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THE CORPORATIVE GOVERNANCE AND INTERNAL AUDIT. CASE STUDY: ROMANIAN CREDIT INSTITUTIONS

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Abstract:
While traditionally the role of the internal auditor was to help the organization to maintain the internal control system of the financial statements, a new series of opportunities emerged as an outcome of the corporative governance. The supreme challenge for the internal auditor is to find the means in order to offer the reasonable degree of insurance expected by all participants. To put it in other way, the internal auditor must become a key element in the corporative governance process. The audit committee tries to improve its efficiency having better and frequent contacts with the internal auditor which stays one of the best sources of information for the committee. Once the alignment of Romania to the European legislative aquis for the banking system in Romania, complies the recommendation of the Committee on Banking Supervision Basel, instituting mandatory existence of an Audit Committee within each bank. The reason for this recommendation lies in the need for an advisory permanent body, supporting a bank's Board of Directors in fulfilling the difficult tasks to maintain and strengthen internal control system.

Key words: *audit committee, corporative governance process, role of the internal auditor, Romania banking system, credit institutions*

JEL classification: M41, M42

INTRODUCTION

The fact that the internal auditor plays an important role within the corporative governance is well known by many organizations, for instance Bank for International Settlements (BIS): „ The role of the auditors is vital for the process of corporative governance. The efficiency of the administration and of the superior management can be improved through the following: the recognition of the importance of internal audit, the adoption of measures improving the independence of the auditors, using quickly and efficiently the conclusions of the auditors, ensuring the independence of the audit committee. The committee must recognize the fact that internal and external auditors are their important critics." Another key aspect is the position of the internal auditor in the corporative governance environment, taking into consideration potential relations (internal or external) with the attendants which usually are not considered.

Another issue analyzed by the literature referring to this subject is the independence of the audit committee, mainly determined by the number of outside members. Taking into account numerous codes, presently in effect in different countries, one may say that there are presently two principles governing the structure of the audit committee: the audit committee should have members that are both non-executives and independent or the members of the audit committee are all non-executives and the majority of members being independent. This option allows the former members or the important shareholders to become members of the audit committee. Nevertheless they can be barely defined as independent.

According to the information supplied by BIS, the audit committee is most often formed exclusively from the non-executive members of the board of directors. In Romania the law of the trading companies stipulates for the audit committee and the remuneration committee a structure containing only three non-executives administrators and at least one with solid background in accounting principles implementation or in financial audit. The specialized literature affirms that the relation with the audit committee must be usually a reporting relation.

In the same direction the Basel Committee alleges that „ when the internal audit reports directly to the audit committee this practice is very well valued from the corporative governance point of view, providing neutral information concerning audited activities"(Basel Committee on Banking Supervision, 2006).

Therefore, in order to „add value" to the organization, an effective collaboration is desirable between the administrative management and the internal auditor. This can be justified by the fact that in the yearly audit plan, the internal auditor must take into account all the risks and all the control tasks identified by the management (Crăciun Ș, 2006).

1. THE INTERNAL AUDIT OF CREDIT INSTITUTIONS

Starting from 2001 in Romania some institutions including banks were required according to law (Law no. 1267, 2000) to do the internal audit within their own entities as „the activity of objective examination of all the activities of the entity in order to provide an independent assessment of the management and control risk and of the processes of entity management".

The interest to organize the internal audit was low, but the National Bank of Romania managed to force the commercial banks to organize internal audit departments as well as permanent audit committees with consultative role, independent from the directors of the credit institutions and directly subordinated to the Board of Directors. The National Bank of Romania issued the rule 15/2003 concerning the organization and the internal control of the credit institutions activity and administration of significant risks, as well as organization and implementation of the internal audit of the credit institutions. The rule was repealed in June 2010 and was replaced by the regulation 18/2009 issued also by the Romanian National Bank. According to these regulations, credit institutions have to create an internal audit function allowing the management to ensure over the quality of the internal controls, regarding their efficiency and also their effectiveness. The efficiency and effectiveness applies also to risk control function and conformity function and to an Audit Committee that must include mainly, members of the supervision department who aren't implied in the management function and who clearly understand the role of this committee within the internal audit performance. The establishment of an internal audit department at institutional level was justified by „relieving the directors of the responsibility to maintain and review the internal controls."(KPMG, 2008)

Credit institutions are organizing their internal audit activity within assurance commitments or, as needed, providing consulting services aiming to ensure that the policies and the procedures of credit institutions are followed. The audit activity is must ensure that the policies, procedures and control mechanisms are reviewed such as to remain adequate to the activity developed.

In order to fulfill the goal, the internal auditor will stipulate within the insurance commitment the following activitie:

- The assessment of the efficiency and the degree of aptness of the internal control system;
- the assessment of the efficiency and the application of the risk management procedures and the methodology to asses the significant risks;
- the assessment of the accuracy and the credibility of the financial statements and of the accounting records;
- the assessment of the appropriateness of the adequacy degree for the bank's own functions regarding the risks they are exposed;
- testing both the operations but also the operation of the specific checking procedures;
- the assessment of the banking operation efficiency;
- the assessment of the compliance with the legal dispositions, requirements of the behavior codes as well as the assessment of the implementation of the bank's policies and procedures;
- testing the integrity , credibility and, if needed, the opportunity reports, including for the external users.

From the above list of activities, one can infer the main types of bank audit (Palfi C. A., 2009):

- financial audit, having as purpose to check the credibility of the informatics and accounting system and of the yearly financial statements;
- compliance audit, having the purpose to check the compliance with the laws, regulations, policies and procedures.
- operational audit, checking the quality and the adequacy of the systems and procedures, the critical analysis of the organizational structure, the assessment of the method's appropriateness and resources in relation to the predefined objectives;
- management audit, which qualitatively assesses the management function in order to fulfill the objective of the credit institution.

Another aspect that one must observe is that the competence area for the internal audit is all-embracing: internal control system, risk management, informational system, accounting, quality of asset management, banking operation, surpassing a traditional internal audit (administrative and accounting checking).

Unlike the insurance commitment, a consultancy commitment involves scheduling meetings with the representative of the branch/department in order to assess the nature and extent of service to be provided, the confirmation that the service beneficiary understands and agrees with the type of consulting engagement, assessment of the consultancy commitment in terms of compatibility with the audit plan, documentation in agreement with the conditions and general requirements and other important factors, the results dissemination and monitoring the implementation of the recommendations.

The importance of the involvement of the corporative governance in the risk management was recently recognized. The banks are under pressure to identify the risks facing it: the social risks, ethics and environment, financial and operational, and how to manage them to an acceptable level. At the same time, despite the fact that banks agrees with the benefits when approaching the risk management, internal auditor's role should not be neglected in the process of managing the entire process of appropriate risk management and its contribution to improving processes and internal control environment of business.

The internal audit, by both roles played in according insurance and consultancy, contributes to the risk management in many ways, its importance increasing more and more in the context of the present financial crisis. Risk management activities are undertaken to identify, assess, manage and control all types of events or circumstances that may affect the bank.

One can observe that the role of the internal auditors is to alert both the operators and managers concerning the risks of violating the law, the regulation procedures and the consequences of own banking activity as well as "to educate the management in order to identify efficient solutions and to implement and develop techniques and tools needed in this field" (Ghiță M., Hlaciuc E., Boghean F., ş.a., 2010).

The conclusions and recommendations of the internal auditors are written on the internal audit reports which are submitted to the management in order to be informed. "The quality and the presentation of such reports adds substance to the value added by internal audit and its functions"(Ioanăş C., Tuțu A., Botea M., 2006). Supervising and managing of the internal audit function is part of the general responsibilities of the audit committee.

Concerning the constituents, the competences and the running of the Audit Committee, the Romanian National Bank applies three of the Basel Committee recommendations: the activity of the committee must be carried on the basis of a regulation approved by the Board of Directors, the component of the committee must prevent the occurrence of the conflict of interest (its own members to be also members of the Board of Directors, without being managers of the credit institutions and at least one member to have background in audit and accounting).

The competences of the Committee are general, encouraging the communication among the Board of Directors members, the managers of the credit institution, internal audit, external auditor and the banking supervision organizations. The main areas of interest of the Audit Committee refers to (Mihai I., Velicu I. C., 2006): operation of the internal control system and of the internal audit department, risk areas that have to be covered by the internal and external audit, the accuracy and the credibility of the financial information supplied to the bank management and other institutions, credit institution's compliance with legal and regulatory provisions. The committee can issue recommendations to the Board of Directors regarding the bank policy in the field of internal control, internal audit and financial audit, as well as the appointment of the financial auditor for the credit institution.

Conclusively, the internal auditor and the audit committee can ensure an improved efficiency by using more adequately the human and material resources as well as a better synchronization among different departments of the company. Internal audit guarantees that the company obeys corporative governance standards and contributes to establishing of an integrity renown which will help business relations to develop based on trust.

2. THE CONTRIBUTION OF THE INTERNAL AUDITOR TO THE CORPORATIVE GOVERNANCE

Keeping in mind different aspects and features specific to the corporative governance we will analyze a range of aspects that can be valuable, emphasizing the contribution of the internal auditor to the corporative governance.

We are pointing out that corporative governance is based on the ethical behavior of the society. Nevertheless, it appears that there are moments that make difficult to balance between ethics and profits. The relations between ethics and profits can be unbalanced, dangerous and ideal, the latter is desirable but almost impossible to accomplish. A written ethics and demeanor code including values such as honesty, trust and integrity should be transmitted to all the members of the organization and even to all the members of the relating organizations in order to be aware of what is acceptable. This is in fact the role of the internal auditor: to advice with the management and to suggest the issues which have to be included in the code. The role of the internal auditor is also to asses if the code was correctly applied and to identify any infringement.

Fraud or more likely minimizing it is another key aspect of the corporative governance. In the paper entitled "The internal audit in Europe" ECIIA asserts that: "the internal audit will ensure that the fraud risk was correctly identified and assessed by the executive management. The internal audit will ensure the correctness of the design of internal checks in order to approach the fraud risk and the fact that there are efficiently functioning". The IIA position referring to the eventual contribution of the internal auditor in detecting and preventing the fraud is clear enough in the following text: "the internal auditor should have sufficient knowledge to identify the indicators of fraud but is not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud. Internal auditors should, among other things, have full responsibilities defined in the prevention, detection and reporting of fraud, and must implement actions aimed to create "awareness". It appears useful in this case antifraud policies or specific training activities dependencies that must be made to increase the perceived need to prevent this fraudulent activity, to identify it and alert" (Chersan C., 2004).

One of the most effective means of preventing fraud is certainly is to update the control environment, mainly the actions agreed by top management (all these must show impeccable behavior), as well as by a behavior code appropriately communicated to all. Thus, the role played by the internal auditor in detecting and preventing fraud is a direct contribution to good corporate governance and should be encouraged the management and administration. However, we can not emphasize that a company auditor plays a role, more likely preventive than a detective role, being prepared rather to play a more active role in fraud (detection and prevention) committed to the detriment of the organization than its benefit.

Although the fraud was treated as a separate risk it's worthwhile to take a closer look at the relationship between the internal auditor, on the one hand and risk management on the other. We have seen that risk assessment and risk management are vital aspects of corporate governance, but in terms of the internal auditor only two issues are addressed: reputation risk management and risk management in a bank.

In order to gain the trust of their clients and to have a recognized reputation, the banks must dispose (Trenca I., 2007) firstly of a solid financial situation, suppoted by the existence of an adequate working capital an by a reasonable flow of incomes and secondly of qualified personell and a cautious manager. There are many banks that can be affected by management mistakes, lack of internal control structure, etc. The reputation of the risk management is a special category of risk, who despite the fact of referring to the management, it reaches over the corporative reputation. A bank reputation (one of the key elements that determine the external perception) can become malleable and by far the most important element for the future success of the organization. We must understand that "the reputation of a bank is not a risk, but the loss of reputation is always"(Cattrysse J., 2005). There are many risks that may jeopardize the reputation of an organization, such as financial performance, corporate governance performance, management quality, ethical, fraud, compliance with laws and regulations, etc. It's the risks that are leading back to the basic aspects of the corporative governance. In fact, an important contribution can be made by the internal auditor through the assessment of the corporative vision and responsibilities, the ethical code, the performance policies, the compliance with the expectations of all involved, the risk management system, the vision in external relations (partners, suppliers, clients).

Concerning the internal auditor, the greater the emphasis on risk management, the more focused the audit planning will have to be in the direction of the risk audit, concentrating more on the risk process. He can bring an important contribution to the "risk process" of the organization providing the insurance referring to the appropriateness and the efficiency of the risk management procedures and consultancy to improve risk identification.

CONCLUSION

Effective corporative governance policies are essential in order to maintain client confidence in the banking system, which is important for the global performance of the economy. Poor corporate governance may contribute to bank failures, which may cause significant and serious expenses because of their potential impact on economic operators and therefore the possibility to extend at macroeconomic level, causing the risk of contamination and impact on payment systems.

Moreover, a poor corporative governance can cause the markets to loose the confidence in the ability of a bank to manage properly the assets and liabilities, including the deposits, causing a liquidity crisis. Excluding the responsibilities towards shareholders the bank have the responsibility towards its depositors.

For instance, Romanian Commercial Bank (RCB) is the first bank who reformed its corporative governance system, according to UE standards and international banking standards. As a consequence, between 2003 and 2005 the value of the bank increased six times, the bank being upgraded by Fitch (fro D to C/D) and Standard and Pours (long term assessment from BB- to B+). Both rating institutions mentioned the improvement of the corporative governance and of the risk management as main reasons of the increased rating. (Bright C., 2009)

Credit institutions must organize the internal audit as a component of the activity of supervising the internal control system and assessment of the own funds adequacy degree depending on the risks the credit institutions are exposed, in order to ensure an independent assessment of the policies and procedures adequacy and the way they are abided.

For credit institutions, the internal audit extends more than on issues directly related to administrative and accounting checks. The internal auditor most important tasks are to ensure the existence of corporative governance, the control systems and risk management processes. While the board of directors is seen eventually as the management of risks, the audit committee can be seen as an extension of the risk management function belonging to the board.

The audit committee plays for corporative governance the role of a valuable tool helping the management to identify and process risk situations issued in a bank.

Finally we can say that the key elements of solid corporative governance in a bank include:

- establishment and enforcement of clear responsibilities, decision-making authority and other responsibilities that are appropriate for the risk profile of the bank;
- strong financial risk management function (independent of the business lines), adequate internal control systems (including internal and external control functions) and functional processes design, with subsequent check;
- corporate values, rules of behavior and other standards of appropriate behavior and effective systems used to ensure compliance. This includes special monitoring of a bank's risk exposures where conflicts of interest expected to occur (eg, relationships with related parties);
- transparency and appropriate information transmitted internally and to their users.

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