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An Internal Audit Perspective on Differences between European Corporate Governance Codes and OECD Principles

Raluca Ivan

Faculty of Economic Science, 1 Decembrie 1918 University, Alba Iulia, Romania,
e-mail: ivanralu@yahoo.com

Abstract *The main purpose of this research is to realize an analysis from an internal audit perspective of European Corporate Governance Codes, in regards with Organization for Economic Cooperation and Development – OECD Principles of Corporate Governance. The research methodology used a classification of countries by legal regime, trying to obtain a global view over the differences between the European corporate governance codes and the OECD Principles provisions, from internal audit's perspective. The findings suggest that the specificities of internal audit function when studying the differences between European Corporate Governance Codes and OECD Principles lead to different treatment.*

Key words Differences, internal audit OECD principles, European Corporate Governance Codes
JEL Codes: M21, M40, M42, M49

1. Introduction

In the view of the latest economic environment evolution punctuated by financial scandals (national, European and international ones) the concept of corporate governance, has become more and more visible. As defined by The Institute of Internal Auditors, governance is "the combination of processes and structures implemented by the board of directors in order to inform, direct, manage and monitor the activities of the organization toward achieving is objectives". In the IIA 2100 Standard – Nature of Work, we have a clear punctuation: „the internal audit activity must evaluate and contribute to the improuvement of governance, risck management and control process using a systematic and discipined aproach" (IIA standards, 2012).

To be effective an organisation's governance process has to have four pillars to rest on: board of directors, management, internal audit and external auditors. Each pillar must be effective and, most importantly, all pillars need to work together to support the achievement or organizational strategy and objective.

Governance is the domain of internal audit, according to the IIA standard 2110, internal audit activity must 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;
- Communicating risk and control information to appropriate areas of the organization; and
- Coordinating the activities of and communicating information among the board, external and internal auditors, and management.

Due to its strategic position, the internal audit function being located to the central point of interests for management, board of directors, shareholders and other stakeholders, it's now more and more important for internal audit to understand the adequate functioning of the corporate governance mechanisms, looking for a continuous enhancing of their activities and their skills, in order to obtain a global vision over the corporate governance system and its effectiveness (Allen, 2008; Leung, 2003; Berinde and Groşanu, 2013).

Our research consist in examining the lit the developments of internal audit in the context of corporate governance at European level. Next section describes the evolution and development of OECD Principles of Corporate Governance. It is followed by a section describing the research methodology used. Thereafter, an analysis of differences of European corporate governance codes comparing to OECD Principles from internal audit's perspective is presented. Finally, the last section contains conclusions.

2. Literature review

The term of "corporate governance" has Anglo-Saxon origins, being mentioned by the Internal Auditing International Standards. Its meaning is management of the organization or unit. Therefore we can define corporate governance as "overall management of the entire organization by accepting all internal components that work together, which eventually will be integrated in management".

This concept can add the need to implement risk management within the entity and in the internal control system and the most important internal audit. The connotations of the concept of corporate governance include: ethical principles, social responsibility, control activities and good business practice. The concept of corporate governance has entered specialized literature relatively recently, namely in the last twenty years. Sir Adrian Cadbury Thus, the one who defined corporate governance as "the system by which companies are guided and controlled" (Cadbury Report, 1992), can be considered one of the pioneers of the concept of corporate governance. He elaborated the famous report in 1992 that has his name

(Cadbury Report), as a consequence of the research conducted on the causes of corporate bankruptcies during the crisis of the late '80s.

The report's conclusions revealed that the serious problems regarding organization and operation of internal control represent the major causes of corporate bankruptcies. Thus, we emphasize that the major deficiencies were on top of the economic entities, their management not being able to avoid failures, and, in some cases, even contributed to their emergence. Later on, other reports have also been published on the same issue (Hampel-1998 and Turbull-2001), which has strengthened the Cadbury's conclusions.

It can be said that corporate governance refers to the distribution of rights and obligations between different categories of participants in the company activity, namely: the board of managers, the executives, the shareholders and other stakeholders, noting how decisions are made, strategies and strategic objectives are established, means are met, as well as the financial monitoring system.

The lack of a single model of corporate governance at global level, has determined OECD to identify a set of principles of corporate governance and publish them in the document entitled "OECD - Principles of Corporate Governance 2004".

These principles do not impose restrictions and do not take into account a thorough implementation in the national legislation. Their main goal is to deliver a reference system, following the identification of goals and the means of achieving them. They have an evolutionary character, being examined and revised according to the evolution of global business. We have reviewed the specialized literature, and we have found the demarcation of the most influent papers as it follows:

Table 1. Situation of papers and authors

Title of the paper	**Author**	**Journal/Publisher and year of appearance**
Corporate Governance	Williamson O.E.	Yale Law Journal, 1984
Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century	Blair M.M.	Washington: Brookings, 1995
The Mechanisms of Governance	Williamson O.E.	Oxford University Press, 1996
Corporate Governance in the United States: The Rise Of Fiduciary Capitalism	Hawley J.P. and Williams A.T.	Working Paper, Saint Mary'sCollege of California, School of Economics and Business Administration, 1996
A Survey of Corporate Governance	Shleifer A. and Vishny R.W.	Journal of Finance, 1997
A Theory of Path	Bebchuk L.A. and Roe	Stanford Law Review, 1999

Title of the paper	Author	Journal/Publisher and year of appearance
Dependence in Corporate ownership and Governance	M.J.	
Competence, Governance, and Entrepreneurship	Foss N. and Mahnke V. (Eds.)	Oxford University Press, 2000
Contests for Corporate Control-Corporate Governance and Economic Performance in the United States and Germany	O'Sullivan M.	Oxford University Press, 2001
International Comparison of Corporate Governance Models	Gregory Francesco Maassen	Rotterdam School of Management, 2002
Internal Audit and Organizational Governance	Hermanson D. and Rittenberg L.	The Institute of Internal Auditors, 2003
The Politics of Corporate Governance Regulation	Gourevitch P.	Yale Law Journal, 2003
Political Determinants of Corporate Governance – Political Context, Corporate Impact	Roe M.J.	Oxford University Press, 2003a
Corporate Governance Theories: From Micro Theories to National Systems Theories	Gérard Charreaux	Working Paper of FARGO - Centre de recherche en Finance, Architecture et Gouvernance des Organisations, 2004
Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance	Clark T	London and New York, 2004
Corporate governance and firm valuation	Brown L. and Caylor M.	Journal of Accounting and Public Policy 25, 2006
Internal audit and corporate governance	Ana Morariu, Suciu Gh., Stoian Flavia	Editura Universitara, Bucharest, 2008
Activism of the investors and the corporate governance	Feleagă Niculae	Business Accounting, Expertise and Audit, 2008
Current issues related to the measuring of the corporate governance level in Romania	Răileanu, A., Dobroțeanu, C., Dobroțeanu, L.	Financial Audit, 2011
Corporate governance	Voicu-Dan Dragomir	Academy of Economic Studies, 2012

Title of the paper	Author	Journal/Publisher and year of appearance
A Real Look at Real World Corporate Governance	David F. Larcker, Brian Tayan	Stanford Business School, 2013
Alternative Models of Governance	David F. Larcker, Brian Tayan	CGRI Quick Guide Series, 2015
Matters: A Closer Look at Organizational Choices and Their Consequences (2nd edition)	David F. Larcker, Brian Tayan	Pearson FT Press, 2015

Source: (Niculae, 2015)

Thus, companies must continuously improve their corporate governance policies, adapting them to the changes that continuously occur due to the innovation process. OECD Principles (OECD, 2004) are divided into six sections, as follows:

1. Providing a basis for corporate governance framework taking into account the promotion of some principles of transparency and efficiency of markets, which should be in harmony with the legislation and clearly formulate the separation of responsibilities between supervisors, authorities of normalization and implementation;

2. Shareholders' rights and the key functions of ownership pursuing protection and guarantee of shareholders' rights;

3. Shareholders' fair treatment, ensuring a fair and adequate treatment within corporate governance, including for foreigners and minority shareholders, stipulating the need to reward all shareholders if their rights are violated;

4. Shareholders' role in corporate governance is seen as a means of creating value and jobs through cooperation between shareholders and companies, corporate governance recognizing the shareholders' rights, stipulated by law;

5. Accurate and timely reporting and transparency should be provided in corporate governance in order to obtain a clear image of the organization in terms of performance, capital, financial position and its governance;

6. Responsibilities of the board of administration must be clearly defined in corporate governance to ensure effective strategic guidance to entities and to allow effective monitoring of executive management by the board of administration, by assuming its responsibilities.

Corporate governance principles set forth by OECD were initially meant to apply the concept of corporate governance in joint stock companies in order to efficiently manage companies, but this concept was later extended to other types of organizations, being taken by most developed or developing countries. We must observe that the emphasis is on the shareholders' role and rights, on the information transparency and on the crucial importance of company managers. OECD principles

are universally recognized, representing one of the 12 basic standards of a solid financial system.
They serve as a reference framework for achieving a large number of national codes on corporate governance (White Chart of corporate management in South Eastern Europe, the Stability Pact, and Agreement of South Eastern Europe for reforms, investments, integrity and economic growth). The central element of OECD principles is the transparency of all financial-accounting information, as they are the basis of the decisions made by the information users. The quality of this information plays an important role in the efficient administration of entities, leading ultimately to the increase of their market value.

3. Methodology of research

The employed research methodology largely relies on literature review particularities. Similar to Ivan (2009), we develop a critical and evaluative account of what has been published within accounting research literature on the internal audit as a pillar for corporate. Therefore, in accordance to literature review methodology imposed each considered study to be analyzed by looking at particular elements such as: board responsibility for governance, corporate governance transparency, director competency and commitment, board accountability and objectivity, ethics, integrity and responsibility. The main purpose of this paper was to develop a content analysis of the European Corporate Governance Codes, from the internal audit perspective, with relevance to the differences with the main provisions concerning the internal audit within OECD Principles of Corporate Governance.

4. Data analysis and research

A. In what the: *Content, Character & Accuracy of Disclosure* is regarded we found only one explicit mention of the internal audit function, although implicit ones can be found several.

In *Switzerland* we have the following regulation: The Audit Committee should review the individual and consolidated financial statements as well as the interim statements intended for publication. It should discuss these with the Chief Financial Officer *and the head of the internal audit* and, separately, should the occasion warrant, with the head of the external audit.
The Audit Committee should decide whether the individual and consolidated financial statements be recommended to the Board of Directors for presentation to the General Shareholders' Meeting (Article II.g.24).
The SWX Swiss Exchange Directive on information relating to Corporate Governance is applicable with regard to detailed disclosures (Article IV.30).

B. In what the *Board Access to Senior Management* is regarded we found only explicit mention of the internal audit function, although implicit ones can be found several.

Only the OECD principles mentions: The contributions of non-executive board members to the company can be enhanced by providing access to certain key managers within the company such as, for example, the company secretary and the *internal auditor …* (Annotation to Principle VI.F)

C. In what the *Audit Committee Meeting Frequency, Length & Agenda* is regarded we found four explicit mention of the internal audit function, although implicit ones can be found more.

OECD principles states: It is increasingly common for external auditors to be recommended by an independent audit committee of the board or an equivalent body and to be appointed either by that committee/body or by shareholders directly. (Annotation to Principle V.C)
The audit committee or an equivalent body is often specified as providing oversight of the internal audit activities and should also be charged with overseeing the overall relationship with the external auditor including the nature of non-audit services provided by the auditor to the company (Annotation to Principle V.C).
In fulfilling its control oversight responsibilities it is important for the board to encourage the reporting of unethical/unlawful behaviour without fear of retribution. In a number of companies either the audit committee or an ethics committee is specified as the contact point for employees who wish to report concerns about unethical or illegal behaviour that might also compromise the integrity of financial statements. (Annotation to Principle VI.D.6)

In UK, we have:

The main role and responsibilities of the audit committee should be set out in written terms of reference and should include: to monitor and review the effectiveness of the company's internal audit function; (Code Provision C.3.2) *See Code Provision* C.3.6 (FTSE 350 companies should put the external audit contract out to tender at least every ten years.) *See generally* C.3, Audit Committee and Auditors.

In Germany

The Supervisory Board shall set up an Audit Committee which, in particular, handles the monitoring of the accounting process, the effectiveness of the internal control system, risk management system and internal audit system, the audit of the Annual Financial Statements, here in particular the independence of the auditor, the services rendered additionally by the auditor, the issuing of the audit mandate to the auditor, the determination of auditing focal points and the fee agreement, and – unless another committee is entrusted therewith-compliance. (§ 5.3.2 *Supervisory Board Committees*).

The Netherlands

The audit committee shall in any event focus on supervising the activities of the management board with respect to: (…) d) the role and functioning of the internal audit function; (Best Practice Provision III.5.4)

Switzerland

The Audit Committee should form an impression of the effectiveness of the external audit (the statutory auditors or, if applicable, the group auditors), and the internal audit as well as of their mutual cooperation.

D. For the *Auditor Independence* item we found one explicit mention of the internal audit function, although implicit ones can be found more

Germany

The General Meeting … elects the shareholders' representatives to the Supervisory Board and, as a general rule, the auditors. (§ 2.2.1) The Supervisory Board shall set up an Audit Committee which, in particular, handles the monitoring of the accounting process, the effectiveness of the internal control system, risk management system and internal audit system, the audit of the Annual Financial Statements, here in particular the independence of the auditor, the services rendered additionally by the auditor, the issuing of the audit mandate to the auditor, the determination of auditing focal points and the fee agreement, and – unless another committee is entrusted therewith – compliance. (§ 5.3.2)

E. When studying the *Internal Control System* we found three explicit mention of the internal audit function, although implicit ones can be found more

UK

The audit committee should monitor and review the effectiveness of the internal audit activities. Here there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report. (Code Provision C.3.5)

OECD

The board should … [e]nsur[e] the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control … (Principles VI.D.7-VI.D.8).
Ensuring the integrity of the essential reporting and monitoring systems will require the board to set and enforce clear lines of responsibility and accountability throughout the organisation. The board will also need to ensure that there is appropriate oversight by senior management. One way of doing this is through an internal audit system directly reporting to the board. … Companies are also well advised to set up internal programmes and procedures to promote compliance with applicable laws, regulations and standards, including statutes to criminalise bribery of foreign officials … (Annotation to Principle VI.D.7).

Norway

The board of directors must ensure that the company has sound internal control and systems for risk management that are appropriate in relation to the extent and nature of the company's activities. Internal control and the systems should also encompass the company's corporate values, ethical guidelines and guidelines for corporate social responsibility. The board of directors should carry out an annual review of the company's most important areas of exposure to risk and its internal control arrangements.
Alin.10. The objective for risk management and internal control is to manage, rather than eliminate, exposure to risks related to the successful conduct of the company's business and to support the quality of its financial reporting.
Effective risk management and good internal control contribute to securing shareholders' investment in the company and the company's assets…The board of directors must form its own opinion on the company's internal controls, based on the information presented to the board. Reporting by executive management to the board of directors should give a balanced presentation of all risks of material significance, and of how the internal control system handles these risks. The company's internal control system must, at a minimum, address the organization and execution of the company's financial reporting.
Where a company has an internal audit function, it must establish a system whereby the board receives routine reports and ad hoc reports as required. If a company does not have such a separate internal audit function, the board must pay particular attention to evaluating how it will receive such information. (Commentary to § 10)

F. When studying the *Risk Management and Oversight* we found one explicit mention of the internal audit function, although implicit ones can be found more

France

Each listed company must be equipped with reliable procedures for the identification, monitoring and assessment of its commitments and risks, and provide shareholders and investors with relevant information in this area. For such purposes:

- the annual report should specify the internal procedures set up to identify and monitor off-balance- sheet-commitments, and to evaluate the corporation's material risks;
- each company must develop and clarify the information provided to shareholders and investors regarding off-balance-sheet-commitments and material risks, and disclose the company's ratings by financial rating agencies as well as any changes occurred during the financial year.

(2.2) The main tasks of the audit committee are … to monitor the effectiveness of the internal control and risk management systems. The review of accounts by the audit committee should be accompanied by a … presentation from the Chief financial officer describing the corporation's risk exposures and its material off-balance-sheet commitments. (16.2.1)

As regards the effectiveness of internal control and risk management systems, the [audit] committee should ensure that these systems exist, that they are implemented and that corrective action is taken in the event of significant weaknesses or flaws. . . It must interview those responsible for the internal audit and for risk control and give its opinion on the organization of their services … The committee shall examine the risks and the material off-balance-sheet commitments, assess the importance of any failures or weaknesses which are communicated

5. Conclusions

We found that only a third of the European states, members or nonmembers of EU are including in their CG code a recommendation for the implementation of internal audit function, still there are too few countries that namely provide sufficient details about the position that internal audit should have within the company in order to ensure its independence.

The aspects referring to the relationship between internal audit and audit committee seem to be much more in the attention of European governance codes. A potential explanation could be the bigger attention paid for defining the audit committee's responsibilities much clearer in the latest versions of governance codes, which actually highlights the relationship that audit Committee should have with internal audit in terms of corporate governance.

The findings of the analysis developed over European governance codes, from internal audit's perspective, allowed us to observe the non-similarity in the recommendations referring to internal audit in the context of corporate governance, comparing to OECD Principles of Corporate Governance.

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