

INTERNAL AUDIT RISK ASSESSMENT AND LEGAL RISK: FIRST EVIDENCE IN THE ITALIAN EXPERIENCE

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Abstract

The objective of this article is to analyze how Italian Firms comply with the Internal Audit rules regarding the administrative liability of entities and to explain what the effect on the organizational structure was. In particular we collected data from 21 companies listed on the S&P/MIB index by sending a questionnaire to each Internal Audit Director. We show the features of internal audit system required by the 231 Italian Decree and how risk assessment and internal audit could serve as Corporate Governance Instruments. The 231 Italian Decree, like the *Sarbanes-Oxley Act* enhances and extends companies' accountability, transparency and integrity especially in business conduct. The innovativeness of this work is due to the idea of considering these elements as influential for the risk management optimization. As a consequence, a risk reduction can be achieved by improving the organizational and management models. Thought is commonly accepted that the risk optimization leads to a reduction of the cost of capital for the enterprise, there is a difficulty in estimating how much the value provided could be.

Keywords: Internal Audit, Risk Assessment, Legal Risk

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+ "Even if this paper is the result of the shared research of all the authors, paragraph 1 can be attributed to A. Miglietta – Project Coordinator – paragraph 2 can be attributed to M. Anaclerio and paragraphs 3-4-5 can be attributed to C. Bettinelli."

1. Introduction and Objectives

This work aims to investigate how Italian Listed Firms comply with the Internal Audit rules regarding the administrative liability of entities. We considered a group of companies listed on the Italian Stock Exchange at the S&P/MIB Index. The S&P/MIB index shows the trend of equities which are selected considering their liquidity, their free float and their sector representation. It is the new benchmark for the Italian stock market.

The analysis of this group is important to value the Internal Audit efforts implemented after the Legislative Decree 231/2001 which regards the administrative liability of corporations. Under this law the company is liable for crimes committed in its interest or to its benefit by individuals who represent, administer or manage the Company. The crimes which determine the administrative liability of the companies are illustrated in Appendix 1, consider for example: embezzlement detrimental to the State, extortion, misappropriation of public funds (*peculation*), Market Abuse, fraud, corruption, false corporate communications, impediment to control, illicit distribution of profits and reserves etc..

The Company is exempt from liability for the crimes committed by the aforementioned individuals,

if it proves it has adopted and effectively implemented appropriate *organizational and management models* to avoid the crimes. Furthermore it has to have charged an *internal Board* (i.e. Supervisory Body) with monitoring the functioning of and compliance with the models adopted.

The exemption from administrative liability for crimes is, for enterprises, an opportunity to reduce the risk of legal action, lawsuits or juridical proceedings (*legal risk*).

This means that managers can reduce the probability of negative situations and of losses due to Pecuniary penalties, Disqualification penalties, Confiscation and Filings of judgment.

The reduction of *legal risks* is allowed only if the company has implemented organizational and management models which prevent the crimes, this implies an improvement of the Internal Audit Function. Our objective is to show that there are some important connections between these factors, in particular we will illustrate that legal risk can be reduced if the company puts into practice a Risk Assessment Process and an efficient Internal Audit System. These synergies led to the abovementioned risk-reduction which is fundamental for the creation of shareholders value by reducing the cost of capital.

2. Internal Audit and Italian Legislative Decree n. 231

The growing attention that companies operating on the Italian Market now dedicate to problems relating to internal control systems is a significative sign of the fundamental importance that such systems have on the smooth running of the companies themselves.

The need to better and optimize company risk assessment as a critical factor in achieving their own strategic aims, the international and national scandals, often a result of the weak internal control systems of the companies involved and the general inadequacy in the running of the same, as well as the frequent problems of internal revision, organization on behalf of the administrators and management responsibility, are all factors to be considered positive and stimulating because aimed at improving the administration of our companies, in respect of the normative and the interests of all the stakeholders.

Undoubtedly the companies that have from the beginning shown more sensitivity to such problems are those quoted on the Stock Exchange, the majority of which have thought it best to adapt themselves to the indications given in the "Codice di Autodisciplina" (Code). Although not a binding rule for the companies – that remain free to adhere – the Code (recently reviewed in March 2006) has gained the merit of propagating in our economic system the principles of 'best practice' in matters of corporate governance, as a system of pre-arranged rules on the planning, management and control of the company activity in its various aspects. In particular, a large part of the non-obligatory normative in the Code refer to the problems regarding the role, the composition, the performance and the responsibilities of the board of administration as well as the adoption of an adequate internal control system, with "rules, procedures and structural organization in order to consent, by means of an adequate procedure of identification, measure, management and observation of the principle risks, a healthy company conduction, that is correct and coherent with the aims that have been fixed in advance".

Given the entity and the involvement of the structure of the company, the Code provides the board of administration with the assistance of an Audit Committee for the definition of the guide lines of the internal control system as well as for the periodical rating of its adequacy. Furthermore, in order to guarantee even better operative coordination between the Board of Administration and the Audit Committee, the nomination of an Executive Administrator has been recently suggested with the job of supervising the smooth running of the internal control system. In particular, his duties regard the identification of the principle company risks, the execution of the guide lines defined by the Board of Administration and the proposal of the figure of a responsible for Internal Audit.

It is clear that this last intervention introduces the necessity to form an Enterprise risk management,, beginning with the more complex company organizations, with the duty to render the management of company risk a "corporate" aim.

The adoption of systems of company management characterized by an optimization of risk management has slowly but surely touched even those companies that are not quoted on the Stock Exchange, becoming a necessity felt more and more by medium enterprises that operate in our economic system. Such a necessity embraces moreover the regime of responsibility of the administrators disciplined by Art. 2381 c.c, in terms of adequacy of the organizational, administrative and accountancy system of the companies.

Theoretically the civil code provides for a Board of Auditors with the responsibility of supervising the adequacy of the system of internal control.

In such a context can be placed the D.Lgs. 231/2001, that introduce into our regulations the discipline of the administrative responsibility of corporations for a series of crimes – peremptorily foreseen by the decree – committed in their own interests by those that hold posts of representation, administration or direction of the same.

The innovation consists in the fact that if such crimes are committed in the interests of the company, as well as the person or persons who have committed the offence being held personally responsible, the company must respond with heavy financial and / or administrative penalties. This regime of responsibility is applicable only for certain types of crimes: offences against the public administration, company offences, offences against public trust, terrorism, subversive behaviour and crimes against individuals.

The D. Lgs.231 is substantially an 'open' normative in the fact that it is subject to continuous integration and up-dating according to the type of responsibility. However the legislative decree does leave a loop hole in that there is a possibility that the company will not have to respond if it can prove that:

1. The Board had adopted and successfully implemented, before the date of the offence, an appropriate organizational, management and control model to avoid the crimes.
2. The supervision of the functionality and the observance of the organizational model has been attributed to Internal Board (supervisory Body) that has freedom of initiative and of control.
3. Someone has committed the crimes eluding in a fraudulent way the organizational model.
4. There has not been insufficient supervision on behalf of the Supervisory Body.

It is possible to note how the adoption on behalf of the company of precautionary methods in order to protect themselves from the risk of crimes being committed, does not in any way constitute an obligation, only for the fact of not having adhered to

the indications in the legislative decree. The implementation of the organizational model constitutes rather the opportunity for the company to revisit that part of the internal control system that gives it the possibility of having an adequate management and risk assessment against those offences specifically foreseen by the D.Lgs. 231, and therefore a minimization of the impact that these would have on the company itself. Therefore, even if there is no normative obligation for an adequate internal control system, it is obvious that the companies that are more sensitive to a culture of company assessment will not want to underestimate this.

It is possible therefore to assert that Internal Audit and organizational, management and control model according to the D.Lgs 231/2001 are fundamental in the context of an optimal management of the company. The risk assessment of the company in all of its aspects and possible manifestations is undoubtedly a necessary condition in order to reach the company aims efficiently and successfully. A company that does not adopt an adequate management system, that permits it to plan its aims and to verify this, by means of a system of regulations and structures oriented to optimize its risk profile, will have difficulty in expanding and resisting competition.

It is certainly obvious though that an optimal internal control system and the necessary up-dating for a functionality has certain costs for the company (not only financial costs, but also in terms of impact on the organizational structures). But it is also true that the company will benefit in terms of risk profile. The adoption of adequate control procedures, will allow the company to reduce its exposition to risk of economical and patrimonial loss caused by those who operate within the company itself.

It is interesting to see how such considerations take on certain relevance on the value generation of the company. In fact on an equal basis of free cash flow generated by management, the company that is able to contain its risk profile, thanks to an adequate internal control system, will be able realize that same cash flow at a tax rate - expression of the cost of the capital in its two components (Equity and Debt) - more content and therefore with a less reduction in generated economic value in respect to those companies with a higher risk profile.

Finally, related to such a theory is the relevance that the risk profile of the company has on the rating placement and the credit merit according to "Basilea 2".

Among the elements and facts that the Financial Institutions take into consideration for the rating, are those of a qualitative nature that can lead back to the governance system adopted by the company and the adequacy of its administration and its accountancy. A company that is found lacking under this profile would certainly benefit from a lower rating and consequently a heavier financial cost, with a higher

impact in terms of devaluation in the generated financial flow.

3. Theory and literature review

Corporate Governance has become an important issue because business activities are nowadays a concern not just for shareholders, but also for the community in general, influencing individuals' savings and investment decisions (Abrahami 2005)¹. In fact Corporate Governance means both directing the company as efficiently as possible and managing the broader responsibilities the company has with its stakeholders. These relationships are the core subject of present laws in force both in the United States and in Europe.

The American experience demonstrates that the *Sarbanes-Oxley Act* (SOA) compliance is a vital device that binds large international and local companies to enhance and extend their accountability, transparency and integrity especially in business conduct and financial reporting. The Sarbanes Oxley Act has a direct and severe impact on all US listed companies which have to fulfil particular obligations regarding information storage, business intelligence, data warehousing, documents management and internal audit. The SOA is mainly dedicated to the following arguments:

Public Company Accounting oversight board, Auditor Independence, Corporate Responsibility, Enhanced Financial Disclosures, Analyst Conflicts of Interest, Corporate and Criminal Fraud Accountability, White Collar Crime Penalty enhancements, Corporate tax returns, Corporate fraud and accountability. Considering the topic of this article, the most significant sections of the Sarbanes-Oxley Act are Sections 302 (Corporate responsibility for financial reports) and 404 (Management assessment of internal controls).

In accordance with Section 302 the principal executive officer is responsible for establishing and maintaining internal controls, has to design such internal controls to ensure that material information relating to the issuer is made known to such officers by others within those entities. Moreover he/she has to present in the report, conclusions about the effectiveness of internal controls.

The signing officer has to also disclose this information to the issuer's auditors and the audit committee of the board of directors.

Moreover Section 404 imposes the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting. It also requires an assessment of the effectiveness of the internal control structure and procedures. The SOA is a complex issue and it concerns all the aspects of

¹ Abrahami, A. 2005 "Sarbanes-Oxley Act Compliance" in *Management Services* 49 (3) :28:32

the company, notwithstanding this, it must to be considered that internal controls are pivotal to the Sarbanes-Oxley Act compliance.

Surely there are a lot of important similarities between the United States and European Union's corporate laws. In the Italian case, most of the rules contained in the SOA are foreseen in a similar manner to those in the Civil Code, in the Legislative Decrees No.58 of the year 1998 and No.231 in 2001, furthermore in Law No. 262 of 2005 ("law for the protection of savings"). It is possible to find a strong resemblance between the SOA and the Legislative Decree 231 taking into consideration that to comply in practice with the Sarbanes-Oxley Act, many companies formed corporate project management teams, frequently consisting of existing internal audit staff.

This kind of team typically has to draw up a personalized structure and methodology for assessing the company's internal control, the setting of projects, strategies and timescales (McNelly and Stephen 2005)². In the report issued by Deloitte & Touche³ it is argued that in the *Sarbanes Oxley era*, Internal audit appropriately structured, can provide great value to an organization, influencing both regulatory compliance and operational excellence. As a matter of fact, internal auditors can reduce costs for the company, by improving accounting controls, financial examinations and organizational support.⁴ As a consequence Wallace (1984) found that the savings that the companies could achieve in bolstering the work of the internal audit (IA) function averaged 10 percent of the independent and external audit fees. In the transaction cost perspective (Williamson 1975,1979,1991)⁵ it would be very expensive for an external IA provider to get the knowledge necessary to perform IA tasks while the firm may already possess the internal knowledge from its functioning activities (Lindow and Race 2002)⁶.

² McNelly, J.S. Wagaman D.D.2005 "Hard Climb is Done, But Trek Continues :Sarbanes Oxley Compliance in Year Two and Beyond" in Pennsylvania CPA Journal.76 (3):1-4

³ Optimizing the Role of Internal Audit in the Sarbanes-Oxley Era, second edition 2006, Deloitte & Touche Report

⁴ Wallace, W.1984 "Internal Auditor can cut outside CPA costs" in Harvard Business Review, 62 (2) 16:20

Wallace, W.1984 "Internal Auditor can reduce Independent audit fees" in Journal of Accountancy, 158 (4) 172:175

⁵ Williamson. O. E. 1975. *Markets and Hierarchies: Analysis and Antitrust Implications*. New York, NY: The Free Press. Williamson. O. E. 1979. "Transaction-cost economics: The governance of contractual relations" in *The Journal of Law and Economics* 22 (2) 233:261. Williamson. O. E. 1991. "Strategizing, economizing, and economic organization" in *Strategic Management Journal* 12 (8) 75:94.

⁶ Widener S.K., Selto F.H. 1999 "Management Control Systems and Boundaries of the Firm: Why do Firms Outsource Internal Auditing Activities?", in *Journal of*

Accordingly with the Agency Theory (Jensen and Meckling 1976)⁷ agency costs are generated by the conflict of interest and information asymmetries between owners and managers of the firm.

In this view IA, may also serve as a monitoring answer to agency costs (Anderson et.al 1993; De Fond 1992; Carey, Simnett and Tanewski 2000)⁸. The Committee of Sponsoring Organizations of the Treadway Commission's (COSO) defined internal control in an effective manner which could be useful to explain the relationship between internal audit and risk assessment. The COSO definition of internal control expands the internal audit's traditional activities, such as practices focused on policies and procedures, to embrace additional elements focused on control environment, information, communication, risk assessment and monitoring. Auditors need more than a catalogue of controls to measure how management deal with risks. Some best practices to be considered are monitoring business activities and performance indicators constantly coordinating with other organization's functions, building up the audit plan based on risk main concerns and getting involved in technology projects (Lindow and Race 2002)⁹. In other words, many internal auditors now offer more mixed control information and guidance than they did as traditional supervisors of only financial control situations (Widener and Selto 1999)¹⁰. An Internal Audit therefore regards how company's activities are managed, organized and monitored (Miglietta Anaclerio 2005)¹¹. The attribution of the risk management role is incorrect, in fact the IA should only *monitor* the risk management process (Protiviti 2005)¹². In the rational decision process, managers

Management Accounting Research, 11 45:73

⁷ Jensen M.C., Meckling W.H. 1976 "Theory of the firm: Managerial behaviour, agency costs, and ownership structure" in *Journal of Financial Economics* 3 305:360

⁸ Carey P., Simnett R., Tanewski G. 2000 "Voluntary Demand for Internal and External Auditing by Family Businesses" in *Auditing: a Journal of Practice and Theory* 19 37:51; Anderson, R. Francis J.R., Stokes D.J. 1993 "Auditing, directorships and the demand for Monitoring" in *Journal of Accounting and Public Policy* 69 (12) 353:375; DeFond, M. L. 1992 "The association between changes in client firm agency costs and auditor switching" in *AUDITING: A Journal of Practice & Theory* 11, 16:31.

⁹ Lindow P.E., Race J.D.2002, "Beyond Traditional Audit Techniques" in *Journal of accountancy* 194 (1) 28:33

¹⁰ Widener S.K., Selto F.H. 1999 "Management Control Systems and Boundaries of the Firm: Why do Firms Outsource Internal Auditing Activities?", in *Journal of Management Accounting Research*, 11 45:73

¹¹ Miglietta A. Anaclerio M. "Il D.Lgs 231/01 sulla responsabilità amministrativa degli Enti per le PMI: problemi o opportunità per essere più competitivi?", *Convegno Ordine Dottori Commercialisti di Bergamo*, 5 aprile 2006.

¹² Protiviti Independent Risk Consulting 2005, "Barometro dei Risk e del Risk Management italiano" prima edizione Protiviti Inc.

are likely to choose an internal and external control mechanisms combination that maximizes their profit or utility (Jensen and Payne 2003)¹³. For this reason we argue that the IA is strongly connected with strategic management decisions.

According to Woods Brinkley from the Bank of America Corporation, a good risk management is the aptitude to recognize the intended and unintended consequences of the company's actions and strategies. It's a constant activity and, in part, the role of every member of the team¹⁴.

Enterprise Risk Management (ERM) calls for supervision of a company's complete risk selection rather than for many different supervisors managing specific risks.

With ERM a company sets up risk definitions and acceptance levels, it classifies procedures to determine and calculate risks and creates monitoring activities. It is indispensable to value the impact which risks associated with any project can have on the whole business (Banham 2004)¹⁵. The creation of Organizational Models for risk management requests the introduction of the risk element in the planning and control budgets (Colombo and Cencioni 2005)¹⁶. In order to defend assets and create shareholder value, managers should consider enterprise risk management. Several current business failures are due to senior level misjudgement and mismanagement of risk, unsuccessful *risk* management puts strong business models in danger.

Drew, Kelly and Kendrick (2006) present a model of corporate governance composed of five elements which can support an approach to corporate risk and help in risk management. Those elements are Culture, Leadership, Alignment, Systems, and Structure, they should encourage the addressing of the *complexities* of risk in meeting strategic objectives¹⁷. Strategists should be interested not only in how risks are distinct and measured, but also in how they are included in the decision making (Drew and Kendrick 2005)¹⁸. Moreover, it is argued that Enterprises that have a corporate risk management approach have also an ethical culture indeed in this age of high risk, the accomplishment

of such a culture entails a longer-term cultural shift (Ewing and Lee 2004)¹⁹.

Even though internal auditors perform many activities and duties that are unrelated to corporate business accounting information systems, many of their responsibilities are related directly to the creation and *monitoring* of accounting information (Moeller and Witt 1999)²⁰.

One of the *primary responsibilities* of internal auditors is to test, evaluate and make recommendations regarding an organization's accounting system and its internal accounting controls. By doing so, internal auditors reduce the risk of fraud and protect assets from theft or loss. Internal auditors generally perform similar activities with similar benefits, particularly when they rely on an organization's internal control. Indeed both internal-and external-auditing texts devote attention to the importance of coordination between internal and external auditors to prevent duplication of effort (Moeller and Witt 1999, Knechel 2000²¹, Jensen and Payne 2003, Widener 1999).

In other words, overall responsibility for enterprise risk is changing not only because of a strategic management initiative but also because of *law* requirements and rules. Both of them require the internal audit function in a company to monitor and evaluate the effectiveness of control systems and the company's risk assessment. The 231 Legislative Decree, by stating the administrative responsibility of the Entities, resolves the problem highlighted by Pae and Yoo²² (2001). The authors argue that when the external auditor liability is excessive firms are willing to under invest in their internal control systems.

4. The Italian Case

Our research was aimed to analyze how the companies were attempting to comply with the Italian Legislative Decree 231 and to explain what the effect on the organizational structure was. In particular we collected data from 21 companies listed on the S&P/MIB index by sending a questionnaire with 51 questions to each Internal Audit Director.

All of them have implemented appropriate *organizational and management models* described

¹³ Jensen K.L., Payne J.L. 2003, "Management Trade-Offs of Internal Control and External Auditor Expertise" in *Auditing: a Journal of practice & theory* 22 (2) 99:119

¹⁴ Brinkley Woods et.al in *Corporate Board*, 2006, 27 (157), 30:30;

¹⁵ Banham R. "Enterprising Views of Risk Management" in *Journal of Accountancy*, 2004, 197 (6), 65:71

¹⁶ Colombo I. Cencioni A. 2005 "Un modello per il controllo integrato della gestione e del rischio" in *Amministrazione & Finanza* 19 33:40

¹⁷ Drew S.A.W.; Kelley P.C.; Kendrick T. 2006 "CLASS: Five elements of corporate governance to manage strategic risk" in *Business Horizons*, 2006, 49 (2), 127:138

¹⁸ Drew S. A. W.; Kendrick T. 2005 "Risk management: the five pillars of corporate governance" in *Journal of General Management*, 31 (2), 19:36

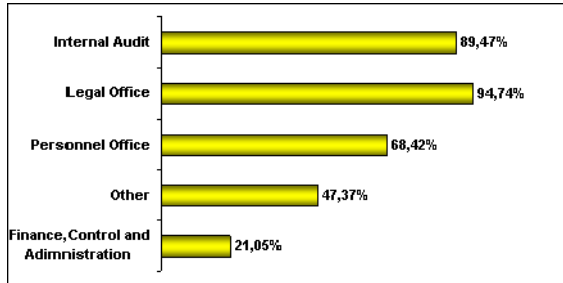
¹⁹ Ewing L.J.; Lee R. B. 2004 "Surviving the Age of Risk: A Call for Ethical Risk Management" in *Risk Management*, 2004, 51 (9), 56:58,

²⁰ Moeller R. Witt. H. 1999. "Brink's Modern Internal Auditing". Fifth edition. New York, NY: John Wiley & Sons Publishing.

²¹ Nichel W. R. 2000. "Auditing: Assurance and Risk". Second edition. Cincinnati, OH: South-Western College Publishing.

²² Pae S., Yoo S.W. 2001 "Strategic interaction in Auditing :An Analysis of Auditors' Legal Liability, Internal Control System Quality, and Audit Effort", in *The Accounting Review* 76 (3) 333:356

by Italian Legislative Decree 231. As shown on Graph 1 the companies examined referred in prevalence to their internal existing departments (Internal audit, Legal Office, Personnel Office, Finance, Control and Administration).

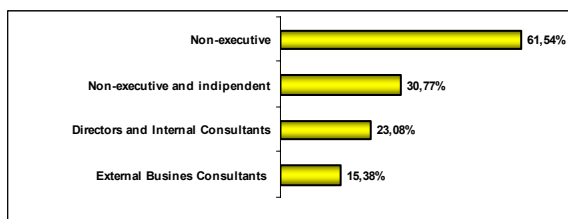


Graph 1. Departments involved

Anyhow, 90.5% combined with the abovementioned internal functions, some external consultants such as lawyers (47.37%), external auditors (36.84%), Business Consultants (21.05%) or Chartered Accountants (5.26%). The implementation of the models required in 76.19% of cases more than 6 months. In the 66.7% of companies examined there is already an *internal Board* (i.e. Supervisory Body) with monitoring functions of the models adopted.

The Internal Board (Graph 2) is composed predominantly by non executives (61.54%), non executives and independents (30.77%), directors, consultants and managers (23.08%), external Business Consultants (15.38%).

This means that the internal board is prevalently composed of internal members. Our findings are confirmed by a similar research made by the Internal Auditors Association²³ where it is shown that the Internal Board has a majority of internal auditors and only 12% of external consultants.

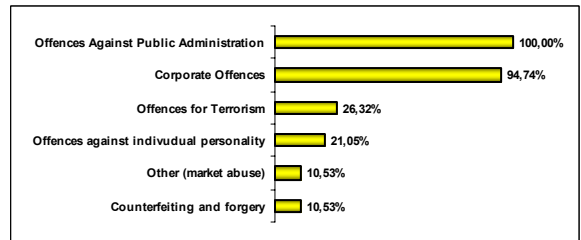


Graph 2. The composition of the internal board

In 52.5% of cases the Internal Board is assisted by external consultants which have to report exclusively to the Board. In all cases the Internal Board must report to the Board of Directors.

²³ “La responsabilità amministrativa delle società” research made by the Pisa University and the Italian Association of Internal Auditors (IIA), they considered 97 listed companies (Italian Stock exchange) the survey is available on www.iiaweb.it.

The companies declared to consider the following kind of *legal risks* as more incident on their activities: offences committed to the prejudice of the Public Administration (100.00%) and corporate offences (84.74%). Graph 3 shows the complete list of crimes including offences such as counterfeiting, forgery, offences committed for the purpose of terrorism or subversion of democratic order; offences against individual personality and Market abuse²⁴.



Graph 3. Legal Risks recognized

With reference to the types of offences indicated above, which are liable to entail a *legal risk* due to the administrative liability of the company, “sensitive” activities (i.e. Risk areas) have been identified, and broken down between those relating to: Purchase department (88.24%), Administrative and Bookkeeping Department (76.47%), Personnel department (64.71%), Finance and Control Department (58.82%), and others (17.65%).

Four Companies out of five intervened specifically in the aforesaid Risk Areas improving the internal process, the delegation schemes, the informative systems, and the whole organizational structure. The most remarkable result is that all the companies recognized that the implementation of some organizational models aimed to improve internal control effectiveness could also improve the risk-management process. Notwithstanding this, we found that it is difficult for all the enterprises to estimate and value how much this reduction would reduce the costs on capital. More than 94% declared that it is impossible to estimate the legal risk reduction due to the implementation of the 231 Legislative Decree model, internal audit system and internal board. In other words there is not, at this moment, the capacity to quantify the value created by the improvement of the Internal Audit System.

5. Conclusion

We considered a group of companies listed on the Italian Stock Exchange at the S&P/MIB Index to

²⁴ These results and the ones of a survey made by the IIAA and Ernst & Young are very much alike, indeed they found that Offences against Public Administration and Corporate Offences were the most probable. The survey was done considering 72 listed and unlisted Italian companies, it is available on www.iiaweb.it.

value the Internal Audit efforts implemented after the Legislative Decree 231/2001 which relates to the administrative liability of corporations. Under this law the company is liable for crimes committed in its own interest or to its benefit by members of the Company.

The Company is exempt from liability for the crimes committed by the aforementioned individuals, if it proves it has adopted and effectively implemented appropriate *organizational and management models* to avoid the crimes. Furthermore it has to have charged an *internal Board* (i.e. Supervisory Body) with monitoring the functioning of and complying to the models adopted.

The exemption from administrative liability for crimes is, for enterprises, an opportunity to reduce the risk of legal action, lawsuits or juridical proceedings (*legal risk*).

This implies an improvement of the internal audit function and the creation of a risk assessment process.

The interaction of internal audit and risk assessment with legal risk leads to the creation of a shareholder value, by reducing the cost of capital and of stakeholders value by reducing the probability of crimes.

For these reasons the goal of a risk management optimization implies a strategic risk factors analysis. The Italian 231 decree, like the Sarbanes Oxley Act, is a device to develop accountability, transparency and integrity of companies. Moreover internal controls are also pivotal to the compliance of the Sarbanes Oxley Act.

We illustrated how Internal audit appropriately structured, can provide great value to an organization, influencing both regulatory compliance and operational excellence. As a matter of fact, internal auditors can reduce costs for the company, by improving accounting controls, financial examinations and organizational support (Wallace 1984).

In the rational decision process, managers are likely to choose an internal and external control mechanism combination that maximizes their profit or utility (Jensen and Payne 2003). For this reason we argue that the IA is strongly connected with strategic management decisions. With Enterprise Risk Management a company sets up risk definitions and acceptance levels, it classifies procedures to determine and calculate risks and creates monitoring activities. Strategists should be interested not only in how risks are distinct and measured, but also in how they are included in the decision making (Drew and Kendrick 2005). As regards the evidence in the Italian Experience we collected data from 21 companies listed on the S&P/MIB index by sending a questionnaire with 51 questions to each Internal Audit Director.

All of them have implemented appropriate *organizational and management models* described by Italian Legislative Decree 231. The companies

examined prevalently referred to their internal existing departments (Internal audit, Legal Office, Personnel Office, Finance, Control and Administration). Anyhow, 90.5% combined with the abovementioned internal functions, some external consultants. The Internal Board (Graph 2) is composed predominantly by non executives. In 52.5% of cases the Internal Board is helped by external consultants who have to report exclusively to the Board. In all cases the Internal Board must report to the Board of Directors.

The companies declared to consider the following kind of *legal risks* as more incident on their activities: offences committed to the prejudice of the Public Administration (100.00%) and corporate offences (84.74%). "Sensitive" activities (i.e. Legal Risk areas) have been identified, and broken down between those relating to: Purchase department (88.24%), Administrative and Bookkeeping department (76.47%), Personnel department (64.71%), Finance and Control Department (58.82%), and other (17.65%).

Four Companies out of five intervened specifically on the aforesaid risk areas by improving the internal process, the delegation schemes, the informative systems, and the whole organization structure.

One of the most noticeable results is that all the companies recognized that the implementation of some organizational models aimed to improve the internal control effectiveness could also improve the risk-management process. Notwithstanding this, we found that it is difficult for all the enterprises to estimate and value how much this reduction reduces the cost of capital.

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Appendix 1

THE ITALIAN LEGISLATIVE DECREE N.231/2001

The Italian Legislative Decree includes the following crimes which determine administrative liability of the companies:

CRIMINAL CODE

- Article 316-bis** Embezzlement detrimental to the State
- Article 316-ter** Undue obtainment of grants detrimental to the State
- Article 317** Extortion
- Article 318** Bribery for the performance of official duties
- Article 319** Bribery for the performance of acts contrary to one's official duties
- Article 319** Bribery for the performance of acts contrary to one's official duties (aggravated pursuant to Article 319-bis)
- Article 319-ter** Bribery for the performance of judicial acts
- Article 320** Bribery of a person responsible for public services
- Article 321** Penalties for bribers
- Article 322** Incitement to bribery
- Article 322-bis** Misappropriation of public funds (*peculation*), extortion, bribery and incitement to bribery of members of the boards of the European Communities and of officials of the European Communities and Foreign Countries
- Article 640, paragraph 2, no. 1** Fraud
- Article 640-bis** Aggravated fraud for the obtainment of public grants
- Article 640-ter** IT fraud
- Article 453** Forgery of money, concerted spending and introduction into the State of counterfeit money
- Article 454** Counterfeiting of money
- Article 455** Non-concerted spending and introduction into the State of counterfeit money
- Article 459** Falsification of stamp duties, introduction into the State, purchase, possession or circulation of counterfeit stamp duties
- Article 460** Counterfeiting of watermarked paper used to make instruments of public credit or stamp duties
- Article 461** Making or possession of watermarks or instruments used for the counterfeiting of money, stamp duties or watermarked paper
- Article 464, paragraph 1** Use of counterfeit or falsified stamp duties
- Article 464, paragraph 2** Use of counterfeit or falsified stamp duties
- Article 270-bis** Associations for purposes of terrorism and for subverting democratic order
- Article 280** Terrorist attacks
- Article 600** Enslavement
- Article 600-bis** Juvenile prostitution
- Article 600-ter** Juvenile pornography
- Article 600-quater** Possession of pornographic material
- Article 600-quinquies** Tourism aimed at exploiting juvenile prostitution
- Article 601** Trafficking in persons
- Article 602** Sale and purchase of slaves

FINANCIAL LAW (TUF)

- Article 184** Information Abuse
- Article 185** Market Manipulation

CIVIL CODE

- Article 2621** False corporate communications
Article 2622 False corporate communications detrimental to shareholders and creditors
Article 2623 False representation in prospectuses
Article 2624 False representation in reports or notices by the accounting firm
Article 2625 Impediment to control
Article 2626 Undue refund of contributions
Article 2627 Illicit distribution of profits and reserves
Article 2628 Illicit transactions on shares or stakes of the Company or of its controlling company
Article 2629 Transactions prejudicial to creditors
Article 2632 Fictitious capital formation
Article 2633 Undue distribution of corporate assets by the liquidators
Article 2636 Illicit influence over the shareholders' meeting
Article 2637 Manipulation (*agiotage*)
Article 2638 Impediment to the performance of duties by public supervisory authorities

Regardless of the Company's administrative liability, if any, whoever commits one of the abovementioned crimes is personally and criminally liable for misconduct committed. Should the Company fail to prove the evidence above, it will be subjected to the following penalties:

Pecuniary penalties: from a minimum of € 25,823.00 to a maximum of € 1,549,371.00.

Disqualification penalties:
disqualification from conducting business;
suspension or revocation of authorizations, licenses or concessions functional to the commission of the crime;
disqualification from contracting with P.A.;
exclusion from facilities, loans, grants or subsidies;
disqualification from advertising goods or services.

Confiscation of the price or profits from crime.

Filing of judgment.