existing, current, and past status. It is also possible that the control assessments are displayed before the final control process has been completed, i.e. the so-called intermediate control evaluations are displayed	In internal audit processes, the timing of the evaluations is determined. Sometimes, when it's already performed, there is no moment of unpredictability
Assessors (evaluators)	Assessors may be both external to the organization and internal persons. For example, when assessing the quality of the produced product, and etc	A significant part of the assessments are made by internal individuals (internal auditors, manager of the internal audit unit, head of directorate, etc.). Regarding the quality of the internal audit, the assessment can also be performed by external people
Documentation and evidence on how to formulate and make the assessment	With the control evaluations, the documentation and evidence on which they are based may be gathered and/or created by external controllers. In this case, the organization shall be given statements, protocols or other documents attesting to the control performed and the result obtained with the assessment. With the internal control, when the assessment is based on internal evidence of the organization, the documentation remains available for the organization's needs. The internal evaluation may be monitored by external control bodies, and in that case, external consultants, when requiring the documentation in due order, may have copies or transcripts of the	A significant part of the documentation and evidence comes from the organization itself and remains at the disposal of the organization. If necessary, the internal documentation may be provided to control institutions through copies or transcripts

(continued)

Table 1.2 (continued)

Criteria for differences	Evaluations derived from a control process	Evaluations derived from internal audit
	original documentation of the internal controllers, used as a basis for this internal assessment	
The processes, which the assessments are based on	The control processes, conducted by external controllers for the organization itself, take place in several stages—pre-conditioning, controlling and completing the control activity. Based on these steps, when violations are detected, the next stage is performing a control action. If the control process has gone through all of these stages, the respective deviations and inconsistencies have been identified, the respective ways and approaches for their removal are presented—then it is assumed the control process has been completed and passed successively through all the stages. The assessment of the control activity is based on the achieved control stages, as well as on the impact the control process had on the object itself, but also on other third parties, directly unaffected and not involved in the overall control process	Internal audit processes take place in a strictly defined sequence, and the effect of suddenness is lacking, as it is in the control processes. Internal audit processes begin with their planning, pass through the verification phase and reach the final reporting phase. The last process is when the internal auditors follow the implementation of the provided recommendations and instructions

the internal audit, as well as the adequacy and effectiveness of the financial management and control system. According to the Internal Audit of the Public Sector Law, the managers of the internal audit are required to include in their annual activity reports information on their findings on the functioning of the financial management and control system, based on the audit engagements performed during the audit period.

Chapter 2

Specificities and Characteristics of the Assessment Bases in the Context of Internal Audit



The growing globalization of the world economy, aiming to achieve an effective and lasting increase in economic, social, technical, political and cultural interactions and relations between countries, organizations and people, is a prerequisite and an opportunity for a global spreading of ideas, scientific discoveries and achievements, coming of new technologies and investments. It can be assumed that globalization processes also affect the research processes, in terms of seeking causal links between the emergence and validation of a given problem and the relevant prerequisites for it. It can be assumed that globalization processes also affect the research processes, in terms of seeking causal links between the emergence and validation of a given problem and the relevant prerequisites for it. This is also the reason for shifting the focus of the survey from the assessments to the assessment bases in the control. The problem of the control assessments as an element of the control method, as well as a means of control, should not be sought only in the ways and approaches for their performing, the problem may be due to the chosen assessment basis, used for determining the relevant type of assessment.

According to Aswath Damodaran, the valuation basis on which the value of a company's internal control is determined relates to the specifics of the company in question and expresses the management's intention to improve the company's operations. The leadership of the company may influence the qualitative change in its management by improving the overall assessment of internal control. Aswath Damodaran presents the term "expected value" as a possible assessment base in the control. It reflects the expected value of the control resulting from the probability of a change in the management and the impact on the value of that change (Damodaran 2006). According to other specialists, using the assessment base "expected value of control", an assessment is made combining three critical factors: the expected payout from the control process, the amount of control to be invested for achieving the expected remuneration, and the cost of the cognitive efforts.

Regarding internal auditing in the public sector, the expected value appears through the fulfillment of one of the main functions of the internal audit to provide confidence on the effectiveness and efficiency of risk management, control and

management processes (Anderson 2012). Confidence is a qualitative indicator of the internal audit; on the one hand, it is built on the expectation that the overall benefits of internal audit work will exceed the expected costs. On the other hand, confidence is built over time with the benefits of the internal audit. Therefore, the expected value for the internal audit is demonstrated both at the beginning of the audit process and during the internal audit itself. In addition to internal audit stakeholders, the internal auditors themselves also make their preliminary calculations and forecasts of the expected end results of the audit process. In this context, it can be assumed that the value added is considered as a type of expected value of the internal audit, especially when it is based on preliminary analyzes and forecasts.

From a regulatory point of view, the legislator does not prohibit or restrict the application of the expected value. This, on the other hand, has its positive aspects in the internal audit activity as it is possible to determine in advance both the expected monetary and the expected non-monetary benefits. In this regard, we assume that the qualitative output of the internal audit state can only be determined when a comparison is made between *the expected value added from the internal audit* and *the actual deduced and determined complementary value of the internal audit*. Therefore, it is very often assumed that the internal audit assessment is subjective. It depends on the predetermined attitudes, views, considerations and motives of the persons concerned.

Other specialists do not pay much attention to the expected value of the control, and studies are aimed at determining the current value of the control. Researchers, such as *Xiaoming Liu and Zhaotong Lian*, assume that both an assessment of the ongoing performance of the control process and a separate assessment of the completed control processes within the correspondingly defined current period should be made, as well as a general assessment of the current state of the overall control for the company itself (Liu and Lian 2009). For this reason, *Xiaoming Liu and Zhaotong Lian* offer, when determined by the management of the company, the value of the control to be drawn on the valuation base of the **current value**, with the evaluation process consistently going into two main stages, namely: the first stage is to determine the effectiveness of the control by assessing all the operational processes in the controlling entity (regardless of its type and form) and the second stage is an evaluation of the control over the company's property (inventory) (Liu and Lian 2009).

Specific refutation or criticism of *Xiaoming Liu and Zhaotong Lian's* thesis is lacking, but by applying the research approaches, deduction, synthesis and analysis of different views on the types of assessment bases in control practice, it is established that the current value is validated as a basis for assessing the control. According to *Dr. Oliver Bungartz and Gregor Strobl*, when the current value of the control (including internal audit) is applied as a basis, the current added value of the control (including the internal audit) should be deduced (Bungartz and Strobl 2012). Under "value added", *Dr. Oliver Bungartz and Gregor Strobl* understand the "quantitative value of the investment, created by the investors' readiness, which would be paid as a surplus for an existing and functioning internal control system" (Bungartz and Strobl 2012) (respectively internal audit). The strongest value

reflection of the added value of the established internal control system is in determining the commercial reputation, i.e. in the case of a purchase or sale of a company, and when the new investor should determine what would be worthwhile if he has to currently set up a new financial management and control system. For the investor, the financial management and control system already in place is an indistinguishable component from the company itself. The system is set up for the enterprise itself, operates in the enterprise itself, and produces results that relate only to the enterprise itself.

In this connection, *Dr. Oliver Bungartz and Gregor Strobl* are doing a further study among investors (buyers of businesses) to determine to what extent they agree with the thesis that a functioning internal control system creates added value for the company itself. It is interesting to note that 85% of the investors accept the thesis (32% of them responded explicitly “YES” and the other 53% rather agreed). 68% of respondents, who are sellers of a company, also accept the view that internal control creates added value. Of these, 48% fully agree and the other 20% rather agree with this opinion. Only 15% of buyers and 32% of sellers say they do not accept that internal control creates added value. Also, a significant proportion of the investors, 42% indicated that they agree to pay more for the acquiring company as a value, under an established system of internal control (Bungartz and Strobl 2012).

Not all control experts consider the importance of value added as an assessment to determine the current state of the control, including the internal audit. It is conceived that what adds the greatest value to an organization (respectively an enterprise) can mean, respectively, that it is a waste of resources for other systems, departments or processes within the enterprise. *James Roth* (Roth 2013) criticizes even the methodology adopted by the Institute of Internal Auditors for conducting surveys among public sector organizations regarding the value added of internal audit. In the survey conducted by the IIA, *James Roth* notices that some of the questionnaires are prepared incorrectly. The respondents were asked to indicate “which of these services performed by internal auditors are considered as value added?” According to James Roth, if we rely solely on the parties concerned to decide which types of services would add the most value, we limit ourselves only to their knowledge of internal audit practices. But the parties concerned are only aware of what they have seen that has been achieved in the past, i.e. “the significance of value added based on the assessment’s current control value is not to limit the capabilities of internal control (internal audit) to previous knowledge and experience, but to represent the increased expectations of control value.

By exploring the best practices in internal audit, *Marin Porrescu* identifies four factors that can help auditors determine what can add value to their audit work: (Popescu 2011).

1. Good knowledge of the organization, including its culture, key players and competitive environment.
2. The intention to implement innovative ways that the parties concerned (including the management of the company) have not expected so far and may not have been aware of the real need for them.
3. Good knowledge of the good practice in the field of internal audit.

4. Creativity to adapt innovation to the organization in ways that lead to surprising results and outweigh the expectations of the parties concerned.

Value added is the ability of the internal audit to improve the financial management and control system, therefore, it can be assumed that the internal auditor is the organizer of value-added capability by creating opportunities, by avoiding duplicate auditing activities, by giving timely solutions to encountered problems, etc. Value added represents the attitude of internal auditors to audit activity in real (current) time. Despite normative regulations such as International Standards on Professional Internal Audit Practice, stating that internal audit adds value to the organization, it can be assumed that “it can not provide an objective assessment of the function of internal audit because it depends on the following” (Popescu 2011):

1. the state of the control environment and the acknowledgment received by the management of the audit department;
2. the quality of disclosure of weaknesses and recommendations provided by management;
3. the preparation of reports within deadlines.

Because of the presented weaknesses of value added, there are researchers who offer this value not to be applied so often, and in order to assess the control (including internal audit), we should use past experience, knowledge and the established achievements of internal auditors. The suggestion for a value, other than the legally established value added, relies on the three key building blocks for value, which are to be provided by the internal auditors of each organization, namely: confidence, transparency and objectivity. We believe that it is more correct to assume that the confidence, insight and objectivity are not so constructive in value, but rather are requirements for evaluation itself, and may also be accepted as requirements for the internal auditors (Nedyalkova 2017).

According to the IIA, the internal auditors should provide confidence in the auditing of the processes, risk management and organization control, and help the organization achieve its strategic, operational and financial goals (Internal Auditing’s Value to Stakeholders 2012). Internal audit is a catalyst to improve the efficiency and effectiveness of the organization by providing transparency and recommendations based on data analysis, assessments and business process analysis. On the other hand, through its commitment to integrity and periodic reporting of its work to the senior management of the organization, the internal audit is defined as an objective source of information.

Regarding all of the above, it can be assumed that there is still no precise definition of the term “assessment base” in the control practice. This may be due to the following prerequisites:

1. From a historical point of view, the rapid development of internal audit started only after 2002, with the adoption of the Sarbanes-Oxley Act and the established need for an internal control system for companies whose shares are quoted on the stock markets. This has automatically triggered the necessity for a review and

ongoing assessment of the financial management and control system, already established and operating in the enterprises.

2. In recent years, the strategic goals and intentions of the International Institute of Internal Auditors have focused on strengthening the internal audit as a universal profession. In this regard, in 2008, the Institute of Internal Auditors (IASB) set up a task force of experts to develop a proposal for an assessment base to cover the interests of the various parties concerned in the internal audit. The Institute of Internal Auditors continues to work in this direction, and this is also demonstrated by the 2009 working group, which involves both specialists, members of the Institute itself, but seeks help worldwide as well, through personal communication with all individuals, direct representatives of the Institute in different countries. Cooperation is also sought from various international organizations, such as the Organization for Economic Co-operation and Development (OECD). With that purpose in view, the Institute of Internal Auditors developed materials for the participants in the discussion to learn about the long-term goals and intentions of the institution.
3. The value assessment of the internal audit theoretically was tied to a specific assessment base only at the beginning of the twentieth century when the different types of assessments were established to determine the past, the current and the future state of control (incl. of the internal audit).

We believe that it is necessary to make a significant distinction between the assessment bases in the control practice, the assessment bases in the internal audit and the assessment bases in the accounting. In this way, we assume that it is much easier to discover not only the differences, but also the benefits of the relevant assessment bases. Also, on the basis of this distinction, the types of assessment bases will be defined, both in the control (respectively the internal audit) and in the accounting.

The main differences *between the assessment bases in accounting and assessment bases in control* are presented and illustrated using Table 2.1.

The information presented in Table 2.1 shows that there are many differences between the assessment bases in the control and the assessment bases in the internal audit, although the internal audit in the public sector is one of the types of financial control manifestations. We assume that the assessment bases in the public sector internal audit have a significant application in the preparation and presentation of the final information in the Consolidated Annual Internal Control Report in the public sector, which includes information on the state of the financial management and control and the internal audit in the public sector, as well as information on the activities related to the coordination and harmonization of the internal control in the public sector by a specialized unit in the Ministry of Finances. Also, the consolidated report should provide information on the progress, main issues, trends and developments in the control and internal audit in the public sector. We believe that generalized consolidated information and an assessment of the state of the internal control and internal audit in public sector organizations cannot be made without affirming common indications and criteria for determining individual assessments on the state