The Role of Internal Audit in Corporate Governance to Substantiate the Decision

Boghean Florin
Cibotariu Irina-Stefana
"Stefan cel Mare" University of Suceava
florinb@seap.usv.ro
irinac@seap.usv.ro

Abstract

Apart from the available research in the field, which is mainly based on quantitative data, the present study uses a wide range of qualitative data in order to detect certain more profound attitudes in the relationship between internal auditing and stakeholders. Investors may wish to provide assurance about the objectives and consultancy on risks and supervision. The success of efficient and effective functioning of corporate governance mechanisms requires integrity, ethical values and professional skills in the active participation of professionals. The research is focused on the relationship between business decision-making and governance. The issues upon which the research is focused relate to the degree of involvement of various stakeholders in corporate governance, especially risk management and internal audit.

Key words: internal audit, corporate governance, risk management, internal supervision
J.E.L. classification: G30, G32, G34, G40

1. Introduction

For many categories of decisions, risk represents, together with efficiency, a major assessment criterion for decisional variants (Arrow, 1965; Bell, 1983; Kahneman&Tversky 1986; Markowitz, 1987; Miller, 1992; Ricciardi, 2007). Descriptive approaches within the decision theory have revealed some features of how managers act in conditions of uncertainty. Faced with the risks, they do not just evaluate but also apply active measures to diminish potential losses (March &Shapira, 1987 Rejdice, 2001 Meulbroek, 2002 Nocco&Stulz, 2006; Desender, 2007). The choice and implementation of such measures are the subject of the internal audit through risk management that is an important function of business management. Changes in the business environment over the last decades, especially those generated by the global crisis, have created new challenges for internal audit. Some sophisticated methods of identifying and assessing risks have proved to be ineffective in the context of developments difficult to predict (Jorion, 1999; Rosen, 2003, Stulz, 2008, Shojai&Feiger, 2010).

Internal audit is a key element of company governance, risk management and internal supervision. Creating an effective audit function is a real challenge for organizations. The competitive advantages that can be achieved fully reward the invested efforts (resources) and comprise: the improvement in the processes of risk management and environmental supervision, strengthening interactionswith regulators, better efficiency through governance, better efficiency in risk management and complianceactivities (Boghean F., 2014)

2. Methodology of scientific research

This contribution entitled "The role of the internal audit in corporate governance to substantiate the decision" has a *conceptual and also methodological dimension*. Firstly, we will address the conceptual research dimension by which we will investigate the current concepts and corporate governance to identify and manage specific risks. The type of the research undertaken will then acquire a *methodological* dimension, through the fact that the steps taken will result in the presentation of a simulation model useful in the decisional processes specific for the capital market. The research is of a qualitative nature. We tried to emphasize the internal audit role in corporate governance with the purpose of substantiating decisions. In our analysis, our scientific approach is based on a deductive approach from general to particular. Thus, we started from the current state of knowledge by defining the key concepts of internal audit.

3. Theoretical background: Risk management systems assessment

The need to implement a model in which risk management responsibilities are clearly defined and properly implemented has led to the emergence of the three lines of defense model. The primary responsibility for managing risks belongs to business departments, where these risks are generated, and which are the first line of defense. It is essential for the business to know the risks arising from its day-to-day work and to take the necessary steps to manage it. The second line of defense, namely the risk management function, has the primary responsibility to provide business support, namely to develop the framework for effective risk management and oversee its implementation by the front line. Therefore, the second line will provide opinions to help the front line take the most accurate decisions and will alert the business if it believes that its decisions are not aligned with the risk principles.

Internal audit is, as stated by one of Deloitte's representatives, "the third line of defense, and has the role of analyzing the work of the other two lines, thus providing an independent perspective on risk management within the organization." (Ţiţirigă Mădălina , 2018)

In a synthetic presentation, there is a shiftregarding the focus, from the internal audit function towards threats to the strategies. In today's environment, a member involved in the management of a public organization might ask (Hoag, Dana L., 2010):

Is it possible for external environmental changes to threaten the achievement of my organization's strategic goals?

- *Can the entity's assets be stolen?*
- *Is the information system and financial reporting organized in order to avert the entity in the event of unwanted situations?*
- *Communication with different categories of users is done taking into account the specific standards of the economic environment in which they operate?*

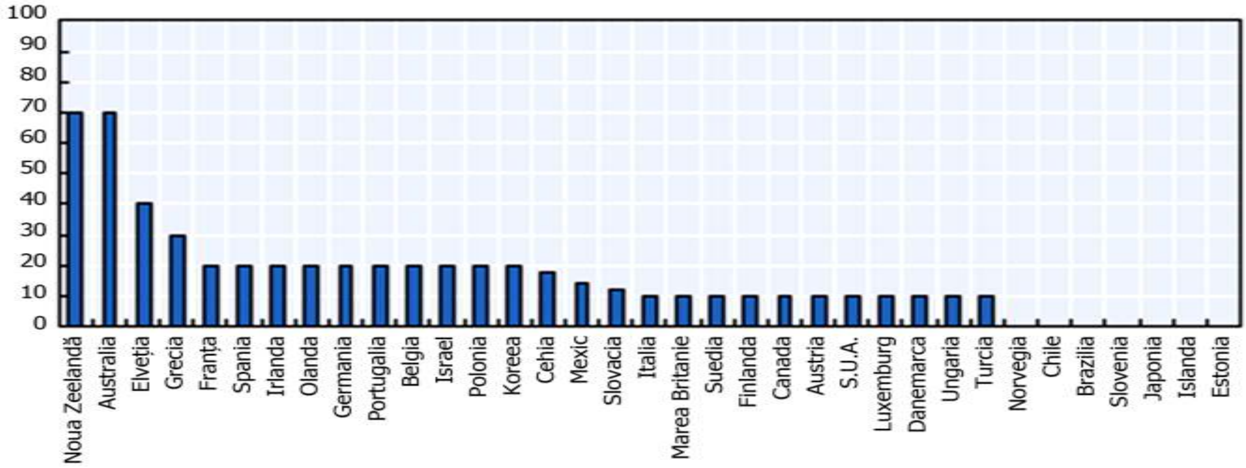
Professionals accountantsand internal auditors are increasingly required to assess and report on threats to an entity. At the process level, several countries now need a management or anexecutive to suit internal control including to risk control processes.

4. Necessity and contributing factors to the corporate governance development

Financial management could not function without information in general and without financial accounting information in particular. Information such as economic, financial, accounting and market information is indispensable for knowing and applying management objectives. For making financial decisions, it is essential to corroborate economic policies at a macroeconomic level with strong governmental footprints, with individual financial decisions taken at the microeconomic level. (Shleifer, Vishny, 1996)

Risks management failures in large corporations have captured the front page of newspapers: environmental disasters such as Fukushima, also accounting frauds (e.g. Olympus, Enron, WorldCom, Satyam, Parmalat, Xerox), or bribery (e.g. Siemens, EADS). One of the shocks of the financial crisis was a failure of risk management. Often, the risk was not effectively managed by companies and because the risk manager was separated from other management structures and not regarded as an essential element of the corporate governance (OECD, 2014)**:**

Figure no. 1. Companies with an explicit risk committee (2017)



Source: Report commissioned by OECD, 2014

Analyzing a series of studies undertaken in the United States, Canada, the United Kingdom and Australia we have found that corporate governance pursues the following reasons (OECD, 2014):

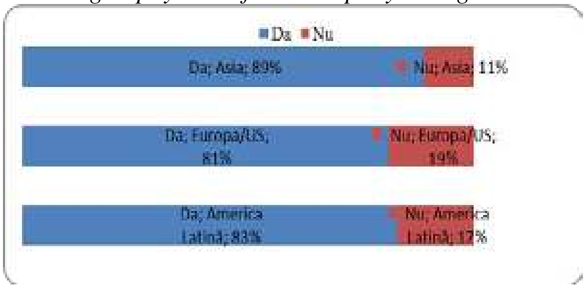
- *Accountability* to shareholders provides a single measurable objective that avoids the risk of disseminating responsibility to managers and executives. If managers and executives are responsible, almost any action can be justified and this gives managers and executives unlimited authority;
- *the long-term focus of shareholders*. The value encourages capital investments to be realized in the most efficient way from a market perspective. In the figure below, according to a study by McKinsey & Company, Investor Opinion Survey, we can observe the elements affecting investment decisions. Percentages reflect the proportion of the total number of institutional investors interviewed who indicated that each of these factors was important to them.

Figure no. 2.The relevance of elements affecting investment decisions

Source: McKinsey & Company Processing, Investor Opinion Survey - The Globalization of Corporate Governance

New technologies and the removal of trade barriers, truly global markets have been created with global competitors for goods, services and capital and even for corporate control. A new level of economic interdependence is current and is deeper and wider through new cross-border business projects, relations between nations, which present a significant signal for change from all the aspects of society, from culture to labor markets and various global policies. Own equity funding, which has long been significant in the U.S. and the UK, have already become a very important source of capital investment in many European and Asian nations.

Figure no. 3. Are investors willing to pay more for a company with good boarding gouverance practice?



Source: McKinsey & Company Processing, Investor Opinion Survey - The Globalization of Corporate Governance

According to chart no. 3 we can easily observe that investors are more than 80% willing to invest in a company with good corporate governance practices. For Asian companies, the investors' interest is approaching 90%.

Corporate governance, risk management and internal supervision are essential practices in conducting the efficient work of some entities. Of course, success is not only guaranteed by positive thinking and optimistic slogans, being mainly based on the way in which the company is run and organized, the integrity of staff, particularly of those in very high positions, business ethics, providing staff with reasonable pay. In the following table are presented the most important codes elaborated after 1997, as well as the issuers and its objectives.

Table no. 1.Corporate governance codes in the countries of the European Union

Organul emitent	Denumirea codului, anul emiterii	La ce companii se referă	Obiective
Governmental and quasi-governmental-mental organizations	Recommendations of the Finance and Banking Commission of Belgium (1998)	Listed companies.	Raising the quality of governance.
	The Recommendations of the Portuguese Securities Market Commission (1999)	Listed companies. They can serve as a model for other companies as well	Increasing company performance, competitiveness and access to capital
	Guide of the Ministry of Industry and Trade of Finland (2000)	Listed companies.	Increasing the company's performance, competitiveness and access to capital
Stock Market Commissions and Business Associations	The Cadbury Report (1992), (UK)	Listed companies. They can serve as a model for other companies as well	Raising the quality of governance of the supervisory boards, inclusively by stipulating rigorous requirements for disclosure information.
	The Peters Report (1997), (The Netherlands)	Listed companies.	Raising the quality of governance of the supervisory boards
	The Hampel Report (1998), (UK)	Listed companies.	Raising the quality of governance of the supervisory boards, inclusively by stipulating rigorous requirements for disclosure information.
Business associations	The Vienot Report (1999), (France)	Listed companies.	Raising the quality of governance of the supervisory boards
	Chamber of Commerce, Industry and Employers Confederation (1997), (Finland)	Listed companies.	Raising the quality of governance of the supervisory boards
	Greenbury Report (1995), (UK)	Listed companies. They can serve as a model for other companies as well	Raising the quality of governance of the supervisory boards, inclusively by stipulating rigorous requirements for disclosure information.
	Berlin Code of Conduct (2000)	Listed companies. They can serve as a model for other companies as well	Raising the quality of governance of the supervisory boards
	Code of the Institute of Secretaries and Administrators (1991), (UK)	Listed companies. They can serve as a model for other companies as well	Raising the quality of governance of supervisory boards and disclosing information to shareholders
Investors' associations	Committee of Institutional Shareholders (1991), (UK)	Listed companies.	Raising the quality of governance of supervisory boards and disclosing information to shareholders
	The recommendations of the VEB (1997), (The Netherlands)	Listed companies.	Raising the quality of governance of supervisory boards and disclosing information to shareholders

Source: author's own processing

From the analysis of this table we can see that among the subjects recommended by these codes is the creation of firm audit committees (Hampel from UK, similar codes issued in France and the Netherlands) consisting of independent executives responsible for financial reporting of the firm and monitoring internal audit and external audit. In fact, the audit committees have become a common feature of European firms, reflecting the tendency to improve the corporate governance structure (IIA, 2015).

5. Conclusions and proposals

In a fairly unstable economic and political environment, risk management has become a much more complex process and the importance given to the risk management by managers has increased by 40% in 2018 compared to 2017. Financial stability is directly influenced by how risk management is dealt with. The benefits are many, such as reducing unexpected losses, optimizing expected revenues and expenses, risk premiums and volatility of financial results, increasing financial position, etc. The benefits of customers, shareholders and investors are not delayed by effective risk management and these can be: tariff optimization, increased quality and diversity of services and products, digitization of products and services, increased cyber security, increased information risk exposures, dividend increases.

Internal auditing through added value to the company contributes to improving operations and building an image of integrity, thus strengthening the position of the entity in the financial market. The internal audit is designed to advise managers, to identify the main risks and to be considered the most important risk assessment tool. Furthermore, it has the role of assessing internal control and its effectiveness and providing recommendations to managers to help them make the best decisions. Auditors increase the effectiveness of internal control and, by doing so, they fight against fraud by increasing the transparency of the economic and financial operations undertaken. The activity of this department is very important, becoming a "key" department of society. (Boghean F., 2016).

Efforts should be made to maintain the importance of these practices and the compliance with national and international standards regarding corporate governance and risk management.

6. References

- Boghean F., 2014. *Developing managerial control - the solution for effective governance*, Bucharest: Didactic and Pedagogical Publishing House.
- Hoag, D. L., 2010. *Applied Risk Management in Agriculture*, Boca Raton, Florida: CRC Press.
- Shleifer A., Vishny R. W., 1996. *A Survey of Corporate Governance,* National Bureau of Economic Research, Cambrige MA 02138, April 1996, [online] Available at http://www.nber.org/papers/w5554.pdf [Accessed 27.01.2018]
- McKinsey & Company, Investor Opinion Survey, *The Globalisation of corporate governance,* [online] Available at: http://people.stern.nyu.edu/adamodar/pdfiles/articles/globalisation_of_corporate_governance.pdf [Accessed 27.01.2018]
- OECD, 2014. *Principles of Corporate Governace*, [online] Available at: http://www.oecd.org/document/49/0,3343,en_2649_34813_31530865_1_1_1_1,00.html [Accessed 05.12.2017].
- IIA, 2015. *Core Principles for the Professional Practice of Internal Auditing*, [pdf], [Accessed 02.01.2018]
- Boghean, F., 2016. *Indicators that can be used to measure performance in the internal auditing activities,* [online] Available at: http://www.seap.usv.ro/annals/arhiva/USVAEPA_VOL.16,SPECIAL%20ISSUE,2016_fulltext.pdf [Accessed 02.01.2018]
- Țițirigă, M., 2017. *Cele trei linii de apărare în gestionarea riscului într-o organizație*, [online] Available at: https://www2.deloitte.com/ro/ro/pages/finance/articles/cele-trei-linii-de-aparare-in-gestionarea-riscului-unei-organizatii.html [Accessed 15.05.2018]