

## CORRELATIONS BETWEEN ETHICS, INTERNAL AUDIT AND CORPORATE GOVERNANCE

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### ABSTRACT

*This paper wishes to put together concepts of high importance, notoriety and relevance such as ethics, business, culture, corporate governance and internal audit. The connections between these elements represent the basis of this paper, being important to understand the importance of the ethical dimension of internal audit and corporate governance in the context of the public trust.*

*The paper highlights the role of internal audit as ethics advocate, considering the fact that it exists a code of ethics designed in order to develop and promote an ethical culture. Internal auditors must respect principles like integrity, objectivity, competence and confidentiality, representing the four principles of The Institute of Internal Auditors' Code of Conduct when performing their work.*

**Keywords:** *Ethics, internal audit, corporate governance, principles, Code of conduct.*

### 1. INTRODUCTION

Nowadays, organizations are expected to function in conformity with the principles of corporate governance. In the context of the financial and moral crisis, it is relevant to question and evaluate the existence of ethical guidelines in the economic and governing activity, as an important tool for the public trust.

Analysing the importance of internal audit is valuable because this concept is perceived as being a crucial corporate governance mechanism.

When addressing the issue of internal audit function and ethics, there are key areas like auditors' assessment of ethical performance, ethical aspects of corporate governance and internal auditors' role in business ethics.

Nowadays, organizations try to ensure that all employees respect legal and ethical principles and rules.

Literature reveals that independence and objectivity were merely associated with external audit, especially in the past, while recently these principles are also related to the internal audit. The presence of internal auditors is important and relevant because it is associated with good corporate governance.

As Steward and Subramaniam (2010) outline, internal auditors have a dual function, being both assurance services supplier within the company and services consultant to managers. Unfortunately, this situation is conflictual for internal auditors, considering the fact that they

are, first of all, employees of the entity. As a matter of fact, this makes the ability of internal auditors of acting in an independent and objective way debatable.

Because internal audit is a part of the organization, the degree of independence and objectivity in expressing and formulating an opinion is lower, when comparing this type of audit with the external audit.

Prior researchers have shown that the Board of Directors who is concerned with the governance of an entity, shall ensure the way the activities and the processes of the companies are conducted in an effective, economic, efficient and consider the ethical filter.

The importance of ethical culture and values should be acknowledged by any country under the form of establishing guidelines in this respect. Verschoor (2004) highlights the fact that the Organisation for Economic Co-operation and Development and World Bank proposed governance principles that also encompass the ethical relationship between the management of the organization and its employees.

It is considered that the global financial crisis has brought up a different paradigm and way of thinking, whose impact was perceived on the focus on both the efficiency and efficacy of the system of corporate governance and the culture of the companies.

## 2. CONNECTIONS BETWEEN ETHICS AND INTERNAL AUDIT

Culture, along with ethics, is important in the context of the need to revitalize and restore the confidence of the public and private sectors through an improvement in the conduct and attitude (Chartered Institute of Internal Auditors, 2014).

In a company with a proper ethical climate the standards should be converted into behaviour, meaning that all stakeholders must respect these rules voluntarily. Internal audit has the ability to support the ethical culture by a systematic assessment of the ethical climate.

European Confederation of Institutes of Internal Auditing (ECIIA) and Schartmann, in 2007 considered that internal auditors should observe whether ethical standards are understandable for employees and communicated to them. Another way of reaching an effective ethical culture is to evaluate whether there are clear and effective strategies to support and also enhance the ethical climate, if there are regularly updated programs. Also, it is suggested that the code of ethics could become effective if the compliance with this code would be associated with incentives (Murphy, 2011). As a consequence, adherence to ethical values should be rewarded. On the other hand, an unethical conduct shall be penalised. However, the author considers this theory shows that ethical values do not come from the heart, conscience and principles of the organizations, but on the cost - benefit analysis.

Audit Committee Leadership Network in North America (2013) mentioned that internal audit has the ability to have a critical role in the supervision of the conformity with ethical principles, due to regular reports presented and disclosed to the audit committee.

Internal auditors' role has become more and more complex throughout years from the assessment of the risk and internal control, representing a source of information related to frauds and other irregularities to providing recommendations for a more efficient use of resources.

Another important function of internal audit relevant for this paper is the capacity of offering a feedback on the adherence of the company to the code of ethics, as suggested by Steward and Subramaniam (2010).

The internal audit department should conduct effective and efficient actions, while considering

the requirement for the internal auditors to apply the Code of Ethics. As mentioned by the Institute of Internal Auditors (2010) in a report about assessing the internal audit effectiveness and efficiency, these two concepts represent the degree to which the established aims are accomplished. Internal auditors should consider the ethical conditions and reality of the company's culture by analysing the perspective and behaviour of the stakeholders of the company.

Ethical principles are relevant for internal auditors, taking into account the numerous ethical dilemmas they are facing and also because internal auditors should play an important role in enhancing business ethics and strengthening corporate integrity while maintaining their credibility.

Internal audit should have an active role in supporting the ethical culture through assessing and evaluating the organisational ethical climate, this being an important priority (Verschoor, 2004).

Another interesting element regarding internal audit and ethics is related to the fact that in some organizations with a lower number of employees the external auditors play a dual role, performing their activity in the dual function of external and internal auditor. As DiGabriele & Ojo (2014) mention, this situation leads to a negative impact on the independence and objectivity which represent important requirements.

According to the paragraph 25 from The Auditing Practices Board's Ethical Standard 5, self- review threat and self- interest threat, advocacy threat, familiarity threat represent several categories of risks to the independence and objectivity of auditors.

A context within the ethical values is even more important and relevant in the economy in general and for each company, in particular, is the Islamic one. In addition to the legal requirements, islamic organizations must be Sharia compliant in order to maintain the public trust. As Yussof (2013) outlines, the requirement to comply with both ethical and religious principles constitutes a distinguishing characteristic of the Islamic world. Here, the moral parameters are of high importance.

## 3. INTERNAL AUDITORS INDEPENDENCE

The majority of articles comprising the literature highlight the importance of internal auditors' independence and objectivity as being

the basis for the effectiveness of the internal audit services. However, the conclusions drawn by Roussy in 2013 are that sometimes internal auditors act like keepers of secrets, by concealing relevant and important information from the audit committee members in order to protect top managers' reputation, by filtering or adjusting compromising information when preparing the reports for the audit committee. This behaviour is characterized by a lack of independence, considered as being a grey independence, as mentioned by Roussy (2013) the problem being the misunderstanding of the internal auditors' role. This outlines that the reality is not actually in accordance with the ethical manner internal auditors are expected to behave. It seems the concept of independence is practiced by internal auditors taking into account the environment and context in which they conduct their activities and missions.

#### **4. CODE OF ETHICS. STANDARDS AND GUIDELINES RELATED TO INDEPENDENCE AND OBJECTIVITY**

The behaviour of persons and companies in the conduct of internal auditing is overseen and supervised by a statement of principles called The Code of Ethics. The purpose of this code is to stimulate and support an ethical culture and climate in the activity of internal auditing. The existence of this code is important because it offers guidance to internal auditors in performing their activity, when facing ethical dilemmas. The code highlights the existence of four principles internal auditors must respect, as mentioned by Russell (2012) namely:

- integrity
- objectivity
- confidentiality
- competency.

According to integrity principle, internal auditors shall carry out their work with responsibility and honesty and shall not perform illegal activities. They must act in a way that does not affect their reputation, as individuals and as members of the professional category.

Objectivity principle refers to the responsibility of internal auditors of being objective in collecting,

Assessing, classifying and disclosing information about the activities and processes being subject to examination. This principle underlines that internal auditors shall take into account the relevant situations and details when

exerting their professional judgement and shall not be influenced by their own benefits and well-being or by others when forming judgements. As a consequence, internal auditors should not be involved in activities or relationships that affect or at least seem to affect their unbiased evaluation and that are in conflict with the companies' interests. Moreover, these auditors must not hide important facts and information, relevant for the organization.

Under confidentiality principle, internal auditors must acknowledge and respect the value of the received information. This implies that they should consider in a prudent manner the information, without using it for their personal profit and gain and in a way that it is not detrimental to the ethical objectives of the companies.

It is not sufficient that internal auditors are honest, responsible, not engaging in discreditable activities, that are objective and prudent in the work they realize if they do not apply the experience accumulated throughout years and their skills in performing their services. The related principle is the competency one, according to which internal auditors should perform activities and services only in the area they have the necessary experience, in order to avoid errors and further losses for the companies where they act. In this direction, they must take into account when performing their services the International Standards for the Professional Practice of Internal Auditing.

Considering the situation of conflict where internal audit is placed, several standards and guidelines related to independence and objectivity have been issued by the Institute of Internal Auditors. In 2001, this professional association published a guide, namely "Independence and Objectivity: A Framework for Internal Auditors" to assist internal auditors in facing threats to objectivity and independence, like economic interest, familiarity, cultural biases, social pressure, self-review.

##### **4.1. Independence Versus Objectivity**

Independence and objectivity are mentioned from the beginning of internal auditing definition, expressing the relevance of these principles for the activity conducted within the companies.

Independence can be considered as being the freedom from conditions that may threaten objectivity, while objectivity is an unbiased mental attitude that enables internal auditors to

perform activities in an honest way, without accepting compromises, or, in other words, objectivity is a state of mind and independence is a combination of circumstances that allows internal auditors act having an objective attitude (Steward and Subramaniam, 2010).

The Institute of Internal Auditors Code of Ethics presents a series of principles internal auditors must take into account and rules of conduct, introducing norms that should govern the internal auditors' behaviour.

Matavire and Dzama (2013) considered that one of the aspects which influence independence is the reporting structure, that is, to whom the chief audit executive or head of the internal audit reports. In the ideal situation, he or she should not report to any of his or her potential audit clients, and this includes the chief executive officer and the chief financial officer.

#### **4.2. How Internal Auditor Can Be Objective and Why Internal Auditor Independence Is Important**

The companies' management and board of directors have the necessity to know which is internal auditors' evaluation related to the risk management, considering the highest possible degree of independence, taking into account the fact that internal auditors have the possibility to inform management having as intermediary the audit committee.

Internal auditors find themselves in the compromising position of serving two masters, as suggested by Thompson (2013): the ones being governed, namely management and the audit committee, who is responsible for governance. Pickett (2010) outlined that internal auditing has a unique place inside the company, considering the fact that it is a provider of important and relevant assistance to audit committee and management, while it is expected to review the conduct of management. Internal auditors can give this assistance by offering objective assurance on control, governance and risk management.

Thompson (2013) considers that internal auditor's independence and objectivity would not be affected if they maintain and respect the Enterprise Risk Management framework and if they are more concerned on performing consulting activities related to the risk management than provide assurance on controls. It is also suggested that internal auditors maintain their objectivity and independence when reporting to a separate board risk management committee.

Internal auditors should avoid the grey independence, by understanding their role is more than serving and protecting the top manager and the company and taking into account the ethical dimension of their activity and mission. Internal auditors must not hide mistakes, but, on the contrary, ensure or at least, encourage accountability and transparency within the company.

Muqattash (2013) considers that audit committees are considered as being an important key safeguard mechanism for internal auditors in maintaining their objectivity.

#### **5. CORRELATIONS BETWEEN ETHICS AND CORPORATE GOVERNANCE**

Corporate governance is a subject of concern for various articles and analysis considering its relevance for researchers, the management of companies and stakeholders. Gradually, managers and owners began to be more and more aware of the associated benefits related to having a good corporate governance structure.

Many authors underline the importance of corporate governance. For instance, McGee (2008) highlights that good corporate governance is relevant in increasing the value of share price and facilitate obtaining capital. Moreover, McGee (2008) draws attention to the fact that the international investors' decision to invest in an organization can be influenced by the company's compliance with the corporate governance principles.

The ethical values of all employees have an important impact on the corporate governance, considering the way the company is governed. In this regard, Muslim countries have developed religious ethical guidelines designed to avoid or, at least, to restrain abusive behaviour in the organization (Aldohni, 2014).

It is considered that companies have the responsibility to support an organizational culture able to promote an engagement to respect the law and an ethical behaviour.

For a good corporate governance system, the moral filter is of high value and relevance.

When referring to corporate governance, according to some specialists' point of view, we are making reference to the principles behind the standards and rules and these principles must have an ethical background. Conversely, an unethical conduct of the directors who are responsible with the governing of the activity will lead to the failure of the whole activities of the organization (Othman and Rahman, 2011).

## 6. DISCUSSIONS AND CONCLUSIONS

Ethics is a very important and actual concept, considering the financial crisis which is believed to be provoked by the moral crisis. There are authors that consider that having an ethical way of conduct contributes to a better performance of the company (Bunget, 2009).

Internal audit functions must include the assessment of the configuration, implementation and effectiveness of the company's goals, activities and plans of action related to ethics. This measure is of high benefit for any entity.

Internal auditors should report any possible identifiable deviation from the engagement to carry on activities in conformity with the code of ethics and conduct.

Shariah audit, specific to companies from Islamic countries, is a relevant and strong example of activity that assesses the degree to which economic, social and ethical aims and objectives are met by Islamic institutions, especially financial ones.

Sound and effective systems of corporate governance attract more domestic as well as international investors through reputation and a proper quality of corporate governance.

At the intersection of ethics, corporate governance and internal audit are located transparency, honesty and rigour in the application of standards.

Each employee of the company has the responsibility of maintaining an ethical culture.

The Code of Ethics comprises four principles internal auditors must respect, these being integrity, objectivity, confidentiality and competency.

According to integrity principle, internal auditors shall respect and promote the ethical objectives of the organisation.

Internal auditors can generate value added to an organization only if they are independent and objective, without legitimizing opacity. Moreover, internal audit is a partner of the ethical culture, considering its characteristics, namely access to senior management, the connection with the audit committee and independence and objectivity.

The Institute of Internal Auditing' vision presented in the 2013 annual report called „Preparing for a Promising Future” is that internal auditors will be universally recognized as being indispensable to effective governance, risk management, and control.

An unethical behaviour can have a strong negative impact on the reputation and afterwards on the performance of the entity and on a long run perspective it can affect the economy on the whole.

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