Strategic challenges for business in the use of corporate responsibility codes, standards, and frameworks.

Internal auditing activity as a matter of corporate governance control.

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Abstract: Corporate governance mechanisms and controls are designed to reduce the inefficiencies that arise from moral hazard and adverse selection. For example, to monitor managers' behaviour, an independent third party the external auditor attests the accuracy of information provided by management to investors (Jensen, 1993). An ideal control system should regulate both motivation and ability.

Keywords: International organizations; auditing; authorities; stock exchanges; management; Internal auditing activity; external auditor.

1. Introduction

Corporate governance principles and codes have been developed in different countries and issued from stock exchanges, corporations, institutional investors, or associations' institutes of directors and managers with the support of governments and international organizations [1]. As a rule, compliance with these governance recommendations is not mandated by law, although the codes linked to stock exchange listing requirements may have a coercive effect. For example, companies quoted on the London, Toronto and Australian Stock Exchanges formally need not follow the recommendations of their respective codes. However, they must disclose whether they follow the recommendations in those documents and, where not, they should provide explanations concerning divergent practices. Such disclosure requirements exert a significant pressure on listed companies for compliance.

International organizations, private sector associations and more than 20 national corporate governance codes, the United Nations Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting ISAR has produced their Guidance on Good Practices in Corporate Governance Disclosure. This decision consists of more than fifty distinct disclosure items across five broad categories:

- Auditing
- Board and management structure and process
- Corporate responsibility and compliance
- Financial transparency and information disclosure
- Ownership structure and exercise of control rights[2]

The investor-led organisation International Corporate Governance Network ICGN was set up by individuals centred around the ten largest pension funds in 1995. The aim is to promote global corporate governance standards. The network is led by investors that manage 18 trillion dollars and members are located in fifty different countries. ICGN has developed a suite of global guidelines ranging from shareholder rights to business ethics. The World Business Council for Sustainable Development WBCSD has done work on corporate governance, particularly on accountability and reporting and in 2004 released Issue Management Tool: Strategic challenges for business in the use of corporate responsibility codes, standards, and frameworks. This document offers general information and a perspective from a business association / think-tank on a few key codes, standards and frameworks relevant to the sustainability agenda. In 2009, the International Finance Corporation [3] and the UN Global Compact released a report, Corporate Governance, the Foundation for Corporate Citizenship and Sustainable Business, linking the environmental, social and governance responsibilities of a company to its financial performance and long-term sustainability. Most codes are largely voluntary. An issue raised in the U.S. since the 2005 Disney decision is the degree to which companies manage their governance responsibilities; in other words, do they merely try to supersede the legal limit, or should they create governance guidelines that ascend to the level of best practice. For example, the guidelines issued by associations of directors, corporate managers and individual companies tend to be wholly voluntary but such documents may have a wider effect by prompting other companies to adopt similar practices [4].

The most influential parties involved in corporate governance include government agencies and authorities, stock exchanges, management including the board of directors and its chair, the Chief Executive Officer or the equivalent, other executives and line management, shareholders and auditors. Other influential stakeholders may include lenders, suppliers, employees, creditors, customers and the community at large. The agency view of the corporation posits that the shareholder forgoes decision rights control and entrusts the manager to act in the shareholders' best joint interests [5]. Partly as a result of this separation between the two investors and managers, corporate governance mechanisms include a system of controls intended to help align managers' incentives with those of shareholders. Agency concerns risks are necessarily lower for a controlling shareholder. A board of directors is expected to play a key role in corporate governance [6]. The board has the responsibility of endorsing the organization's strategy, developing directional policy, appointing, supervising and remunerating senior executives and ensuring accountability of the organization to its investors and authorities [7].

All parties to corporate governance have an interest, whether direct or indirect, in the financial performance of the corporation. Directors, workers and management receive salaries, benefits and reputation, while investors expect to receive financial returns. For lenders, it is specified interest payments, while returns to equity investors arise from dividend distributions or capital gains on their stock. Customers are concerned with the certainty of the provision of goods and services of an appropriate quality; suppliers are concerned with compensation for their goods or services, and possible continued trading relationships. These parties provide value to the corporation in the form of financial, physical, human and other forms of capital. Many parties may also be concerned with corporate social performance. A key factor in a party's decision to participate in or engage with a corporation is their confidence that the corporation will deliver the party's expected outcomes. When categories of parties stakeholders do not have sufficient confidence that a corporation is being controlled and directed in a manner consistent with their desired outcomes, they are less likely to engage with the corporation. When this becomes an endemic system feature, the loss of confidence and participation in markets may affect many other stakeholders, and increases the likelihood of political action. There is substantial interest in how external systems and institutions, including markets, influence corporate governance [8].

2. Ownership structures and elements

Ownership structure refers to the types and composition of shareholders in a corporation. Researchers often 'measure' ownership structures by using some observable measures of ownership concentration or the extent of inside ownership. Some features or types of ownership structure involving corporate groups include pyramids, cross-shareholdings, rings, and webs. German 'concerns' [Konzern] are legally recognized corporate groups with complex structures [9].

Fig.1 Quality management in corporate governance and effectiveness of auditing

3. Internal corporate governance controls

Internal corporate governance controls monitor activities and then take corrective action to accomplish organisational goals [10].
Examples include:

Monitoring by the board of directors: The board of directors, with its legal authority to hire, fire and compensate top management, safeguards invested capital [11]. Regular board meetings allow potential problems to be identified, discussed and avoided. Whilst non-executive directors are thought to be more independent, they may not always result in more effective corporate governance and may not increase performance. Different board structures are optimal for different firms. Moreover, the ability of the board to monitor the firm's executives is a function of its access to information. Executive directors possess superior knowledge of the decision-making process and therefore evaluate top management on the basis of the quality of its decisions that lead to financial performance outcomes, ex ante. It could be argued, therefore, that executive directors look beyond the financial criteria [12].

Internal control: procedures and internal auditors: Internal control procedures are policies implemented by an entity's board of directors, audit committee, management, and other personnel to provide reasonable assurance of the entity achieving its objectives related to reliable financial reporting, operating efficiency, and compliance with laws and regulations [13]. Internal auditors are personnel within an organization who test the design and implementation of the entity's internal control procedures and the reliability of its financial reporting [14].

Balance of power: The simplest balance of power is very common; require that the President be a different person from the Treasurer. This application of separation of power is further developed in companies where separate divisions check and balance each other's actions [15]. One group may propose company-wide administrative changes, another group review and can veto the changes, and a third group check that the interests of people customers, shareholders, employees outside the three groups are being met [16].

Remuneration: Performance-based remuneration is designed to relate some proportion of salary to individual performance. It may be in the form of cash or non-cash payments such as shares and share options, superannuation or other benefits [17]. Such incentive schemes, however, are reactive in the sense that they provide no mechanism for preventing mistakes or opportunistic behaviour, and can elicit myopic behaviour. In publicly-traded U.S. corporations, boards of directors are largely chosen by the President / CEO and the President / CEO often takes the Chair of the Board position for his/herself which makes it much more difficult for the institutional owners to 'fire' him/her. The practice of the CEO also being the Chair of the Board is known as 'duality'. While this practice is common in the U.S., it is relatively rare elsewhere. It is illegal in the U.K.

3.1 Internal auditing activity

Internal auditing activity as it relates to corporate governance is generally informal, accomplished primarily through participation in meetings and discussions with members of the Board of Directors [18]. Corporate governance is a combination of processes and organizational structures implemented by the Board of Directors to inform, direct, manage, and monitor the organization's resources, strategies and policies towards the achievement of the organizations objectives. The internal auditor is often considered one of the "four pillars" of corporate governance, the other pillars being the Board of Directors, management, and the external auditor.

A primary focus area of internal auditing as it relates to corporate governance is helping the Audit Committee of the Board of Directors or equivalent perform its responsibilities effectively. This may include reporting critical internal control problems, informing the Committee privately on the capabilities of key managers, suggesting questions or topics for the Audit Committee's meeting agendas, and coordinating carefully with the external auditor and management to ensure the Committee receives effective information.

The scope of internal auditing within an organization is broad and may involve topics such as the efficacy of operations, the reliability of financial reporting, deterring and investigating fraud, safeguarding assets, and compliance with laws and regulations. Internal auditing frequently involves measuring compliance with the entity's policies and procedures. However, internal auditors are not responsible for the execution of company activities; they advise management and the Board of Directors (or similar oversight body) regarding how to better execute their responsibilities. As a result of their broad scope of involvement, internal auditors may have a variety of higher educational and professional backgrounds [19]

3.2 Role in corporate governance

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4. External corporate governance controls

External corporate governance controls encompass the controls external stakeholders exercise over the organization [20].
Examples include:

- competition
- debt covenants
- demand for and assessment of performance information especially financial statements
- government regulations
- managerial labour market
- media pressure
- takeovers

The board of directors has primary responsibility for the corporation's external financial reporting functions. The Chief Executive Officer and Chief Financial Officer are crucial participants and boards usually have a high degree of reliance on them for the integrity and supply of accounting information. They oversee the internal accounting systems and are dependent on the corporation's accountants and internal auditors [21].

Current accounting rules under International Accounting Standards allow managers some choice in determining the methods of measurement and criteria for recognition of various financial reporting elements. The potential exercise of this choice to improve apparent performance increases the information risk for users. Financial reporting fraud, including non-

5. Conclusion

One area of concern is whether the auditing firm acts as both the independent auditor and management consultant to the firm they are auditing. This may result in a conflict of interest which places the integrity of financial reports in doubt due to client pressure to appease management. The power of the corporate client to initiate and terminate management consulting services and, more fundamentally, to select and dismiss accounting firms contradicts the concept of an independent auditor [22].

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