INTERNAL AUDIT AND ITS ROLE IN IMPROVING CORPORATE GOVERNANCE SYSTEMS

Neculai Tabără[1]
Mihaela Ungureanu[2*]

ABSTRACT: The corporate governance implies a cycle that extends from the steering and monitoring role of the board, to the administrative and operational executives and the role of internal and external auditors certification. These roles come from three different levels of governance. Efficiency level can impact another, but also governance throughout the organization. In this sense, the system includes all activities, from monitoring, operation and control to the processes and activities to meet the needs of different stakeholders.
Implementing a system of corporate governance involves the basic principles leading to relations between different participants, to define responsibilities and ensure the correct operation of the decision making process. A well-based information system is essential for optimal functioning of organizations, but also for their future development.

Key words: corporate governance, internal audit, audit committee, corporate control

JEL codes: M14, M42, O16

Introduction

Once the business development, managerial revolution led to a separation of owners from the control system, in most large companies, where this activity has past from entrepreneurs to professional managers, while property rights were dispersed among dozens, even hundreds of unorganized shareholders who are not part of the current administration of the economic entity.

The objective of corporate governance is to ensure a balance between the various actors and to implement power control instruments, both for shareholders and other interested parties in the capital of the entity. Modernizing economic environment, but also the social one, has made that current governance system to not only take into consideration the need to inform shareholders, but also their satisfaction, the company's ability to respond positively to the new market restrictions, the relations established with external bodies, employees, general public, etc. Economic or profitability criteria are no longer sufficient to analyze the enterprise, adaptability and responsiveness, ethical and responsible attitude towards the economic and social factors are becoming increasingly important for business development.

The idea that shareholders and managers have divergent interests is the dominant approach for corporate control in economics, agency theory and its legal equivalent. This theory defines corporation as an integrated set of contracts between directors, shareholders and managers, on one side and between employees, creditors, customers and suppliers, secondly, an interest more or less contradictory on how they are distributed earnings in a given period.

Internal audit – mechanism of governance system

Internal audit is defined by the Institute of Internal Auditors as a objective activity certification and consultation which seeks streamlining the operations of an organization, but also

[1] "Alexandru Ioan Cuza"University, Iaşi, Romania, *e-mail: neculaitabara@yahoo.com*
[2] "Alexandru Ioan Cuza"University, Iaşi, Romania, *e-mail: myhaella5@gmail.com*

processes of risk management, control and governance. Internal auditors are integral parts of corporate governance and their expertise in control has a primary contribution in ensuring the integrity and reliability of financial statements.

Figure 1 illustrates the most important functions of corporate governance and the place of audit in such a system.

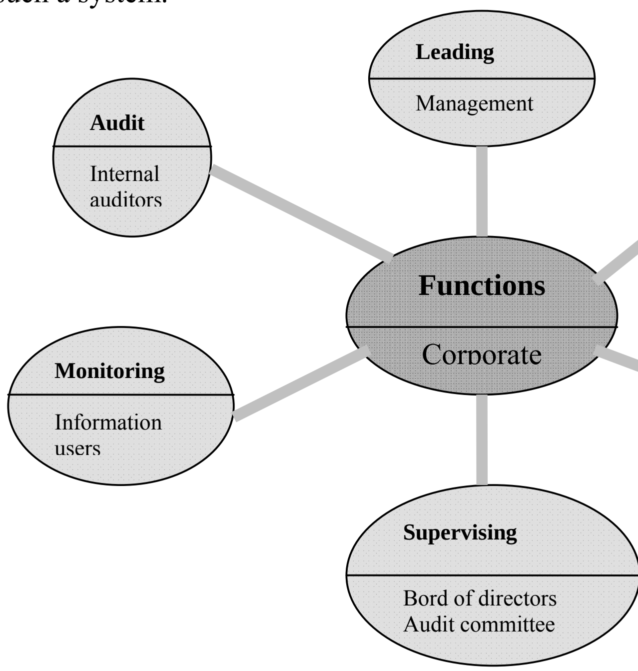

Figure no. 1. - Internal audit among the functions of a governance system

In time, internal auditor's role was expanded to evaluating and improving management activities. Such a specialist should continually monitor the financial reporting process and to find those indicators called *red flags* that signal the possibility of illegal acts.

Internal auditors' activities can be summarized in the following functions:

- evaluation of operational performance;
- ensuring the adequacy and effective internal control system;
- reviewing financial reporting process to ensure quality and integrity in the production of reliable financial information, relevant, useful and transparent decision making;
- ensuring a responsible governance;
- prevention, detection and correction of fraud, particularly in the financial statements, which may threaten the integrity and quality of reports.

The process of governance is focused on the development and maintenance of adequate and effective internal audit to protect assets from loss or steal. In this context, corporate governance is seen as a mechanism to monitor the actions, policies and decisions taken by management to achieve business objectives.

According to the theory organization, corporate control seeks mainly disputes about power and the process by which this is taken by the main shareholders. In most countries, board of directors has the power to direct the corporation, although such a situation is subject of specific limitations contained in instruments of governance. In addition, many frameworks prohibit shareholders initiatives requiring directors to take certain measures, unless they are an advisory proposals.

Tensions between those who want supported control activities and those who speak about collaborative approaches to governance are increasing. The debates persist on topics such as the ability of people outside the company or the holders of information internal to dominate the board, if executives should be monitored or authorized to act freely and how the board should allow market discipline or excess of power or to protect the managers of market abuse. By applying agency theory can by detalieted these conflicting issues, but potentially complementary. Based on economics and finance theory informs about a control approach which aims to reduce opportunistic behaviors of managers with a possible negative impact on major owners' property.

Internal audit has evolved from a function which targets financial and accounting issues to a function that focuses on a wide range of operating activities and becomes an integral part of the governance structure. Its role is to assist all persons and other functions within the company to meet commitments, giving required recommendations, evaluations and information.

The role of audit committees in leading an enterprise

An internal audit service and an audit committee chaired by a non-executive member, have the role to advise the directors of the company. Audit committees must have the best references in overseeing the design of annual accounts, election reviewing accounting policies and practices, monitoring internal control systems and working framework of internal and external auditors.

Audit committees are required specifically to assess the accounting decisions and deciding on the proposed amendments and restatements following an audit. In response to accounting errors, omissions or disagreements with the accounting policies related managers, auditors may propose changes before financial disclosure or restatement of prior period results.

Functions of an audit committee include ensure the quality of accounting and control system. Agency theory foresees the creation of audit committees as a means to mitigate agency costs and improve internal control, being considered an effective monitoring device for improving communication. The presence of independent directors does not affect revenues and does not involve management earnings reduction.

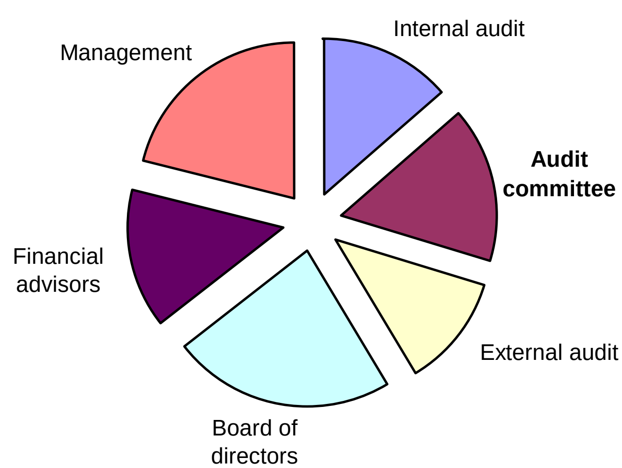

Figure no. 2 - Audit committee in the governance system

One of the main objectives of corporate reporting is to provide the necessary elements to external users in decision making. However, that information not to lose their economic value, opportunity shall be performed.

Opportunity is recognized by the accounting profession, users, regulatory and professional agencies, as an essential feature of financial and accounting reports. Moreover, there is the assumption that the opportunity is one of the evaluation elements of audit quality, being considered an important tool to reduce privileges, information leaks, or as a way to reduce information asymmetry.

OECD Principles of Corporate Governance states that an annual audit to be conducted by an independent, competent and qualified person, able to provide the Board and shareholders an objective certification of financial statements, with the role of statements of financial position and business performance.

Audit committees are appointed to be responsible for overseeing the financial reporting process, including the risks and related controls. Domain literature captures a series of skills that will contribute to audit services quality and, ultimately, the audit report: Domain literature captures a series of skills that will contribute to audit quality and, ultimately, the audit report: specialization, independence, industry expertise, technical competence in the application of GAAP, GAAS/IFRS and ISA, a wide range of skills such as analytical, proactive, initiative, due diligence, commitment to provide and maintain a quality service, professional expertise of audit reputation, high ethical standards, strong knowledge of audit.

Committee members must be “educated” in the financially spirit professionally qualified, have operational knowledge and work independently for an activity responsible and vigilant. The audit committee should meet frequently, as appropriate, with the external auditors, board of directors, CEOs, CFO, etc. both simultaneously and separately, to review and assess the integrity and reliability of financial reports.

The Smith Report entitled “Audit Committees - Combined Guide” recommends:

– company either has an audit committee or explains in the annual report the reasons for its absence, and reviews this need from one period to another;

– audit committee should be composed of at least three non-executive directors and specify clear terms of reference of the authority and responsibilities;

– audit committee should take the place of internal audit function, and to review external auditors’ results.

In a system of governance are certain variables that can be manipulated to affect the financial reporting process. Figure 2 is an example of how such variables can improve or rather, weaken a system of governance, given the relationship between board and audit committee. Were considered management board, the proportion of independent directors, the financial expertise of audit committee members.

	Strong	**Weak**
Board of directors		
Size	20	20
Independent members	17	13
Chairman	Independent	Company owner
Audit committee		
Size	7	4
Independent members	7	4
Description	Powerful	Relatively weak
Convocations in a period of a year	8	3

Figure no. 3. - Relationship between board and audit committee in a governance system

SEC requires that a report of the audit committee to be included in each annual statement published by listed companies. Such a report must submit the following aspects of the committee activities:

- if the audited financial statements were reviewed with the managers;
- if the external auditors have discussed those issues to be communicated to the audit committee in accordance with generally accepted accounting principles;
- if the audited financial statements and related recommendations were included in the annual report of the board.

The Audit Committee is considered an important part of the enterprise, crucial for implementing corporate governance practices. One of its most important functions is to oversee internal and external audit performance and to advise the Board on specific issues. Corporate governance principles emphasize the contribution of the audit committee in improving financial reporting. For analysts, the credibility of these reports is a function of professional expertise, undertaken on a wide range of skills, ethical standards and knowledges of accounting and auditing.

Improving audit work

A solution to remedy agency problems is to implement within the company a set of good governance. OECD noted as elements of good governance, transparency and reducing the reporting period. If property right is widespread, there is an agency cost caused by asymmetries between managers and equity holders. Audit activities favor reducing informational risk by attesting the reliability of published financial information of current and potential investors. One can notice a lack of informational flow from management to the board and auditors, on the other hand, can occur a lack of management response to the recommendations of auditors.

The auditors alert managers about the questionable nature of used accounting practices, but the latter is likely to disregard the warnings. Signals of such a situation might not be understood on the background of an inefficient dialogue between managers and auditors. Lack of alignment can show to investors a failure of internal controls and the fact that top management has an important guilt in this respect. To avoid such problems, it is considered important for enterprises to adopt measures to remedy the governance, in cooperation with the external auditors and audit committees.

When a restatement is announced by the auditor and not by the enterprise, market reaction will be more negative and the chances that investors to suspect a fraudulent intent would be higher, leading to uncertainty and loss of value of the company. Board and therefore the audit committee should play an active role, not a passive one by implication, with management, in verification and reporting of financial matters. Under the new corporate governance regulations, the active role of the audit committee should consider at least the following aspects:

- the antifraud and control managerial programs, including identifying risks and implement necessary control measures;
- management's ability to overcome controls or any other improper managing influence;
- analysis of periodic reports regarding the nature and status of potential fraud and misconduct;
- an internal audit plan covering the risk of fraud and a mechanism to ensure audit committees the possibility to express any doubts regarding the commitment of management to implement adequate internal controls or to report suspected fraud.

Analyzes on the recent failures of corporate governance systems have put their cases on behalf of the board and audit committees that have not monitored properly, financial reporting and protecting the interests of those involved. An indicator reflecting the reduced quality of governance is the restatement of earnings. In response to a rapid increase in restatements and other indicators of failure of governance, Blue Ribbon Committee recommended increasing the independence of directors, and Sarbanes-Oxley code underlined the need to enhance the independence of audit committees' members.

Researches show that the enterprise environment can shape a negative relationship between audit committee independence and scope of reprocessing and reduce restatements may also arise from effective monitoring or a reluctance in the reformulation. Literature regards restatements as a threat more than audit adjustments because reprocessing send a direct signal to the market on failure of the audit committee's role in monitoring.

A collaborative approach requires to groups within the company to work together, which means advice and strategy formulation. From a structural point of view, insiders are valued for their operational expertise, while the CEO is a control unit that can clarify the authority of decision, may reduce the conflict role and provide security to shareholders. In addition, directors and persons with the property right can be strongly identified with the company, internalizing views on its performance and strategies.

Conclusions

A corporate governance system is based not only on supervisory actions and incentives to achieve performance. Governance plays a key role in improving capital market efficiency, through its impact on their operations and integrity of information provided. New initiatives on basic principles and governance codes developed by national securities exchanges and other professional organizations, are designed to improve quality and transparency of audit reports and functions, but should not replace necessary reforms in the accounting profession and financial community.

Audit committees are permanent commissions composed of independent and non-executive directors. These have the responsibility to supervise the corporate governance, financial reporting process, internal control structure and audit functions. Efficiency of monitoring function depends on the attitude, mentality and practices of the whole board. Thus, the priority role of the audit committee is to ensure integrity, quality and reliability of the reporting process, without disrupting the functions and management decisions on financial statements.

Board of directors, management and internal auditors are categories of enterprise, in connection with the mechanisms of governance. Various trials held in each of the three levels in order to assist management in making effective decisions are called processes of governance.

Aknowledgements

This work was supported by the the European Social Fund in Romania**,** under the responsibility of the Managing Authority for the Sectoral Operational Programme for Human Resources Development 2007-2013 [grant POSDRU/CPP 107/DMI 1.5/S/78342].

References

1. Ghiţă M., Briciu S. et al., 2009. Guvernanţa corporativă şi auditul intern, Aeternitas Publishing House, Alba Iulia
2. Griffin P., Lont H., Sun Y., 2008. Corporate Governance and Audit Fees: Evidence of Countervailing Relations, Journal of Contemporary Accounting & Economics, Volume 4, Issue 1, p. 28.
3. Horomnea E., 2011. Audit financiar. Concepte. Standarde. Norme, Ediția a II-a revăzută şi actualizată, Alfa Publishing House, Iaşi
4. Kaplan R., Atkinson A., Young S., 2011. Management accounting: Information for Decision Making and Strategy Execution, Pearson Education, U.S,
5. Klapper L., Laeven L., Love I., 2006. Corporate governance provisions and firm ownership: Firm-level evidence from Eastern Europe, Journal of International Money and Finance, Volume 25, Issue 3, p. 439.

6. Richard J., Tabără N., 1993. Forme de audit financiar contabil în cadrul grupurilor, Expertiza contabilă, issue 7
7. Schöndube B., Schöndube J., 2010. Reputation concerns and herd behavior of audit committees – A corporate governance problem, Journal of Accounting and Public Policy, Volume 30, Issue 4, p. 334.
8. Tabără N., Ungureanu M., 2011. Evoluția şi actualitatea conceptului de guvernanță corporatistă pe plan mondial şi în România, Finanțe Publice şi Contabilitate journal, issue 3, Bucureşti
9. Voicu D., 2010. Guvernanță corporativă şi sustenabilitate în Uniunea Europeană, Editura Economică, Bucureşti, p. 71.
10. ***, OECD Principles of Corporate Governance, 2004, http://www.oecd.org/ dataoecd/32/18/ 31557724.pdf.