Business Audit: The New Concept of the XXI Century

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Abstract: Using the provisions of the theory of systems transformation, the article studies the regularities of and prospects for development of one of the most complicated types of professional activity—the audit. The article also formulates the concept and the new paradigm of the audit of XXI century, on which the innovative activities of auditors are based: the audit of intellectual capital, the audit of business processes efficiency and the strategic audit. In addition, the article suggests the formula of calculation of the intrinsic value of a business, which is the target of audit.

Key words: Audit • Business • Business processes • Intrinsic value of a business • Intellectual capital • Strategic audit

INTRODUCTION

The world economic crisis of the early XXI century and the high-profile corporate scandals precedent to it, which were related to falsification of financial statements by the largest market players [1], showed the inefficiency of the current accounting systems, as well as the systems of financial control and, first of all, the audit. Instead of being the cornerstone of reliability of information provided by companies to all interested users, even the elites of the profession (represented by Arthur Andersen) turned out to be not only involved, but virtually the accomplices of the great financial deception [2].

But the most awful thing is not the facts of the auditors' failures because they are typical of any activity and no one is proof of them. The rise to concern is given by what actions and what vector of the audit development strategy they cause with the market authorities and legislators. In fact, the whole post crisis reform of the audit institution was reduced to improvement of the in-house company control and the external control of auditors' performance, i.e. to implementation of the provisions of the Sarbanes-Oxley Act [3] and similar legal acts on organization of audit activities and control over their quality in other countries [4].

Sorting out the mess in the audit quality control system and abidance by the standards of professional ethics of auditors is necessary by all means. But the more important issue is if audit in its current structure complies with the demands of the contemporary society. And if not, what changes are really necessary?

To find an objective response for the disputed questions, the author carried out a research, the results of which were published in the Business Audit book [5]. In 2013, the book picked up the Sapphire Award as the best literary composition in Russia in the Treasury Discipline category [6]. The award was handed out during the welcoming ceremony of the 2nd "Cinema about Finance and Financiers FinFest-2013" Festival [7].

The thesis that fundamental changes in the audit activities usually follow financial scandals or economic crises was taken as the working hypothesis of the research. Such events become certain breakpoints in the history of audit development and result in the necessity to change the base paradigm of the activity.

In fact, the expressed hypothesis was the application of the systems transformation theory to the audit development history in its function as an activity type. The basic concepts of the systems transformation theory were formulated in the Grow or Die: The Unifying Principle of Transformation work by J. Land [8].

Consideration of the history of audit development as an activity from the perspective of the systems transformation theory allowed to identify three evolution phases of its development:
- The formation phase-the verification audit (between the late 19th century and the 1930s);
- The development phase-the system-oriented audit (between 1940s and 1980s);
- The completion phase-the risk-based audit (between 1990s and the early 21st century).

The verification audit mainly comprised verification of documentation that supported accounting operations and of the correctness of their grouping in financial statements. This work was also called book audit, which highlighted the fact that three fourth of the working time was spent for technical calculations and verification of bookkeeping records. In the situation when an auditor was to provide detailed verification, there was no need in special standards of auditing and auditors training arrangement. Audit was carried out by single experts and organizations and was not mandatory.

Fundamental changes of the auditors' performance principles took place after the 1929-1933 world economic crisis, which can be certainly called the first breakpoint in the audit development. In 1933, as a response to the crisis, the New York Stock Exchange issued the rules, which made it obligatory to provide audit of companies, whose shares were listed at the stock exchange. Starting from the mid-1930s, virtually all developed countries began to introduce mandatory requirements for the scope of information, which was to be included in annual statements, published and verified for consistency by professional auditors. Thus, the phase of the verification audit came to its end. Conceptually, audit started being treated as a system-oriented process.

The concept of the system-oriented audit, which emphasized the audit of control instruments rather than simple verification of transactions, was first introduced in 1941 by Victor Brink [9]. The system-oriented audit comprised monitoring systems, which control operations (assessment of the company's in-house control system). It was proved that if the in-house control system operates efficiently, it is not necessary to provide in-depth audit, as one can trust the in-house control system in revealing errors and prevention of standards violation. The distinctive properties of the system-oriented audit, which describe it as a development phase, are the development of audit standards, primarily on the national level, as well as the establishment of regulatory authorities and self-regulating organizations of auditors with the purpose of control over the auditors' performance. The acme of the development phase was the development of international audit standards, which started in 1969.

The second breakpoint in the development of audit falls at the period of the so-called information revolution, which brought the economics science to the development of the post-industrial [10] (information) [11] society theory. Historically, it is dated the early 1990s, namely 1991. If we represent the dynamics of capital expenditures during the industrial and information epochs in the form of charts, we will see that both curves intersect in 1991. During this period, the expenses for industrial equipment equaled to US$112 billion and those for information technology equaled to US$107 billion [12]. Therefore, the year 1991 is considered the first year of the information epoch. On the microeconomic level, the information revolution manifested itself in, first of all, the occurrence of the intellectual capital concept [13] and secondly, in the fundamentally different concept of business risks associated with the new intellectual assets of a company. Multiple theories and methodologies of risk management appeared. All this required revision of the methodology and the practice of accounting and auditing. This caused transition to the new audit phase-the risk-based or risk-oriented audit.

The risk-based audit is a process, which embodies the positive features of the verification and system-oriented audits. The concept of the risk-based audit is based on focusing the auditing work on the spheres involving higher potential risks, which facilitates auditing the spheres with lower potential risks. The peculiar feature of such audit is, first of all, the close interaction of the in-house and external audits, as during an audit, the quality of the in-house control systems is evaluated at the preliminary stage. Secondly, an auditor identifies the spheres of activity and the economic operations associated with higher risks and carries out their audit involving extended audit evidence. At that, the people who control the system are watched and the managerial decisions they take are assessed. The audit is carried out on a selective basis depending on the enterprise operation environment. Mainly, the bottlenecks (the critical spots) in its operation are audited.

The new vision of audit as an activity associated with high risk required changing the system of regulation and control of auditors' performance. For example, in order to increase the confidence of investors in the reliability of financial statements of companies, the European Commission issued the Commission Recommendation of 15 November 2000 on quality assurance for the statutory audit in the European Union: minimum requirements [14]. The so-called soft approach was suggested as the minimum requirement: auditing organizations were allowed to control the quality of the performed mandatory
audit using either peer review when the practicing auditors invited by the audited organization are engaged, or quality monitoring by the employees of the organization.

Currently, in the period after the 2008-2009 world economic crisis, we can say that audit activity is at the stage of completion of its development as a social institution of the industrial epoch, i.e. at the third breakpoint. According to the systems transformation theory, the process of reforming the audit institution, which is currently necessary, must be the change of the audit conceptual principles in its essence. The concept of the industrial epoch (the concept of narrow view on the audit) must be replaced with the concept of the information era-the concept of the extended understanding of audit and the responsibility of auditors.

The concept of the extended view on the audit and the auditor as a profession, first of all, resides in the replacement of the financial statement audit concept with the business audit concept. Replacement of the financial statements audit concept with the business audit category means the change of focus of auditors from verification of formal aspects of the financial statements formation by an organization to the essential aspect of the organization's activity, i.e. to the business processes that take place indeed, as well as to the current and planned results. In the contemporary (information) society, an organization's counterparties are interested, first of all, in the future status of the organization (i.e. the future amount and structure of its capital, its future financial results), rather than just in the current profit and the capital accumulated during precedent periods. These values mainly depend on the efficiency of organization and the coordination of business processes, which increase the value of the 'business' capital. Thus, in order to enable the audit institution to carry out its main mission-the provision of reliability of information used by market players, the responsibility area of audits must at least include such objects as:

- The intellectual capital of a business;
- The current and future transactions of a business (business-processes);
- The future financial results of a business.

The extension of the object audit base will inevitably require changes in the audit methodology, which will result in, first of all, occurrence of new audit types:

- The intellectual capital audit;
- The business process efficiency audit;
- The strategic audit.

The above-mentioned types combined with the traditional financial statements audit are treated by the author as the integral elements of the uniform concept of business audit, of which the finite goal is the opinion of an auditor on the dynamics of changes and the expected value of the intrinsic value of a business.

The previous works of the author [15] contain reasoning of the following principal formula of the intrinsic value of a business:

\[ W = C_e + \sum_{n=1}^{T} \frac{P_n D_i}{(1 + D)^n} - D_i (1 + D)^{T+1} \]  

\[ D_i = f(D, r, I) \]

where \( W \) is the intrinsic value of a business index;
\( C_e \) is the value of the business capital as of the evaluation date;
\( C_{x} \) is the average chronological value of the business capital in the nth year of the forecast period;
\( C_{(T+1)} \) is the average chronological value of the business capital in the first year of the post-forecast period (n=T+1);
\( P_n \) is the financial results of the business for the nth year of the forecast period;
\( P_{(T+1)} \) is the financial results of the business during the post-forecast period;

The profitability of own capital in the post-forecast period is assumed to remain unchanged;
\( n \) is the number of years in the forecast period (\( n = 1 \ldots T \));
\( D_i \) is the discount rate of the business capital as the function of profitability (value) of the capital (\( D \)), business risks (\( r \)) and other information provided by the organization to outside users, which information affects the market value of the business (\( I \)).

Thus, application in the legislative construct of certain countries and the international auditors' practice of the concept of extended vision of audit and the auditors' role in the process of information exchange of market participants will actually mean the entrance of the audit institution into the phase of formation of the new audit of 21" century. Otherwise, according to the rules of the systems transformation theory (refer to Figure 1), there is another way to pass the third breakpoint.
Fig. 1: Phases of the system transformation and breakpoints
(which manifested itself in the current world economic crisis), which is to keep on following classical rules with only providing face-lifting of the audit activity, which endangers audit to be assimilated by other professions and cease to be a separate one.

REFERENCES