Internal Audit and Corporate Governance

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Abstract: Boards of directors from all kind of companies are charged with responsibility for the effectiveness of their organisations' internal control systems, in order to promoting effective corporate governance. Corporate governance is the system by which business corporations are directed and controlled. After the chute of Enron, some regulations, including an emphasis on anti-fraud and whistle-blower provisions and the potential impact on stock prices, have compelled auditors to take a more active role in governance. One of the major governance issues brought to light by the bankruptcy of Enron was the conflict of interest involved with having financial officers of a company both manage and be equity holders of entities that conducted significant business transactions with Enron. The Institute of Internal Auditors present that regardless of the reporting relationship the organization chooses, there are key measures that will ensure that the reporting lines support and enable the effectiveness and independence of the internal audit function. This paper presents the concepts of Corporate Governance and Internal Audit through relationship between these, and the role of Code of Corporate Governance. Based on a research on the National Corporate Governance Codes among European Union countries, regarding the relationship between Internal Audit and Corporate Governance, there was identified three main categories of countries: countries in witch Internal Audit is foreseen by Corporate Governance Code, countries in witch Internal Audit is recommended by Corporate Governance Code and countries in witch Internal Audit is not foreseen.

Keywords: Corporate Governance, Internal Control, Internal Audit, Strategic Management

Introduction

More and more frequently, boards of directors from all kind of companies are charged with responsibility for the effectiveness of their organisations' internal control systems, in order to promoting effective corporate governance. In this case, the internal audit function plays a key role in assisting the board to discharge its governance responsibilities.

Corporate governance represents a lot of different things depending on the organization in which it is applied. The definitions are sometimes different but, however, they need to be interpreted in their proper context.

“Corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence. Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined….Corporate governance is the system by which business corporations are directed and controlled.” [6]

“Effective corporate governance ensures that long-term strategic objectives and plans are established, and that the proper management and management structure are in place to achieve these objectives; while at the same time making sure that the structure functions to maintain the organization’s integrity, reputation, and accountability to its relevant constituencies.” [8]

In this case it appears a strong relationship between Corporate Governance and Internal Controls, especially Internal Audit.
Approaches of Corporate Governance and Role of Internal Audit
During the last decade, new approaches of the Corporate governance, totally confirmed the board's responsibility for ensuring the effectiveness of their organisation's internal control framework. These theories stressed the key role that internal audit can play in supporting the board in ensuring adequate oversight of internal controls and in doing so form an integral part of an organisation's corporate governance framework. The key role of internal audit is to assist the board and/or its audit committee in discharging its governance responsibilities by delivering:

- A review of the organisation's control culture, especially the "tone at the top".
- An objective evaluation of the existing risk and internal control framework.
- Systematic analysis of business processes and associated controls.
- Reviews of the existence and value of assets.
- A source of information on major frauds and irregularities.
- Ad hoc reviews of other areas of concern, including unacceptable levels of risk.
- Reviews of the compliance framework and specific compliance issues
- Reviews of operational and financial performance.
- Recommendations for more effective and efficient use of resources.
- Assessments of the accomplishment of corporate goals and objectives.
- Feedback on adherence to the organization’s values and code of conduct/code of ethics.

Audit committees are vital to investors and internal auditors. For the investor, they have to provide confidence in corporate governance. For the internal auditor, they have to assure his independence. Recent developments have given audit committees more authority on the one hand and more responsibility on the other.

During the boom times of the 1990s, people’s trust in business grew along with rising stock prices. Serious interest in risks, controls, and ethics on the part of the media and many investors was limited. Although internal audit began to allocate resources based on risks and the function’s visibility increased, staffing levels were relatively constrained and audits often focused on performance improvement opportunities.

However in attempting to adequately discharge their responsibilities, internal auditors often find themselves in an anomalous position. They report to senior management within the organization, yet are expected to objectively review management's conduct and effectiveness. The only satisfactory solution to this problem is for internal audit to report primarily and directly to the board and its audit committee rather than to senior management.

After the chute of Enron, some regulations, including an emphasis on anti-fraud and whistle-blower provisions and the potential impact on stock prices, have compelled auditors to take a more active role in governance. In the US, the Sarbanes-Oxley Act of 2002 makes no mention of internal audit, or of any equivalent role other than the board's role generally in the preparation of the accounts and the setting of accounting standards. One of the major governance issues brought to light by the bankruptcy of Enron was the conflict of interest involved with having financial officers of a company both manage and be equity holders of entities that conducted significant business transactions with Enron. Enron’s Code of Ethics and Business Affairs explicitly prohibits any transactions that involve related parties unless the Chairman and CEO determined that his participation ‘does not adversely affect the best interests of the Company’.

Other developments in corporate governance and internal audit, aside from the regulatory and legislative changes post-Enron, include the fact that boards took great strides to remove their director nominating decisions from the CEO’s control through the use of nominating committees. The number of outside directors (referring to those directors who are not members of management) also increased during the period, as did directors’ equity compensation as a percentage of their total director compensation. [7]

In 2003, the U.S. Securities and Exchange Commission approved final versions of revised New York Stock Exchange (NYSE) and Nasdaq requirements. The NYSE now requires that listed companies
have an internal audit function. The IIA has clarified roles and responsibilities by affirming the importance of risk management and corporate governance. Internal auditing, according to the institute, "helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes." [2]

This also means that in the financial services industry, according to the Basel Committee, there is no distinction in its guidelines as to the natural reporting line for the internal audit function except to note that "the principle of independence entails that the internal audit department operates under the direct control of either the organization's CEO or the board of directors or its audit committee".[1]

The Basel Committee was formed in 1974 and includes members of thirteen countries. The committee has no formal authority and relies mainly on the commitment of its members. The main objective of the Committee is to promote sound banking supervisory standards.

Before deciding the reporting lines for internal audit, it is critical to consider the fundamental distinction between the respective roles of the board (oversight) and management (decision making and the execution of those decisions)

In order to improve internal audit function, these regulations presents in our days some success factors. For example, if internal audit is strategically positioned into a company, he can contribute to increase business performance. That means the mission and role of internal audit should be defined within a wider governance framework and are effectively communicated. Also, the structure of internal audit should promote objectivity, consistency and business understanding. Internal audit should contribute value to the business as defined by appropriate success criteria.

Internal audit should have a strong risk identification and planning methodology for deliver a high quality service and he must use an appropriate technology to enhance the provision of internal audit services. For measure internal audit's performance, an appropriate framework should be used in order to develop and manage appropriate relationships with companies’ key stakeholders.

In these cases, internal audit must be independent from all decisions factors involved in corporate governance. The internal audit function must be independent of the activities being audited and must also be independent from everyday internal processes, and must be able to exercise its assignment on its own initiative in all departments, establishments and functions of the organization.

The structure and reporting lines adopted for the internal audit function should promote independence, objectivity, consistency and business understanding. This can be achieved by combining the concept of a clear reporting line to the board/audit committee with an organizational structure that allows internal audit to operate independently of other functions within the organization.

The Institute of Internal Auditors also suggests that regardless of the reporting relationship the organization chooses, there are key measures that will ensure that the reporting lines support and enable the effectiveness and independence of the internal audit function. [9] The charter for the internal audit function should clearly articulate both the functional and administrative reporting lines for the function as well as its principal activities. The reporting line should facilitate open and direct communications with the CEO, the senior executive group and line management. Also, there are some benefits and challenges of internal audit reporting directly to the board audit committee. [5] presented in the Table no. 1.

In order to develop a better internal audit function and a stronger relationship with corporate governance, the Internal Audit structures focused on these problems. For example, The European Confederation of Institutes of Internal Auditing (ECIIA) is the professional representative body of 36 national Institutes of Internal Audit in the wider European area. The ECIIA’s objective is to support corporate governance and the internal audit profession in the European Union and in the ECIIA’s member countries and to promote the application of the global institute of Internal Auditors’ Standards
and Code of Ethics to all internal audit professionals in the public and the private sector. The ECIIA undertakes research on topics related to internal audit, business control, risk management and corporate governance.

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<th>Table no. 1 Benefits and Challenges of Internal Audit Reporting directly to the Board Audit Committee</th>
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<td><strong>Benefits</strong></td>
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<td>Ability to transcend all departments without fear of limitation of scope by being tied to, for example, the finance department.</td>
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<td>The board and audit committee know that the information they are receiving on the internal controls and risk management systems reflects a true description and has not been &quot;watered-down&quot; or filtered by management beforehand.</td>
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<td>The independence of the internal audit function is absolute.</td>
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<td>The funding of the internal audit function is outside the normal process of budgeting thereby allowing resources to be allocated by the assurance needs of the organisation as assessed by the board/audit committee.</td>
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<td>Enables the board/audit committee to directly analyse and evaluate the internal audit function in its contribution to the fulfilment of the board's responsibility for internal controls.</td>
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<td>Reinforces the board/audit committee's knowledge of the business and its risk profile when dealing with management and stakeholders.</td>
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The ECIIA conducted a review of the Corporate Governance Codes currently in place in its member bodies in order to determine the extent that internal audit is considered in the governance structure of listed companies under the typical “comply or explain” regulations. This principle was aimed at forcing companies to explain those aspects in which their situation did not ‘follow’ the recommendations. The reason for the introduction of this principle was to force companies to at least consider the recommendations and to stimulate companies to ‘comply’ so that they would not need to explain.

The research revealed that approximately 90% of EU member countries require or recommend the presence of an internal audit function in listed companies. [2]

The research identified that there are some attributes of corporate governance almost totally present in Corporate Governance Codes, like discipline, transparency, independence, accountability, responsibility, fairness or equitable treatment, social responsibility. The report is also presenting the main approaches and roles identified for these attributes:

- Accountability must provide investors with the means to question the board and its committees. Accountability will ensure that the board monitors the systems of internal control, takes into account the expectations of the stakeholders in general and the shareholders in particular and that governance roles and responsibilities are sufficiently known.
- Responsibility is all about being responsible for the actions and the decisions taken by management. Responsibility ensures that the board is responsible for taking action should corrective intervening be called for. Responsibility equally involves compliance with laws and regulations.
- Fairness should be aimed at balancing the interest of all stakeholders in general and at protecting the rights of the (minority) shareholders in particular.
- Social responsibility implies that proper priority is given to ethical values and socially correct behavior. This will ensure a ‘decent’ corporate reputation.
ECIIA states that the governing body of an organization is responsible for strategic risk oversight. The board and audit committee should be required to define a clear delegation and accountability for risk management and internal control. In this statement, called the “Three Lines of Defence” model, internal audit assumes responsibility for providing overall assurance to the governing bodies, consistent with existing financial sector regulation. On this basis, internal audit should be required for most organizations. According ECIIA, factors that need to be considered are the complexity of the organisation and the need for the governing body to obtain systematic, continuous independent assurance, rather than the size of the company.

Based on a research on the National Corporate Governance Codes among European Union countries, regarding the relationship between Internal Audit and Corporate Governance, ECIIA identified three main categories of countries [2]:

- Internal Audit is foreseen by Corporate Governance Code in: Finland, France, Greece, Italy, Latvia, Luxembourg, Malta, Romania, Slovakia, Slovenia, Spain;
- Internal Audit is recommended by Corporate Governance Code in: Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Germany, Hungary, Ireland, Netherlands, Sweden, United Kingdom;
- Internal Audit is not foreseen in: Lithuania, Poland, Portugal.

Regarding the role of the internal audit in Corporate Governance, the research also identifies that 41% of the codes consider an internal audit function mandatory, 48% of the codes strongly recommend the presence of an internal audit function and only 11% of the codes do not have a specific requirement or recommendation about internal audit.

**Conclusions**

Based on this paper, we can conclude that the Internal Audit represents an important management tool which assist and support company management in order to identify and manage the risks bringing extra value for company activities. Internal Audit is in a interdependent relationship with Corporate Governance.

**References**

[1] Basel Committee on Banking Supervision; "Internal Audit in Banks and the Supervisor's Relationship with Auditors", August 2001