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Global Markets, Governance and Internal Control Systems

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Abstract

The global competition sees for effective internal control systems ability to face risks and to pursue business performances with a correct balance between economic and financial conditions in the long term.

Management of the complexity following globalization increases the need of adequate internal control systems.

From a more evolved perspective, the responsibility for adequate internal control systems is associated with the top of the organization

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1. Governance and Global Competitiveness

In recent times, the focus on corporate governance has increased, first at the legislative level, then in terms of best practices for organizations. Following this process, a lively scientific debate has emerged within the economic and managerial literature.

In fact, the comprehension of complex phenomena requests the use of correlations capable to select, if not casualties, at least the fundamental critical variables useful in planning and orienting the entrepreneurial praxis into carefully judging the adequate evolutions.

The link between Governance and globalization of competitiveness is really tight; this statement is very important, among others, considering the long period perspective for the balance of the firm, and the strategic planning of the organization, within the competitive framework of the organization.

Italian firms recently went through a significant legal reform process:

- the introduction of the Consolidated Law On Finance for a modern discipline of the listed companies;

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- the Corporate Law reform introduced the monistic model (based on the Anglo-Saxon governance corporate system) and the dualistic model (based on the German corporate system);
- the introduction of penal responsibilities for the legal entities according to compliance programs of US origin;
- the introduction of the Basil Committee II agreements, that deeply influence the relationship among banks and firms, introducing a shared rating system;
- the Bankruptcy Law reform, imported from the American system classes of creditors and acknowledged the international doctrine on crisis management;
- the International Accounting Standards (IAS and IFRS) that carried out the globalization process on accounting and corporate reporting;
- the recent accomplishment of *MIFID* (*Markets in Financial Instruments Directive*) supervising the investing services and the negotiation of financial instruments.

The need to contribute with a contemporary, modern discipline to the international competitiveness is one of the Italian firms' most frequent, explicated objectives within the above-mentioned reforms.

As one can see, the strong evolution of the Italian legal framework has been promoted by other legal systems in order to harmonize at the European and international level.

These phenomena clearly indicate that the evolutionary direction of the legal framework – as well as within the competitive system – is certainly oriented to the international scenario.

A further signal of this trend is represented by the diffusion of codes of self-regulation, relatively new for the Italian national experience. For example, the "Preda Code", issued in 1999 and reviewed in 2002, defines the governance system for listed companies and their subsidiaries. The Preda Code is coherent with the new corporate law and, most of all, up to date with international best practices.

The increasing diffusion of the Code of Ethics and the Code of Behavior reinforces the same inclination toward the promotion of high reputation of the firm. Codes should express the ethical responsibility of the organization towards stakeholders and promote an internal system of shared values.

From this point of view, the strategic behavior of the firm, based on the dynamic relationship between the organization and the environment, has to face a new scenario preferably with a pro-active attitude rather than a formal and ritualistic one.

2. The Managerial Implications of a Coherent Governance System

At the various levels of the organizational structure, the management is the actor that interprets new roles defined within the international governance framework and that contributes to the definition and the implementation of coherent strategies.

One of the profiles that better characterizes the new managerial style is the integration between decisional processes and compliance.

The literature on governance tends to develop its analysis along two directions:

a) structural perspective of the governance: oriented to the morphological dimension defined by formal structures and roles (assets of ownership, boards, audit committees, boards of auditors, internal auditors, organizational structures);
b) operational perspective of the governance: studies directives, mechanisms of internal regulation, policies, formal procedures, delegations of authority, formal responsibilities, internal control systems, information systems, and disciplinary processes.

In actual fact, the two aspects are complementary. They have to be planned consciously and to be defined according to the evolution of the strategic structure of the organization.

The aim, also practical, of this governance framework, is to insure an adequate accountability for the firm: the recognition, according to the international standards, of profiles of excellence and reliability of actors' behaviors. Moreover, it derives consensus, trust, and availability from the markets and economic operators as conditions for the sustainability of strategic plans, even of those highly competitive and legitimately aggressive.

The management behaves more and more in a context in which the commercial and economic performances have to be balanced with integration skills involving the governance structure and the system of rules. In fact, different needs have to be conjugated, together with the pursuit of the following irrevocable financial and economic parameters:

- consistency with the institutional finalism of the organization and with the affirmed system of values;
- focus toward the reputational risk, within the framework of the risk monitoring of the firm;
- integration of the individual decisions within the increasingly complex decisional framework, that includes competitive variables, elements of governance, and organizational structure; preventive advices and ratifications of the holding; strategic guidelines coming from the industrial planning; delegations of the board; directions from the executive committee; teamwork, vertical and horizontal coordination processes of organizational dynamics (project groups, quality circles, budget committees, temporary work laboratories).

Within this evolutionary environment, the managerial style faces new requisites: the individual skills must conjugate with a certain degree of formalization, due to the necessity of operating in structured contexts with high external credibility. Moreover, stakeholders are more and more attentive to the balance between performance and risk management of the organization: supervision authorities, control bodies, rating agencies, mass media, industrial and commercial partners, other stakeholders.

A fundamental dimension of the globalization consists, in particular, in enlarging the perimeter of contact with the social parties. This result is due to the more significant articulation of businesses, with different markets and profiles of customers served, more needs to satisfy, diversity of culture, contractual dynamics, local competitors, varied laws and countries' uses.

Global players are usually organizations characterized by the majority of international employees, foreign customers, different use and symbolic values of products and services, dynamic and differentiated. The phenomenon of *demand bubbles* together with *market driven management* implies adaptability skills, versatility, promptness with the production management and the comprehension of more instable demand. In fact, the life cycles of products and services are now shorter and imitative tension of competitors particularly aggressive.

Following the evolution that interprets the firm as an open system, management must combine core skills with the wide attitude of general management in the business; this means the global comprehension of the criticalities of the business, the ability to integrate and coordinate processes all along the value system, the spirit of belonging to the organization, and the acceptance of its values.

From this perspective, organizational dynamics favor flexible processes oriented to customers and markets that abandon the traditional hierarchical structures and the associated organizational inertias, resistance to change, and inefficient communications. Information about markets are transferred to logistic and production cycles (and not more functions); organizations are progressively adaptive in reengineering processes to be coherent with the need of the markets, the competitive niches, and the emerging demand bubbles.

3. The Internal Control Systems' Role within Governance

The internal control system represents a fundamental infrastructure of the firm and contributes to the correctness of the operational processes.

From the milestone represented by the COSO Report – the famous American report on international praxis of governance and control issued in 1992 after the explosion of serious defaults following lack of internal control – until the recognition by the legal system and the international doctrine, the role of the internal control system is becoming a central point for the functioning of governance.

Generally speaking, the internal control system involves the following functions:

- pursuing efficiency and effectiveness of processes;
- coherency with decisional processes and strategic goals;
- safeguard and valorization of the assets, also intangibles, of the firm;
- respect of rules, laws, and procedures;
- supervision of the firm's risks related to the following areas: reputation, market, strategy, business, operations, organization, finance, compliance, information and legal systems.

The global competition sees the organization in different, flexible contexts, with increasing rhythms of innovation for products and processes, financial markets more and more volatile, and general turbulences of the environment. This effect calls for effective internal control systems ability to face risks and to pursue business performances with a correct balance between economic and financial conditions in the long term.

Management of the complexity following globalization – together with the numerous and discontinuous combinations of product/market/technology/customer, the heavy structure of the organization, and the variety of stakeholders – increases the need of adequate internal control systems. According to the paradigm of differentiation/integration of Lawrence-Lorsch, control systems have the peculiar function of integrating and insuring the coordination of a variety of elements within the global firm or inside the dynamic boundaries of global networks.

From a more evolved perspective, the responsibility for adequate internal control systems is associated with the top of the organization: the board, which conjugates the prerogatives of governance, and strategic orientation supported by a coherent organizational structure.

The supervision of adequacy of the internal controls is also the responsibility of the audit committee, within the board and its independent administrators, and the board of auditors. These bodies exercise continuous cross-supervision with the cooperation of the internal auditing that – on the basis of the principle of the separation of the managerial control – is an independent body and refers directly to the board. The internal audit verifies the formal and substantial correctness and monitors the risks related to the different managerial functions, checking anomalies and critical aspects for a prompt response.

Other special control bodies are the compliance manager and the risk manager. The first verifies the conformity of the firm’s operations with the legislation, the internal rules and the contracts; the latter supervises different operational, marketing, and business risks on the bases of performance measures linked to specific goals.

These control instruments are necessary and operate typically as controls at a distance of second and third level.

The leading character of the internal control system, however, is management. It has to interpret its own performances, within the inseparable process of description-action-control, reassuring the top of the firm and the customers about the correctness and the consciousness of its decisions. Managers can also achieve the highest level of recognizable skills in terms of reliability, professionalism, and ability to reach adequate performance in terms of effectiveness, total quality, and compliance.

Also the system of managerial incentives comprehend more and more frequently and with more importance profiles of compliance, together with the traditional parameters of performance such us productivity and net income.

The management is the leading character of line control of the first level inherent to the business, which is more immediate and coherent in terms of promptness, local and frontal needs.

This subsystem of internal control, called *management control*, represents a kind of self-control (“controllo autonomico” with the words of Franco Amigoni) that acts like a mechanism of learning and problem solving. It merges the strategic and operational dimensions to concretely create a management that is in line with the governance guidelines, the strategy, the value system, the legislation, the internal rules, and the external sensors (markets, competitors, customers, technologies).

Within this delicate composition of constraints and goals, management must experience and express better performances and innovation compared to organizations with a limited vision. The process is favored by the knowledgeable conciliation of management by commercial and profitable objectives and the respect of rules and responsibilities for the continuity of the firm.

Nowadays, management can rely on the reporting system and the controller - planner and consultant professional at the same time – developing a strategic dimension for the decision-making system and correct behaviors.

The interactive use and search of data for advanced business intelligence systems based on ERP technologies (*enterprise resource planning)* is the source of a complex, multidimensional, flexible and predictive information system; the latter can also become an instrument of benchmarking when connected with external data providers.

In synthesis, internal control systems assume a strategic role as a competitive advantage of the firm in global markets, promoting standing image and high rating recognizable by the economic and financial international community.

More specifically, advanced management control systems, if skillfully planned from a methodological point of view, can profit from information technology opportunities. The aim is to promote management professionalism with the ability to interpret strategically the discontinuous competitive environment of the global economy.