

INTERNAL CONTROL- CORPORATE GOVERNANCE

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ABSTRACT: In this article I have attempted to highlight both the distinctive features of the concepts of corporate governance, internal control and the interferences that characterize them, taking into account the fact that we can not talk about a specific line that can separate practically the processes these concepts involve, processes conducted at the economic entity level, by default processes involving long-term value creation. Furthermore, this article is to highlight the causal connection between the success of internal control and corporate governance at the entity level, precisely because good corporate governance can not be provided based on an internal control system working with serious deficiencies, resulting from this the imperative need for establishing permanent regulatory frameworks to enable a real and procedural functioning of the internal control system.

Keywords: internal control, corporate governance, objectives, top-management, economic entity

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Introduction

In this article, I tried to highlight both the distinctive features of the concepts of corporate governance, internal control and the interferences that characterize taking into account the fact that we can not talk about a specific line that can separate the processes involved by these concepts, processes conducted at the economic entity level, which, by their substance enable us to see the economic entity as a whole, creating value. Below we highlight some theoretical aspects concerning the mentioned concepts.

In the part we discussed issues related to the definition of internal control that corporate governance and summarized some aspects regarding a brief presentation of two models of internal control, namely: COSO model, developed by the Committee of Sponsoring Organizations U.S. and COCO

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model, developed by the Canadian Institute of Chartered Accountants, which promotes the improvement of internal control at the economic entity.

The second part comes to highlight issues connected with the need to implement a risk management system at the economic entity level and link this concept with the entity's internal control system. ERM essentially relates directly proportional to ensuring an adequate framework in order to achieve the objectives set out in top-level management.

The third part is meant to highlight some theoretical aspects concerning the relationship of interdependence between internal control and corporate governance inside the economic entity. Resounding failures of some world class companies such as Enron, Worldcom, Parmalat come to show essentially directly proportional relationship between internal control and good corporate governance inside the economic entity. Concerning this aspect I come to emphasize that these resounding failures are the concrete results of poor corporate governance and this because it was based on an internal control working with serious deficiencies. In essence, implementing good corporate governance is clearly the result given by an internal control system which operates on an effective and efficient manner, and efficient operational mechanisms embodied in results at each level of the organization.

Research Methodology

Through this article I tried to detect the crucial link that exists between the concepts of internal control and corporate governance. Taking into account the fact that the PhD thesis on which we decided to channel our resources is represented by the contribution of the internal control to a sound and sustainable corporate governance, I believe this project can be a first step towards a detailed study of the mentioned theme, with the intention to highlight as relevant as possible the relationship between these concepts.

In essence, our goal is to make a connection between the one accounting field on one hand and corporate governance on the other side. Meaningful analysis relative to any field, here the economic activity, implies the existence of a methodology and a scientific research model. Accounting field is essentially a substantial source of information for senior management and not only at the entity level, in order to support decisions, to set goals respectively.

In this article we used the comparative method relative to different perspectives and approaches to define the concepts mentioned.

Non-participating observation stands to support a short theoretical analysis in terms of interference and interdependence between internal control and corporate governance.

Regarding the typology of research, in this paper, I used a qualitative research.

To achieve the objectives of this article, I used a range of research techniques, namely: the study of bibliographic references, information gathering, processing information, establishing correlations between them, selection and synthesis of information.

In my view, inside the economic entity belonging to either public or private sector, concepts such as corporate governance or internal control are complementary, they fusion and moreover they reveal a dependency relationship to each other in achieving the objectives set at the top-management.

Internal control, corporate governance concepts -The current state of knowledge and terminology

The current state of knowledge and terminology of internal control.

Definition of internal control - Basel Committee

The Basel Committee defines the internal control as a process conducted by senior management, Board of Directors and by default every member of that organization at all levels. This way the internal control is defined as an operational process, undertaken by a continuous basis at all levels of an entity (banks), not just a simple procedure, senior management and Board of Directors being responsible for creating an appropriate culture inside the company in order to ensure a process of effective internal control. Structures mentioned above will have their own responsibility in continuously monitoring internal control activities, underlining the fact that each individual within the entity will be an active part in this process.

Definition of internal control - the U.S. Committee of Sponsoring organizations COSO

COSO defines internal control as "a process conducted by the Board of the entity, management and other personnel, designed to provide reasonable assurance of achieving the objectives in the following categories: effectiveness and efficiency of operations, reliability of financial reporting, compliance with regulations and applicable laws. "

Definition of internal control - INTOSAI Guidelines

In view of INTOSAI Guidelines for Internal Control Standards, Internal control is defined as an integrated process conducted by senior management and staff of an entity designed to take risks and to provide

reasonable assurance that the entity's activity translates into the following objectives : protecting assets from loss, misses, compliance with applicable laws and regulations, fulfillment.

Definition of internal control- CCA

CCA defines internal control as a meeting of elements (culture, resources, systems, processes) at the organization level which work as a whole towards the objectives set.

Models of internal control

In the context of limited resources and accounting information users' requirements for various services and quality, performance management is a challenge for entities from public sector or private. Achieving this goal is supported by top management and professional bodies. Management is concerned with the implementation of an effective internal control system, monitoring it carefully to assess risk while, professional bodies are concerned with the elaboration of internal control models ready to meet management's requirements. The offer professional bodies come with points to COSO and COCO as internal control models.

COSO model, developed by the Committee of Sponsoring Organizations of the U.S. Commission, clearly separates the concept of internal control of the inspection. In this vision, internal control is a process implemented by management, employees of the entity, in order to give reasonable assurance on the following objectives: effectiveness and efficiency of operation, reliability of financial information, compliance with laws and regulations.

Key concepts of the internal control system are (Tiron, 2007):

- Internal control is a process. It is a means to an end and not an end in itself.
- Internal control is performed by humans. It is not just some policy forms and manuals, but consists of people at every level of an entity.
- Internal control can provide only reasonable assurance, not an absolute one for entity's management and board.
- Internal control is directed towards their targets in one or more separate categories, but overlap.

Essentially, the entire internal control system is continuously monitored, and problems that arise are addressed in a timely manner, emphasizing proactive attitude as a vital concept to ensuring long term profitability of the economic entity.

The components of the COSO model are: control environment, risk assessment, control activities, information and communication, monitoring.

The control environment reflects the general attitude, integrity, ethical values and behaviors of employees, operating philosophy and management style, the assignment of authority and accountability as well as the manner an entity is organized and the way it developed.

Risk assessment is to define the objectives and conditions that must be considered in the context of dynamic environment in which the entity operates.

Control activities are carried out within the entity as a whole, of all hierarchical levels and include policies, procedures by which the entity's objectives are achieved. The typology of control activities can vary depending on the entity's organizational culture, nature, complexity and organizational structure.

Information and Communication is the glue between the control environment, risk assessment, control activities, on one hand and monitoring, on the other hand. The information must be relevant and communication, an effective one. The information is relevant to the extent they are comprehensible, credible, comparable and timely. Communication must involve full entity structures and activities, both inside and outside.

Monitoring is the assessment of quality and performance of the system in time, performance achieved through ongoing supervisory activities, separate evaluations, or mixing the two.

COCO model, developed by the Canadian Institute of Chartered Accountants, promotes the improvement of internal control. In this sense, internal control entity includes all elements which, collectively, help staff to achieve the entity's objectives: effectiveness and efficiency of operation, reliability of internal and external information, compliance with laws, regulations and internal policies. The components of the model are: purpose, commitment, ability, monitoring and learning.

The aim of clearly identified objectives include identifying, assessing and managing risks faced by the entity, opportunities for risk management policies and objectives, planning and performance indicators. Commitment contributes to the affirmation of identity and values of an entity and points out to ethical values, including integrity, human resources policies, responsibilities and reporting obligations, mutual trust.

The capacity evaluates organization's capacity and competence and it refers to knowledge, communication processes, information, coordination, control activities.

Monitoring and learning concerns the need for oversight of the entity's internal and external environment, monitoring performance by reporting its results to the objectives, information needs reassessment when

you change targets or when communication is poor, monitoring, evaluating control effectiveness. The short research on the two models of internal control, COSO and COCO shows that although they differ in some respects, such as: the definition of internal control in view of the COCO is a supplement provided by COSO, COCO has internal control model founded on the smallest unit of an entity, which is the person ready to perform duties based on understanding their purpose, building on his/her capacity to perform ,his/her skills, resources; COCO model is open to improvement, which allows entities to implement , evaluate and modify their model, the steps that the entity must take to implement the best measures are different, the objectives are common.

In conclusion, the concept of internal control is a process, a process to achieve an end, not an end in itself, is a process and not a function of the entity, involving the entity as a whole, employees, management at all levels of the entity and not only procedures policies, activities, documents, involving management, which has the primary responsibility for organizing internal control, providing a reasonable and not absolute assurance for top - management.

The analysis of internal control models implemented by public sector entities show that regardless of the steps that comprise them, they focus on the same objectives: effectiveness and efficiency of the entities, internal and external informational reliability, compliance with laws, regulations and internal policies.

The current state of knowledge and terminology of corporate governance. Corporate governance in the international sense - Define concept

Corporate governance is the system whereby a company is managed and controlled. The concept of corporate governance emerged in 1992, following the Cadbury report. It represents a development of the concept of "social responsibility of the economic entity." In the 1970s, Milton Friedman's stake-holder theory is "believed that maximizing financial results of the dividends paid to shareholders is the greater social responsibility of an economic entity", but concepts were later changed.

Currently, it is considered that an entity belongs to the community soon as it operates, to which has both rights and obligations.

The literature points to a diverse range of definitions in relation to the concept of corporate governance, highlighting the perception of each "actor" of the economic field.

In this regard we highlight the following perceptions relative to this concept:

"Corporate governance is understood as a control and management system used by economic entities. Corporate governance structure includes the way the division of rights and responsibilities between different members of the entity and the board of directors, executives, shareholders and other stakeholders is done and states rules and procedures for making decisions regarding the entity. Thus, corporate governance provides the structure determining the entity's objectives and the means by which the objectives are achieved and performance is monitored." (OECD definition)

"Corporate governance can be defined as a company's overall relations with its shareholders, or more broadly, society as a whole." (Financial Times, 1997)

Internal control- ERM

Each and every organization and each and every individual that intends to achieve some goals, establish its activities leading to achievement of goals and at the same time, seeking to identify as many "threats" that would prevent them from taking the necessary measures in no time.. Managing risk means identifying and assessing risk and determining how to respond to risks. But resources available for managing risk are limited and risk increases with the number and complexity of organization activities to achieve objectives. It is therefore necessary to seek an optimal response to risk in a certain order of priorities resulting from risk assessment. Each organization must take steps to manage risk to a level considered acceptable. This level is called risk tolerance. In other words, even if we are not familiar with the concepts of risk and risk management, our actions, consciously or not target this aspect. Therefore, acquiring a coherent system of concepts and rules, universally accepted internationally, is essential for each organization operating in private or public sector.

The need for risk management

The motivation of implementing such a system comes to mitigate to some extent the risk that an entity is subjected during its lifetime by simply going to achieve its business objectives. In this regard we emphasize the following strengths in implementing such a system:

- *Risk management requires changing management style*

Managers of organizations need not to confine them self to handle each time, the consequences of events that occurred. Treating the consequences does not improve the causes, therefore, the risks materialized in past, will also occur in the future, usually with a higher frequency and increased impact on the objectives. Managers should adopt a reactive management style, which means that it is necessary to devise and implement

measures likely to mitigate the risk event. Future-oriented response allows the organization to master, within reason, past hazards, which is tantamount to increasing the opportunities to achieve their goals.

- *Risk management facilitates achieving organizational objectives*

Clearly knowledge of threats allows their classification according to their possible materialization, the extent of impact on the objectives and costs involved in measures designed to reduce the chances of developing or limiting unwanted effects. Establishing a hierarchy is the support for inducting order of priorities in allocating resources, limited in most cases, following an analysis of "cost-benefit" or, more generally, "effort and effect." It is essential that the organization should focus its efforts on what is really important, and not to disperse resources in irrelevant areas related to its purposes. However, regular review of risks, as set out in standards, leads to reallocation of resources, in accordance with priorities. In other words, risk management involves concentrating resources in areas of current interest.

- *Risk management provides the basic conditions for a sound internal control*

If internal control is a whole set of management measures to obtain reasonable assurance that objectives will be met, results that risk management is one important mean by which this is done, just because risk management monitors the threats that can have a negative impact on the established objectives. In other words, if it seeks to strengthen internal controls, risk management implementation is essential. Action plan must be backed up by a plan that includes measures that mitigate the risks and also plan the event handling difficult situations.

Risk management is a process conducted by management and other personnel of the organization consisting of: defining the strategy to be applied, identifying and assessing risks that may affect the organization and activities taking place within it, taking into account the partnerships and environmental control such risks that they fall within the limits of risk tolerance, monitoring, reviewing and reporting risks continuously and as a benefit of the experience, to obtain reasonable assurance regarding the achievement of organizational objectives.

Items of this conception are reflected in the following scheme:

Risk management is only part of the application of principles contained in the level of theory. Risk management is a continuous process of learning from past experiences, their own or others. What is extremely important in its efforts to reach an effective risk management is to

strengthen permanently the organizational culture concerning risks. We talk about a process of identifying and assessing potential risks, we also talk about specific tools for system-wide internal controls designed to limit the impact of these risks by:

➤ Preventative internal control devices:

These internal control tools are designed to limit the possibility that some risks will materialize. The more the materialization of risk is undesirable, the more important is the implementation of internal control preventive tools. Most instruments used in the organization work tend to belong to this category.

➤ Internal control remedial nature devices:

These tools are designed to limit the impact of the materialized risk. For example, contracts include provisions that allow the overpayments recovery whether this risk occurs, the insurance allows financial recovery if the insured risks materialize, management plans regarding difficult situations provides organizations the strength necessary to return to normal situation, ensuring continuity.

➤ Internal control detective devices:

These tools are designed to identify internal control risks that have materialized in order to treat the consequences. Usually, these internal control tools are known as verification procedure as it relates to materialized risks.

Causal relationship: corporate governance- internal control

Corporate governance is a concept which does not lend itself to simple definition. It covers a wide range of fields, from economics and business administration to law and accounting. In a broad vision, the concept of corporate governance refers to institutions, rules and good practice governing relations between managers on one hand and shareholders on the other side. In the context of business globalization the issue of business' and capital markets' integrity is a key dimension.

Major fraud case registered in financial accounting over the past decade, fraud primarily affecting world class companies in the United States of America and Europe were those that were the basis of resounding failures. They have questioned the foundations of surveillance systems and capital markets have also triggered a crisis of confidence in corporation systems. Enron Cases (2001), MCI WorldCom (2002), One.tel (2001), Sunbeam (2001), Webvan (2001), and Parmalat (2003), have produced material for countless debates on firms' business administration and of

international political institutions regulating the market, supranational financial organizations, the media, academia respectively.

It became obvious that good management of companies, as good corporate governance is a key element for the functioning of capital markets, improving economic efficiency and establishing an attractive investment climate. As weaknesses of management systems in companies threaten the stability of the international financial system, improving corporate governance practices has become a priority in most countries and a constant preoccupation. James D. Wolfensohn, former World Bank President stated: "Corporate governance is more important to global growth than the states' policies. " In the same register can subscribe the declarations entered by the Basel Committee president for banking supervision in 2005 that highlighted the causes of the resounding failures of world-class companies such as:

- little or no internal controls or which seemed appropriate in terms of scripting, but were not implemented in practice;
- internal and external audit has not been vigilant enough and did not detect fraud, or in some cases even encouraged it;
- lack of independence, Board members' and senior executives' conflicts of interest that led to inappropriate decisions;
- Board did not understand the risk assumed by the entity relative to these practices, did not ensure proper oversight and has not questioned the actions of top management;
- transactions were designed to reduce the transparency of the transactions distorting the image of the actual situation of the entity;
- corporate culture has fostered unethical behavior by discouraging recognition of the real problems the entities faced.

In this respect we emphasize that these resounding failures are the concrete result of poor corporate governance because it was based on an internal control system working with serious deficiencies. We can say that the major responsibilities of the internal control system focuses on protecting assets, ensuring the adequate management of the business and not least on mistakes identification and avoidance concerning the activities.

As the major corporate governance failures are caused by malfunction of the internal control systems, entities belonging either public or private sector must take a proactive stance to improve internal controls leading to increase profitability and providing long-term competitive advantage.

Since between the success of corporate governance and the internal control system there is a direct causal link the relevant regulatory bodies worldwide have taken attitude developing standards.

In 1992 the Cadbury Committee drew up the so-called Cadbury Report which was attached to a code of good corporate governance practices focused primarily on accountability relating to the entity's management structures and greater transparency of the business.

Turnbull Report in 1999 focused on internal controls in order to build corporate governance framework and managed to revolutionize the practice in this field having a substantial international impact.

In 2002 in response to the Enron bankruptcy and Worldcom, bankruptcy due mainly to conflict of interest and approach between the entities and their external auditors, according to U.S. Congress' view, it elaborates Sarbanes-Oxley law designed to limit the activities and services to external auditors can offer and this aimed to avoid conflicts of interest and strengthening the independence of external auditors.

The same law is meant to put serious emphasis on the annual reports of entities providing these situations also must contain „Report on internal control". This report focuses on assessing internal controls and financial reporting procedures of the issuer. In this regard the following aspects are covered:

- internal controls must be stable and continuous, providing the entity the ability to ensure that information offered is liable;
- evaluation on the effectiveness of internal controls must be highlighted in the report;
- any fraud involving management or employees of the control system must be reported to the entity's auditors and the Audit Committee;
- the report is meant to inform of any change that may affect the entity's internal controls.

In the same way more and more EU Member States have developed codes of corporate governance to improve internal controls. OECD, the organization with the greatest impact in this field was the one supporting and facility the adoption of all these codes

Conclusions

In essence there is a directly proportioned link between the performance of economic entities and effectiveness of corporate governance model. As an obvious increasing trend, there is investors' interest in the

importance of corporate governance systems implemented at the level of economic entities, and they are willing to pay more for good results in this field.

Companies are clearly aware of this reality and give considerably more importance to this aspect than they did previous years. Good and bad examples from the international market highlight strengths and weaknesses of economic entities bringing in light, on one hand, economic entities that have put a lot of effort and time to achieve high standards of corporate governance being, therefore, perceived as exponents of governance based on added value, being able to maximize company's value systems and processes that allow managers, regardless of hierarchical level, to evaluate and monitor its performance, and on the other hand companies who failed to build the puzzle of corporate governance and also failed concerning the transparent approach towards the various stakeholders. In conclusion, the shortcomings of such systems are meant to highlight economic entity that has no real consistency and functionality of their subsystems, be it the system of internal control, internal audit or top management. In fact at the level of these economic entities we can not talk about the existence and functioning of a strong and sustainable corporate governance system, which can be quantified in concrete results and long-term settled objectives.

If we consider the actual situation on the international market, we can conclude that corporate governance will remain on the list of top management time to come. All that implies this state of affairs is transcribed into a simple "equation": companies which will adopt a culture of transparent and efficient corporate governance model will have a much better performance compared to those which refuse to accept this reality and need to experience poor results.

In essence, the combination of factors such as market volatility, pressure from shareholders and economic uncertainty will create premises for the risk that the top management acts ethically incorrect. As such, the importance of an effective model of governance that controls and evaluates the performance of a company, satisfying the needs of all stakeholders and thus creating long term added- value is vital for a company in a competitive environment marked by important changes.

Finally, corporate governance applied proactively, effectively, procedurally and for real at all levels of the economic entity, whether belonging to public or private sector becomes an essential tool in creating and maximizing long term value of the entity.

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