SOME ARGUMENTS THAT JUSTIFY THE AUDIT TRINITY'S APPROACH IN THE CONTEXT OF CORPORATE GOVERNANCE

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Abstract:
The purpose of this paper is to develop a synthesis of the main arguments that could justify the necessity of audit trinity's approach (internal audit, external audit, audit committee) in assuring good corporate governance. The aim of the paper is also to synthesize relevant theoretical and empirical latest literature that argues the significance of audit functions as an important mechanism in the effective functioning of corporate governance system. From methodological point of view, the construction of this paper has adopted a normative approach, the research being primarily, based on a examination of relevant literature, with a focus on developments that have more or less implications over the progress of corporate governance issues, especially in these difficult economic context that requires urgently the adopting of effective solutions. By presenting on overview over the latest literature ad discussing the shifting demands with respect to the audit's contribution to ensuring good corporate governance, the author of this paper hopes to stimulate further research and constructive debates in the field.

Keywords: *Internal audit, external audit, audit committee, corporate governance, audit trinity*

1. Introduction

If we are looking for the origins of corporate governance, in the speciality literature (Paape, L., 2007) it's generally accepted that Berle and Means (1932) are the real founders of this controversial issue. Berle and Means (1932) have promoted the idea of separation of ownership and control, because the ownership is dispersed among small shareholders, while control is concentrated in the power of managers. According to Berle and Means (1932), while typical shareholders are not interested in the day to day affairs of the company, the management and the directors who are directly interested in day to day affairs have the ability to manage the resources of the company to their own interest without the effective shareholder's control.

"The property owner who invests in a modern corporation so far surrenders his wealth to those in control of the corporation that he has exchanged the position of independent owner for one in which he may become merely recipient of the wages of capital... [Such owners] have surrendered the right that the corporation should be operated in their sole interest..." (Berle and Means, 1932)

In the following years, other specialists like Williamson (1975), Jensen and Mecckling (1976), Fama (1980, 1983), Jensen (1983), Fama and Jensen (1983), developed the idea of separation of ownership and control, developing the *agency theory*. The *Agency Theory* tries to define the relationship that should be between the principal *(shareholders - the owners)* and the agent *(managers who manage the property)*. According to agency theory every agent or interest group works to maximize its own position, being mostly motivated by self-interest. The conflict appears when the goals of the principal are not the same with the ones of the agent. There were realized some studies (Rutledge and Karim, 1999) that try to explain why sometimes managers choose to take some decisions that did not represent the best objectives of the company. *Does the agency theory influence the issue of corporate governance?* According to Paape (2007) corporate governance is an agency problem *pur sang (par excellence),* most of researches dedicated to corporate governance being approached from the perspective of agency theory, being more focused over the agency problems between management and shareholders (Jensen&Mecckling, 1976, Fama, 1980, Fama&Jensen, 1983, Eisenhardt, 1989, Brennan & Solomon, 2008).

If from scientific point of view, corporate governance issues was in the centre of researchers' interests mostly beginning with the second half of 20th century, in terms of recognising the legitimacy the moment of recognition of the importance of corporate governance took place quite late. The first significant step in this direction could be identified in Europe (UK) and is given by the issuing of Cadbury Report in 1992 by the Cadbury Committee managed by Sir Adrian Cadbury (*Cadbury Committee Report: Financial Aspects of Corporate Governance*). The major objective of this report was to find some answers to the concerns manifested by public sector, but also as following to the corporate failures of some major corporations from private sector. All these concerns were also increased by the fraud events that affect Maxwell Company, but also by the ease with the abuses of power could be achieved within such large corporations. Some of the Cadbury Report' conclusions showed that corporate bankruptcies were generated by the major problems of internal control system functioning, all these aspects being in the top management's responsibility, which not only failed to avoid such problems, but in some cases, it was proved that it had a important contribution to disaster. At the end of 1992 year, the Cadbury Report has been completed with a Code of good practices, promoting the idea that the existing system of corporate governance was weak and lacking only from a single point of view, the one of transparency and accountability issues (Cadbury, 1992).

Later, there were issued also many reports, each of them having more or less a significant contribution to the development of corporate governance. A synthesis of most important reports that influenced at international level the corporate governance developments is presented in Table no.1.

Table no.1 *A synthesis of major reports that influenced the developments of corporate governance at international level.*

Source: author's projection based on literature review

Country	Year	Report
Australia	1993	**Hilmer, F. G.**, *Strictly Boardroom: Improving Governance to Enhance Company Performance* (Melbourne, The Business Library.
	1995	**Bosch Report**, *Corporate Practices and Conduct*. Third Edition published and distributed by Woodslane Pty Ltd
	1997	**Audit Office of NSW, Australian performance report**. Public sector corporate governance, *Corporate Governance - Volume One: in Principle*, June.
	1997	**Audit Office of NSW, Australian performance report**. Public sector corporate governance, *Corporate Governance - Volume Two: in Practice*, June.
	2001	**Ramsay Report**, *Independence of Australian company auditors: review of current Australian requirements and proposals*, Center for Corporate Law and Securities Regulation, The University of Melbourne, October.
	2002	**IFSA Report**, *The blue book-Guidelines on Corporate Governance for fund managers and corporations,* Investment Financial Services Association of Australia.
	2010	**ASX Corporate Governance Council, second edition**, *Corporate Governance Principles and Recommendations* (amended in 2010).
United States of America (USA)	2002	**Sarbanes-Oxley Act**, 2002, United States Federal law enacted 30 July 2002.
	2003	**National Association of Corporate Directors (NACD),** Blue Ribbon Commission reports: *Executive Compensation and the Role of the Compensation Committee*, December.
	2003	**NYSE, Corporate Governance Guidelines**.
	2008	**National Association of Corporate Directors (NACD**), *Key agreed principles to strengthen Corporate Governance for U.S.publicly traded companies.*
	2010	**The California Public Employees' Retirement System**, *Global principles of accountable corporate governance*, updated February.
	2010	**Business Roundtable**, *Principles of Corporate Governance*. April.
Canada	1994	**Dey Report**, *Where Were The Directors? Guidelines for Improved Corporate Governance in Canada*, The Toronto Report, December.
	2006	**Toronto Stock Exchange**, *Corporate Governance: A guide to good disclosure.* December.
South Africa	1994	**King Reports I** on Corporate Governance, *The South African Corporate Governance Code*
	2002	**King Reports II** - *The South African corporate governance code*
	2009	**The King Report III** on *Corporate Governance in South Africa*
United Kingdom of Great Britain (UK)	1992	**Cadbury Report** with Code of Best Practice Committee on the *Financial aspects of Corporate Governance.* December, London:Gee Publishing, December.
	1995	**Greenbury Report**, Study group on Directors' Remuneration, Report of a study Group chaired by Sir Richard Greenbury. July, London: Gee publishing.
	1998	**Hampel Report**, *Committee on Corporate Governance: Final report*. January, London: Gee Publishing.
	1999	**Turnbull Report**, *Internal Control -Guidance for Directors on the Combined Code.* Institute of Chartered Accountants in England and Wales, September, London.
	2001	**HM Treasury**, *Institutional Investment in the United Kingdom: A Review,* Myners Report, London: HM Treasury.
	2003	**Higgs Report**, *Review of the role and effectiveness of non-executive directors,* January, London.
	2003	**Smith Report**, *Audit Committees Combined Code Guidance,* January, London: Financial Reporting Council.
	2008	**Financial Reporting Council**, *Combined Code on Corporate Governance*, June, London:Financial Reporting Council.
	2009	**Walker Report**, A review of corporate governance in UK banks and other financial industry entities: Final recommendations,(The Walker Review), 26 November.
	2010	**Financial Reporting Council**, The UK Corporate Governance Code, June.

Analysing this synthesis of major reports on corporate governance issues, it can be reached the observation that the first relevant sign of recognising of legitimacy for corporate governance was given by Cadbury Report starting with 1992. Anyway, from this moment a long period of time was necessary until the late 20th century and early 21st for governments and professional organizations of various countries around the world to recognize the necessity to integrate the elements of corporate governance within a legal framework, which could applicable at least for the companies listed on stock market.

1. The necessity of enhancing corporate governance from audit function perspective

The relevancy of corporate governance issues was strongly accentuated by the increasing volatility of international economic context, which was in the latest time more and more pressed by some resounding financial failures that determined real concerns from investors over the credibility of financial reporting provided by the entities. Every financial scandal that shuddered the last 100 years has had a more or less strong effect over the professional competence and responsibility of auditors in exercising their profession (Fraser & Pong, 2009). The major challenge of this moment for the audit profession is represented by the decline of many categories of investors in the professional capabilities of auditors, this decline being mostly caused by the succession of bankruptcies and financial scandals that have strongly affected some of the major corporations at global level, like Enron (2001) and continuing with WorldCom, Adelphia, Global Crossing, Parmalat (2002). All these events have had been issued a major risk, the one that many investors to lose their confidence totally in the success of the companies and their investments, but also to lose their confidence in the reasonable assurance provided by auditors over the quality and true and fair view reflected by financial statements of the companies.

2. The audit function – a significant mechanism in the ensuring of a effective corporate governance

The Enron bankruptcy was widely publicized, its consequences being truly disastrous for audit professional, a certain argument in this direction being the quickly disappearance of one of the most important audit firm, member of Big Five – Arthur Andersen. Many researchers in the speciality literature have devoted their attention to analyze the audit’s responsibility in the issuing and propagation of such negative phenomena (Gillan & Martin, 2007; Deakin & Konzelmann, 2004; Healy & Palepu, 2003; Ribstein, 2003; Fusaro & Miller, 2002; Gordon, 2002; Weil, 2002; Benston & Hatgraves, 2002; Vinten, 2002; McLean, 2001).

The consequences of such negative events over the audit activity was very significant, among the auditors being perpetrated the idea that this activity is losing its credibility, its appeal, the fulfilling of audit activity being perceived as an obligation imposed by legislatives provisions and not as a service that should provide added value to their entities, the investor's confidence in the credibility of financial statements being strongly influenced, because there were strongly concerns about the real independence of auditors in exercising their activities (Healy & Palepu, 2003).

In this controversial context, the professional organisms from various countries started to develop different action plans in order to rebuild this confidence of investors. In this direction, a relevant example is given by the Auditing Practices Board (APB) which is a component of Financial Reporting Council (FRC) – the main regulatory body for corporate governance and financial reporting, being also responsible for overseeing the accounting profession in United Kingdom (UK). In order to rebuild the public's confidence in the auditor professionalism, APB proceeded to review the ethical standards, issuing a new version of the ethical standards that should coordinate the activities of auditors (APB, 2004). In the same time, a commission was established within this Committee *(Audit Inspection Unit)*, who proposed as main objective to monitor all audits of publicly traded companies, but also the audit of significant entities from public sector of UK.

In this manner, the spectrum of challenges that audit have to face with has become a really complex one, and the concept of financial reporting of corporations is more obviously addressed by juxtaposing with other concepts such as corporate social responsibility and risk (Sikka et al., 2009). The fast expansion of financial scandals that affected the economies of various well developed countries have led to many pressures from public about the real effectiveness of corporate governance mechanisms functioning, in the same time, ***internal and external auditors being more and more criticized because they were not able to identify warning signs that should prevent such negative events*** (Fraser & Pong, 2009; Sikka, 2009; Leech, 2008***)***.

Another important element that will influence more and more the audit function's evolution, in the context of latest period of time, will be determined ***by the audit approach within a larger spectrum, being identified many connections that should exist between audit, corporate governance and corporate social responsibility*** (Porter, 2009**;** Sikka, 2009). Even more than that, some researchers from latest speciality literature (Porter, 2009) promotes the idea that audit trinity (internal audit, external audit, audit committee) could be the key element in ensuring the corporate responsibility in front of the public which is following to its activity with a real interest.

2.1. The external audit – first pillar of audit function

Starting with summer of 2007, there were generated some premises consisting of some difficult events that seems to announce the next financial crisis of US stock market, which gradually has became known as "credit crisis", but in spite of these, there are few specialist that could predict the extension of this crisis to such a global level, affecting seriously the economies of various countries.

In the international speciality literature, but also in the international latest press, a lot of specialists and professional organizations paid a lot of attention to the identifying of major factors that had a important contribution to the issuing of this global economic crisis. A report of *Association of Chartered Certified Accountants (ACCA*) over the major determinant factors in credit crisis (*credit crunch*) ranks among the top list of these factors, ***the failure of corporate governance***, because the conflicts of interests between principal (shareholders) and the agent (managers) were not quite reasonably solved, the necessity of implementing the professionalism and ethics starting from high level of the company being more and more urgent, the same position being shared by other specialists (Reddy, 2009; Kirkpatrick, 2009).

Analysing this issue of corporate governance failure, a specific role is assigned to the external auditor, which due to its position and assuming that he should have a full knowledge of the complexity of accounting rules, ***external auditor is perceived as being the person that should be able to assess efficiently the effectiveness of which the directors are managing the financial health of enterprises.*** External auditor, through its opinion, is providing a quite reasonable assurance level over the fact that the company's accounting practices and policies were verified and certified (Sikka et al., 2009).

2.2. The internal audit – second pillar of audit function

Another negative factor that was considered as being determinant in economic crisis is represented by the weakness of risk management, its failure in the process of identifying and effective management of various groups of risks, due to an increasing complexity of services offered and because of risky nature of business conducted. The impact of such factors like weak management and inefficient corporate governance was also highlight at the European Conference on Corporate Governance (*8th European Corporate Governance Conference*), held in Stockholm in December 2009, the great critics given to audit function was the ineffectiveness in fighting against to a poor corporate governance and against to a weak risk management process.

The gaps in risk management process as the main determinant factor for the issuing of this current economic crisis were also emphasized by the report realized by a group of lawmakers from United States of America, UK, France, Germany, and Switzerland (Senior Supervisors Group, 2008), through there are highlighted major shortcomings of risk management process. ***A reasonable assurance over the effective functioning of risk management is provided or should be provided by internal audit,*** without being responsible for taking some actions response in order to counter the negative risks identified. In other words, ***internal audit is not responsible for implementing actions to identified risks, but internal audit is responsible for providing to management of some significant reports over the assessment of key risks and the effectiveness in managing all these types of risks*****,** this being noted both from international and national authors (Leech, 2008; Pop & Boţa-Avram, 2009).

In fact the role of internal audit is increasingly highlighted by the latest developments of corporate governance concept, which are emphasizing more and more the idea of internal audit's approach as an integral part of the corporate governance framework, thus giving the possibility to ***the internal audit to become more active and so to be one of the key role players in managing businesses successfully*** (Allen, 2008, Paape *et al.,* 2003). Now, management and board of directors have growing expectations from the chief internal auditor and his team. ***The internal auditors should adopt a global vision over the corporate governance, looking for solutions to improve their activities and their skills in the direction of assessment, monitoring and enhancing corporate governance mechanisms***. It is crucial for chief internal auditor to understand all the key element of corporate governance framework in order to be able to detect those areas where internal audit could provide a real added value (Leung, 2003). The internal audit's position is more important in the context of corporate governance; as it is strategically located to the point where there intersect the interests of management, board of directors and other stakeholders (Allen, 2008).

Whitley (2005) highlights through his study the main steps that internal audit should fulfil in order to provide its contribution to the corporate governance system, of which the most important are:

- Internal audit must assist the board in the self assessment of its governance;
- Internal audit has to promote to the audit committee of the best ideas on best practices on internal controls and risks management processes;
- Internal audit has to include in its audit plan some major objectives like information and transparency in the annual audit plan.

2.3. The audit committee – third pillar of audit function

The audit committee and its responsibilities begins to be in the centre of researchers interests starting with the beginning of 21st century, but being mostly analysed under the perspective of the relationships of audit committee with internal audit (Bishop et al., 2000), the role of audit committee and internal audit in the enhancing of corporate governance being the subject of intense debates (McElveen, 2002). If most of research from the international literature in this field is focusing mainly on the effectiveness of the audit committee till the end of 20th century (McMullen, 1996; Porter & Gendall, 1998; Beasley et al., 2000), starting with the beginning of 21st century it is increasingly felt the necessity to investigate the way that internal audit interact with internal and external audit, especially in the context of increasing the importance given to the ensuring good corporate governance (DeZoort, 2002), which subsequently resulted in the developing of various studies with respect to how audit committee interacts with internal audit (Mat Zain & Subramaniam, 2007; Sarens & DeBeelde, 2006; Mat Zain *et al.,* 2006; Krishnan, 2005; Gramlin *et al,* 2004; Gendron *et al.,* 2004; Willekens *et al.,* 2004; Turley and Zaman, 2004; Goodwin, 2003; Goodwin and Yeo, 2001).

If we try to synthesize the results of these studies into a general idea, this could be at least that ***internal audit has intensified his relationships with the audit committee, and how long this audit committee will be approach by internal auditors as a independent forum where different entity' business problems are solved, than the premises for a good corporate governance are assured.*** Also, the same as internal audit and external audit, audit committee has known significant changes in the objectives' area, so if at the beginning he was exclusively focused over the financial reporting process, now the objectives of audit committee are a lot more extended, being strongly connected to the ensuring of good corporate governance of the entity (Porter, 2009).

3. National approaches of audit function in the context of corporate governance

It is obviously from the above presented, the corporate governance issues is quite deeply investigated at international level in the speciality literature, this problematic generating a specific interest for Romanian researchers also. Through their studies (Dobroteanu *et al.,* 2009*;* Zapodeanu *et al.*, 2009; Danescu & Spatacean, 2008; Dobroteanu *et al.,* 2008; Dragomir V.D., 2008; Feleaga & Feleaga, 2008; Feleaga, 2008a; Feleaga, 2008b; Feleaga; 2008c; Feleaga; 2008d; Feleaga, 2008e; Manolescu, 2008; Mihaileanu, 2008; Lazar, 2007; Manolescu & Roman, 2007; Morariu, 2006; Rusovici & Popescu, 2008; Bota-Avram, 2008), Romanian researchers intend to investigate essential aspects of corporate governance mechanisms taking in considerations its developments at international level.

But still, there are some areas which are not enough investigated like the value added by internal audit in the context of corporate governance (Weaver, 2008; Morariu *et al.*, 2009*;* Morariu *et al.*, 2008; Dobroteanu & Dobroteanu, 2006). The effectiveness of audit committees and their structure and responsibilities are developed in the Romanian scientific literature (Stanciu & Stoicescu, 2009; Audas, 2008; Bowman, 2008; Danescu, 2007), the development of analysis in the context of corporate governance being developed only for a limited number of papers (Dobre, 2007). Also, another area that needs more attentions from Romanian specialists is given by the effectiveness of the communication that the auditor should develop with the persons responsible for ensuring good corporate governance (Manolescu *et al.,* 2010).

4. Conclusions and recommendations

Currently, it is obviously the conclusion that on the scene of corporate governance, a significant mechanism is audit function in its audit trinity, within three categories of players should have a very well determined role, but interacting in the same time very closed:

- **External audit** – its role is to ensure the responsibility of financial reporting in front of their users, providing them a reasonable assurance that these financial statements are reflecting a true and fair view of the entity' performances.
- **Internal audit** – its main responsibility is to assess and monitor the internal control system, risk management, all these systems being implemented by the managers in order to obtain the control over the activities. Internal audit must provide an assurance that the targeted objectives are going to be achieved – ensuring in this way the effectiveness of corporate governance.
- **Audit committee** – represents the key element that should oversee and coordinate the audit activity, fulfilling the responsibility to ensure the credibility of financial statements, before approval and subsequently after their publication.

So, a quite significant research direction that could and probably should be intensively developed is given by the necessity to analyse the role of the audit function through a trilateral approach, based on a comprehensive and integrated researches over the activity of these three pillars: internal audit, external audit and audit committee, in the context of corporate governance, taking in consideration, also the fact, that at international level, but also in national literature, there are less papers that follow to investigate through an integrated manner all these three activities, from the perspective of corporate governance.

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