

## ANALYSIS OF INTERNAL AUDIT PRACTICES AND OF THE AUDIT COMMITTEE IN THE CONTEXT OF THE CORPORATE GOVERNANCE OF COMPANIES LISTED ON THE BUCHAREST STOCK EXCHANGE – BVB

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### **Abstract:**

*In this paper, the subject discussed refers to the existence of practices and auditory committees in the context of corporate government. We considered debating this subject important because we wanted to highlight the way in which companies listed on the Bucharest Stock Exchange have managed themselves in the context of the new tendencies towards globalization and the context of corporate government which appeared relatively late in Romania, during the turn of the century. This concept, however, has changed the last few years, responsibility and transparency becoming key factors not only for shareholders but also creditors, investors, suppliers, etc. Thus from the practical perspective we wanted to analyze the degree of corporate government development in Romania. The conclusion reached was that entities with an international organizational culture (foreign shareholders) put more emphasis on corporative government, while between those with Romanian capital, less than 50% apply the corporate government code.*

*Corporate government is an increasingly disputed subject in the last few years and the connection between management and financial reporting is of paramount importance. In this connection the audit committee plays an important role in drawing up those practices meant to ensure the quality of financial reports.*

**Keywords:** *Corporate government, internal control, internal audit, audit committee, principles of corporate government.*

**JEL:** F40, M14

### INTRODUCTION

Recent financial scandals have proven that the risk of accounting fraud can be confusing in any type of economic system and determined us to debate this thematic. In this case informational transparency is an in disposable element of market competitiveness; it is an important function in corporate government systems and especially for audit ones. Thus, as a result of the lack of information transparency the governance issue must be seen as a support against pressures that lead to fraud.

We chose to study these themes in tandem because of the connection that should exist between the audit department and the audit committee, namely the head of the internal audit department should be subordinated to the audit committee, and also the results and findings of the internal audit can be regularly submitted to the audit committee.

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I.Bostan and V. Grosu (2010) consider the role of the internal audit as essential in preventing accounting fraud, considering that every type of governance, regardless of the way in which it is set up and the reference market that it is a part of, in order for it to be considered efficient it must provide opportune mechanisms of control, that may intervene in critical situations and protect the interest of all user groups. The role of the internal audit of the company, taking also into account the influences over management control, assumes a prime importance in the corporate government sphere.

The Romanian economy is in the process of economic and financial structuring, a fact that leads us to the conclusion that its economy is emergent, reason for which in our study we set out to analyze the existence of the audit department and committee in the context of corporate governance for societies listed in the first and second category of the Bucharest stock exchange.

## **RESEARCH METHODOLOGY**

The main objective of this research is determining the measure in which internal audit practices and those of the audit committee for the Bucharest stock exchange listed societies fit in the context of corporate governance.

Thus, for reaching this goal, we relied on an approach from general to particular, engaging in a process of specialist scientific literature analysis in our interest field and continuing with the practical aspect.

So, the first part of the study will contain a predominantly theoretical perspective realized through quality research, and which includes the definition of different concepts, such as: internal control, internal audit, corporate governance, audit committee, efficient corporate governance.

The second part of the paper contains the practical aspect that was realized through quantitative research. In this part we set out to analyze the existence of the audit department and committee in the context of corporate governance for societies listed in the first and second category of the Bucharest stock exchange.

The initial regarded sample consists of 40 societies, that later on is reduced by the number of societies that have not implemented such an audit department/committee, or have not presented information on their web sites, considering them irrelevant, a fact pointed out by applying a survey template, that for completing it, we analyzed the “Apply or Explain” Declaration as well as the Corporate Governance Rulebook, the survey being taken by the 40 entities in the first and second BVB category. We chose to study only societies listed in the first and second category, because we took into account that it is more likely for these companies to have adopted and conformed voluntarily to the provisions of the Bucharest Stock Exchange governance code.

## **CONCEPTUAL DELIMITATIONS OF INTERNAL AUDIT PRACTICES AND THE PRACTICES OF THE AUDIT COMMITTEE IN THE CONTEXT OF CORPORATE GOVERNANCE**

According to the COSO definition, internal control is “a process implemented by the administrative council, management and other staff members, designed so as to supply a reasonable assurance in regards to reaching the following objectives: efficiency and effectiveness of operations, reliability of

financial information and ensuring current rules and regulations compliance”. (Coopers and Lybrand, 1992)

Internal control is represented by the sum of organizational structures and measures, as well as the ensemble of monitoring policies and procedures, surveillance and evaluation taken by those in governance, management and the whole staff. (I. Oprean, 2010)

Internal control of an entity is under the control of the audit committee, this being reflected at all hierarchical levels, and it supplies information to management staff, in regards to the real situation of the entity, changes that occur in its internal and external environment. (J. Krishnan, 2005)

The concept of corporate governance is increasingly debated on a national and international scale because of the current financial crisis, but also because of the collapse of the energy giant Enron, this being considered one of the symbols of corporate fraud. Ever since the Enron collapse, the concern for corporate governance has increased, because managers weren't trusted anymore and the administration board wanted to reach through it a level of transparency.

Through corporate governance increasing the performance of the company and harmonizing different interest groups are aimed. After the large scandals that shook companies such as WorldCom or Enron, governments and control authorities focused their attention on implementing a more efficient system of company governance. Thus, according to A. Morariu, corporate governance “encompasses the private and public institutions of a country, both formal and informal, that govern together over the relations between the people that manage corporations and all those that invest resources in the corporations from that country.”

The efficient running of the corporate governance process offers auditors – external and internal – essential roles in regards to the transparency of financial reporting, such as monitoring internal checks, meant to ease the assumed risks of the organization in carrying out business. (Dobroțeanu C.L., 2010)

The internal audit assists an organization in achieving its objectives by implementing a systematic approach in evaluation and enhancing risk management effectiveness, control and governance processes. Consequently, only after studying the field of corporate governance, risk management and the internal control system can we address the real value of the internal audit and its role within the organization. (A. Shleifer, R. Vishny, 1997)

The internal audit supports the concept of corporate governance, playing an important role in assisting the reorganization of the internal control system and counseling of the general management. In practice, any organization wishes to implement the following ideals: corporate governance; risk management and the internal control system, and the internal audit is that key component of monitoring these.

Thus, the internal audit offers independent and objective counseling services in order to help mid-level management of the entity to improve risk management, control and governance. Entities use the internal audit in order to evaluate policies and procedures used to reach objectives, through harnessing the recommendations of auditors. The internal audit has become part of risk management, next to those that deal with activity monitoring. (Ungureanu, 2010)

Joseph V, Carcello and Terry L. Neal (2000, p.458) consider that in regards to the audit committee, it not only plays an important monitoring role in order to ensure quality financial reporting and corporate responsibility, but it also serves as an important governance mechanism, because the potential litigations risk

confronting the audit committee members ensures that these members of the audit committee fulfill their responsibilities efficiently.

## **INTERNATIONAL STUDIES**

A similar study was made by Y. Zhang, J. Zhou, and N. Zhou in 2007 in Journal of Accounting and Public Policy. In their paper they investigated the relationship between the audit committee, the independence of the auditor, as well as the deficiencies of internal control after the coming into effect of the Sarbanes-Oxley Act. They started with a sample of companies with internal control deficiencies, and, depending on business, size and performance, and studied if they could fit these companies to a sample of companies without internal control deficiencies. Their results show that there is a relation between the quality of the audit committee, the independence of the auditor and the deficiencies of internal control. They are a lot more susceptible to be identified with a weakness in internal control when auditors are more independent. Added to this, companies with recent changes in auditors are much more predisposed to internal control deficiencies.

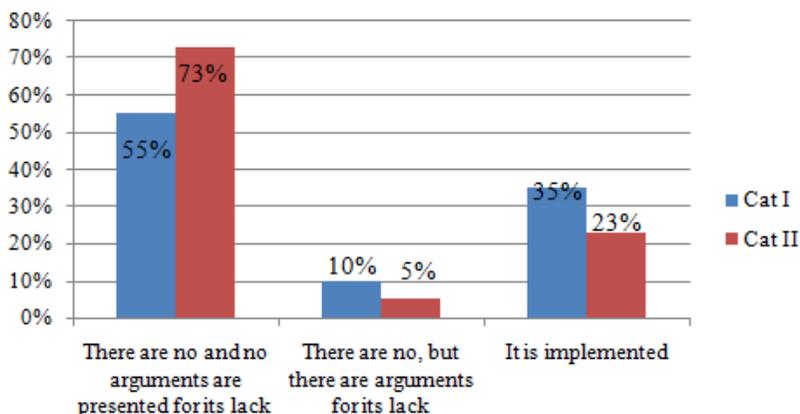
Another study that compelled us to debate this issue was the empirical study of Jayanthi Krishnan from his work Audit Committee Quality and Internal Control from 2005. He studied the relation between the quality of the audit committee and the internal control in the context of corporative governance. In order to realize this study, J. Krishnan used a regression model in which the dependent variable was the quality of internal control and the independent variable was the quality of the audit committee. Utilizing the disclosure index and the binary system, he gave a value of 1 to entities that presented problems with internal control and 0 to entities that didn't present problems with internal control. The results of the study point to the fact that independent audit committees and audit committees that have financial expertise are significantly less susceptible to be associated with the incidence of internal control problems.

## **CASE STUDY – ANALYSIS OF THE INTERNAL AUDIT PRACTICES AND THE ANALYSIS OF THE AUDIT COMMITTEE PRACTICES IN THE CONTEXT OF CORPORATE GOVERNANCE OF BUCHAREST STOCK MARKET LISTED SOCIETIES**

The analyzed societies from this case study are listed on the Bucharest stock exchange, the sample consisting of 40 societies.

### **Analysis of the internal audit practices in context of corporate governance**

Through this analysis we wished to point out how many of the societies from the chosen sample have implemented a department of internal audit, its independence, role and responsibilities, its organization, if they did or didn't publish the internal audit report on their web-site, as well as the relation between the audit department and the audit committee. The results of the research are as follows:

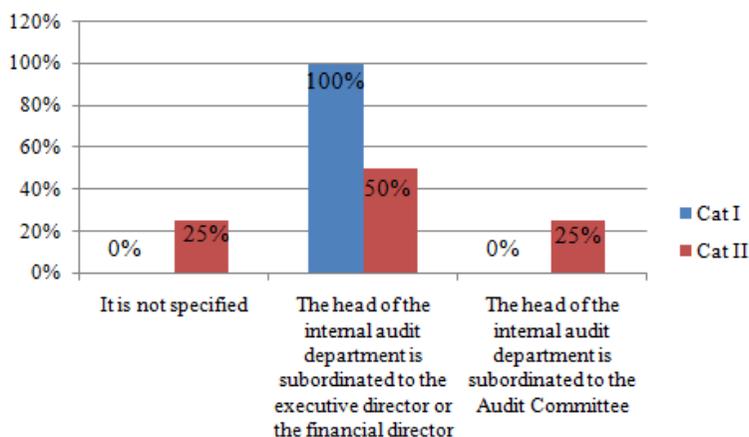


**Figure 1-** Existence of the internal audit department

Source: www.bvb.ro

In regards to the existence of the audit department, it is implemented for more societies from the first category than the second, 35% compared to 23%, are nonexistent, but there is no argument for the lack of the department for 55% of the societies in the first category and 73% of the societies in the second category, for too few societies explanations were given as to the lack of the audit department, more precisely 10% from the first category and 5% from the second category (the explanation – they have permanent financial audit).

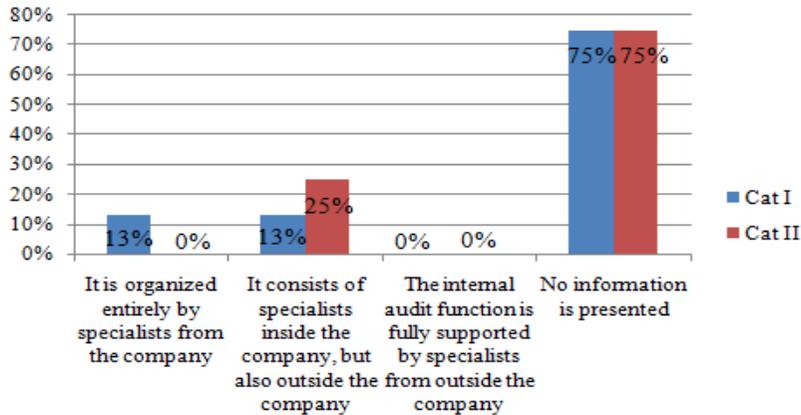
In USA and United Kingdom is recommended a minimum of 3 members, although the German corporate governance code does not refer directly to the membership of the audit committee. The most corporate governance codes refer to an optimum number of three to six members (PWC, 2003, p. 20). Bertschinger and Schaad (2003, p.20) believe that the members of the audit committee should not exceed a total of 4 members, except for unusual circumstances. We could say that the number of the members of the audit committee is directly related to the size of the company and to the workload.



**Figure 2 -** Position of the internal audit department within the company (its independence)

Source: www.bvb.ro

Analyzing the position of the internal audit department in the company (its independence), we found that in all societies from the first category the head of the audit department is under the executive director or the financial director. In regards to the second category, for 25% of societies the head of the internal audit department is under the audit committee, something that does not exist for the first category, although it would be preferable, 50% are under the executive director or the financial director and in 25% of the cases the position of the internal audit within the company was not stated.



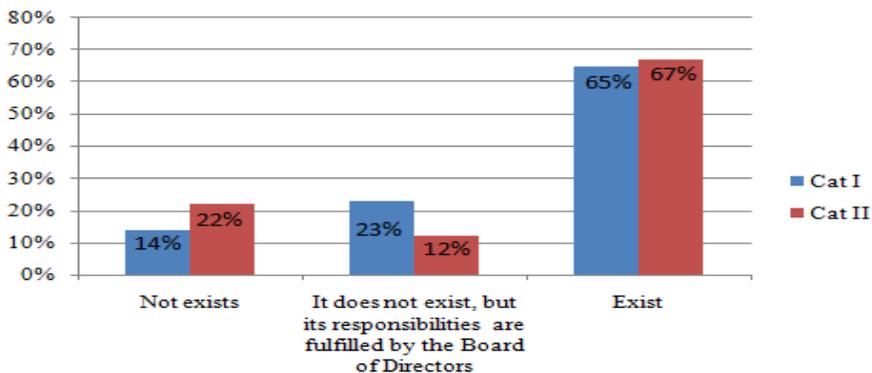
**Figure 3 – Organization of the audit department**

Source: www.bvb.ro

In regards to the organization of the internal audit department we encountered difficulties because for 75% of societies from both categories there was no information presented. We did however observe that the internal audit function is not fully endorsed by specialists from outside the company.

**Analysis of the audit committee practices in context of corporate governance**

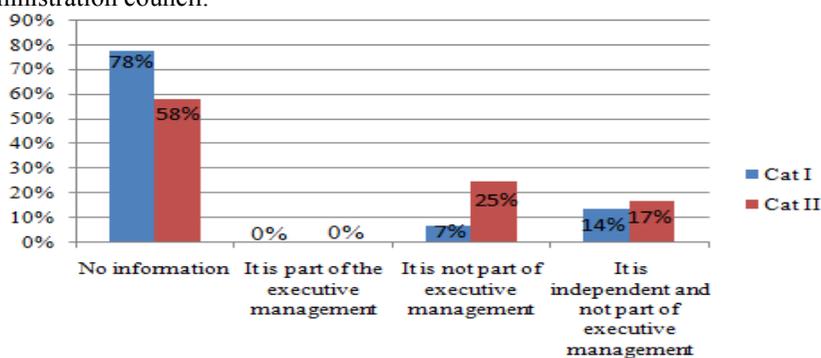
Through this analysis we wanted to point out how many of the societies from the chosen sample have implemented an internal audit committee and what the independence of the president of the audit committee is. The research results are as follows:



**Figure 4 - Existence of the Audit Committee**

Source: www.bvb.ro

As we can observe, the audit committee is implemented in a proportion of 65% at the societies from the first category and 67% at the societies from the second category, but at 23% of the societies from the first category the responsibilities of such a committee are fulfilled by the administration council, and for the societies in the second category, for 11% the responsibilities are of the administration council.



**Figure 5** – The president's independence

Source: www.bvb.ro

Regarding this element we encountered some difficulties, because in the case of societies from both categories, there was no information provided (78% - first category, 58% second category). From the received information, we noticed that 7% of the societies analyzed in the first category specify that the president of the audit committee is not part of executive management, and for the second category, this fact was specified for 25% of the societies. Information regarding the fact that the president of the audit committee is independent and not part of executive management was specified at 14% of the societies from the first category and 17% of the societies from the second category.

The study came to the conclusion that the role of the audit committee in corporate governance is essential, although some issues are more or less neglected by the companies from the variety on which the study was conducted.

## CONCLUSIONS

The first conclusion we reached is that not all the companies listed on a stock exchange have a separate audit committee, with clearly defined responsibilities. These companies are listed on Bucharest Stock Exchange. In contrast, all the entities selected in the sample and listed on the London Stock Exchange have a separate audit committee, with clearly defined responsibilities. It is obviously that the managers of Romanian entities do not understand the necessity of an audit committee in corporate governance.

We can state that the corporate governance system leads to the improvement of the economic efficiency of an entity, through extending the competencies of the internal audit and the establishment of audit committees, organizing internal control, understanding the significance of transparency and quality for financial information and improving management.

Good governance within an entity decreases risks, improves performance, opens the way towards financial markets, increases the marketing ability for goods and

services, improves management, and presents transparency and social responsibility. The efficiency test of the governance model is the measure in which the maximization of the investor's profits is realized.

Currently all organization and most countries are preoccupied with implementing the principles of corporate governance.

The conclusion we reached realizing this study is the fact that first category societies put a larger emphasis on the internal audit position as a promoter of corporative government than societies from the second. By percentages there are 45% societies with foreign participation to the social capital and 65% are Romanian capital only. Of those with foreign participation 88.99% (16 societies from 18 with foreign capital) apply the corporate governance code, while in the case of those with Romanian capital only 52.55% (12 societies from 22 with Romanian capital) of societies put emphasis on corporative governance. With proof from the above we can state that an international organizational culture helps to better follow the corporate governance code.

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