CORPORATE GOVERNANCE. PRINCIPLES, IMPORTANCE, NECESSITY

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ABSTRACT

This article aims at presenting the advantages of implementation of corporate governance principles in Romania. The current financial and economic crisis, the lack of trust experienced within the corporate sector, the governmental sector and the non-profit sector will determine companies to adopt a higher level of transparency in financial reporting in order to regain the trust of investors with respect to business opportunities and to risks and to the future evolution thereof. The introduction of corporate governance principles in Romania will entail a dimishment of pressure exerted by future economic and financial crises. The coordination of all systems that make up the corporate governance (internal control, internal audit, external audit etc.) within each Member State of the European Union will lead to corporate and governmental sectors that are more efficient and transparent.

KEYWORDS: *internal audit, corporate governance, corporate governance principles, agent theory.*

1. Corporate governance - concepts, necessity.

In the Anglo-Saxon find the concept of corporate governance - "Corporate Governance" - also found within the "international standards of internal audit". The term "governance" is synonymous with the Romanian word "administration/management process. The term "corporate" comes from "body" which lead to think the whole, whole, unit organization.

According to other authors (Marcel Ghita)[1] the term "governance" means "leadership" and the use of "corporate governance" would bring something in addition to corporate governance. According to the author's use of "corporate governance" is no inferior term "corporate governance" and I think that where we have synonymous terms in the vocabulary of the Romanian language should be used as such.

Corporate governance is the management of the whole organization by accepting the internal components that work together but eventually will be integrated administration and implementation of risk management within the organization and financial management system and internal control including internal audit.

Functional structure of corporate governance is shown in Fig.1.

Necessity. In recent years, international companies involved appeared in fraudulent financial combinations which led to a series of financial scandals. The best known are: Enron, Merrill Lynch, Parmalat, Anderson and others Because of this behavior, "corporate governance" suffered by induced negative advertising. I think it is wrong to belittle its importance to organizations as if the famous financial scandals listed above there was no question of good corporate governance that led to distorting the efficient allocation

[1] Ghita, M., *Corporate governance*, Publishing House, Bucharest, 2008, p.13

of capital in the economy, keeping foreign investment, reduce corruption by promoting equity holders trust .

Corporate governance is a concept that includes the following elements:

- responsibility for the accuracy of the information managers of financial reports;
- there is very tight deadlines for financial reporting;
- transparency of internal audit and external audit processes.

Corporate governance includes methods and systems for the management organizations of whatever form of organization and type of capital. According to Anglo-Saxon corporate governance is "the system by which companies are directed and controlled"[1].

Every organization wants implementation of corporate governance, risk management, internal control system and internal audit as part of its monitoring (Fig. 1). In the corporate governance internal audit has a role to educate the senior management of effective solutions. Study carefully the field of corporate governance, risk management, internal control system will enable internal audit to "play" an important role in the organization.

Practice recognizes that we have a universal method of organization of management leadership. In England and USA driving is done by a council which has responsibility for Corporate Management Executive Director and Chairman of the Board ensures the effective functioning of the Board. In other EU countries there is a dual management system where the board is responsible for implementing management organization and management board responsible for implementing and supervising board.

In other sectors are formed key committees such as: audit committee, remuneration committee subordinate to the Board[2]. Term corporate management has emerged in the 1970s in the United States during the Watergate scandal when it was discovered the involvement of American companies in political contributions to various political parties[3].

In Europe, concerns have emerged in the '80s from the research common causes of corporate failures in the private system. Following these investigations the result that corporate bankruptcies are due to major problems of organization and operation of internal control.

"General management not only failed to prevent disasters products but in some cases, even the source of these failures" (Cadbury Report, 1992). Later, in 1999, were developed OECD[4] principles and codes of corporate governance which is a set of principles unanimously accepted worldwide.

Principles of corporate governance is not a universal model of management but long term trend is to develop global standards of corporate governance[5].

Regarding the concept of corporate governance literature suggests several concepts, each bringing clarify terminology.

We believe that IFAC[6] is the most comprehensive concept "corporate governance is a set of practices of the management board and executive management exercised in order to provide strategic directions for action, achieve goals, risk management and responsible use of financial resources".

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1 *Cadbury Report of the Comittee on the Financial Aspects of Corporate Governance*, 1992

2 Institutul Auditorilor Interni din Marea Britanie şi Irlanda, *Guvernanţa corporativă şi managementul riscurilor*, Ediția I, 2002, pp. 4–5

3 Buzatu, L., *Capital market in Romania*, Academy of Economic Studies, Bucharest, p. 137

4 *OECD – Organization for Economic Cooperation and Development*

5 Shleifer, A., Vishny, R., "A Survey of Corporate Governance", *Journal of Finance*, no. 52, 1997, p. 737

6 *IFAC – International Federation of Accountant*

2. Corporate governance characteristics.

It operates on the basis of principles regarded as pillars of sound management (Cadbury Report), namely: integrity, transparency and accountability.

Integrity. Includes an appropriate and ethical conduct, that concern for the interests of others and social responsibility. In the private sector, integrity is a principle that in the obtaining of profit.

Transparency. In general, irregularities, poor performance occur, most often behind closed doors. Shares to be examined by the media contribute to improving behavior and performance. Without a full opening there will be no development, performance and better efficiency.

Liability. Is the most representative of the corporate governance principle. In most organizations responsibility is defined and clear enough for management and staff organization.

3. Models of corporate governance.

In international practice there are several models of corporate governance[1]. The most representative are:

• **American corporate governance model** is based on the dominance of "outsiders" - independent and individual shareholders who are not related to corporate business relationship. The model is efficient, as investment provides mobility and placing them in areas that are inefficient in the developing effectively.

Negative side of the model is targeting excessive on profitability at the expense of development. According to Michael Seely, "companies promote business with one goal – shareholder enrichment.[2]"

• **German corporate governance model** is based on a high concentration of capital. The major shareholders of the corporation are related by common interests and take part in company management and control. Benefit model is that shareholders are oriented towards a long term strategy and stability.

• **Japanese corporate governance model** is based through a company-level cohesion. The state has an influence in the strategic planning of companies. Analyzing the three models can be observed that the Romanian economy to meet the elements of the German model. For an analysis and a clearer understanding of corporate governance is necessary to consider a classical model that has a share in place.

• **Classic model of corporate governance.** Following the financial scandals of 2002 Institute of Internal Auditors UK and Northern Ireland proposed reform "corporate governance" which is based on seven pillars of corporate governance: executive management, leadership, specialized committees, non-executive directors, auditors internal, external auditors, shareholders.

In the U.S., in 2005, following the financial scandals of the last decade, several models have emerged in corporate governance. The K.H. Spencer Pickett[3], also based on seven pillars, is seen in most American companies. Background is given on the pillars:

- shareholders, directors, managers, supervisors and operational staff;
- reflect the scale of compliance, performance and accountability;

[1] Păuzari, S., Spinei, I., *Corporate governance*, Moldova, Chisinau, 2004, p. 13
[2] Seely, M., *Vision of value - Based Governance, Directors and Boards*, 1991
[3] Spencer Pickett, KH, *The Internal Auditing Handbook*, Second Edition, John Wiley & Sons Inc. III River Street, USA, 2006

- legislation, fiscal costs and ethical standards;
- external audit;
- audit committee;
- internal audit;
- performance, commitment and skills, respectively: risk management, risk registers, internal control system, operational procedures work, statements of internal control, internal audit statements.

The concept of corporate governance developed from agent theory highlights the relationship between investor/shareholder and manager/administrator. This theory is based on the idea that top management acts as agent of the board of shareholders, having a single task: maximizing return on investment/profit. This approach excludes liability for labor, suppliers, customers, etc.

This theory is criticized by advocates of the theory of agent managers/agents. The theory emphasizes the role of managers in maintenance management and organization development. Theory supports leading management organization on behalf of shareholders. This protects the interest groups, shareholders, labor, suppliers, customers and management.

Following the financial scandals already mentioned, in 1990 the U.S. has formed a committee of accounting bodies, financial audit and to establish a code of practice of corporate management.

The document produced is titled "Internal Control – Integrated Framework", known as COSO literature. COSO document hierarchy has five components: control environment, risk assessment, control activities, information, communication and monitoring.

COSO model hierarchical control systems requires composition, bottom to top organization, to apply for internal audits and monitoring to be done from the top to base (Fig. 2. The corporate governance).

A. The shareholders, directors, managers trial is the first pillar of the COSO model structure of KH Spencer Pickett. In the context of model owners / shareholders appoint directors to oversee corporate organization as agent theory. In order to implement the strategy, recruiting managers managers, supervisors and operational staff (Fig. 2 - Component A).

All corporate activities are processed in an accounting system and the Directors report results to shareholders through an annual report which includes final costs and performances. Shareholders verify corporate financial results to ensure that their infusion of capital is intact and has produced dividends.

B. Dimensions of compliance performance - responsibilities. The dimensions of corporate governance has published accounts of strategic performance and accountability leading to compliance principles set out the theory agent. Directors establish performance indicators for the objectives to be formalized in performance reports.

Corporate conduct has the concepts of performance, compliance and accountability as a framework for the conduct. Respect how compliance and accountability in strategic performance will ensure correct operation of the organization (Fig. 2 - Component B).

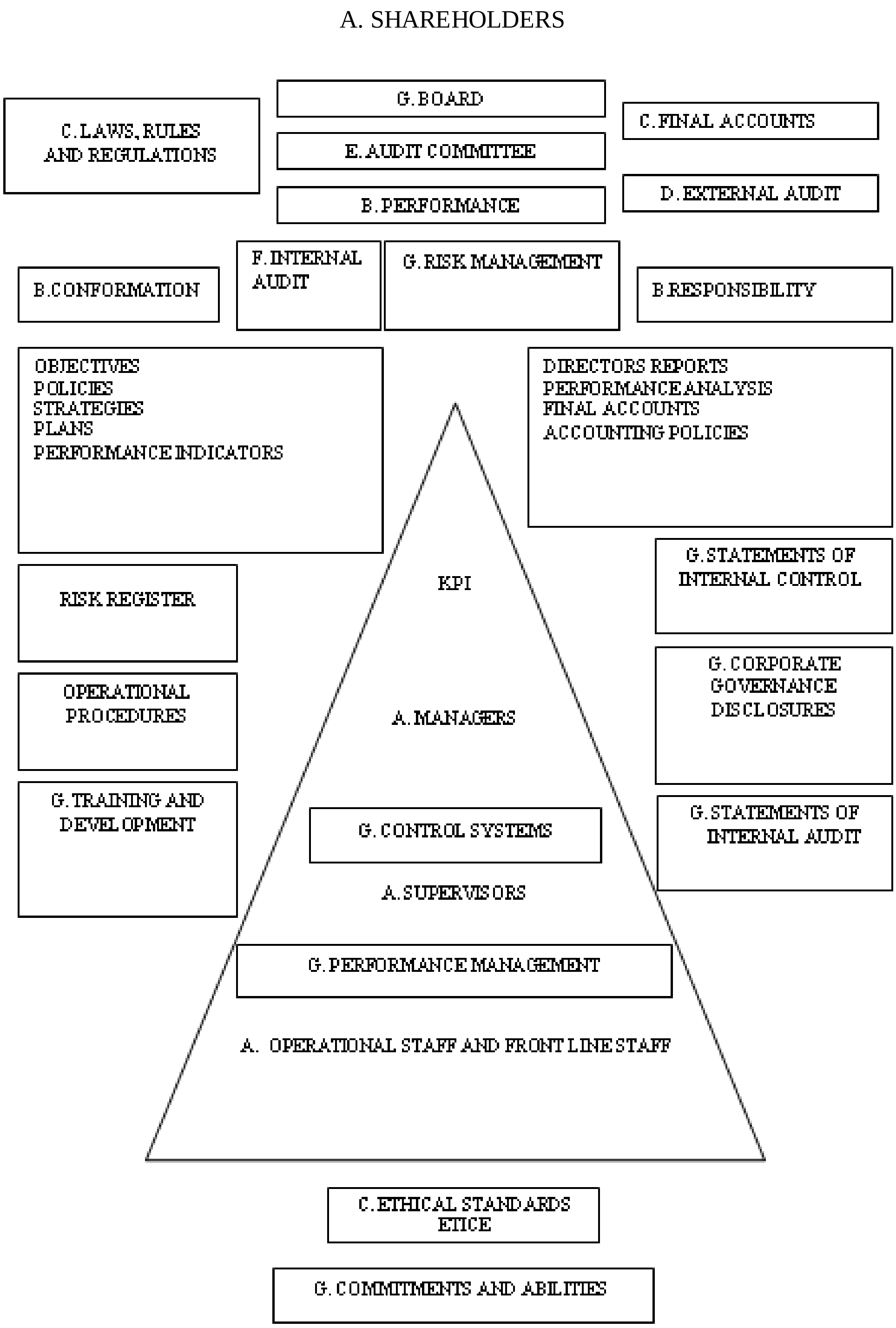

Figure 2 The corporate governance

Source: Spencer Pickett, KH, *The Internal Auditing Handbook*, USA, 2006, p. 119

C. Legislation and corporate regulation - the final accounts.

Legislation governing the corporate area is complex and dense on different issues: the organization of work, rules in trade, competition, anti-fraud, stock exchanges etc.. Important is that all regulations to protect groups of people who have invested and have a direct interest in the organization.

The final accounts of the organization are audited annually by an external audit firm on reality and their reliability. Final accounts and annual report must be submitted in accordance with International Accounting Standards and is a window between the organization and the outside world. Legislative and final accounts of corporate governance pillar three (Fig. 2 - Component C). Components A, B and C in Fig.2. is a standard model of corporate responsibility.

Corporate ethics. Financial failures recorded both in the United States and European Union have imposed the need to establish corporate codes of ethics within organizations covering such topics as behavior, integrity, usefulness, relations with internal and external partners, incentives system etc.

D. External Audit. External audit work materializes in providing a report on the annual accounts. Corporate governance model includes an additional level of responsibility, the result of external audit activity (Fig. 2 - Component D) and four are the mainstay of management.

External audit should establish clear objectives which they belong:

- external audit will test the relevant transactions representing financial statements;
- the external auditor will strengthen overall management, there is a system of risk management and internal control of significant operations of the organization.

External audit with internal audit are part of the "pillars" of corporate governance. Have very clearly defined internal audit functions compared with external audit as key differences between them but also the interference between areas / fields of activity. Standards of practice implementation 2050-1 Institute of Internal Auditors include common tasks and tasks that interfere type:

- tasks of internal audit and external audit should be coordinated to ensure proper coverage and minimize duplicated efforts;
- may be more effective if the external auditors and internal auditors techniques, similar methods through effective coordination of future tasks.

E. Audit Committee. Specific corporate governance is a concept used by the Board of Directors. The Audit Committee shall consist of at least three non-executive directors (Fig. 2 - Component E) representing five pillar of corporate governance.

Non-executive directors are appointed by the Board of Directors (the UK) to balance power and executive directors from outside the company. In essence, the Audit Committee has concerns focus on the organization and ensure smooth functioning of the risk monitoring and internal control implementation of internal audit and external audit work with.

F. Internal Audit. In Fig.2 - Component F is the internal audit which is the pillar of the six corporate governance. Standard 2130 Institute of Internal Auditors regulate the internal audit and internal audit is the integration of corporate governance model.

Accessing EU funds showed interest and private sector organizations and non-profit organizations to implement internal audit function. The legal framework for private sector was amended by Law no. 31/1991 Art. 159 to 160, entering the mandatory internal audit needs compartment formation by turnover and statutes.

Internal audit, the sixth pillar of corporate governance model, is one of "building blocks" together with the audit committee, top management and external audit. Internal auditors, by this model have access to the Board's agenda and must be the most "that friend" for the Audit Committee by credible and unbiased information they can provide. Principles of corporate governance can not reach without the implementation of internal audit - six pillar and the audit committee - the five pillar model structure.

G. Performance, commitment and skills. Commitment and skills are two concepts that have added performance, compliance and accountability (Fig. 2 – Component G) and seven pillar of corporate governance.

Commitment requires the implementation of corporate governance values into the consciousness of those who have interest in the company.

The skills are directly related to professional training, budget, serious tasks of control self-assessment.

Performance, compliance, responsibility, commitment and leadership skills are keys to ensuring the information available in corporate governance.

Managementul riscurilor reprezintă un sistem eficace de administrare a riscurilor în cadrul organizaţiilor şi a proceselor ce intră în sistemul de raportare.

To implement the seven pillar is necessary to organize a management system for risk management through the establishment of registers of risk analysis and developing an appropriate system of operational procedures work. For management to be effective, it requires a high performance training and development system in conjunction with a system of key performance indicators (KPI) for all activities. To implement these elements is desirable to establish other committees: nomination, remuneration, risk.

4. Conclusions

Implementation of internal audit function directly incorporates risk management, internal control system and processes that harmonize corporate administration as Fig.2. Model in Fig.2 is based on the principles of corporate governance, codes of good practice, guidelines, regulations and standards that organizations mari.Toate suitable components are now part of corporate governance system and we appreciate that this is an "umbrella concept" conducting an effective control and reporting system to ensure achievement of performance criteria and accountability.

European Community's priority is development of integrated control framework, similar to the model implemented in the U.S., which seek a reduction of direct interventions, offset by increased responsibility of member countries. The European Community wants to achieve an integrated internal control framework of internal control by interconnection of countries. Given these considerations, it is necessary to coordinate all components of corporate governance systems (internal control, internal audit, fraud and other forms of action control) in each European Union member countries, including Romania.

The current financial crisis, lack of confidence in the corporate sector, in government and nonprofit sector will force companies to greater transparency in financial reporting for regaining investor confidence on business opportunities, risks and trends in perspective.

Current economic and financial pressures will require development, improving corporate governance principles of the desire to establish viable business partners.

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