

Corporate Governance and Internal Control Systems in Italy. The results of an empirical research

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The Corporate Governance (CG) theme has recently been the subject of significant measures in trying to restore confidence among investors by encouraging information and communication transparency. The Italian Parliament approved Law 262 in 2005; and in 2006 the CG Committee of the Italian Stock Exchange approved the new Self-Regulatory Code for listed companies. This paper deals with general issues of controls and moves on to causes and cases of their failures in Italian “for profit” companies. On the basis of information gleaned from published records, interviews were carried out with members of Italian boards of auditors, internal and external auditors, and questionnaires to this effect were completed. The results obtained from the data so collected revealed key factors in relation to the above and to the state of the Italian situation. The interfacing of these factors and the coming into force of Law 262 were the main catalysts for a review of the roles of all Internal Control (IC) bodies. The final aim was to come up with suggestions about the possibility of finding areas for improvement within those companies IC systems.

Field of Research: Corporate Governance

1. Introduction

During 2005 and 2006, the Italian system witnessed the introduction of important changes concerning CG, especially for the listed companies. In fact, in terms of law following the reforms of 1998 (Combined Finance Act, “*Testo Unico della Finanza*”) and 2003 (Company Law Reform), Law 262, the so-called “savings protection law” was approved in 2005. In terms of self-discipline, 2006 represented a key stage, with the revision of the “Self-discipline Code” that was issued by a committee consisting of representatives of major listed companies, financial institutions and interested trade associations, as well as experts, under the aegis of the Italian Stock Exchange. Against the backdrop of such context, the current work intends to investigate; through an empirical survey, the main limits and room for improvements in the working of company IC system(s) and in the scope of role of the three main professional bodies currently in charge of it in Italy (i.e. Internal Auditors - IA, Statutory Auditors - SA and External Auditors - EA).

2. Literature Review

Company governance activity was recently a subject of significant legislative and regulatory measures, reflected in the specialised international literature. In

the previous decades it was undoubtedly a central theme (Monks and Minow, 2001; Sheikh & Rees, 1998). The Italian literature is extremely scant on this subject in terms of the number of contributions. This is the reason why this study describes the most recent legislative innovations at the national level, as these will probably constitute the subject of future comments and publications. Paragraphs 14, 15 and 30 of the above mentioned Law 262/05 introduced important changes in terms of profile of responsibilities related to the drafting of company financial reports; more precisely, it refers to the power and responsibilities at a personal level (to which possible sanctions are connected), which find their inspiration in the key principles of the U.S. Sarbanes-Oxley Act. In particular, the IA activity, if implemented according to the international standards with regard to the independence and objectivity profile of its operations, will turn out to be, following the U.S. experience, an element of significant assurance: both for the top management as well as for the different stakeholders with positive returns in terms of company reputation.

It is reasonable to expect that such implications will materialise (at least partially) in the Italian system as a consequence of the coming into force of Law 262/05. With regards to the internal organisation of listed companies, the major change introduced by this law (Paragraphs 14 and 15) is the appointment of the “manager” in charge of issuing the company financial reporting. That manager must be given powers (i.e. decision autonomy) in order to let him provide the company with accounting and administration procedures designed to assure the organisation a structure/system of producing truthful economic and financial information and data. Proper planning, management and monitoring of the whole company’s IC system are required in order to develop effective procedures and to limit the risks of false communications. Listed companies are also required to publish, according to the CONSOB (National Commission for Companies and Stock Exchange) instructions, a statement of adherence to the national Codes of Conduct.

The prescribed regulation base was also strengthened by the possibility of aggravated penalties and administrative sanctions (Paragraph 30, Law 262/05). It is expected that all the prescribed changes will exert influence especially through IA, in setting up a proper information flow focusing on the risk assessment. In Italy the IA function is not regulated by the law and there is some overlapping area(s) between independent bodies (not only IA) and people involved in the auditing activity with different roles that are still in place, even following the Company Law Reform, thus representing an important issue to be reviewed. The authors believe that the analysis of the connections between IA, SA and EA is a step forward to understand and develop a better control system.

3. Methodology and Research Design

The main tool for the implementation of this research was a survey with the same matrix for the three investigated groups. Personal interviews were conducted to pilot-test the effectiveness of the questionnaire before making it final and sending it. Paragraph 4 of Tables 1 and 2, shows the summary of the responses received. These are divided into two sections: the first one (A)

centred on main issues and impediment factors of the specific auditing activity while the second one (B) is related to improvement areas and actions.

The Tables are organised as follows:

- in the first column there is the text of each question;
- the columns with headings of “mode”, “median” and “mean” report the results of the processing of the data of the previous columns (the meaning of the scores from 1 to 6 is as follows):

SECTION	Score “1”	Score “2”	Score “3”	Score “4”	Score “5”	Score “6”
A	No problem	Marginal problem	Enough Relevant problem	Relevant problem	Very relevant problem	Decisive factor of auditing failure
B	Totally useless	Marginally useful	Enough useful	Useful	Very useful	Of decisive importance

- the “d*”, reported in the last column, is the *Leti* index, that expresses the dispersion of the frequencies of the observed phenomenon. *Leti* index range in this case goes from 0 (minimal dispersion) to 1 (maximum dispersion).

The collected data refer to the current Italian situation and is updated to the month of August 2006.

4. Discussion of Findings

The research questionnaire was sent to:

- a sample of 50 Italian listed companies registered with the Italian Association of Internal Auditors (AIIA). More than one questionnaire was sent to each of the 50 listed companies for a total of 221 mailings. Thirty-five duly filled in questionnaires were returned by the due date (16% of the sample), representing 22 companies (44%). Each of the 35 questionnaires received and subsequently examined were filled in by people in charge of Internal Auditing;
- The questionnaires were sent to 130 chairmen of Boards of Statutory Auditors of Italian ‘for profit’ listed companies. Fifty-nine correctly filled questionnaires were returned giving a response rate of 45.4% of the considered sample;
- Questionnaires were sent to 119 partners of Auditing companies that signed a number of financial reports issued of Italian listed companies for the period ending on December 31, 2004. Twenty-one completely and correctly filled in were received back giving a response rate of about 20% of the sample.

Table 1 summarises the results of Section A of the questionnaire and focused on the aspects/items that could cause problems and/or limit the effectiveness of control activities. Table 2 summarises the answers of Section B of the questionnaire and focused on the main improvement actions to overcome limits and impediments to the control effectiveness as in Table 1.

Table 1 – Relevance of aspects / factors that cause problems or limit the effectiveness of control activities as perceived by Internal Auditors (IA), Statutory Auditors (SA) and External Auditors (EA)

Aspects / Factors	Mode			Median			Mean			d*		
	IA	SA	EA	IA	SA	EA	IA	SA	EA	IA	SA	EA
1. Technical aspects of controls (inadequacy of standards and methodologies)	2	2	2	3	2	2	3.28	2.59	2.29	0.61	0.57	0.49
2. Insufficient and non-systematic definition of control procedures and practices	4	2	1	4	3	2	3.85	2.81	2.24	0.48	0.58	0.52
3. Personal characteristics (shortage of technical preparation, experience, professional ethics, commitment, motivation and perception of the role)	5	2	1	4	3	2	3.89	3.07	2.48	0.58	0.67	0.65
4. Personnel management and policies (excess of workload and hierarchic pressure, turnover, incorrect incentives, limited flow of information)	5	2	1	4	2	2	3.58	2.63	2.19	0.57	0.56	0.49
5. Insufficient internal operational support by the other company functions and the other control bodies	4	3	4	4	3	3	3.81	2.91	3.10	0.51	0.53	0.49
6. Public policies and system factors ("gaps" in the regulations, in the role of authorities, in the juridical guidelines)	3	3	3	3	3	3	3.25	3.07	2.76	0.52	0.46	0.39
7. Indifference of the Board of Directors (or other management bodies)	6	4	5	5	3	4	4.56	3.37	3.57	0.61	0.65	0.63
8. Impediments put in place by the management to the flow of relevant information	5	3	3	5	3	3	4.32	2.92	3.24	0.55	0.64	0.74
9. Excessive "political" orientation	5	2	1	4	3	2	3.68	2.76	2.00	0.61	0.63	0.42
10. Inappropriate interest connections (lack of independence, conflicts of interest, inappropriate connections between auditors and audited people)	5	2	2	5	3	2	4.11	3.31	2.38	0.72	0.75	0.53

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Table 2 – Relevance of possible improvement actions as perceived by Internal Auditors (IA), Statutory Auditors (SA) and External Auditors (EA)

* Question not applicable to the considered role.

Actions	Mode			Median			Mean			d*		
	A	SA	EA	IA	SA	EA	IA	SA	EA	IA	SA	EA
11. Protection of the independence versus the audited functions (definition of clear forms of incompatibility with other roles or tasks)	5	4	*	5	4	*	4.5 0	3.9 0	*	0.5 6	0.6 5	*
12. Penalties strengthening in case of incorrect behaviour of process owners, managers and other controllers	5	1	6	4	2	5	4.0 3	2.2 7	4.3 3	0.5 4	0.5 8	0.7 4
13. Improvement in responsibility, through appreciating professional autonomy and critical judgment capability	5	4	*	4	4	*	4.3 2	3.8 1	*	0.4 0	0.5 0	*
14. Educational skills reinforcement through specialised training courses eventually practice oriented	5	2	2	4	3	2	3.9 1	3.2 2	2.5 7	0.4 5	0.5 6	0.5 2
15. Widening horizons of education paths with higher attention to professional ethics	3	3	2	3	3	2	3.1 5	3.3 4	2.2 4	0.4 2	0.6 0	0.4 6
16. Increase in the number of more detailed rules, standards and manuals with reference to different sectors specificity	4	3	4	3	3	2	3.2 4	3.3 7	2.4 8	0.4 7	0.6 1	0.5 4
17. Streamlining duties focusing on the most important aspects of controls	4	4	4	4	4	4	4.0 9	4.0 8	3.2 4	0.5 2	0.5 1	0.5 2
18. Introduction of transparency measures and thorough communications of audit results	4	4	2	4	4	2	3.9 7	3.6 1	2.5 2	0.4 8	0.5 3	0.5 3
19. Double checking the results of the control systems through	3	3	1	3	3	2	3.4 7	2.9 7	2.4 3	0.5 3	0.6 0	0.6 5

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sample inspections of their effectiveness entrusted to independent bodies												
20. Increasing public supervision authority powers and resources	3	2	2	3	2	3	3.2 6	2.5 9	2.7 6	0.5 1	0.5 4	0.5 5

Internal Auditors

The governance issue is considered a decisive factor for the failure of controls, especially in terms of relationship between the different control bodies, the management and the IA function (7, 8 and 10). As a proof of the great importance of the governance issue, it was put at the centre of the subjects treated by the above mentioned Law 262/05. A greater transparency of the information chain, in particular, represents one of the key elements on which the Italian legislator insisted to prevent market information asymmetries. Issues viewed relatively less relevant, are, organisation and policies of the personnel in charge of the IA function (4), technical aspects of the audits (1) and public policies, together with system factors (6). The areas considered more relevant and hence candidates for main improvement actions are: protection of Internal Auditors independence (11), appreciating and making them more responsible for their role (13), streamlining auditors' duties (17) and strengthening penalties for incorrect behaviours of process owners (12).

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Statutory Auditors

Only three out of the ten questions proposed to the respondents (3, 6, 7) are considered "relevant enough", based on the meaning assigned to the results, by the Chairmen of the Boards of Statutory Auditors. The control that belongs to the Board of Statutory Auditors concerns the processes of decision making and choice making by managers and people delegated by them, the information and the components considered, the reasons that generated them, their conformity to provisions of the law and the statute. Namely, such a body must verify that the suggested choices are reasonable, appropriate and compatible with the company's resources and assets, therefore creating a control that has been defined by many sources as "substantial legitimacy" control (Gallucci, 2006).

The "improvement" actions considered more relevant are: streamlining of auditors duties (17), protection of the independence of SA with reference to controlled functions (11), making statutory auditors more responsible and appreciating their role (13) and introduction of transparency measures and thorough communications of audit results (18). It is really interesting an interesting fact that according to the opinion of Statutory Auditors, the three top improvement proposals are the same as those identified by Internal Auditors, even though inversely classified in terms of relevance. This point, together with the regulation factor, could be interpreted as a sign, coming from the SA, of the need to focus their control activities on the 'most critical' aspects, while today they are quite 'broad-based' on the current regulations,.

External Auditors

For EA only three out of the ten aspects proposed to the respondents gained an average score higher than three and are therefore considered “relevant enough” by the consulted auditors. It was the same for SA. The largest issues related to the auditing activity may come from the indifference of management bodies towards the activity performed by the auditors (7), as well as from an insufficient internal support of the activities focused on drafting the audit or certification report (5). The inappropriate interest connections or the excessive “business” orientation of auditing firms are not perceived as possible issues.

The most relevant aspects identified by external auditors with reference to improvement actions are: strengthening penalties (12), streamlining bureaucratic duties (17), increasing public supervision authority powers (20) and reinforcing auditors’ education (14). The penalty theme is evidently judged of primary importance, taking also into consideration the scandals that involved some auditing firms during the last years; penalty can therefore be seen as a deterrent that give some kind of further “assurance” to the auditors’ actions. The “new” ERM (Enterprise Risk Management) model, as a logical evolution of the former CoSO (Committee of Sponsoring Organisation of the Treadway Commission Report) model, could therefore contribute to reduce most of the limits and problems related to the execution of control activities (Table 1), by affecting the improvement components (Table 2).

5. Conclusions

The first five paragraphs deal with specific comments as to the answers obtained by IA, SA and EA. As far as the IA function is concerned Italy is currently going through a “significant evolution” phase, both in terms of its duties and in terms of its relationships with other control bodies; this function could (should) hopefully “favour”, in perspective, the work of the “new” role of manager in charge of issuing company’s accounting and financial reports, actively collaborating with this person. The perception of people working within the IA function, the main issues that limit the effectiveness of their action have been identified, such as: indifference of the Board of Directors towards the IA activity; impediments to the information flow; inappropriate interest connections; personal characteristics; insufficient and non-systematic definition of control procedures and practices; insufficient operational support by other company functions and control bodies.

To meet the mentioned challenges, more relevant actions aimed at improving the control effectiveness are summarised, for example: independence protection; appreciation and formalisation of (responsibilisation) of their role; penalty strengthening for incorrect behaviour by process owners and need for greater information transparency on control subjects. The main issues identified by SA as limiting their control effectiveness are the following: indifference of the Board of Directors towards their activity, personal characteristics, public policies and system factors, impediments to the information flow. As possible improvement actions: streamlining auditors’ duties; focusing them on the most relevant aspects of control; independence protection; formalisation of their responsibilities and increase in professional autonomy. EA identified the insufficient internal operation support as one of the issues that could undermine

the control effectiveness, besides the ones related to the indifference of the Board of Directors and the impediments put in place by management. Strengthening penalties for incorrect behaviour of process owners, managers and possible other controllers, together with streamlining auditors duties, are classified as the main and most important improvement actions.

The remaining paragraphs cover cross conclusions. The general perception of interviewed people is that the control framework of company and the role of the different professionals in charge are not without “grey areas” issues and related improvement areas. It is suggested that in coming few years, it will be possible to check the outcome of the recent reforms through the examination of listed company financial statements within the framework in which the information is required by the mentioned supervision bodies and recent law provisions relating to such reporting requirements. A continuous and active collaboration between the three studied subjects/bodies, managing the related possible role overlaps, is a key step to improve and fix current critical issues in the area of control.

Secondly, the aspect that perhaps strikes more, again in the general perception of interviewed people, is the indifference behaviour of the Board of Directors toward the IA and control activity. For all the three interviewed bodies, this is the key issue / impediment for a real and effective working of the new IC system. This is being made even more critical, in the case of Internal and External Auditors, by the existence of impediments put in place by management to the flow of information relevant for the purpose of control. Such a situation should make us re-think. The emerging fact is that there is still a presence of management bodies that did not perceive the “positive” value of controls and that maybe find themselves dealing with them, trying to minimise their interferences with the management and in terms of activity execution. And that is valid also, even though in a minimal way, in the case of SA. From this point of view, it is not astonishing the fact that the recent business aggregations, with the related needs to rethink corporate governance structures, tend to implement solutions typical of the German system, characterised by the presence of a Management Council and a Supervision Council, where the last one surely appears to be a body equipped with greater powers, operating areas and functions, if compared with the Board of Statutory Auditors.

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