A New-style Internal Auditing: The Governance-oriented Internal Auditing

Liying Fu [*] *Zhejiang Normal University/Renmin University of China*

Abstract: The transformation of internal auditing (IA) from the function of supervision, management and control-oriented to governance-oriented are fulfilled while governance-oriented internal auditing emerging from the demand of corporate governance. The governance-oriented internal auditing (GOIA) is a risk-based assurance and consulting activity designed to add value into the organization focusing on the effectiveness of corporate governance in supervision and assessment by compound professional aims. Governance-oriented internal auditing includes board auditing, strategic auditing, management responsibility auditing and risk management auditing, etc..

Key words: corporate governance; governance-oriented internal auditing; risk management-oriented

Governance-oriented internal auditing dealt in this paper means that in the governance mechanism of modern corporate, the function of internal auditing has expanded from supervision, assessment, management and control to governance accompanied by the transformation of internal auditing objective, organizational structure, technology and method, contents and extension, etc.. It exhibits the following image of internal auditing: a risk-based assurance and consulting activity designed to add value to the organization focusing on the effectiveness of corporate governance in supervision and assessment by compound professionals aims. GOIA also solves the following problems: Who assess the performance of corporate governance? Who audit the board? All in all, it solves the basic economic problem of who supervise the supervisors?

1. Corporate Governance and the Formation of GOIA

Efficient operating in modern corporations requires disciplined governance. So far, the international convergence trend is more and more distinctive though there are still a lot of differences in theories and practices on corporate governance. By the driving of OECD (Organization for Economic Cooperation and Development) and the like, especially the birth of *OECD Principles of Corporate Governance*, this progress has been sufficiently realized (Zhu &Ye, 2004). Whether the governance models in England, America, Japan or German or the different enterprises under the different internal or external circumstances in the same country, there are at least following similarities in corporate governance: (1) Corporate governance concerns a set of relationships among the managers, the board of directors, shareholders and other stakeholders. The governance structure is a kind of leash mechanism to solve the problems of the responsibilities, authorities and benefits between shareholders, board and management; (2) Governance aims at adding values for shareholders to maximize the values of stakeholders; (3) The important factors of corporate governance are supervision, risk management, control, rewarding vs. restricting, objective, responsibility, and authority; (4) The effective governance requires sufficient resources to supervise control and risks of organization.

[*] Liying Fu, PhD candidate of Renmin University of China, associate professor of Zhejiang Normal University; Main research field: Auditing Theory and Practice; Address: Room 930, Pinyuan 4#, Renmin University of China, Beijing, Postcode: 100872.

In the past decade, hopes to enhance governance were increasing from listed enterprises further to other enterprises. There are two reasons to perfect governance. First, enterprises were confronted with so many disasters, such as financial fraudulence, bankruptcy, so investors and stakeholders hope to add value through risk-reduction or cost-reduction. Second, pressures resulted from the supervision of law and code, such as the famous American *Sarbanes-Oxley Act, the Combined Code on Corporate Governance* and so on. Here is another problem: how to develop the special function of internal auditing under the corporate governance circumstance?

Our scholars have launched research on the relationship between corporate governance and internal auditing. It is considered that internal auditing is a part of modern corporate governance (Guangyuan Wang, 2003; Chang Song, 2004; Shu Li, 2004, etc.) and there are interactions between internal auditing, internal control and corporate governance (Xinsheng Cheng, 2004; Youhong Yang, etc., 2004; Yanjuan Miao, 2002; Yanli Chen, etc., 2004; etc.). In return, internal auditing appraises the effectiveness of internal control while as a part of it. As a part of corporate governance, internal auditing takes part in its effectiveness auditing. Thus, a variety of new internal auditing are formed, for instance, governance auditing, strategic auditing, risk management auditing and so on (Weian Li, etc., 2002; Xian Shi, 2003; Shi Liu, 2004, Wei Zhang, 2004; etc.). IIA (2003) emphasized: " At many sides, internal auditing is two main kinds of governance activities---frontline players of supervision risk and control effectiveness; 'ears and eyes' of auditing committee in corporate governance… Internal auditing plays a role in supervising, appraising and analyzing risks and various controls of organization, checking and verifying that information is reliable and in conformity with relative policies, procedures and laws. It also assists administrators to provide guarantee in risk control and governance to board, auditing committee and organs of execution and administration. It also provides any suggestion good to promote organization to perfect processes, policies and procedures."

Enterprise is a set of contracts between factors of production that are droved by self-interests---enterprise agent conducts according to the rule of maximizing self-benefits (Coase, 1937, 1960; Alchain & Demsetz, 1972; Jensen & Meckling, 1976). Thus, emerging of demoralization, speculation, internal control, fraudulence of administrator, slack staff and so on, so corporate governance, internal control and internal auditing have to focus on the management of everywhere risks. Enterprise not only have to consider how to control risks in acceptable category but also self-assess control in risk management for internal control aims at reducing agent risk between corporate managers and sub-managers[1]. Corporate governance points to reduce agent risk between stakeholders and managers. Risks are the core factor of corporate governance. The transformation from dictating and controlling tactics to management model of operational risk indicates that corporate governance not only is structural arrangement but also reflects specific practical ability. It focuses on assessing and supervising risk management since internal auditing guarantees the effectiveness of control and governance. Naturally, internal auditing is risk management-oriented.

The objective of internal auditing is serving administrators and helping them perform their responsibilities before emphasizing corporate governance, the function, technology and methods, contents, scope, independence and the like of traditional internal auditing hinges on that objective. COSO (Committee of Sponsoring Organization of the Treadway Commission) (1992) considers that internal control framework includes circumstance of control, risk assessment, information together with communication, activity of control and

[1] According to the comprehension of COSO under the framework of internal control, we consider corporate governance as a part of internal control, that is to say, internal control should be promote to board of directors level from the theory of system and control, thus internal control includes controls of management and governance, especially management control in this article.

supervision. Among them, corporate governance is the circumstance of corporate control and internal auditing. The objective of internal auditing is identical to that of value-added and meanwhile with the new orientation and change of its function, technology and method, content and scope, etc.. Thus, it brings out governance-oriented internal auditing.

2. The Further Exploration on Internal Auditing Takes Part in Corporate Governance

Economically, the structure of corporate governance solves this problem: How to form a constraint mechanism among shareholders, directors and managers so as to minimize the agency costs undertaken by shareholders. According to Jensen & Meckling (1976), agency costs include supervision cost, bonding costs (monetary or non-monetary) and surplus losses. In a nutshell, it increases the cost of supervision and contract-compliance and reduces monetary loss (surplus loss) caused by differences between agent decision and that of maximizing principal's welfare while enterprises is paying for their leashing expenditures in internal auditing, external auditing, internal control and so on. The all agency costs are reducing owing to the volume of reduction is sure to be more than that of increasing. Further on, its existent is a signal sent to principal by manager to indicate that their objective is maximizing his welfare when internal auditing is fixed on the traditional model of serving administrator, synchronously, which of internal auditing also is a kind of bound cost. It is a kind of monitoring cost when internal auditing is fixed on the model of serving for stakeholders (being responsible for and reporting to shareholder). The nature of former kind is identical with the latter-economically, this also is the goal of corporate governance. It is evident that, from angle of economics, that internal auditing accomplishes the function of governance by reducing agency costs indicates that it is a part of modern corporate governance.

The main function of early internal auditing with potential governance nature was financial supervision and evaluation while in the late half century, there was not obvious governance function though auditing in business operation, management, internal control and effectiveness auditing became the major parts of internal auditing and the function of management and control were strengthened. Its function wasn't distinctive until governance became the theme of improving modern enterprise system in the late twenty years. The weak independence resulted from past serving for management became better when it developed to governance-oriented internal auditing.

The American government issued *The Sarbanes-Oxley Act* immediately after the broken of Enron financial scandal. Auditing committee, management authority, internal and external auditing are the four cornerstones according to the act, which was accepted quickly by all societies and reached consensus. IIA also emphasized specially: Corporate governance includes management, boards of directors and audit committees, internal and external auditing and supervisors and so on. Audit committee plays the bridge role in governance body[2]. The co-governance of internal and external auditing becomes more and more obvious owing to the driving from accountant responsibilities. "Porter thought this driving force promotes companies' supervision, management and its three auditing functions (internal auditing, external auditing and audit committee)", she raised: "The effect of three functions depend on the fulfilling extent of different roles by different participators and supplement and mutual-supporting among them"[3]. Under the framework of corporate governance, audit committee selects the

[2] Under the governance of German or Japan model, supervisory committee is similar to auditing committee. It isn't explained at length in this article.

[3] Cited from the test of speech of Jane F Mutchler at Conference of Accounting Professor Association (2004)---president of Georgia State University and candidate for president of US accounting association.

accounting firm and is responsible for the communication with independent auditors including deciding available audit fee through discussion, which will weaken conspiratorial opportunity between auditing personnel and management authorities and be helpful to facilitate disciplined entrusting relationship, which makes external auditors better bind management supervision as internal auditors. As one of principle part, internal auditing make risk-based auditing plan to guarantee corporate risk management, control, rationality and effectiveness of governance procedure while auditing strategy of audit committee as standard. Internal audit report will be presented to audit committee that will be responsible for the communication with authority, which will make the result of internal auditing be valued and implemented under the guarantee of authority power. At the same time, audit committee coordinates the co-governance procedures of internal and external auditing through settled meeting with personnel in internal and external auditing and inviting them participating in their meeting to improve the effectiveness of mutual supplement and support.

3. The Practical Significance of Governance-oriented Internal Auditing

3.1 GOIA Established the Foundation of Corporate Governance to Guarantee the Effectiveness of It

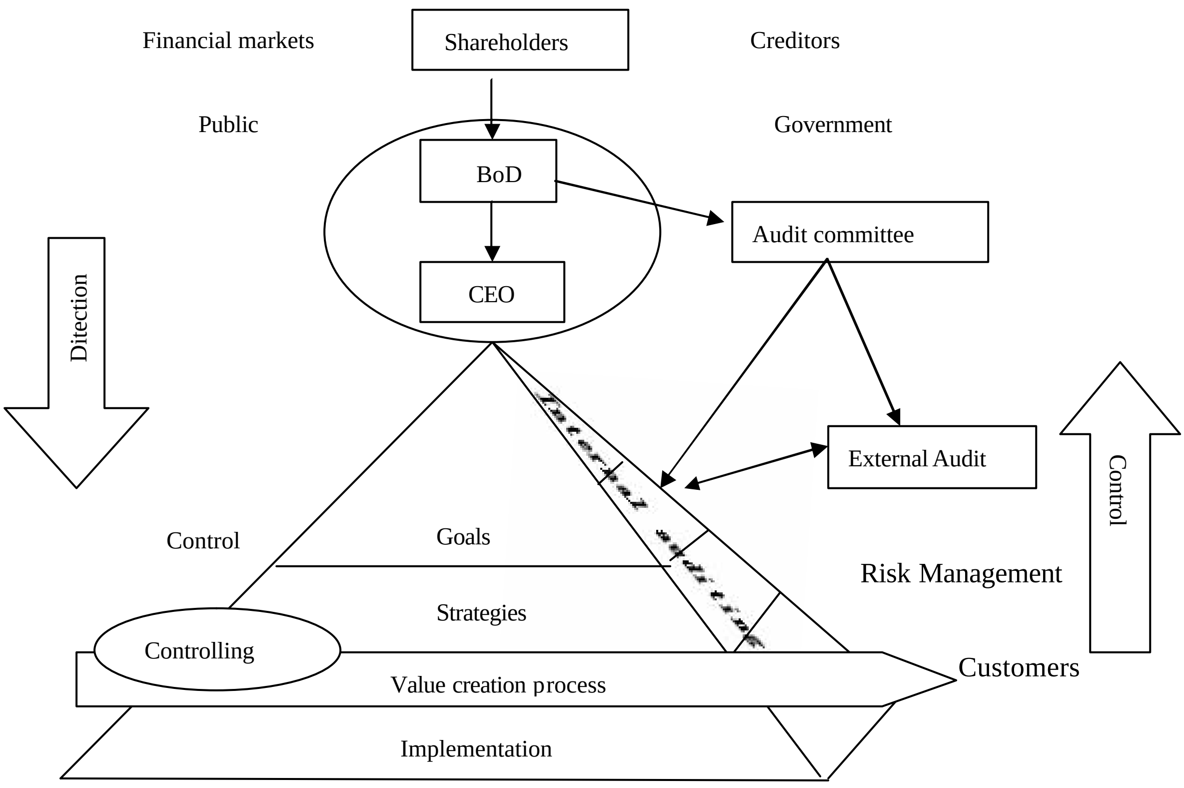


Figure 1 The Foundation of Corporate Governance

Note: Source: IIA Research Opportunities in Internal Auditing, Chap.3, P75

Cadbury's report (1992) defined the corporate governance as a system of supervising and controlling enterprise, and OECD (1999) thought that corporate governance is a set of relationships between manager, the boards, shareholders and stakeholders that provides a structure to make objective of enterprise and determine the method to realize the objective and supervisory achievement. Figure 1 indicates that under the guiding of corporate vision and target, management authority design, appraise and implement corporate strategy[4], then take various procedures of control and business and mechanism of risk management to realize objective and strategy and value creation. Thus accountabilities to shareholders and stakeholders are fulfilled. The corporate performance is directly determined by internal control and the effectiveness of risk management in the course of value creation, so the management authority requires relative information and professional improving suggestions, which is performed by internal auditing called as experts in internal control and risk management while external auditing as 'the independent third stage' issues suggestion according to the accounting statement provided by management authority. Audit committee is responsible for systematically re-guarantee the information provided by internal and external auditors to insure shareholders and stakeholders make right policy. Managers, audit committee, internal and external auditing are four essential cornerstones. Internal auditing is closely related to other parts, the most important is that it guarantees the effectiveness of two focuses---internal control and risk management.

3.2 The Problem Who Audit the Effectiveness of Corporate was Solved

That appraising the performances of directors, boards of directors and managers were raised by most country's governance principles for the performance of corporate governance involves two most important factors---the effectiveness of the board and manager in agent responsibility. In the light of principle of internal control, assessment includes self-assessment and re-assessment so as to guarantee its impartiality and the implementation of re-assessment result. Here is the problem: who has corresponding function, sufficient independence and authority to supervise the governance process of director and manager and to re-assess governance performance at the base of self- assessment? The answer is governance-oriented internal auditing. According to the governance circumstance of corporate, let it serve high-level governance mechanism to enlarge its independence and authority in organization once the internal auditing was endowed with the governance function that will effectively develop corporate governance auditing. That will solve the problem---who re-supervise the supervisor and more or less avoid the formalization of supervision owing to the director board called rubber stamp is not familial with operating.

3.3 GOIA Turns the Ideal That Internal Auditing Services the Organization to be Realism.

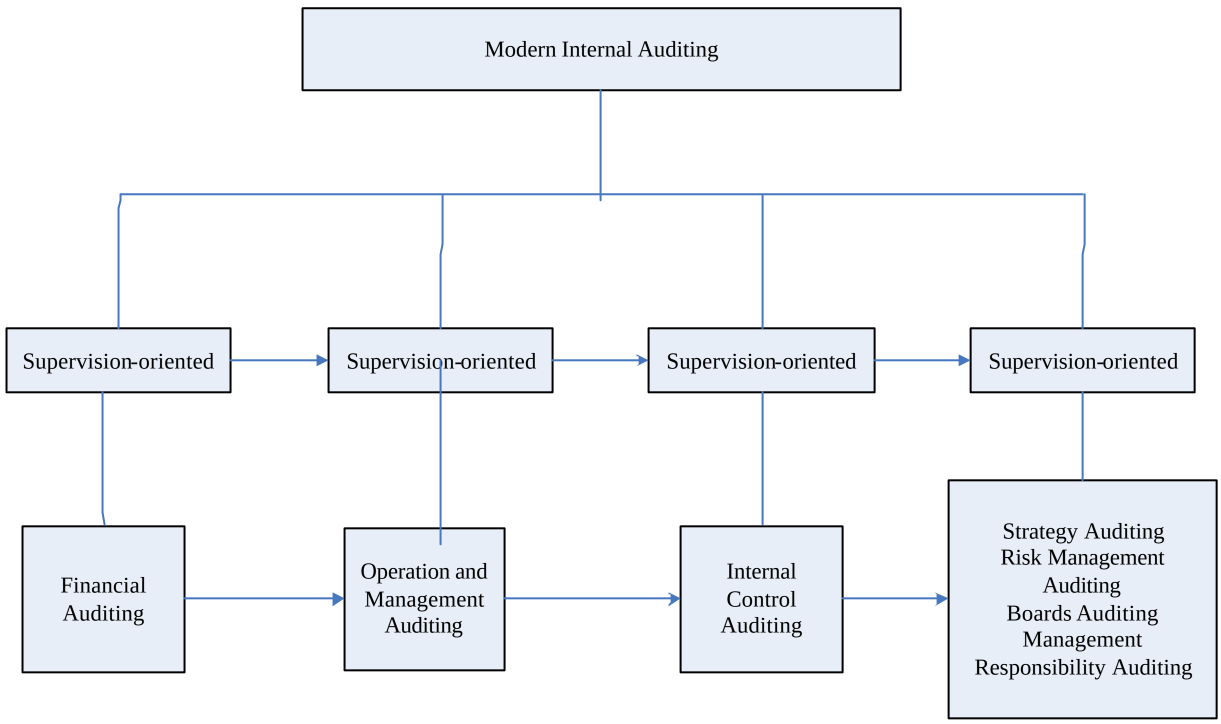
Internal auditing is an independent and objective guarantee and consulting activity aiming at increasing value and improving operation. It appraises and promotes corporate risk management, control and effectiveness of governance course through a set of systematic and disciplined ways, which is helpful to achieve the objective of enterprises (IAA, 1999). There are two methods to increase value, one way is economizing costs, the other one is creating new value under the efficient governance circumstance. That the traditional seeing-after-events internal auditing that had no any direct and obvious link with value-adding like assets assessment served manager to fulfill their responsibility (IIA, 2003), but GIOA which is conductive to perfect corporate governance, supervise and appraise the governance effectiveness, has function of governance and same objective with corporate governance so as to initiatively serve increment of value.

3.4 GOIA Improved Modern Internal Auditing and Practical System

Functions of internal auditing ranged from original supervision and evaluation to derived management, control and serving to today's governance. So far, internal auditing has undergone following process:

[4] Board and management have different division in participating corporate strategy---board is responsible for deciding the direction of development, considering and formulating corporate strategy while manager is responsible for realizing strategic vision.

supervision-oriented---management-oriented---control-oriented---governance-oriented accompanied by financial auditing, business operational auditing, internal control auditing, risk control auditing, strategic auditing and governance auditing and so on. The technologies and methods of internal auditing also changed from low to high: card of account-oriented---system-oriented---risk management-oriented (as shown in figure 2). GOIA, which makes modern internal auditing could touch economic activity of every level and improved the theory and practice of it.



4. The Chief Characteristics of GOIA: The Exploration Based on the Audit Relations and Methods

4.1 The Principal Part of Auditing and Its Organizational Arrangement

Enterprises of different style have their own principal part to conduct governance auditing and its organizational arrangement model in spite of the same purport making internal auditing be more independent. The existent models are shareholders commission-dominated, board of directors-dominated, supervisory committee and board of directors-co-dominated. The prerequisites of shareholders committee-dominated governance is that shareholders committee as the core, shareholders and other stakeholders entrust auditing personnel to audit the responsibilities of boards and operators, and then auditing information is delivered to shareholders and other stakeholders by auditing personnel (Wei-an Li, Xinsheng Cheng; 2002). Correspondingly, the department of internal auditing is subordinated to shareholders committee, supervisors and staffs of internal auditing evaluate board, responsibilities and performance of operators and report to board, so in reality some enterprises name department of internal auditing as department of supervising and checking. In addition, it is also available that board or entrusted CFO lead internal auditing to audit operator's responsibilities as supplement (but it must be independent of operator-dominated financial management), which is conductive to financial control and auditing.

Board-dominated governance auditing: boards of directors as core, interest of this kind of enterprises is scattered, the control ability of shareholders committee is weak[5]. Its department of internal auditing is subordinated to the boards or audit committee: on one hand, independent directors and staff of internal auditing supervise and evaluate the performance of board governance; on the other hand, board appoints and authorizes CFO to lead staff of internal auditing to audit the responsibilities of operators. Under the bilateral governance model of German and Japan, there is a executive board of directors below supervisory committee without boards of directors, governance auditing in corporate governance, internal control and legitimacy of financial report and so on fulfilled by supervision auditing with independent auditor from different angles. Its auditing effect is generally accepted (Weian Li, Xinsheng Cheng, 2002). Ours and Japanese' belong to the category of co-governance by supervisory committee and boards of directors (though they are not entirely the same). Systematically, supervisory committee with staff of internal auditing represents shareholders to audit agent responsibility of board; audit committee with personnel of internal auditing audit agent responsibility of directors and management while department of internal auditing is double-leaded by supervisory committee and auditing committee. Political separation of the three powers is manifested in corporate structure of organ (Jinsong Tan, 2003). Strongest systematic support is provided to governance auditing from the theory of "power levels"[6].

The principle part of governance auditing is multi-sided. Under the leadership of corresponding organ, it is divided into internal governance auditing and external governance auditing according to the demand of others' participation, such as full-time staff of internal auditing, professionals from relative department, external independent auditor and independent directors, etc, which is fit to the theory about modern internal auditing from IIA---the 'internal' barrier of internal auditing vanished so external staff also could participate. Out-sourcing and co-sourcing of internal auditing are available as long as it is keeping with principle of cost efficiency. Generally speaking, external auditing is fitter to take part in the evaluation and supervision of internal auditing in financial availability, financial control and risk[7].

4.2 The Objective and Content of GOIA

4.2.1 Auditing of Governance Process

(1) Strategy auditing. Strategy auditing supervises and evaluates its availability before strategy is put into force so as to ensure it is suit to the benefit of shareholder and whether managers transform strategic objective into the action of corporate. Strategic standard reflecting a basic economic reality is crucial to strategic auditing---Shareholder's loyal degree of long term depends on competitive ROI (Donaldson, 1995), but it is not easy to find out an index of financial performance reflecting the above connotation and easier to understand. G. Donaldson (1995) raised a lot of indices such as ROI of accounting owner, CFROI, EVA, TRS and so on, he said an ideal index could not be fixed for advantages and shortcomings existed in every one. It is a major studying project for internal auditing to further explore this problem.

(2) Auditing of risk management. Auditing of risk management evaluates degree of the implement and utilization in risk management to guarantee managers employing proper governance and control to deal with risks,

[5] This refers to unilateral governance model of US or UK.

[6] But the effect of implementing system design depends on lots of factors. Some studying indicates that the result of dual-governance of our supervisory committee and board is not so good. The reasons are our *Corporate Law* hasn't endowed with definite rights that resulted in repeated supervision including artificial factor, etc..

[7] The research of Dan Mei (2004) on this problem makes us believe that our scholars have begun to study it. The author united strategic auditing standard with BSC ideology at the base of above four financial indices and also took other indices such as custom, the process of internal auditing, learning, development, etc., into account.

it also could provide suggestion in reducing, transforming or tolerating risks and the like (IAA, 1999). In the past, internal auditing was responsible for serving manager and providing information of operational management for them, auditing always was in or after business. Auditing of risk management pays more attention to the work in and before business and replaces single fixed method by more flexible and more systematic method of risk analyzing.

(3) Auditing of internal control. Management auditing still is the important part of GOIA at the core of evaluation of internal auditing. Auditing of internal control soundly evaluates internal control system by utilizing description of word, investigation chart, flow chart and so on, to check and evaluate whether internal control system is healthy, complied and effective through walk-through tests or stress tests to apply compliance tests (Chang Song, 2003).

4.2.2 Post-governance Auditing[8]

(1) Boards auditing. Boards auditing evaluates its structure, members, style, training, and work (including formulation of mission and strategy, creation, productivity, marketing, personnel developing, teamwork and ultimate gain, etc.) to guarantee governance responsibility of board and its achievement (Tricker, Robertlan; 1987). The difficulty of auditing on board is the option of evaluation criteria. Mueller (1985) thought the following could be evaluation criteria in board responsibility: law, code, policy, social norm, history model, corporate tradition; long-term strategic object related to business; the identification of responsible staff; credit and developing ability of board; the board participates or interferes in business; the business performed and industrial analyzing, etc.. In fact, code of corporate governance has formed a set of all-round indices system in governance evaluating.

(2) Management responsibility auditing. Management responsibility auditing appraises management responsibility, reviews and evaluates operational control to find out differences, develop potency, improve or attest benefit, evaluate management performance, provide consult and increase corporate value through measuring its economy, efficiency and effectiveness by certain criteria (Chang Song, 2002). Ours is a typical management responsibility auditing involving auditing in decision-making, efficiency, management and fraudulence and a kind of governance auditing with Chinese characteristics.

4.3 Auditing Technology and Method

After entering into twentieth century, transformation in auditing technology and method were required owing to the changes of auditing objective causing by the changes of entrusted economic accountability (Rongsheng Qin, 2003). As the result of adapting internal auditing objective in different period, auditing technology and method from account note-oriented, control-oriented, procedure-oriented to present risk management-oriented paying attention to manager's risk assessment (possibly infect manager's performance) to decide what internal auditing need to do.

In some big companies, risk management-leading internal auditing has been well implemented and utilized. Generally speaking, these companies all have sound risk control systems, board and risk department of management have distinctive duty division in risk strategy, designing and selecting good risk management policy, assessment and risk implement, etc. Under the comparative perfect control circumstance, internal auditing appraises whether its procedure is sound or not and whether every necessary part (corporate, every sector, every unit, business flow and so on) all has risk management procedure and guarantees that managers have perfect internal control to reduce risk to could be accepted by board of directors at the base of risk management so as to

[8] This article adopted "after-business' auditing" in order to stress evaluating the effect of corporate governance.

re-supervise risk management representing manager's responsibility.

CPA risk-oriented auditing stresses to formulate auditing strategy and method to analyze and appraise risks in corporate financial control from acceptable auditing risk. So internal auditing is different from LPA in risk-leading, the latter pays more attention to set out from auditing risk in method while the former stresses risk management as core in contents although auditing itself is an important factor in internal auditing.

References:

1. Rongsheng Qin. *Internal Auditing*, China Financial & Economic Publishing House, 2000 (1)

2. Rongsheng Qin. *Auditing Risk and Risk-oriented Auditing*, Contemporary Finance and Economics, 2003 (7)

3. Rongsheng Qin. *The Relation of Coordinated Internal Auditing and Corporate Supervisory Committee*, Forestry Finance and Accounting, 2001 (2)

4. Song Chang. *Management Auditing and Its Function in Corporate Governance*, Auditing Research, 2002 (6)

5. Song Chang. *Thinking on Improving and Developing Corporate Internal Auditing*, Auditing Research, 2003 (6)

6. Shi Liu. *Statement on Impacts on Internal Auditing by Corporate Management*, Auditing Research, 2004 (2)

7. Wei-an Li, Xinsheng Cheng. *The Imploration in Corporate Governance Auditing* (Ⅰ, Ⅱ), Chinese Auditing, 2002 (1, 2)

8. Xinsheng Cheng. *Research on Relations among Corporate Governance, Internal Control and Structure*, Accounting Research, 2004 (4)

9. Wei Zhang. *Governance-oriented Internal Auditing---A Kind of Value Creation*, Auditing Research, 2004 (4)

10. Jingsong Tan. *Independent Directors and Corporate Governance at the Base of Research on Listed Companies*, China Financial & Economic Publishing House, 2003: 207-209

11. Xiaoping Zhu, etc.. *International Convergence Trend and Our Present Situation in Governance Structure---A Summary*, Accounting Research, 2004 (3)

12. Yanjuan Miao. *The Enlightenment from Governance and Reformation Act of American Corporate---The Function of Internal Auditing in Corporate Governance*, Learned Journal of Nanjing Economic College, 2002 (6)

13. Youhong Yang, Yan Hu. *Statement on the Linkup between Corporate Governance and Internal Control*, Accounting Research, 2004 (10)

14. Jane F, Mutchler. *The Governance Trend of Internal and External Auditing: Experience and Lessons*, the test of speech at 9th Chinese Conference of Accounting Professor Association (Xi'an), 2004

15. Jensen, Michael C. & Meckling, William H. *Theory of the Firm: Managerial Behavior, Agency, Costs and Ownership Structure*, Journal of Financial Economy, 1976 (3): 305-360

16. Tricker, Robertan. Auditing the Board's Effectiveness, Management Auditing, 1987 (5)

(Edited by Heng Zhuang, Eric and Jianfeng He)