

# INTERNAL AUDIT FOR FINANCIAL INVESTMENT COMPANIES – ASSURANCE FOR ADEQUATE SUPERVISING OF CORPORATE GOVERNANCE PRINCIPLES

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*ABSTRACT: In the risk assessment process, financial auditors often rely on internal auditors when establishing the control risk level. Therefore, adequate internal audit function, as part of a solid corporate governance is a factor of lowering control risk, when assessing audit risks for Financial Investment Companies. The paper intends to approach issues related to internal audit as a relevant source of added value for listed companies and the main objectives related to internal audit engagements for Financial Investment Companies. The authors are trying to answer how internal audit contributes in an effective manner in the process of supervising corporate governance principles that Financial Investment Companies as listed companies, must comply with.*

*Keywords: investment companies, corporate governance structures, internal control, management policies, tests and procedures*

*JEL Codes: M42*

## **1. Internal audit – relevant source of added value for publicly traded companies**

Internal audit is an independent and objective activity, which provides an entity a certain level of assurance regarding controlling business operations, advising for a better assessment of operations and contributing to added value generating process<sup>1</sup>.

Internal auditing is a both a profession and an activity involved in helping organizations achieve their stated objectives, by using a systematic methodology for analyzing business processes, procedures and activities with the goal of highlighting organizational problems and recommending solutions. The scope of internal auditing within an organization is broad and may involve topics such as the efficacy of operations, the reliability of financial reporting, deterring and investigating fraud, safeguarding assets, and compliance with laws and regulations<sup>2</sup>.

Internal auditors perform tests and procedures to evaluate whether the management policies, rules and controlling processes are designed and operating effectively, providing recommendations for improvement.

## **2. Objectives related to internal audit activities for Financial Investment Companies**

Financial Investment Companies must implement and maintain a segregated internal audit function, independent from other operating functions, requiring the following responsibilities<sup>3</sup>:

a) Projecting, implementing and maintaining an internal audit plan, to assess and examine the efficiency and adequacy of internal control mechanisms and procedures;

<sup>1</sup> Camelia Liliana Dobroteanu, Laurentiu Dobroteanu, *Internal Audit*, Ed. InfoMega, 2007, pg. 27, adapted from the definition issued by the Institute of Internal Auditors (IIA).

<sup>2</sup> <http://en.wikipedia.org>

<sup>3</sup> Romanian National Securities Commission Rule no. 32/2006 regarding financial investment services.

b) Issuing recommendations based upon the results of those activities planned to perform according to internal audit schedule;

c) Verifying how recommendations are followed and implemented;

d) Reporting upon internal audit issues regarding internal control system and risk assessment process.

Based on a risk assessment process of the investment companies, the Audit Committee inside the oversight Board of Directors determines where to focus internal auditing efforts. A typical internal audit project for Financial Investment Companies may involve the following phases<sup>4</sup>:

- Establish and communicate the scope and objectives for the audit to appropriate management;
- Develop an understanding of the business area under review;
- Identify control procedures used to ensure each key transaction type is properly controlled and monitored;
- Develop and execute a risk-based sampling and testing approach to determine whether the most important controls are operating as intended;
- Report problems identified and establish action plans with management to address the problems. Internal auditor typically reports the most critical findings and issues to the Audit Committee generally on a monthly basis, along with management's progress towards resolving them. Critical issues have a reasonable likelihood of causing substantial financial or reputation damage to the Financial Investment Companies;
- Follow-up on reported findings at appropriate intervals.

### **3. The Role of Internal Audit function for supervising Financial Investment Companies operating activities**

Traditionally, investment companies regarded both as institutional investors (closed-end funds) and traded companies on a regulated capital market, issue securities that are offered to public, placing the raised funds in portfolio financial investments. Subsequently, the owner of the shares issued by investment companies, gains interest in a collective investment scheme, managed by the investment company itself.

For a better understanding of internal audit function as a source of creating added value for Financial Investment Companies, the following perspectives are relevant in a detailed approach:

#### **✓ Internal audit in relation with internal control**

Internal auditing activity is primarily directed at improving internal control. Under the COSO Framework, internal control is broadly defined as a process, maintained by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following internal control categories:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with laws and regulations.

#### **✓ Internal audit in relation with risk management processes**

Internal auditing professional standards require monitoring and evaluating the effectiveness of the organization's risk management processes, related to how an entity sets objectives, identifies, analyzes and responds to those risks that could potentially impact its ability to realize its objectives.

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<sup>4</sup> <http://en.wikipedia.org>

Under the COSO enterprise risk management (ERM) Framework<sup>5</sup>, management performs risk assessment activities as part of the ordinary course of business under strategic, operational, financial reporting, and legal/regulatory categories. Sarbanes-Oxley<sup>6</sup> regulations also require extensive risk assessment of financial reporting processes.

Internal auditors may evaluate each of these activities, focusing on the processes used by management to report and monitor the risks identified. For example, internal auditors can advise management regarding the reporting of forward-looking operating measures to the Board, to help identify emerging risks.

#### ✓ **Internal audit in relation with corporate governance**

Corporate governance is a combination of processes and organizational structures implemented by the Board of Directors to inform, direct, manage, and monitor the organization's resources, strategies and policies towards the achievement of the organizations objectives. The internal auditor is often considered one of the "five pillars" of corporate governance, the other pillars being the Board of Directors, management, audit committee and the external auditor.

A primary focus area of internal auditing relating to corporate governance structures is helping the Audit Committee inside the Board of Directors perform its responsibilities effectively. This may include reporting critical internal control deficiencies, informing the Audit Committee privately on the capabilities of key managers, suggesting questions or topics for the Audit Committee's meeting agendas and coordinating carefully with the external auditor and management to ensure the Audit Committee receives effective information.

#### **4. Supervising corporate governance principles through internal audit**

Corporate governance includes structures that govern together relations between those who invest resources and those who monitor and manage business in that country. These relations are both formal, defined by rules and regulations as well as informal, materialized in business practice, ethical codes, etc. In such approach, transparencies in relationship with investors, as well as the quality of financial reports addressed to them, are primordial factors that may significantly influence the decision of undertaking a certain level of risks associated to financial investments<sup>7</sup>.

The success of implementing corporate governance depends upon reliability allocated to corporate operators, being required cooperation and responsibility. In today's business climate, corporate governance has become necessary concerning the fact it assures a certain level of reliability, requested for an adequate functioning of a market economy<sup>8</sup>; lowering the informational risk and the cost of capital, as well as efficiently resources consumption.

The importance of corporate governance for Financial Investment Companies has led to specific regulations inspired from national law system (Companies Act, Accounting Regulations, Capital Market Law, Rules issued by Romanian National Securities Commission) as well as international law (European Directives and Recommendations, Corporate Governance Codes, OECD Principles from 1999 and 2004, etc.)

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<sup>5</sup> The new Enterprise Risk Management (ERM) COSO framework emphasizes the importance of identifying and managing risks across the enterprise. The new COSO framework consists of eight components: a) Internal control environment b) Objective setting c) Event identification d) Risk assessment e) Risk response f) Control activities g) Information and communication h) Monitoring.

<sup>6</sup> SOX 404 Section - Management Assessment of Internal Controls: Each annual report should contain an internal control report, which shall: (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. With respect to the internal control assessment, each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer.

<sup>7</sup> Tatiana Danescu, Ovidiu Spatacean, *Corporate Governance- Applied principles for companies listed on a regulated capital market*, Financial Audit Magazine (August 2008), issued by Romanian Financial Auditors Chamber.

<sup>8</sup> *Principles of Corporate Governance*, OECD, 2004.

Disclosure and presentation of adequate information related to Financial Investment Companies are regarded as a relevant instrument for management supervising, as well as strong influencing factors for price movements on the stock exchange. Provided that investors lack of confidence in the disclosure of financial or non-financial information, they will search another investment options. On an international scale, new possibilities have emerged for minimizing investment risks, for instance the requirements of a Code principles adherence.

In Romania, Bucharest Stock Exchange has adopted the Corporate Governance Code<sup>9</sup> to reflect corporate governance principles addressed to companies that have issued financial instruments traded on a regulated capital market, encouraging other companies' adherence.

The main aspects that should capture internal auditors' interest concerning adequate application of corporate governance principles and rules, may be described as it follows:

➤ **Assuring adequate framework for efficient corporate governance**

Corporate governance must promote transparent and efficient markets, must comply with rules and regulations, clearly segregating responsibilities between regulators and operating entities. From this approach, Financial Investment Companies must adopt clear and transparent corporate governance structures, establishing adequate functions, abilities and responsibilities for management and the Board of directors. Furthermore, in their annually report, Financial Investment Companies must insert special paragraphs to describe relevant events related to corporate governance, as well as explications to inadequate application of recommendations from the Bucharest Stock Exchange Corporate Governance Code.

Transparent relations between issuers of securities and investors represent a fundamental requirement for promoting an adequate level of informational efficiency for Romanian stock market. Therefore, specific laws and regulations<sup>10</sup> require Financial Investment Companies to respond at investors' informational needs by reporting:

✓ *inside information*: Board of directors' decisions for General Shareholders' Meeting callings, changes in control possession or in managerial structures, auditors' changes, ceasing commercial contracts that resulted in a decline of revenues at least by 10%, changes in rights attached to securities, litigious events or bankruptcy procedures initiation, off-balance sheet with significant impact upon financial condition, etc.

✓ *significant events that may cause relevant changes in stock prices*: liabilities resulting in financial condition depreciation, asset sales and acquisitions in value of at least 10% from total assets, contracts in value of at least 10% from annual turnover, new products or services that significantly affect resources, etc.

✓ *quarterly and biannually financial reports*: these include interim reports, Board of directors' reports, audit or reviewing reports.

✓ *supplementary reports*: issued by internal or financial auditors at the request of shareholders owning at least 5% of in-paid capital.

➤ **Rights of securities owners and main functions of property**

Corporate governance structures must protect and facilitate exercising of shareholders' rights, through:

✓ *safe methods for securities register and transfer operations*;

✓ *regular and operative disclosure of relevant information related to corporate events occurred in Financial Investment Companies*;

✓ *free access to vote for all shareholders entitled to participate at a General Meeting*;

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<sup>9</sup> Corporate Governance Institute of Bucharest Stock Exchange (<http://www.governantacorporativa.ro>).

<sup>10</sup> Capital Market Law no. 297/2004, Romanian National Securities Rule No. 1/2006 regarding issuers and securities transactions, Romanian National Securities Rule No. 15/2004 regarding authorization and operating of asset management companies, mutual funds and depositaries.

✓ *transparent prices and fair treatments for all shareholders, designed to improve market efficiency and investors' rights protection.*

✓ *consulting investors, especially institutional ones, on matters such fundamental rights and market abuse prevention.*

#### ➤ **Fair treatment of securities owners and effective communicating**

Corporate governance structures must assure equal treatment to all shareholders, including those in minority. From this perspective:

✓ *all investors should be able to obtain equal treatment regarding information related to rights attached to all classes of financial instruments, before buying, and any changes occurred in voting rights should be subject to approval from all negative influenced shareholders.*

✓ *minority shareholders should receive adequate protection against abusive measures and should benefit from effective measures to recover any potential losses.* Mainly, such measures refer to:

- the right to "exit the company" as a result of a public purchase offer or of a merger against minority shareholders' will,

- the right to express cumulative vote at the request of a significant shareholders for electing members of the Board of directors.

✓ *inside trading and individual abusive business operations should be prohibited. Members of the Board of directors and other relevant persons charged with corporate governance should reveal any material interest in any transaction affecting Financial Investment Companies<sup>11</sup>.*

#### ➤ **Securities owners' role in the system of corporate governance**

Corporate governance structures must recognize the shareholders' fundamental rights, so they are established by law or mutual agreements, encouraging active cooperation between Financial Investment Companies in creating wealth and sustaining national economy from a financial point of view.

#### ➤ **Disclosure and transparency**

Corporate governance structures should assure correct and operating dissemination of all material aspects related to Financial Investment Companies, including financial statements, property rights and governance policies.

Dissemination and transparency respond to reporting requirements applied to Financial Investment Companies, related to relevant aspects, such are: financial and operational results, development strategies, management objectives and philosophy, property rights and voting rights of shareholders, remuneration policies regarding management and the Board of directors, transactions involving related parties, risks and uncertainties with significant impact upon entities, etc. Disclosure and presentation of financial and non-financial information should comply with high quality financial reporting standards and dissemination tools should provide equal, efficient and operative access to all users, especially investors.

Information produced by financial reporting system should be subject of internal audit process, in an independent, objective and professional manner, to assure management and Board of directors that financial statements reflect in all material aspects, a true and fair view of financial position and performances. Internal auditors should also test the efficiency and reliability of internal controls, in aspects that may have relevant impact upon financial statements.

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<sup>11</sup> Capital market regulations oblige reporting to supervising authority (Romania National Securities Commission) and to market operator (Bucharest Stock Exchange) any transactions closed on behalf the management, the Board of directors or other relevant persons in close relations, on behalf investors that are linked to a single investment policy related to a Financial Investment Company, as well as on behalf those persons who acquire stock above the limited level of 1% from the total number of shares issued. Furthermore, the Board of directors should report any transactions of a higher level than 50.000 Euro, involving members of the Board, management, employees, shareholders and other relevant persons in close relations.

### ➤ Board of Directors' duties

Corporate governance structures should facilitate strategic guiding of Financial Investment Companies through effective monitoring of management by the Board of directors. Members inside the Board of directors should act in good faith and with due diligence on the behalf of all securities holders, complying with adequate ethical conduct and managing key responsibilities, such are:

- ✓ *reviewing and guiding general development strategy of Financial Investment Companies, plans of actions, risk management policies, annual budgets and business plans;*
- ✓ *targeting and monitoring performance objectives and major investment expenses;*
- ✓ *monitoring efficiency related to corporate governance relevant practices, undertaking measures for changes or correction, where it is required;*
- ✓ *assuring a transparent and formal electing system for all members of the Board and other persons charged with corporate governance;*
- ✓ *managing and monitoring any potential conflict of interests between management, members of the Board and shareholders, including any misrepresentation of financial assets owned by Financial Investment Companies;*
- ✓ *assuring integrity of financial reporting, including adequate functioning of internal controls, risk management process and complying with rules and relevant professional standards.*

## 5. Conclusions

Internal audit function established for Financial Investment Companies is a fundamental component of a healthy corporate governance structure, at least from the perspective of helping in maintain stability in raising funds through capital markets mechanisms (IPO's - Initial Public Offerings) as well as improve the level of transparency and reliability in relationship with investors according to international accepted principles.

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