

The Role and Implications of Internal Audit in Corporate Governance

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Abstract This article aims to address audit role in corporate governance in the light of scientific literature. The foundation of this study is achieved by synthesizing current state of knowledge through quantitative and qualitative research. So we extracted the main lines of topics: conceptual levels on internal audit, corporate governance developments at national and international levels, internal audit in corporate governance of public and private entities from Romania and other corporate governance issues. As a research method, we used survey and data were processed using a statistical program. The novelty that we caught in the present paper is the analysis of the role of internal audit in the governance in public and private entities through two pillars: promoting ethics and values within the organization and ensuring effective organizational performance management/governance.

Keywords Internal audit • Corporate governance • Audit role • Ethics and value • Performance management

1 Introduction

As we cannot build a strength building without a strong foundation, so we cannot achieve good governance unless we respect a number of requirements and essential features. Through our article, we want to emphasize the importance of internal audit in improving corporate governance.

In carrying out this paper, we have focused on the various issues of the corporate governance and the internal auditing of organizations, starting on the assumption that creating the syntheses containing the results of these comparative studies is essential, thus enabling them to become real lessons for the practical applicability of the various corporate governance theories, with the possibility of outlining the best practice guidelines for corporate governance in general and for auditing in particular. Therefore, we set out to grasp the attitude towards the value of internal

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auditing in the public and private organizations comprised in the sample by means of the questionnaire. We chose to analyse both sectors in order to draft a comparison that would pertinently emphasize the methodology and implications of the internal auditing in the corporate governance within the public and private entities in the North-Eastern part of Romania.

2 The Conceptual Spectrum of Internal Auditing

During the last years, we have witnessed an acceleration of events in regard to the global economy. Therefore, we have experienced an unmatched rise due to certain factors such as the independence, expertise, professionalism, impartiality and quality services being rendered. The retechnologization, the realignment and the excessive sector specialization offered the dream of endless prosperity to the corporations and led to ignoring the risks, the defective control and the trust granted to the employees without any verification. The same direction was taken by the internal auditors, adopting a libertine and gentle position towards the organizations. What followed, and here we make reference to the financial collapse, the accounting frauds, was a catastrophe, given that the entities no longer presented any credibility, they were in inability to pay and the price of the shares had dropped. The trust of the stakeholders as well as of the other users of financial accounting information was regained by the internal auditing secured on each level of the enterprise's functions. Through auditing, the verticality of the profession was regained, as well as the credibility of reporting.

The definition of internal auditing (IIA 1999) is now familiar and well accepted: "Internal auditing is an independent, objective, assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes".

Internal audit is a permanent and active instrument of corporate governance because we recounted it in the financial accounting, operational, commercial and IT functions.

Internal auditing is a profession that has always redefined itself throughout time, given the wish to meet the ever-changing necessities of the enterprises. In time, a shifting in the objectives of the auditing occurred from focusing on the financial accounting problems of the enterprises to identifying the risks and evaluating the internal control to currently holding a position of evaluation and counselling.

Through the activities unfolded, the internal auditing adds value both by evaluating the internal control system and by analysing the risks associated with the auditable activities, as well as through the recommendations to be found in the auditing report drafted and transmitted in order to ensure that the organization meets its objectives.

3 Corporate Governance: Ideological Landmarks

The issue of corporate governance expanded greatly, as mentioned before, during the last decades on the international level and during the last 10 years on the national level. As a natural consequence to the rise in the concept's importance, a series of theories and models of corporate governance developed, which define and underline the significant elements.

In the literature we find various models of corporate governance. However, only a few are approached with frequency: the model based on the analysis and solving of the divergences that might occur between the owners and the managers (agency theory), the model founded on the idea that the success of a company can be quantified by its capacity of creating capital acquired for all of the interested parties (stakeholders theory), the model focusing on the management philosophies of the administrators (stewardship theory), the political model, the model based on theory of the hegemonic management, etc.

In conformity with the agency theory, the principles of corporate governance protect the interests of the investors that are interested in recovering the investment made, as well as the benefits afferent to it, and solve the conflicts that might occur between the owners and the managers (Tricker 2012). The stakeholders' model associates the corporate governance with a system that ensures the optimum usage of resources in favour of the interested parties. Mulili and Wong (2011) consider that a participation of the groups of interests in the decision-making process may generate an increase in the organizational efficiency and reduce the conflicts of interest. The political model, in conformity with Turnbull (1997), takes into consideration the fact that allocating the corporate power, the privileges and the profits between the owners, managers and other interested parties is highly influenced by the political factor. The stewardship theory (the administration theory) established the fact that the managers are skilled administrators that render quality services in the interest of the companies' owners because they consider this approach the most favourable one to their interest on the long term; therefore, they will not pursue their own benefits (David et al. 1997). An interesting research in this area was made by Syriopoulos and Tsatsaronis (2012) which claim that agency and stewardship theories put forward conflicting arguments in favour or against CEO duality/separation.

Regardless of the moment of occurrence or the context in which they were applied, each of the theories described has a well-established place in the literature dedicated to the methodology of governing the corporations, constituting the fundament for subsequent approaches in the development of the concept of corporate governance at the scale of global economy. Tricker (2012) firmly advocates the idea that all of the entities need to be managed and governed, even if they are public or private, governmental entities, charitable organizations, academic institutions or non-profit associations, mentioning that if during the twentieth century the management was at the centre of attention, in the twenty-first century, the focus will be on a relatively new concept, that of corporate governance.

The difference between corporate governance and management is the following: the executive management is responsible for managing the company and the governance ensures that the business unfolds in the best direction, in conformity with the objectives established by the owners at the shareholders' general meeting, agreed upon and subsequently assimilated by the other internal stakeholders of the organization (Pirtea et al. 2014).

4 Can We Talk About Corporate Governance at Public Organizations?

The concept of corporate governance has been assimilated by the auditors and provided also by the international internal audit standards. Public internal auditing plays an important role in corporate governance through its monitoring function (Ghita et al. 2010). According to national legislation represents a functionally independent and objective activity that gives assurance and advice to management on the good administration of public revenue and expenditure, perfecting the public entity activities. Also, internal audit helps the public entity to fulfil their objectives through a systematic and methodical approach which evaluates and improves the efficiency and effectiveness of the management based on risk management, control and management processes.

The updated Public Internal Audit Act 672 (2002) specifies that internal audit departments exercise the following types of actions: audit system, performance and regularity. Through their work, auditors can bring balance between current activity and the expectation of public entities on the basis of risk quantification. Outside the executive function, the public internal audit can have a supportive role in corporate governance. Public internal audit could contribute by supportive role in legislative adjustment or in initiation of a legal system more efficient and effective governance that bring added value to public entities.

Through auditing missions, supportive legislator's activity occurs most "gentle" in the system of corporate governance. Identifying risk in the existing legal system, nuisance and problems leading to inconsistencies and difficult operation of the entities will be made directly to the scheme.

The role of internal auditor will be an intermediary between persons who perform gainful activity in various departments, divisions, departments and public entities and the promoters of the missions' legislative project with supportive role. For corporate governance, to provide a coherent legal system that is pragmatic, transparent and effective requires a special effort from both the auditors and the authorizing officers. The role of the auditor can be expressed through *plastic magnifying glass effect* element which aims to highlight the problems of a system and to provide the superior hierarchical structures with decisional capacity.

In conclusion, the role of internal audit through supportive role for legislative issues, although it only has an advisory function, is a key element in the development of laws with significant repercussions on corporate governance.

5 The Involvement of the Position of Internal Auditor in the Governing Process of the Public and Private Entities in the North-Eastern Part of Romania

5.1 Research Method

The governing process of the entity is unfolded effectively by the persons or managerial divisions whose owners delegate authority in this sense, such as the administration council, the management, the auditing committee, the internal and external auditors and the regulating factors within the different areas that have as main competence the monitoring of risks and performing the verifications adopted by the management, in view of reaching the objectives of the entity and maintaining its value (Chambers and Odar 2015).

The purpose of the research is to provide pertinent scientific conclusions in view of improving the relationship between the producer and the beneficiary of the internal auditing recommendations and to emphasize its role within the corporate governance.

In order to gather data, we have used the most known method: the investigation. This consists of a questionnaire and a sample representative for the population being considered and that has been chosen for the present research. In unfolding the research, we have chosen to analyse the private companies and the public institutions in the North-Eastern area of Romania. The sampling unit in the present case is represented by the staff of the private companies that hold executive positions, the public servants and the contract personnel. The investigation unfolded by using electronic questionnaires sent by email to the entities being analysed, as well as by travelling to the headquarters of certain public institutions that had responded positively to our solicitations, but chose to communicate personally.

The questionnaire developed is characterized by a high level of structuring, which contains questions that are mostly closed and some open questions. The main open questions refer to the respondent identifiers (county, type of entity, respondent's position in the organization) but also aspects related to the role and duties of the persons that govern the entity or the impact of internal audit in corporate governance.

In achieving the paper and in the idea of obtaining relevant information, we have chosen as a sample private companies and public institutions in the North-East Romania with the districts of Iasi, Suceava, Bacau, Botosani, Neamt and Vaslui.

The database included mainly large- and medium-sized organizations, where suitable a priori recommendations on the field of corporate governance but also a

number of small institutions, such as communal city halls. So, private entities over which the questionnaire was applied are listed on the Bucharest Stock (Exchange) since those companies are subject to the Code of Corporate Governance and perform internal audit activities. We chose to analyse the public institutions also, more exactly the local public administration authorities, as they are under the law that stipulate the obligation to perform internal audit activity. Sampling units in this case were person with power of decision within the various structures of governance of the entities, mostly managers, shareholders in such companies, authorizing officers in public institutions, members of the boards of directors, business executives and financial accountants.

Data collection was conducted from September to November 2014, and this requires a continuing effort to get as many answers, ensuring constantly the respondents about the confidentiality of the data highlighted in the questionnaire.

Throughout the investigation, we have also had difficulty in obtaining the information in the sense that the number of persons who responded were less than expected compared to the initial sample. Having the possibility of directly contacting the responsible persons may lead to a decrease in the level of risk and to an increase in the level of trust. However, the lack of resources and, particularly, the distance did not permit us to apply these measures.

Following submission of the questionnaire via email and through direct contacts to a number of 412 organizations, we have received response from a total of 43 public entities and 36 private companies. We believe that the response rate of 19.17% is a satisfactory response rate compared to other studies with similar methodology.

We can state the fact that during the last years, a growing interest in the relation between the internal auditing and the corporate governance of both private and public organizations is noticeable. The research unfolded showed that 40% of the private organizations in the sample have been implementing the internal auditing as a pillar of the corporate governance for at least 2 years. If in the case of multinational companies, the internal auditor benefits from experience gained within the group, in the case of public institutions the department for internal auditing has been created only quite recently, starting from zero or, alternatively, taking over the staff and the methodology of the older structures of internal financial control.

Regarding regional distribution of respondents (Fig. 1), there is an increased receptivity of organizations from Suceava county, since most of these were personnel contacted to complete questionnaires, compared with Vaslui County that had a small number of responses.

5.2 Results and Discussion

The analysis at private entity level (listed on the stock exchange) reveals that the internal audit activity is organized in the proportion of 87.80%. Detailing the

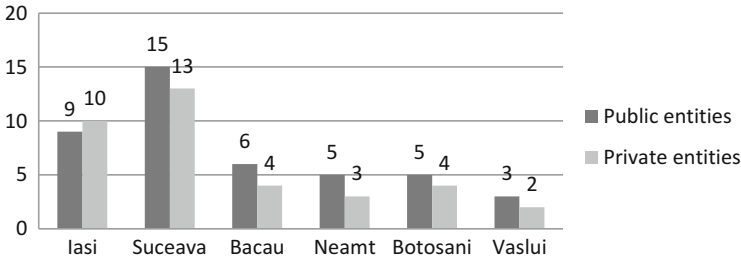


Fig. 1 The distribution by county

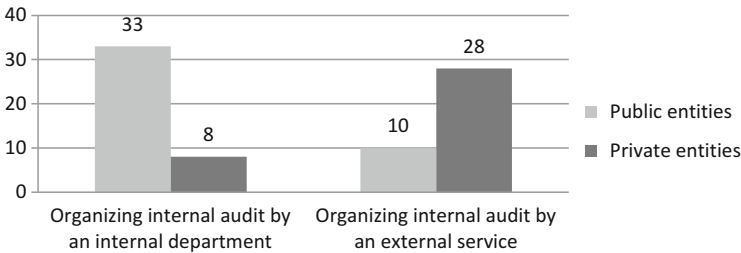


Fig. 2 The organization of internal audit at public and private organizations in Northeast Romania

results obtained, we can say that a total of 8 units have a Department of Internal Audit; the remaining 28 units have outsourced function through an external service.

Within public institutions, the internal audit activity is organized in 95.55 % of cases (33 institutions within their own department and 10 institutions have outsourced the service) as we can see in Fig. 2.

What we can observe is that, in terms of the organization of internal audit, public institutions have largely internal audit department, which is due to new legal regulations existing, and private entities have outsourced internal audit through external services.

In order to analyse the role of internal audit in public and private entities in the Northeast Romania in terms of implementing the recommendations of good governance, it was proceeded to testing of an econometric nature. Regarding this, we firstly proceeded to the coding of responses received from respondents, giving scores to each question. So, score was ascending given, as the answers correspond to the recommendations of good governance. Because all the questions in the questionnaires were fully completed, we didn't normalize values.

The internal audit activity should assess and make appropriate recommendations for improving the governance process. In this idea we analysed the entities in terms of promoting appropriate ethics and values within the organization and ensuring effective organizational performance management/governance. We believe that through analysis of these two pillars, we can confirm the hypothesis from which we started, namely, internal audit plays an important role by being a basic support for good governance in public and private entities.

The first line of research, promoting appropriate ethics and values within the organization, provides an overview of the degree to which ethics and values are promoted properly according to the needs of the organization. In a democratic society, a distinctive feature of the profession of internal auditor is to establish a code of ethics regulated at national level. Ethics is a set of principles that give moral value. Ethical behaviour is necessary for an organization to function in an orderly manner. AICPA Code of Professional Conduct provides both general rules for ideal conduct and specific conduct rules with concrete application (Arens and Loebbecke 2000).

From Table 1 we can see that ethics and values are promoted to a great extent (43 %), positive aspect for our analysis. Also from Table 2 we can see that most public institutions and private entities put great emphasis on promoting ethics and values within the organization. Internal auditing help corporate governance by reviewing the organization's code of conduct and ethics policies to ensure they are current and are communicated to employees.

Everett and Trembla (2014) consider that ethics of auditing is not enough to focus only on the practice of auditing; it is also necessary to consider the ethical character of the auditor herself or himself. One need ask about the type of person or character most valued in the field of audit (Francis 1990). This is not to overstate the need to focus on character, however, as virtue ethicists focus on both a person's thoughts and actions, or intentions and behaviours as Armstrong et al. (2003) said. The virtuous person is one who thinks and, more importantly, acts in a virtuous way.

Figure 3 shows that public entities take into the discussion ethics and values to a medium and large extent, private entities alike, with one exception: we have a public organization that emphasizes not all with this variable. The results are more than satisfactory, since an equal number of seven public and private promote ethics and values in very large measure.

The second pillar investigated regarding the performance management/governance reflects a satisfactory situation. Table 3 highlights the following aspects: 17 public institutions argue that the governance has an average performance, largely 14, 10 have a very large extent, and only two entities have a low efficiency. Private entities said they own a largely efficient management.

Ernst&Young (2008) emphasized that besides the methods (identified in 2007 survey) used in measuring internal audit's performance like completed internal audits in comparison to the internal audit plan and the length of time for issuing internal audit reports, there is one more frequently used, namely, *the results from shareholders surveys*. They identified that only 34 % of respondents use length of time to resolve internal audit findings and only 22 % use support of key business initiatives as a key metric.

A strong preoccupation for internal auditors with regard to effectiveness and performance of management can be observed in Fig. 4. The technology provides a great added value for a lot of activities including internal auditing and performance management. Thanks to technology, now, internal auditors have the possibility to

Table 1 Promoting appropriate ethics and values within the organization—global values

		Frequency	Valid percent	Cumulative percent
Valid	Not at all	1	1.3	1.3
	In a small measure	9	11.4	12.7
	In a medium measure	21	26.6	39.2
	Largely	34	43.0	82.3
	In a very large measure	14	17.7	100.0
	Total	79	100.0	

Table 2 Promoting appropriate ethics and values—detailing by types of entities

Count		Promoting appropriate ethics and values					Total
		Not at all	In a small measure	In a medium measure	Largely	In a very large measure	
Entity	Public	1 ^a	5 ^a	12 ^a	18 ^a	7 ^a	43
	Private	0 ^a	4 ^a	9 ^a	16 ^a	7 ^a	36
Total		1	9	21	34	14	79

^aEach subscript letter denotes a subset of promoting appropriate ethics and values categories whose column proportions do not differ significantly from each other at the 0.05 level

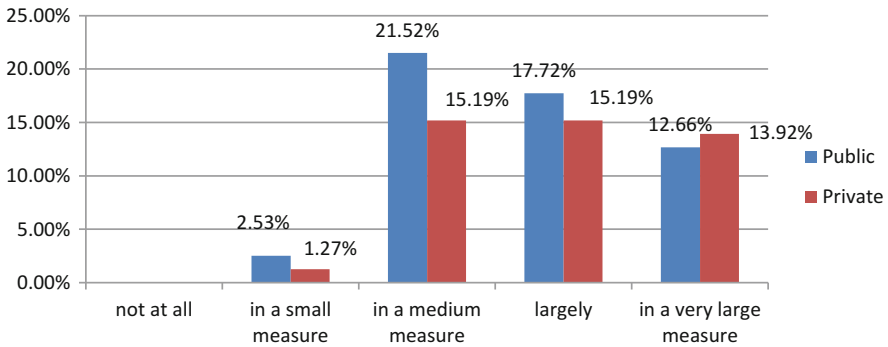


Fig. 3 Ethics and values on public and private entities

Table 3 Effective organizational performance management/governance

		Effective organizational performance management/governance				Total
		In a small measure	In a medium measure	Largely	In a very large measure	
Entity	Public	2 ^a	17 ^a	14 ^a	10 ^a	43
	Private	1 ^a	12 ^a	12 ^a	11 ^a	36
Total		3	29	26	21	79

^aEach subscript letter denotes a subset of effective organizational performance management/governance categories whose column proportions do not differ significantly from each other at the 0.05 level

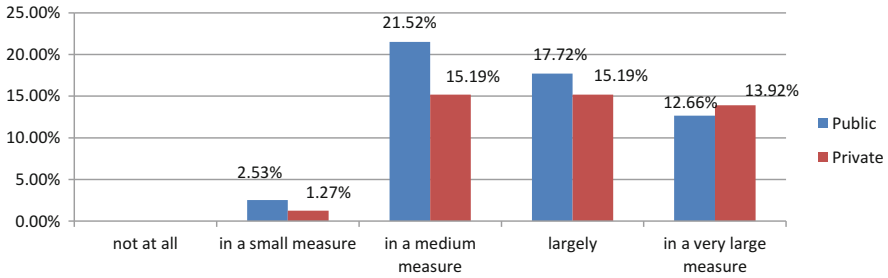


Fig. 4 Effective organizational management in public and private entities

assess the entirety of their transactions, being able to develop data analysis more accurately and completely.

Regarding the quantification of performance management, we released the following hypothesis: there is a strong relationship between the performance management and the incomes collected from the work carried out.

To prove this hypothesis, we used Pearson correlation coefficient that measures the strength and direction of the relationship between the two variables.

The correlation between effective organizational performance management/governance and managers’ salaries/authorizing officers is 0.213 (less than 0.5) indicating a direct and weak connection between the two variables as we can see in Table 4. This is highlighted by the bidirectional level of significance or probability of 0.06 which is much higher than the 0.001, so we can guarantee a 0.95 % probability that the Pearson correlation coefficient is significantly different from 0. So, correlation is not statistically significant. The degrees of freedom (df) are 77 (79-2).

There is a direct, weak and insignificant relationship between governance performance and salaries for the work achieved by managers/authorizing officers ($r=0.213$, $df=77$, $p>0.001$). The activity of private entities, managers and authorizing officers in case of public institutions is not strongly influenced by the level of salaries. In other words, our hypothesis was disproved, the governance performance is not influenced by the incomes received, other elements are more influenced, and we will identify them in a future study.

To confirm those mentioned above, we created the scatter diagram for the two variables in order to highlight the lack of correlation between them.

What we can easily observe from Fig. 5 is the existence of a direct relationship between governance performance and salary levels, but the spread of the points in diagram is pointing the lack of a strong correlation between the two variables. A very important element that has marked the evolution of audit activity is the internal audit approach in a more comprehensive spectrum, being identified multiple connections that exist between audit, governance and social responsibility of organizations (Soh and Martinov-Bennie 2015).

More than that, Porter and Schwab (2008) advance the idea that professional accountants specializing in audit, through a three-pronged approach (internal

Table 4 Descriptive statistics

		Effective organizational performance management/governance	Salary
Effective organizational performance management/governance	Pearson correlation	1	0.213
	Sig. (2-tailed)		0.060
	N	79	79
Salary	Pearson correlation	0.213 ^a	1
	Sig. (2-tailed)	0.060	
	N	79	79

^aCorrelation is significant at the 0.05 level (2-tailed)

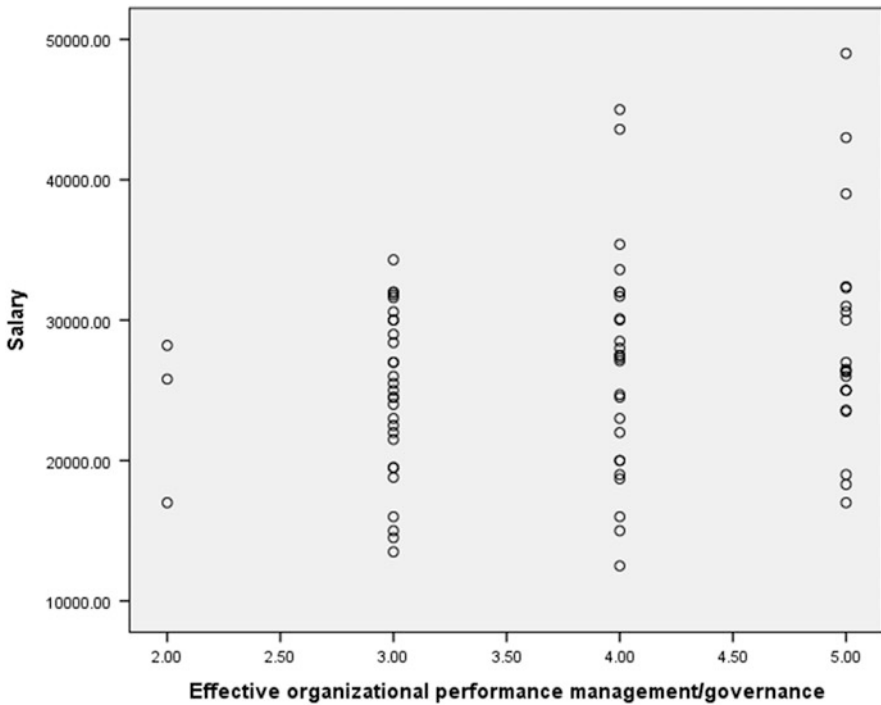


Fig. 5 Scatter diagram

auditors, external auditors, audit committees), could be the main key in ensuring accountability to stakeholders.

Even before the recent changes that have affected the corporate governance procedures, a large number of sampled individuals have acknowledged the great challenge faced by internal audit in managing the agenda of corporate governance, a function that may enable them to directly support the requirements and

responsibilities of senior management in this respect. Another study argues that internal auditors generally regard the leanings of corporate governance as benefiting their cause—such as, for instance, the first Turnbull Report of the UK (1997)—and have reported that the managers of public institutions allege that these leanings have helped them change their attitude towards internal audit in a positive way and, thus, departments have frequently asked for the advice of internal audit when they had to enforce new procedures (Spira and Page 2003). Moreover, Goodwin (2004) has found evidence that organizations possessing an integrated framework of risk management are more likely to use internal audit.

6 Conclusions

In the context of corporate governance, effective internal audit plays a key role, providing an important support to the organizations management in fulfilling its responsibilities by ensuring a supervisory on internal controls of the organization. Realizing this task, the internal audit is seen as the “last line of defence” against inappropriate corporate governance practices and financial reporting.

By analysing the two pillars (promoting appropriate ethics and values within the organization and ensuring effective organizational performance management/governance), we have highlighted how public and private entities regard these two variables as significant painters in the internal audit role in the spectrum of corporate governance.

We can affirm that the internal audit activity improves the efficiency and performance of the entity by expanding the responsibilities of internal audit and setting up of audit committees, promoting ethics and values at the entity level, understanding significance of transparency and quality of financial information and improving management. Consequently, corporate governance will be at a high level. Following the study conducted, we conclude by saying that there is a close and favourable relationship between audit, managers and corporate governance.

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