

Leveraging Internal Audit for catalyzing Good Corporate Governance

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Since the beginning of the 21st century, the corporate world has witnessed series of failures (Enron, WorldCom, RBS, Northern Rock; Oceanic bank, Intercontinental bank), which brought about a heightened public awareness to corporate governance issues. The global economic crunch which began in 2007 added further strands to corporate governance practices and policies. These developments witnessed in the corporate sector have intensified investors' involvements. And with that trend, have come more and more demand for high corporate governance standards, to ensure the efficient and effective use of capital, which provides good returns on investments in a manner responsible for society's interest; and is protected from malfeasance and misappropriation. Corporate governance is about the procedures and processes according to which an organization is directed and controlled. Corporate governance tends to encourage the efficient use of scarce resources as well as ensure accountability for the stewardship of those resources. There is a growing clamor for a mandate for internal audit to raise its game and be an enabler for raising the effectiveness of Corporate Governance.

Good corporate governance is a sine-qua-non for the success of any organization. Its relevance was further stressed in a 2002 McKinsey survey which stated that 'corporate governance is at the heart of investment decisions'. And investors tend to put corporate governance at par with financial indicators when evaluating investment decisions. Corporate governance is not an end in itself but a means to an end. As such, there are different factors that may lead to the accomplishment of its objectives. One of those factors is effective internal audit function (IAF). The concept of internal auditing has been central in the debate on corporate governance and regulating financial reporting; its activities play an important part in the effective governance and risk and control framework. As defined by the Institute of Internal Auditors "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". This clearly indicates that the role of the internal audit function must go beyond the traditional concept of controlling and safeguarding corporate assets, regulatory compliance and enforcing corporate policies. The role of internal audit is rather to focus on value creation for an organization, and on evaluating and suggesting improvements to corporate governance systems of organizations.

Transformation of IA over the years

Internal audit once was perceived to be a department staffed with hardliners who should be able to find faults in everything within an organization. World, as far as financial transactions and

operational processes are concerned, used to be very simple then. With dramatic changes in technology everything from the process of manufacturing, processing, providing of a services to accounting for all these processes has become more complex and dynamic. As a result the scrutiny of historical data has become less relevant as far as the role of internal audit is concerned.

Over the period of years the expectation of those charged with governance and senior management from the internal auditors has changed and the scope of internal audit has widened. Following concepts, linked to Internal Audit, have changed drastically:

- **Finger pointing** – Internal audit is no more about finger pointing to the management in order to create a sense of existence within the organization for the internal auditors. The difference of “you and me” has reduced to the extent that internal audit is considered as a coaching rather than fault finding department.
- **Reviewing the past** – The requirement of going an extra mile from preserving value to creating value has created a need for Internal Audit to go beyond just reviewing past activities. Internal Audit is no more about sitting in a room and vouching through the transactions of past periods, it is much more participative in what is going on in an organization today and what is going to happen tomorrow.
- **Compliance and control validation**–Though the compliance and evaluation of controls remains one of the functions where Internal Audit has a major role. However, with the evolution of separate compliance function within organizations the role of Internal Audit has shifted from compliance and routine validation of controls to creating business value.

Corporate governance

Corporate Governance broadly refers to the mechanisms, processes and relations by which corporations are controlled and directed Governance structures identify the distribution of rights and responsibilities among different participants in the corporation (such as the board of directors, managers, shareholders, creditors, auditors, regulators, and other stakeholders) and includes the rules and procedures for making decisions in corporate affairs. Corporate governance includes the processes through which corporations\ objectives are set and pursued in the context of the social, regulatory and market environment. Governance mechanisms include monitoring the actions, policies and decisions of corporations and their agents.

Principles of Corporate Governance

- **Rights and equitable treatment of shareholders** : Organizations should respect the rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by openly and effectively communicating information and by encouraging shareholders to participate in general meetings.
- **Interests of other stakeholders**: Organizations should recognize that they have legal, contractual, social, and market driven obligations to non-shareholder stakeholders, including employees, investors, creditors, suppliers, local communities, customers, and policy makers.
- **Role and responsibilities of the board**: The board needs sufficient relevant skills and understanding to review and challenge management performance. It also needs adequate size and appropriate levels of independence and commitment.
- **Integrity and ethical behavior** : Integrity should be a fundamental requirement in choosing corporate officers and board members. Organizations should develop a code

of conduct for their directors and executives that promotes ethical and responsible decision making.

- **Disclosure and transparency** : Organizations should clarify and make publicly known the roles and responsibilities of board and management to provide stakeholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information.

Internal Audit – Mechanism of Governance System

Recognizing the important role that the internal audit function plays in a corporate governance system of an organization, **the Institute of Internal Auditors has issued a standard no. 2110 on 'Governance'** which states that “An effective internal audit function provides assurance that there are appropriate corporate governance processes and internal control procedures in place. The internal audit activity should assess and make appropriate recommendations for improving the governance process in its accomplishment of the following objectives:

- Promoting appropriate ethics and values within the organization
- Ensuring effective organizational performance management and accountability
- Effectively communicating risk and control information to appropriate areas of the organization
- Effectively coordinating the activities of and communicating information among the board, external and internal auditors and management.”

Effective internal audit functions help organizations accomplish their business objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management and control process. The internal auditor should, at least annually, carry out an assessment of the overall effectiveness of the governance, risk and control frameworks of the organization, together with an analysis of themes and trends emerging from internal audit work and their impact on the organization's risk profile. A comprehensive report is then presented to the audit committee and the board with the results and recommendations as well as the challenges that may need board interventions to handle.

Implications of Corporate Governance on the Internal Audit

Looking back at corporate governance as a whole, i.e. the demands, pressure and tasks of the audit committee, management and the board in general, the expectations of the different stakeholders, the position of the internal auditor within the organization, etc., an impact on the workload and the responsibilities of internal audit appears unavoidable. The audit committee relies 'heavily' on the internal auditor for its review of the system of internal control as prescribed by corporate governance codes and recommendations. Virtually all guidelines on sound corporate governance practice, includes recommendations for risk management through internal control and audit as a critical part of the governance mosaic. This relationship can be seen as an intricate part of the stewardship model of corporate governance.

Performance standard 2130 deals in particular with 'Governance': 'The internal audit activity should assess and make appropriate recommendations for improving the governance process in its accomplishment of the following objectives:

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Corporate governance is a compilation of numerous aspects all aiming at contributing to the realization of the attributes to which corporate governance aspires. The ultimate objective being: 'to meet the expectations of all stakeholders'. The internal auditor therefore must not only be familiar with these attributes and these aspects, but he is also expected to evaluate the system which is meant to provide reasonable assurance concerning the achievement of that objective. The internal auditor can add value by helping to provide assurance to the stakeholders (via the audit committee) that the system which looks after their expectations and interests is efficient and effective. 'Internal audit has become a participant of corporate governance as a key pillar in assuring that the board can fulfill its task as good as possible

Corporate governance can be thought to have seven interrelated components: board of directors and committees, legal and regulatory, disclosure and transparency, business practices and ethics, enterprise risk management, monitoring, and communication. Internal audit performs critical roles in all aspects of corporate governance by:

- **Supporting** the audit committee in fulfilling its heightened responsibilities;
- **Participating** in the organization's disclosure committee;
- **Reviewing** the effectiveness of the organization's code of conduct, ethics policies, and whistle-blower provisions;
- **Helping** assess risks and gauge performance across the organization;
- **Monitoring** corporate governance activities and compliance with the organization's policies;
- **Facilitating** and enhancing communications with the chief executive officer, general counsel, chief financial officer, chief information officer, and other oversight executives; and
- **Evaluating** the effectiveness of the corporate governance activities and recommending areas for enhancements.

The Internal Auditor's Tools

Auditing the effectiveness of its governance systems, practices, and performance requires a rigorous methodology and comprehensive view of the organization. The Key challenge for the Internal Auditor is how to measure, evaluate and monitor corporate governance performance. The fact that corporate governance encompasses so many different kinds of aspects, both 'hard' and 'soft', indicates that perhaps some of them can be measured more easily than others. Some of the following tools may be strategically used by the Internal Auditor.

- **COSO 'Evaluation Tool** -offers no less than 14 pages of possible considerations and 'points of focus' on the control environment factors which are the basis for a sound corporate governance process

- **Red Flags** are warning indicators which may be helpful to the internal auditor in deciding which aspects of the organization or of a process or department need closer looking at. It includes red flags on accounting, behavioral matters, infrastructure complexity, limitations of responsibilities and authorities, communications, remunerations..
- **The checklist** designed by the Institute of Internal auditors UK and Ireland is called 'Good Corporate Governance – A Checklist: which comprises a total of 47 questions with regard to the following aspects of corporate governance:
 - statutory accountability (1 question)
 - accountability for funds (3 questions)
 - communication with stakeholders (5 questions)
 - roles and responsibilities (25 questions)
 - annual reporting (3 questions)
 - internal controls (5 questions)
 - audit committee (1 question)
 - external auditors (1 question)
 - leadership (1 question)
 - code of conduct (2 questions)
- **The scorecard** was designed by the DVFA (Deutsche Vereinigung für Finanzanalyse und Asset Management) and is called the 'Scorecard for German Corporate Governance' includes the evaluation of seven criteria:
 - corporate governance commitment (10%)
 - shareholders and the general meeting (12%)
 - cooperation between management board and supervisory board (15%)
 - management board (10%)
 - supervisory board (15%)
 - transparency (20%)
 - reporting and audit of the annual financial statements (18%)
- **The 'Global Reporting Initiative Guidelines:** The 'guidelines' provide useful information on a number of aspects which may interest the internal auditor such as the principles themselves, the performance indicators (which could be applied as a kind of checklist), or even its overall mission and vision along with comments on corporate governance trends

The emerging opportunity and challenge for the Internal Auditors

Companies can play 100% by the rules and still 'fool' their shareholders and stakeholders. Furthermore, it has become clear from the paper that corporate governance is a lot more than rules and compliance and that a lot of it has to do with 'attitudes' and 'decent behavior' for which there are few rules.

it has become obvious that corporate governance is 'on its way' and that the opportunities for the internal auditor to put his 'mark' on the process are manifold

Corporate governance is often referred to as 'doing the right things and doing things right'. That is why business nowadays depends increasingly more on 'ethics and values', fair play, honesty, openness etc. because businesses just can no longer afford to 'mess things up': one error can be fatal! Moreover, the past 'accidents' have resulted in a 'there is no more room for excuses' mood. So the internal auditor must be 'on top' of things, exercising his risk assessment in all its aspects and giving timely signals to the board and management in order to 'safeguard' the organization in every possible way.

Despite Internal Auditor's access to diverse parts of the company and knowledge of both business and governance, they're not often being tapped to actually go in and do rigorous evaluations around full aspects of governance. IIA's 2019 Pulse survey, found a very low allocation of time in the audit plan to governance and culture (3.8 per cent on average), compared with higher time priorities, such as financial reporting (14.5 per cent), compliance/regulatory (15.5 per cent) and operational (16.4 per cent).

The internal audit profession has gone through a significant revolution and has received renewed emphasis internationally. There is also a growing recognition of the role internal auditing can or should perform in contributing to improved corporate governance. An effective Internal Audit function plays a fundamental role in assisting the Board to discharge its governance and control responsibilities. Boards and audit committees should be leveraging their internal audit functions in helping to fulfill their duties. The Board must, however, set the right 'tone at the top' and to ensure desired support to be extended to the internal audit at all levels within the organization. And while the internal auditor up until a short while ago just might have been somewhat reluctant to 'rock the boat', it must be clear that he will go down with the boat if he does not rock it in time!

Conclusion

Investors and other stakeholders value companies that anticipate problems and show evidence of strong internal oversight. Internal audit should be a champion in assessing opportunities where corporate governance can be strengthened and suggesting corrective action as needed. A focus on corporate governance offers internal audit the opportunity to become a more active and strategic team player. Recent surveys have shown that management and boards of directors are looking for greater contributions from the chief audit executive (CAE) and internal auditors. Internal auditors can meet the heightened expectations by taking a more holistic view of corporate governance and aligning internal audit skills and activities to assess, improve, and monitor their organizations' corporate governance capabilities. Hopefully this paper can contribute to this awareness and help the internal auditor in his constant search for ways to add value to his organization, for then the paper will have achieved its objective.