

CONTEMPORARY ROLE OF INTERNAL AUDITING IN CORPORATE GOVERNANCE

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Abstract

The internal audit function has been constantly evolving in line with changes in the business environment. Contemporary challenges in the environment are closely related to risk and associated corporate governance issues. Consequently, shifting the internal audit function towards addressing corporate governance problems has called for greater independence of that function. In Slovenia, a new Companies Act was adopted in July 2015. In response to the need for a more independent internal audit function, it requires that decisions regarding the appointment and removal of the chief audit executive as well as their remuneration be approved by the supervisory board. The changes indicate that internal audit's role in management-governance relationships has altered. The paper provides an overview of these changes, the trends leading to internal audit's enhanced role in corporate governance, the expected benefits of internal audit's organizational independence, and future challenges. Interviews were used to support the theoretical findings with observations from key stakeholders in Slovenia.

Keywords: *governance, internal auditing, organizational functions, agency theory, stewardship theory*

1 INTRODUCTION

Over the last 30 years we have witnessed a major shift in focus of the internal audit function regarding its primary role in organizations, followed by changes in its organizational and reporting relationships. Internal auditing's traditional aim was to verify accounting records along with assessing and reporting on internal control systems. Around the turn of the century, developments in the business environment called for a greater focus on risk management. The role of internal auditing has trans-

formed accordingly, placing a strong emphasis on evaluating corporate risk management. Lately, numerous cases of corporate fraud, often related to accounting malpractice, have triggered a debate on the inefficiency of corporate control mechanisms. In light of these developments, the need to assure greater independence of the internal audit function has been recognized, thereby shifting the internal audit function's focus more towards addressing corporate governance problems.

Yet, contrary to expectations, the newly adopted EU Directive 2014/56/EU on statutory au-

ditions of annual accounts and consolidated accounts did not call for the increased independence of the internal audit function. In Article 39 it merely states that audit committees should monitor the effectiveness of the company's internal quality control and risk management system and, where applicable, its internal audit, regarding the financial reporting of the audited company. Despite the absence of general EU guidance in this field, the Member States are increasingly incorporating the internal auditing independence requirement in their corporate governance codes. The requirement was also added to the newly adopted IIA's International Standards for the Professional Practice of Internal Auditing – Standard 1110. Recently, the amended codes and standards have also led to new regulatory requirements. In Slovenia, a new Companies Act was adopted in July 2015. It requires that the internal audit function become more independent of management; decisions regarding the appointment and removal of the chief audit executive as well as their remuneration must be approved by the supervisory board.

The role of internal auditing has been changing in light of these developments. Its role in corporate governance has been highlighted as supervisory boards and audit committees are becoming ever more involved in internal audit planning and reporting. The need for the internal audit function to become more independent represents a clear step away from stewardship theory, building on the premises that management cannot be trusted, and is driven by self-interest as presumed by agency theory and thus in need of independent internal control.

The aim of the paper is to compare the internal audit function in relation to management, in relation to the supervisory board and its audit committee. It considers the new arrangement from the perspective of stewardship and agency theories. Moreover, it points out the challenges for the internal audit function due to the shift in its role toward the field of corporate governance. The paper contributes to the corporate governance literature, particularly to organizational theory of the relationship between governance and management, by acknowledging how the internal relationships between the two organizational functions have evolved due to the said changes.

The paper is further structured as follows. First, we briefly present the development of the field of internal auditing in the last few decades with a particular stress on its relationship with management and governance bodies. Second, we analyze the current legislation, regulation, governance codes, and internal auditing standards to present the current situation in the field in Slovenia, comparing them to general practice within other EU Member States. Third, we discuss the ongoing changes and present the future challenges.

2 OVERVIEW OF THE DEVELOPMENT OF INTERNAL AUDITING AND ITS ROLE IN CORPORATE GOVERNANCE

“Governance and management are formal organizational functions, assuring the rational achievement of business goals within the interest of the owners” (Rozman, 1998). Their relationship is crucial for the success of the company (Rozman, 2000). In the paper, we focus on the relationships between management and governance, their roles and functions with respect to the changing role of internal auditing. The relationships, roles, and functions are transforming due to the increasingly active role of internal auditing in the governing-managing process.

The governing-managing process is a unified organizational process (Rozman, 2000) in which decisions start with the governance and continue in management where the line is determined by the owners and the law and varies in relation to the dominant governance model. The main governance roles are strategic planning and strategic control, thus encompassing decisions on strategies and control of the management to protect the owners' interests. They further include decisions about nomination, compensation, control, strategic decisions, and management in crises (Fama and Jensen, 1983). The rest of the process is the role of management, closely related to execution (tactical planning and control, planning and controlling the organization, actuating). Internal auditing is gaining an important role in corporate governance due to providing quality information on the execution of strategic plans for the purpose of better supervision of managerial decisions by governance bodies, as

well as an important consulting body in making decisions on strategic issues accepted by the management-governance body, as seen from the newly assigned roles.

The corporate governance literature has addressed the principal-agent relationship in an organizational context from two opposing theories: agency theory and stewardship theory. Agency theory claims that agents will act to maximize their own interests and not act in the interest of the principals (Jensen and Meckling, 1976) in the absence of a tight control and compensation scheme (Davis, Schoorman and Donaldson, 1997). As a control mechanism and remuneration schemes lower the outcome for the principal, the solution is not optimal. On the other hand, stewardship theory proposes that agents' goals can be aligned with the owners' goals in the absence of a control mechanism as agents are pursuing higher personal goals like achievement, affiliation, and self-actualization (Caers et al., 2006; Tosi, Brownlee, Silva and Katz, 2003). The relationship is based on trust, leading to decision-making in the interest of the principal (Davis, et al., 1997; Donaldson and Davis, 1991). As agency theory dominates the governance literature in explaining principal-agent relationships, the role of internal auditing is increasingly being related to a lack of trust and the need for higher control mechanisms for better corporate governance. Ramamoorti explains (2003, p. 3):

In sum, the collective effect of growing transaction complexity and volume, the owner/manager's ("principals") remoteness from the source of transactions and potential bias of reporting parties ("agents"), technical (accounting) expertise required to review and summarize business activities in a meaningful way, the need for organizational status to ensure independence and objectivity, as well as the procedural discipline necessary for being the "eyes and ears" of management all contributed to the creation of an internal audit department within business organizations.

Stewardship theory is generally perceived as too idealistic to be implemented to enhance the performance of large organizations due to its great emphasis on external control mechanisms. How-

ever, some existing studies, specifically in public sector organizations, indicate it might be possible to reduce fraud by relying on intrinsic motivation and internal control (Segal and Lehrer, 2012). The relationship between trust and control is parallel, as found in alliance relationships (Das and Teng, 1998) where control mechanisms were found to impact the trust level. Moreover, they confirmed that the level of trust moderates the control mechanisms in determining the control level.

In practice, the prevailing two models of corporate governance include the Anglo-American model and the German model. The Anglo-American model prevails in the USA and the UK, whereas the German model is dominant in Germany and continental Europe (Chhillar and Lellapalli, 2015), including CEE countries (Hardi and Buti, 2012). In the Anglo-American model, governance decisions are made by the board of directors, whereas in the German model strategic control is in the domain of the supervisory board and strategic decision-making in the domain of management. Despite the differences in governance bodies, the role of internal auditing in relationship to management and governance is evidently changing in both models to assure sound internal auditing to prevent management misconduct.

The primary focus of internal auditing has been transforming since the profession was established. At first, the pace of change was relatively slow but started accelerating around the turn of the century. In the 1950s, the primary task of the internal auditor was to verify accounting records, as described by Brink and Cashin (1958, p. 35):

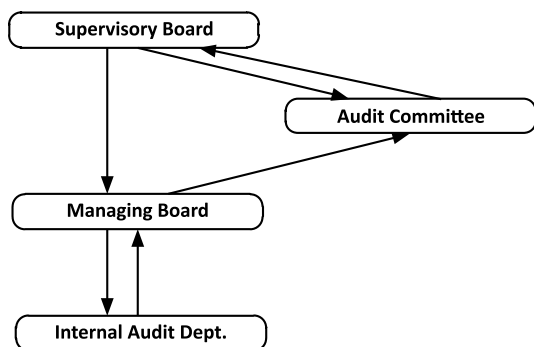
Internal auditing thus emerges as a special segment of the broad field of accounting, utilizing the basic techniques and method of auditing. The fact that the public accountant and the internal auditor use many of the same techniques often leads to a mistaken assumption that there is little difference in the work or in ultimate objectives. The internal auditor, like any auditor, is concerned with the investigation of the validity of representations, but in his case the representations with which he is concerned cover a much wider range and have to do with many matters where the relationship to the accounts is often somewhat remote.

The role of the internal auditor was upgraded from accounting supervisor to operational supervisor when the examination of operational procedures was added as a new direction in the 1960s. The 1970s represent the first milestone in the history of internal auditing, placing the assessment of internal controls and reporting on internal control systems in the core of its scope. In 1978, the Institute of Internal Auditors (IIA) adopted the *Standards for the Professional Practice of Internal Auditing* that contained the following definition and objective of internal auditing (Ramamoorti, 2003, p. 6):

Internal auditing is an independent appraisal activity established within an organization as a service to the organization. It is a control which functions by examining and evaluating the adequacy and effectiveness of other controls. The objective of internal auditing is to assist members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel, and information concerning the activities reviewed. The audit objective includes promoting effective control at reasonable cost.

Concerning relationships to management and governance bodies and supporting its primary role of controlling within the organization, the internal audit department at this point reported directly to the management board (see Figure 1). In Figure 1 (and all subsequent figures) the downward arrows

Figure 1: Reporting and communication relationships between internal audit department and management-governance bodies in the German governance model as adopted in Slovenia in the 1980s



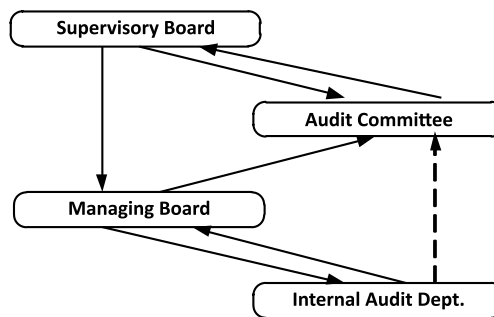
represent the direction of assigning tasks, duties and responsibilities whereas upward arrows represent the direction of reporting.

A remarkable opportunity for internal auditing to take a step forward from its historical characterization as the »organizational policeman and watchdog« (Morgan, 1980, p. 161) came at the end of the 1990s. At that time, the corporate governance guidelines promoted the importance of risk management, stressing that risk should be objectively identified and managed. Building on their expertise in corporate internal control systems, internal auditors efficiently entered into the field of risk management. Considering the trends in the profession, the IAA adopted a new definition in 1999, emphasizing the value-added approach of internal auditing, fulfilled by its role in evaluating and improving corporate risk management (Sarens and De Beelde, 2006, p. 66):

The internal auditing activity should evaluate and contribute to the improvement of risk management, control and governance.

To support the altered role of the internal audit function, the relationships to management-governance bodies changed towards building a direct-reporting relationship to the audit committee of the supervisory board, which in practice was still mediated by the management board (see Figure 2). The relationship in Figure 2 is represented by a dotted line indicating no formal authority of the audit committee over the internal audit department.

Figure 2: Reporting and communication relationships between internal audit department and management-governance bodies in the German governance model as adopted in Slovenia in the 2000s

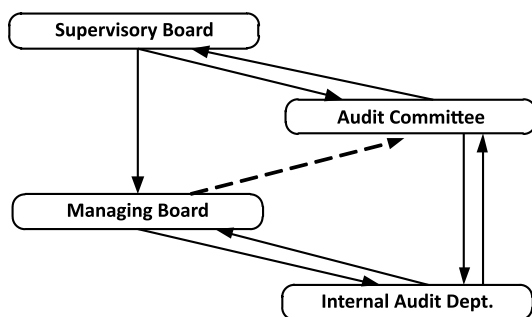


In recent times, the numerous cases of corporate fraud, often related to accounting malpractice, have triggered a debate on the inefficient corporate control mechanisms and called for strict changes in legislation related to corporate governance. In light of these developments, the need to assure the internal audit function's greater independence has been recognized, further stressing its role in improving corporate governance practice and refocusing on the quality of internal controls (Odar, Korošec and Horvat, 2006). Current developments in internal auditing are reflected in the most recent IIA definition (Definition of internal auditing, 2016):

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

The definition clearly indicates that internal auditing is becoming an important actor in supporting governance decisions related to strategic control as well as strategic planning, as its role as a consultant to management on strategic matters is becoming explicitly stated. The reporting and communication relationships are changing, respectively. The audit committee is in charge of assigning additional tasks to the internal audit department, and in respect of monitoring and control within organizations the in-

Figure 3: Reporting and communication relationships between internal audit department and management-governance bodies in the German governance model as adopted in Slovenia in the 2010s



ternal audit department reports directly to the audit committee. The internal audit department's reporting relationship to the management board is upgraded with a consultancy relationship on strategic aspects of the business, whereas the management board retains its role of confirming the internal audit function's tasks. The relationship between the management board and the audit committee is transformed into a less formal role represented by a dotted line (see Figure 3).

By placing more emphasis on corporate governance related issues – the prevention of fraud and misconduct in particular – the recently achieved higher level of organizational independence provides an opportunity for internal auditing to regain the confidence it has lost in the wake of the corporate accounting scandals at the turn of the century.

3 CONTEMPORARY LEGISLATIVE TRENDS IN THE FIELD OF THE INTERNAL AUDIT'S INDEPENDENCE IN THE EU AND IN SLOVENIA

Despite the latest IIA definition of internal auditing stating that it is an independent and objective assurance and consulting activity designed to add value and improve an organization's operations (Definition of internal auditing, 2016), the newly adopted EU Directive 2014/56/EU on statutory audits of annual accounts and consolidated accounts does not call for the increased independence of the internal audit function. Article 39 merely states that the audit committee should monitor the effectiveness of the company's internal quality control and risk management system and, where applicable, its internal auditing, regarding the financial reporting of the audited company (Directive 2014/56/EU).

In spite of the absence of general EU guidance in this field, the Member States are increasingly incorporating the internal audit function into their corporate governance codes. In 2012, the European Confederation of Institutes of Internal Auditing (ECIIA) carried out a study on corporate governance codes in EU Member States to determine the current status of internal audit department in the governance structure of listed companies. The study revealed that 41% of the corporate governance

codes (i.e. in Finland, France, Greece, Italy, Latvia, Luxembourg, Malta, Romania, Slovakia, Slovenia, and Spain) regarded an internal audit department in listed companies as mandatory. Slightly more, namely 48% of the codes (i.e. in Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Germany, Hungary, Ireland, the Netherlands, Sweden, and United Kingdom) strongly recommended an internal audit department, whereas internal audit department was not foreseen in 11% of the codes, namely in Lithuania, Poland and Portugal (Corporate governance codes on internal audit: Current status in the EU, 2012). The study also reports that internal auditing was consistently mandatory within the financial institutions sector. The problematic finding of the study was that little guidance was provided in the governance codes on how to ensure an efficient internal audit function mainly in terms of its independence and scope. The ECIIA's recommendation in this regard was to properly structure the internal auditing to enable it to achieve the objective of global assurance, a goal that can only be reached with: 1) organizational independence; 2) exclusion of limitations on the scope of its review; 3) full and unrestricted access to any information and person necessary to achieve its objective; and 4) the adoption of the IIA's International Standards for the Professional Practice of Internal Auditing (hereafter: IIA Standards), including internal and external quality assessment reviews (Corporate governance codes on internal audit: Current status in the EU, 2012).

The motivation to highlight the key role of independence stems from the numerous recent cases of corporate fraud, often related to the inefficient corporate control mechanisms and the similar trend for independent corporate boards (Johanson and Østergren, 2010). Consequently, the independence requirement was added to the newly adopted IIA's Standards (International Standards for the Professional Practice of Internal Auditing, 2013), particularly Standard 1110 – Organizational Independence, Standard 1111 – Direct Interaction with the Board, and Standard 1120 – Individual Objectivity. The independence requirement is explicitly defined in Standard 1110, mandating independent internal audit activity and objective internal auditors. In this standard, the organizational independence of inter-

nal audit activity is defined as follows (International Standards for the Professional Practice of Internal Auditing, 2013):

Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive has direct and unrestricted access to senior management and the board. This can be achieved through a dual-reporting relationship. Threats to independence must be managed at the individual auditor, engagement, functional, and organizational levels.

To the best of our knowledge, the only holistic study that shed some light on the development and profile of internal auditing in Slovenia, before the new legislative requirements were adopted in 2015, was the study by Odar et al. (2006). The study was conducted in all Slovenian companies employing more than 250 employees that have established an internal audit unit. Companies in both private and public sectors were studied. Contrary to the previously described developments in the profession, the internal audit function in Slovenia has lagged behind the global trend. The study revealed some problematic areas regarding the independence of the internal audit function. Although 85% of the responding organizations reported that their internal audit departments were autonomous (and formally directly subordinated to the top management), in the remaining 15% the internal audit function was organizationally involved in the accounting department structure, which may cause independence problems. The study also showed that the annual plans for internal auditing are approved only by the management (and not also by the supervisory board) in up to 51.8% of organizations. Moreover, the authority to hire, fire, and compensate the chief internal auditor was in 96.7% of the responding organizations in the hands of top management. The results pointing to these problematic areas suggest that the organizational independence of Slovenian internal auditors is jeopardized as they may be faced with independence and objectivity problems (Odar, et al., 2006).

The Corporate Governance Code of Listed Companies in Slovenia (Kodeks upravljanja javnih delniških družb, 2009), the new IIA Standards (International Standards for the Professional Practice of Internal Auditing, 2013), and increasing evidence of corporate control inefficiency also stimulated new legislative requirements concerning internal auditing in Slovenia. Two years after adopting the new IIA Standards, a step towards a more independent internal audit function in Slovenia was taken by adopting the new Companies Act in July 2015. More specifically, new Article 281.a demands that the internal auditing becomes more independent of management; decisions regarding the appointment and removal of the chief audit executive as well as their remuneration should now be approved by the supervisory board. In addition to banks and insurance companies, where the internal auditing was legally required by the corresponding industries' specific legislation already in 1991 and 1993, respectively (Odar, et al., 2006), the Companies Act of 2015 introduces the organizational independence requirement for all companies that have established internal audit units.

4 CHALLENGES AND FUTURE DEVELOPMENTS

The approach to recognizing the challenges and future developments is based on a literature review, professional articles, and interviews conducted with different stakeholders including internal auditors, executives, members of supervisory boards, and audit committees in Slovenia. The semi-structured interviews were carried out between February and April 2016. Each interview lasted 30 minutes on average and took place in person or via a telephone conversation. Two representatives were selected from each group of stakeholders to obtain a variety of perspectives on the research topic. The recognized challenges primarily relate to the future role of internal auditors and their position within the management-governance structure.

The development of internal auditing and its role in corporate governance is an ongoing process, closely related to the business environment and regulation. On one hand, developments in the business

environment call for constant regulatory changes that affect the role of internal auditing. On the other hand, good corporate practices in the field contribute to regulatory changes. Although it is not easy to predict future changes in the role of internal auditing, recent developments in the business environment suggest that the areas of risk, governance, and consulting will retain their pivotal role.

The role of internal auditing in risk management has already been further enhanced in the financial sector where the characteristics of the business environment already justified a broader approach to enterprise risk management referred to as the "three lines of defense model" (Doughty, 2011). This approach assigns responsibility for enterprise risk management to three lines of defense (i.e. business operations – first line of defense, internal risk and control functions and compliance – second line of defense, internal audit – third line of defense) and is already widely adopted in the financial sector (Corporate governance insights: Reinforcing audit committee oversight through global assurance, 2012). As the importance of risk management stretches beyond the financial sector, it is highly probable that the involvement of additional resources will also be needed in the non-financial sector that will adopt the "three lines of defense model" for effective risk management related assurance.

Decaux and Sarens (2015) outline the future role of internal auditing in the field of combined assurance. Currently, to apply and carry out reliable governance practices the governance bodies rely on a number of internal and external assurance providers such as internal and external auditors, legal departments, quality assurance, compliance departments etc. They all provide different assurance in respect of proper practices of risk management, accounting, and control within the company. Since the mentioned assurance activities are performed in isolation, the auditors, the management, and the board are overwhelmed with inflated activities in this area. However, they still suffer from assurance gaps, leading to inefficient reporting to governing bodies (Sarens, Decaux and Lenz, 2012). In this context, the internal audit is at the crossroads: it could either become marginalized between a variety of other assurance, compliance, and risk management tasks, or emerge as an established and

stronger profession (Lenz and Hahn, 2015). The increased organizational independence and enhanced focus on corporate governance provide grounds for internal auditing to execute the needed coordination among various assurance providers. Although combined assurance implementations are still relatively rare (Decaux and Sarens, 2015), their potential in the corporate governance field suggests they could be regarded as a viable trend in the future development of internal auditing.

The interviews conducted with different stakeholders in Slovenia reveal that the supervisory board members, audit committee members and executives agree with internal auditors that the changing role of the internal auditor results in increasingly demanding tasks, workload (including administrative burden), as well as supervision. Moreover, only a handful of experts who have obtained the professional title Certified Internal Auditor (in April 2016 there were 106 professionals with valid licenses) can carry out chief internal auditor tasks in sectors where particular legislation imposes requirements for the internal auditing (banking and insurance, in particular).

In Slovenia, the last five years have brought visible changes to the main tasks of internal auditing. Areas such as internal control testing have been replaced by risk-based auditing (closely relating the audit tasks to the identification and measurement of risks), the enhanced role of consulting (in the field of processes and corporate strategy), and governance (auditing of governance-related areas).

Expansion of the internal auditing role to include consulting activities addresses the weakness of the German governance model: since independent supervisory boards may, in some circumstances, fall short of having very specific knowledge on firms' internal operations, they may relate to strategic consulting provided by internal auditors who are better informed by virtue of their insight into the company.

In specific regulated areas, such as insurance, governance-related audits are required on a yearly basis and focus on different aspects of corporate governance, including compliance with regulation and the effectiveness of established practices. The internal auditor's enhanced role suggests that for the first time in history management is being con-

trolled by both external and internal control mechanisms. One of the interviewees noted:

As the role of internal auditing is spreading to new areas that were previously somewhat neglected [such as corporate governance] a question arises whether the system is mature enough to adapt to this change. As sensitive areas, including the activities of executive and/or supervisory boards and their committees are being scrutinized by these audits, one insurance company in Slovenia has already decided to hire an external audit firm to carry out the governance-related internal audits.

The new developments and broadened role of the internal auditor, especially in the governance field, call for the greater independence of internal auditors. On the basis of corporate governance codes, International Standards for the Professional Practice of Internal Auditing, and existing good practices in the banking sector, the Slovenian internal auditing profession has persuasively advocated the introduction of independence-related articles to the national legislation. Pursuant to the new Companies Act (Zakon o gospodarskih družbah, 2015), decisions regarding the appointment and removal of the chief audit executive as well as their remuneration should be approved by the supervisory board. One interviewee pointed out the possible consequences of these changes for the internal auditor's remuneration:

Although the internal auditing profession has been evolving over a long period, assuming new tasks and transferring from control-related supervisor to risk-based assurance provider and consulting expert, the remuneration did not adequately follow the trends reflected in the new responsibilities and the higher value added of internal auditors. I see the legislative changes as an opportunity for the chief internal auditor to be recognized [by the supervisory board] and rewarded as one of the key value-adding positions in the company.

Due to the described development and trends, internal auditing is increasingly becoming an important player in the field of governance. Its role is evolving from a strictly internal organizational function of assuring information and providing control over internal compliance with standards and regu-

lation to control over management’s strategic decisions and providing value added in the form of strategic advice.

The second challenge reflects the position of internal auditing within the management-governance structure. Internal auditing is declared as “an organizationally independent unit and subordinated by function to governance bodies for supervision” in the new standard for internal auditing. Organizational independence refers to reporting to that level of leadership within the organization which allows the internal auditing to fulfil its role and duties (International Standards for the Professional Practice of Internal Auditing, 2013). Legislation thereby brings possibilities to achieve greater changes in the internal auditing.

Organizational independence can be interpreted as independence from other departments, and the unit being subordinated directly to the CEO. As employees of the company, internal auditors need the support and cooperation of executive management to perform their tasks effectively. Having a direct reporting relationship to governance bodies, including the audit committee of the supervisory board, means the internal auditor must communicate and cooperate directly with the governance body in terms of supervision. In this respect, it is subordinated to the supervisory board, consequently leading to management having less impact on the information being presented to its supervisors and included in the company’s annual report. They should be able to report fearlessly and criticize management’s performance if necessary. However, the accepted dual reporting has weaknesses (Chambers and Odar, 2015). The issue “of serving two masters” as recognized by Ramamoorti (2003) creates friction and tension for internal auditors, which need to be managed carefully.

Further, the interviews reveal that in practice there is a challenge in assuring the independence and direct reporting. As experienced by some interviewees, the relationships are still following the previous reporting paths to management, questioning the maturity of the system in Slovenia:

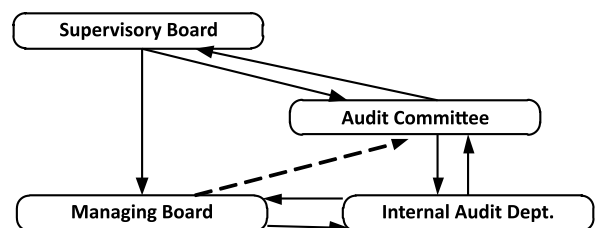
Internal audit still reports to management. Then reports go to the audit committee and then to the supervisory board. It is still sequential.

Slovenia is not mature enough for the system of independence bypassing the management and reporting straight to the audit committee and supervisory board. The internal auditor could be put under a lot of pressure and eventually be replaced. For this to work in practice, it will take some time.

We can conclude that in practice the reports are still initially screened by the management, then sent to the audit committee and finally to the supervisory board. The process of reporting is still sequential, compromising the independence and objectivity of the internal audit department (Ramamoorti, 2003), indicating the dual reporting structure’s instability in practice. In this respect, we can discuss where the internal audit should be positioned within the management-governance structure.

The Slovenian Institute for Auditing (Poročilo o delu Slovenskega inštituta za revizijo, 2014) anticipated that management would recognize internal auditing as an equal partner and take advantage of the contribution the function can make to improving risk management, internal control, and governance. However, this has not been the case in practice and also the consulting role has been overlooked. The reason lies in the weak communication relationships between management and the internal auditor. Internal auditors do not receive the necessary information from management, and they lack time to contribute, indicating a low level of maturity of the responsible parties and no support for stewardship theory. As the level of maturity increases, the relationship might evolve to the level of partnership to which the auditing practice aspires, and is presented in Figure 4.

Figure 4: Possible future reporting and communication relationships between internal audit department and management-governance bodies in Slovenia in the German governance model



In some sectors (e.g. banking, where the regulation has been stricter and the changes have already been implemented), experience shows the legislation has not prevented wrongdoings, as emphasized by one interviewee. In spite of its independence from other departments, the fact that internal audit department is directly subordinated to top management, and is sending reports directly to the supervisory board, without management intervention, has still not meant that risks are recognized and scandals prevented. Important lessons can be learned and further problems exposed.

The downside of the legislation is that it is still ineffective in practice. Managers are better informed, can to some extent impact the information flows and misuse the system for their own interest. The solution might not lie in tightening up the supervision role and the independence of internal auditing, cutting off ties to management, as suggested by audit professionals (Chambers and Odar, 2015) when building on the assumptions of agency theory. It may lie in a reliance on stewardship theory, building good, trusting relationships with management, as one interviewee explained:

Legislation can't make up for the good working relationships, professionalism and organizational culture, where management strives for transparent working relationships and reporting. To build such an environment, you need to train employees, create workshops, share best practices, etc.

The positive impact of the legislation is that the stakeholders involved are starting to talk about the problems of internal control, its role, and relationships. The emphasis on consulting management regarding processes and strategy can also benefit the company, but should be accompanied by building transparent working relationships. One interviewee explained the changes:

From the formal role of internal audit department, with time we moved to a good way of cooperating. Internal audit department had to devote more time to carry out the audit and present its outcome. It had to go around, into the field, ask the employees involved for their opinions. This way they were given a chance to explain, as experts, their own views of the

processes. After three years, the internal auditors recognized they were more satisfied with their job, were preparing better reports and suggestions for improvements were implemented faster. Encouraging personal and open communication, that is what worked.

With the stressed role of consulting to the management on strategic questions, the responsibility and accountability of the internal auditor's advice further increased. The question is whether internal audit department is prepared to accept this accountability. As the job description changes, it impacts the knowledge needed to make an informed judgment, requiring internal auditors to possess knowledge beyond the business, its processes, and operations in detail. The transformation from an accounting specialist to a consultant possessing a wide array of professional skills (accounting, risk management, and assurance only being a prerequisite for the position) is a long-term process. On one hand, examples of successful company practices are needed to contribute to the broader acceptance of the altered role of internal auditors. On the other hand, internal auditors should acquire additional knowledge and skills to successfully carry out all their tasks related to their broader role. In addition to the study programs being transformed from a high accounting specialization to a more interdisciplinary approach, companies will also have to increase the training and development funding of their internal auditors before they accept the new responsibilities and are made accountable for influencing strategic decisions.

With regard to double reporting relationships, identified as flawed, double reporting in modern organizations should no longer be a problem if supported by an appropriate organizational culture and norms. With multidimensional structures, emphasized teamwork, horizontal mechanisms of coordination, employees communicate and report to several coworkers. One interviewee concluded:

Several lines of reporting are common in today's workplace, matrix structures are common. As employees, we can handle this. All we need are constructive working relationships.

5 CONCLUSION

The paper makes a contribution to the corporate governance literature by presenting the current developments in the role of internal auditing and its relation to organizational theories, agency and stewardship in particular. The paper provides evaluations of present conditions in the field and is predominantly based on a review of the legislation and regulations, and interviews with representatives of different stakeholder groups: internal auditors, members of audit committees, supervisory boards, chief internal auditors, and management. Accordingly, the conclusions are generalizable to a limited extent.

The new legislation which is trying to strengthen the supervision role by introducing stronger independence of the internal auditing is aligned with agency theory in greater control of management, whereas the increased advisory role and consulting management on strategic issues requires open communication, transparent, and trusting relationships among all stakeholders involved,

which is in line with stewardship theory. The requirements are therefore somewhat contradictory, particularly as internal auditing should also control the effectiveness of the corporate governance. The paper therefore addresses challenges faced in practice with respect to the new role of internal audit department and its relationships to management and governance bodies, stressing it will take some time to adjust to the new requirements.

As a viable future research opportunity, the challenges of internal auditing could be studied on the basis of a qualitative analysis in the form of structured interviews with chief internal auditors of Slovenian public companies and other parties involved. This approach would reveal best practices for relationships to contribute to the overall effectiveness of organizations, even learning from the mistakes of some sectors (e.g. banking) where the changes were applied sooner than elsewhere. An international comparison of selected EU states would further contribute to improved governance practices in Slovenia.

EXTENDED SUMMARY / IZVLEČEK

V zadnjih 30 letih smo bili priča velikim spremembam v nalogah in vlogi notranje revizije v podjetjih, katerim so sledile spremembe v notranjih organizacijskih razmerjih in razmerjih poročanja. Na začetku je bil cilj notranje revizije preverjanje računovodskih izkazov ter ocenjevanje in poročanje o notranjih sistemih nadzora. Na prehodu v 20. stoletje so spremembe v okolju preusmerile pozornost oddelka na obvladovanje tveganj. Vloga notranje revizije se je preoblikovala v skladu s temi novimi usmeritvami in dala velik poudarek na ocenjevanje obvladovanja tveganj v podjetjih. Pogoste prevare v podjetjih, povezane s slabimi računovodskimi praksami pa so v zadnjem času sprožile diskusijo o neučinkovitosti notranjih mehanizmov nadzora. V luči teh dogodkov se je pojavila potreba po večji neodvisnosti notranje revizije, s čimer je preusmerila pozornost funkcije k reševanju problemov korporacijskega upravljanja.

Vendar pa v nasprotju s pričakovanji, nova Evropska direktiva o revidiranju letnih in konsolidiranih računovodskih izkazov (2014/56/EU) ne zahteva večje neodvisnosti notranje revizije v podjetjih. V 39. členu direktive je navedeno le, da mora revizijska komisija nadzorovati uspešnost notranje kontrole kakovosti in sistemov obvladovanja tveganj ter, kjer je potrebno, še notranjo revizijo glede finančnega poročanja revidiranega podjetja. Kljub odsotnosti splošnih usmeritev Evropske skupnosti, države članice vedno pogosteje vključujejo pogoj o neodvisnosti notranje revizije v svoje kodekse korporacijskega upravljanja. Zahteva je bila vključena tudi v najnovejše Mednarodne standarde strokovnega ravnanja pri notranjem revidiranju (Standard 1110). V zadnjem času so spremembe v kodeksih in standardih vodile tudi v nove zakonske zahteve. V Sloveniji je bil tako v juliju 2015 sprejet nov Zakon o gospodarskih družbah (ZGD-11). Ta zahteva, da postane notranja revizija neodvisna od managementa, odločitve o imenovanju in razrešitvi notranjega revizorja ter njegovo nagrajevanje pa mora biti potrjeno s strani nadzornega sveta.

Vloga notranje revizije se je spreminjala vzporedno z opisanimi spremembami v okolju. Ker nadzorni sveti in revizijske komisije vse več pozornosti namenjajo notranje-revizijskemu načrtovanju in vse natančnejše obravnavajo redna notranje-revizijska poročila, se krepi pomen notranje revizije v strukturi korporacijskega upravljanja. Zahteva po večji neodvisnosti notranje revizije pomeni odklik od teorije zaupništva (angl. *stewardship theory*), saj temelji na razmišljanju, da management pri svojem delovanju sledi predvsem lastnim ciljem, kar je temeljna teza teorije agentov (angl. *agency theory*).

Članek primerja razmerja med notranje-revizijsko funkcijo in managementom, nadzornim svetom ter revizijsko komisijo. Razmerja prikazuje v luči teorije agentov in teorije zaupništva. Pregled literature in izvedena kvalitativna študija kažeta, da je sodobna vloga notranjega revizorja v organizaciji dvojna. Po eni strani njegova povečana neodvisnost kaže na nižjo raven zaupanja do managementa. V skladu s teorijo agentov notranji revizor principalu omogoča, da management pri svojem delu v večji meri upošteva interese lastnikov družbe. Po drugi strani pa je povečana vloga notranjega revizorja na področju nudenja svetovalnih storitev tesneje povezana z zaupanjem, ki je pomemben del teorije zaupništva.

V članku izpostavljamonekatere izzive, s katerimi se sooča notranji revizor pri izvrševanju svoje nove, razširjene vloge. Članek prispeva k nadaljnjemu razvoju področja korporacijskega upravljanja na področju razmerij med organi upravljanja in managementa.

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