

INTERNAL AUDIT AND CORPORATE GOVERNANCE, AN ADDED VALUE FOR ENTITIES' MANAGEMENT

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ABSTRACT: The audit service is setting itself the purpose of an historical preview in the area of the internal audit and the Corporate Governance, having the goal of evaluating the past, present and the future of an entity in achieving the target-objectives so vital today for the public and economic entities in Romania. Through its objectives, the internal audit helps the management through the internal audit planning to discover the risk of business, the lacks of the internal control and the shortage of an inefficient management of the material, financial and human resources.

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Internal audit concept has recently emerged in the accounting profession in Romania and it elbows its way, systematically, according to the way in which modern management practices are implemented in the companies whose goal is to become more performing and competitive on the actual market. Effectively, there is not a lot of time for waiting that the modern management principles become predominant in Romanian entities. Since the moment of our entrance in the European Union, our companies are being in a direct competition with the first class European companies and the quality of management has become the determinative element on the integrated market.

Otherwise, the Romanian entities which has just started to operate on an European or international market, organized an adequate management and an audit function thinking that this is an important solution to survive in a world in which, above all performance would be in case, the most important is the competitiveness.

Public institutions are permanently confronted to theirs performances improvement. The function of the Internal audit offers, from this point of view, the reasonable security that the operations developed and the decisions taken are under control and that, in such a way, it contributes to the achievement of the entity's target-objectives.

It is very important to know the internal audit history and that of the corporate governance in order to evaluate the past, the present and their importance for the future of Romanian entities.

The name of internal **audit** that is used actually represents a recent concept and it was used first in the United States of America when the entities were affected by the economic recession and when they had to pay important amount of money for external auditors that had to certificate the accounts of the stock exchange listed companies.

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These companies began to organize their own audit departments in order to reduce their costs by assuming the realization of the preliminary work within the entity and, in order to achieve the process of certification, they appealed to external audit offices, which were entitled to supervise the company's activity. The offices' employees were called external auditors and the companies' employees were called internal auditors in order to make a distinction between these two auditors' categories.

During the evolution of internal audit we can remark the following important stages:

The Audit of the accounts was attested for the first time as a current practice on the European continent in ancient Greece and after that in the Roman Empire. The Athenian public finances System predicted even government auditors who examined the rappers of everyone who was responsible for the managing of public money especially at the moment of their mandate expiration.

After the fall of the Roman Empire, barbarian invasions caused a decrease in the level of the economy and the social life in Europe. Italian towns were the first to recover from that economic situation and they assumed audit as a current practice. Audit objective remains unchanged in order to look after the **prevention of the frauds**.

Until the sixteenth century, the principal goal of audit practices was the control of the managers integrity and not the registration quality. At the beginning, audit wasn't based on the internal control and it had not a goal, even a secondary one, like the accounting supervising as a registration of the transactions. Audit techniques consisted in the verification of all the transactions that had taken place.

After the beginning of the Industrial Revolution, the attitude facing the accounting system changed radically, because of the business development including the industrial one and because of additional capital requirements. Accounting began to be standardized in a way and the results of the internal control began to be used during the audit procedures, but audit continued to be based on an exhaustive examination of the transactions in order to detect the frauds.

After the middle of the nineteenth century, the owners tried to verify themselves the accuracy of the managers, but they realized that the checking of the accounts required a qualified labour force who needed to be independent to the management of the supervised company. From this moment, audit profession started to get an important enthusiasm because of the increasing demand for specialists with an independent statute.

Audit objectives began to get new values. If by that moment, the accent was on checking the financial situations, supervising that all the company's transaction had been registered and reflected correctly in the books and in the balance of the accounts, since 1904 it was decided that the auditor verify even the physical existence of the company's assets.

Audit development in Great Britain through the nineteenth century, as a result of the Industrial Revolution and of capital growth, has deeply influenced the evolution of the auditor profession in the United States. Even if, by the year 1932, the US audit practice had known a strong British influence, during the first decade of the twentieth century, this profession took an important impetus in America, developing itself as an independent profession.

American audit developed very rapidly towards the use of "**audit tests**" as some procedures adapted to the rhythm of business expansion for the U.S. market. In parallels with the investigation, it is also used the technique of transactions verification by the middle of **third parties confirmation**. The Americans were the first who started uniformization and standardization of audit practices since 1917.

Actually, internal audit is a very well organized profession, which could be found in more than 80 national institutes that are inscribed in the Institute of Internal Auditors (I.I.A.) whose head-office is in Orlando, in the United States. Also, **I.F.A.C.I.** (The French Institute of the Audit and Internal Control) is one of the most important and dynamic national organisms.

After the year 1950, audit knew a great period of important progress, the first and the most important objective continuing to be **the determination of the financial statements fidelity degree**.

The internal audit function was established in England and France in the early 60s, being deeply marked by its origins as financial and accounting control. Only after the 80s – 90s, the internal audit function began to appear in the business activity and, since that moment up to the present, it has been developing continuously.

In June 1999, The Board of Directors of **I.I.A.** gave **the definition of internal audit**: „internal audit is an independent and objective activity, meant to assure and to assist the entity in order to furnish an added value and to improve its operations. Internal audit helps the entity to achieve its objectives, assessing the company’s process of risk management, control and organization governance by the means of a systemic and methodic approach in order to make proposals to enhance their efficiency”.

Internal audit objectives are very different and depend on the entity’s size and structure and on the management and its staff requirements.

Internal audit activity presents the following objectives:

- Review the accounting system and the internal control system: the leaders’ responsibility in setting an appropriate accounting system and an internal control one, in order to grant a major importance to the principle of business continuity.
- Consideration of financial and operational information: the review of the methods used to identify, to count, to classify and to report the information and the specific examinations of some entity’s activity distinguished aspects, including a detailed verification of transaction, account balances or of the procedures used for setting them.
- review the economic system functionality, the efficiency and the effectiveness of all activities and operations categories;
- Review the conformity with legal settlements in force and with that issued by internal decision of company’s leadership;
- Special investigations in particular domains, for example, fraud suspicion and any kind of losses prevention;

According to these realities, internal audit definition performed in many aspects connected to the evolution of this profession. The official definition that appears in all the rules and in the specialized literature is criticized by someone, others are considering it more restrictive or being explained insufficiently by professionals who are interested in researching or in positioning accurately the internal audit concept.

By simplifying and summarizing these concepts, we can say that the most appropriate internal audit definition would be: „ *internal audit is an independent and objective activity that gives insurance to the entity regarding the degree of operations control, guiding it in order to improve its operations and that contributes to the creation of added value.*”

Romanian entities are expecting from intern auditor advantages issued by cost-benefit ratio. But how could we get these advantages? Or why the entity’s management doesn’t succeed always in realizing objectively the criteria attended at a moment when intern auditor is really in the possession of all professional knowledge in that field?

Where are the weaknesses? We read carefully the first part of the internal audit definition: “it is an independent and objective activity...”

How could a manager understand the auditor independence as far as the company pays him for an undetermined period and the company finds when he makes a recommendation concerning the activity’s deficiencies, uncomfortable? But there is a simple way to follow:

Internal auditor should not be subordinated in the theory and in facts to any functional structure of the entity; he must act directly, in terms of independence and objectiveness in order to support the suitable company's function ability.

In such a context, it is understandable that the internal auditor independence attributes do not represent an impediment for the manager. The last is required to see the truth that internal auditor represents a specialist who develops an activity for the simple interest of the management, an activity that should not be managed towards "convenient" areas but towards a real and necessary support, sometimes inconvenient.

Practically, we cannot involve and make interfering management in internal audit, but he is fully interested to take in consideration, to appreciate and to develop efficiently the conclusions learned from this activity. It is entirely wrong to consider any tendency to lead the internal auditor towards an insignificant control, which would not be able to create something else, but a great confusion between management responsibility for internal control and the responsibility of system functionality as a whole.

In this respect, it is important to point the independence double character, emphasized by the service independence within the entity and also by the independence of internal auditor who practices the objectiveness. This does not mean that the financial auditor represents a second manager. On the contrary, we must consider his function subjectively, in the context and for business support.

The manager, at his turn, has the duty to ensure even since the early phase of internal auditor engagement, the professional ability of that person, his authority, but also his psychological constitution, according to the requirements of the future activity, respecting the objectives and entity's specific in discussion.

In other words, there is some "market" like an offer from internal auditors, and those who wish to qualify for winning internal audit contracts have the entire interest to achieve certain standards, which could situate them in the bottom of the retraining pyramid.

Otherwise, this is what the Chamber of Financial Auditors in Romania propose, in order to support the members who are developing such activities. Therefore, the Chamber made available to professionals the following things: the international standards of internal audit; professional rules; the code of ethic etc and the Chamber plans to develop a set of minimum specific rules.

Concretely, internal audit helps the entity to achieve its objectives, evaluating by the means of a systemic and methodic approach, its process of risk management, of control and entity's governance in order to make proposals to enhance their efficiency in a total independence and not dependent to the management.

We consider appropriate to clarify the following terms:

- **Control degree:** *the efficiency of internal control system functionality;*
- **added value in internal audit:** *the insurance of some advantages regarding rational management of entity's resources;*
- **Evaluation:** *a group of methods for the appreciation of process functionality;*
- **systemic and methodic approach:** *the using of some techniques and procedures, based on the Practical Rules of the Internal Audit Standards Application.*

In this context, it is obviously that we must accept a clear distinction between internal control and internal audit: internal control is a system designed to offer a reasonable insurance regarding the achievement of management objectives and, internal audit, as well as its definition attests, **evaluates its functionality.**

Corporate Governance represents a set of principles, standards and best governance practices, settled by an institution whose application does not have an obligatory character, but one optional. The adoption of corporate governance principles was materialized in the principles of Cooperation and Economical Development Corporate Governance Organization (OECD).

In the European Union, the corporate governance concept began to take shape after the year 1977, when the most part of the countries adopted corporate governance codes. The impulse of these codes' adoption were financial scandals connected to the bankruptcy of some British companies listed on the capital market. On the other hand, the Asian economic crisis as well as the investors' withdrawals from Asia and Russia determined great problems for the international business community, problems connected to the consequences of the investors mistrust in companies management. Thus, Cadbury Code from 1992 was established in order to prevent some similar financial scandals and to regain the public and investors confidence in companies governance practice. United Kingdom has the largest number of corporate governance codes, almost the third part of all codes issued by European Union member countries. Corporate governance includes the relation between the Board of Directors and interested parties such as the shareholders, the employees, the clients, the suppliers, the government and also the great public.

*The main goal? **The efficient management of material, human and financial resources, the fraud prevention and the minimization of risks regarding the events and the transactions that take place in an entity.***

Besides the classic insurance mission, internal auditors assume an advising role in order to improve the entity fundamental process. Audit missions make evident the anomalies and the significant weaknesses in the processes that are developed at the institutional level in order to remedy or to attenuate its consequences.

Internal audit must propose audit planning based on risks analyze in order to establish the audit activity priorities. Audit based on risk analyze, modifies the way in which auditors perceive the control and the risk. **Internal audit must help the public entities management to maintain an appropriate internal control, evaluating its efficiency and its effectiveness and encouraging the continuous improvement.**

Risks evaluation should consider the management of change: people are changing, methods are also changing, and risks are changing too. Risks evaluation means their identification and their analyze evidenced in the achievement of the objectives in order to know how they should be managed.

We consider that the expectation of a public internal audit, which consists in managerial support, is meant to help the leaders to organize and improve internal control. By sharing knowledge, public internal audit allows the designation of the prospects and contributes to progress.

It is very important for internal audit to participate to the debate at the highest decisional level within the entity, the debate of the major problems that have important system implications to the activity of the entity as a whole, creating by this way, the possibility of targeting this activity of internal audit to the issue faced by the management.

Internal auditors must show brightness, consistency, professionalism, amiability, competence, communication etc and must aware the entities audited of their support, for their interests and, what is the most significant, for the goal of creating an added value. **This added value resulted from internal audit is the effect of the contribution in competence caused by the use of a rational internal control.** We have to approach internal audit in a constructive manner, which would be based on a future oriented partnership between the manager and the auditor. This partnership would be based too on the auditors' professionalism and objectivity, as well as on the responsibility of the audited entities concerning internal audit role. Public internal audit was established in Romania by Law no. 672/2002, which determined also the beginning of internal audit structures and activities within public institutions. According to internal regulations, the General Rules for the exercise of internal audit were developed, and from these rules, public entities established their specific rules in order to practice internal audit.

Conclusions

Audit has developed itself from an exhaustive verification of the transactions in order to detect frauds, to an investigation in order to detect the main entities risks and to evaluate internal control which is organized and exercised at this level

Corporate Governance is practically an attempt to define a good management practice and an introduction of some mechanisms for verifying their implementation and their functionality according to the existant requirements. The fact that Romania joined the European economic espace, forces the professionals to establish a Corporate Governance Code as well as European countries had settled, accepted and applied before.

Internal audit helps the institution to achieve its objectives by assessing its process of risk management, of control and of leadership. By the means of permanent advices, internal auditors could help the institution to identify, to evaluate and to implement a risks management and control device in order to be able to manage these risks.

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