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THE STRENGTH OF AUDITING AND REPORTING STANDARDS IN RELATION TO FINANCIAL REPORTING QUALITY

Review Article

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Abstract

The quality of the accounting information is determined by many factors - internal and external to the firm. In this paper we focus on the strength of auditing and reporting standards (SARS), that is considered one of the influencing factors of financial reporting quality. Recently, more and more countries around the world choose to apply International Financial Reporting Standards (IFRS). Thus, the power of these standards is essential, because only with a comprehensive set of rules, clearly regulated and understood by their users, the effectiveness of these standards can be guaranteed. Our main objective is to analyse the strength of auditing and reporting standards theoretically and to describe its determinants. This paper contributes to the literature regarding the determinants of SARS and is relevant for several categories of users of financial information.

INTRODUCTION

The quality of the accounting information is determined by various factors internal and external to the firm, which may be divided into several categories. In accordance with Dechow et al *(*2010), the quality of the accounting information is influenced by the characteristics of the entity, financial reporting practices, governance and control systems, auditors, the incentives of the capital markets, as well as by other external factors (policies, taxation, legislation). The multitude of these factors determines the complexity of the financial reporting quality and causes difficulties in the way of defining this concept.

International Financial Reporting Standards are considered to be a set of high-quality accounting standards used in order to improve and uniformize the financial reporting. Under IFRS, accounting data is more easily comparable and harmonized. Recently, more and more countries choose to apply IFRS and IAS in the desire to realize the international accounting convergence and harmonization process. Accounting is often defined in the literature as being the 'language of business'. But there is one question that arises in regard to this: 'Can all the accountants from all over the world speak the same language?' (Grossman et al, 2013). Effective accounting standards offer the investors the possibility to have access and use qualitative, reliable and adequate financial information. That is why the strength of reporting standards is associated with the quality of the financial reporting. Under strong reporting standards, accounting information is more reliable and less manipulated.

In this paper, we focus on the strength of auditing and reporting standards in relation to the financial reporting quality. The remainder of the paper describes the concept of SARS, presents its determinants and emphasizes the role of SARS in determining the accounting quality.

GENERAL CONSIDERATIONS REGARDING THE STRENGTH OF AUDITING AND REPORTING STANDARDS

The increasing trend of globalization of businesses and markets requires higher quality financial information produced in accordance with strong auditing and reporting standards. Research demonstrates that earning quality is value-relevant. Firms with lower quality of earnings experience poorer future stock returns (Chan et al, 2001). Francis et al (2005) and Barth et al (2010) show that earning quality is associated with the cost of capital Firms with lower quality earnings have higher costs of capital, while firms with more transparent earnings benefit from a lower cost of capital. Also, the literature shows that country-level accounting quality is relevant to users of financial information (Boolaky et al, 2013; Hail and Leuz, 2006; Ang and Ciccone, 2001).

The strength of auditing and reporting standards (SARS) can be viewed as an integral component of institutional transparency that is relevant for businesses, investors and governments (Boolaky et al, 2013). Good accounting and auditing regulation improve institutional transparency through better disclosure of information and easier cross-firms comparisons. Strong regulations offer firms the incentives to provide investors with valuable and relevant information. If regulations are weak, firms may choose not to disclose information or to manipulate it. The risk arising from the lack of financial transparency is related to trade obstruction, portfolio decisions and direct investments of the capital-holders influencing the relations with third parties (suppliers, creditors, customers, employees, banks). Moreover, this risk is reflected on the governments, by the fact that they seek economic progress through the creation of a framework more attractive to foreign investments, and not only, and when the business environment is considered to have a high degree of opacity, this attractiveness drops dramatically.

The strength of auditing and reporting standards (SARS) is measured by the World Economic Forum using a survey that asks the leading business executives from 144 countries the following question: 'In your country, how strong are financial auditing and reporting standards?' The answer is based on a Likert scale, with one implying a negative answer to the question, and seven a very positive one. However, this indicator is not easily determined, because it is influenced by a multitude of factors. In the next section, we concentrate upon the determinants of SARS in order to capture the essence of this concept and understand its meaning.

DETERMINANTS OF THE STRENGTH OF AUDITING AND REPORTING STANDARDS

Studying the accounting literature, we find several studies regarding the strength of auditing and reporting standards (Boolaky et al, 2013; Boolaky and Cooper, 2015; Boța-Avram et al, 2015) which analyze the determinants of SARS at international level, in Europe, Asia and the United States of America. SARS is influenced by various factors, which have been analyzed for the first time by Boolaky et al (2013). The results show that the institutional infrastructure, the development of the financial market and the level of education and training, together, play an important role in shaping the strength of auditing and reporting standards at each country level. These results confirm once again what the literature in this field shows as being the determining factors of the SARS. Careful research of the literature shows that the institutional transparency is influenced by three major factors, as follows.

Firstly, the institutional infrastructure plays a key role in determining the institutional transparency (Boolaky et al, 2013). The institutional infrastructure can be classified into two categories: public and private. These categories include economic, legal and governance infrastructures. David and Brierley (1985) claim that the type and efficiency of a country's legal system influence the system of financial reporting. Salter and Doupnik (1992) take this idea further and claim that the political and legal infrastructure of a country impacts the accounting regulations. The same point of view is met at El Ghoul et al (2010), who demonstrate that the legal environment plays an important role in influencing the audit quality. Anyway, not only the public institutions influence the institutional transparency, but also the private companies. For example, in the USA, FASB is a private body responsible for drawing up accounting standards in order to ensure the transparency of financial reporting. Also, Berry and Holzer (1993) conducted a study on the restructuring of the accounting's functions in the developing countries and demonstrated that the private sector has an important role in relation to institutional transparency.

Ethics and corporate responsibility are the basic components of the power of private institutional infrastructure (Boolaky et al, 2013). Wright (1996) presents the empirical records for the first time with regard to the relationship between the credibility of financial reporting and the features of the corporate affairs. He uses the composition of the board of directors as an indicator of the quality of the corporate governance. Labelle et al (2010) analyze if between the level of corporate ethics and the quality of its financial reporting there is a connection. They are using the diversity of the management as a proxy for the ethical behaviour of the company and the earnings management as an indicator of the financial reporting quality. In this study, the hypothesis is that the companies which promote ethical behaviour in the conduct of their businesses processes, incorporates the interests of all categories of stakeholders, not only of their shareholders, and will tend to have a greater distaste for the practices of earnings management.

Secondly, the level of market's development is another key-factor of institutional transparency. The studies in this field are numerous and have a long history. Zysman (1983) claimed that a country which has a developed stock market requires strong audit and reporting standards, as compared to any other country that has a less developed financial market. Adhikari and Tondkar (1992) carried out a cross-country study on the level of information disclosure, concentrating on the role of the environmental factors. The results confirm the fact that the size of the capital market explains the variations of the level of information disclosure. Similar results are obtained by Nobes (1998) when analyzing the causes of the international differences between financial reporting practices. El Ghoul et al (2010) conclude that the companies that are activating in countries with developed stock markets are associated with a greater demand for accounting transparency. Starting from these facts, Boolaky et al (2013) consider that the development of the capital market influences the power of the audit and financial reporting standards in a country. Furthermore, the states in which foreign financing through the capital market is major should exhibit a greater level of accounting quality, due to the informational need of the investors. Anyway, the transparency and credibility of financial information cannot be obtained alone. There is a need for the capital market to be clearly regulated, only this way it can provide a quality financial reporting, at least of the companies activating on the stock exchange.

Thirdly, the literature shows that there is a positive relationship between the level of education and the professional competence of the accountants. Shoenthal (1989) claims that that the level of professional education is in close connection with the quality of financial reporting. Nobes (1992) suggests that the age and size of the body accountants cause the differences in the level of the SARS. Perera (1989) suggests that each country must establish its required levels of education and training in the field of accounting in order to improve the overall quality of financial reporting. Also, Hronsky and Houghton (2001) sustain that experienced and trained accountants determine the overall quality of the financial reporting, as they apply and maintain a certain level of the accounting practices and standards.

Therefore, the strength of auditing and reporting standards is determined by the quantity and the quality of the professional education and training. A high level of education and professional competence is mandatory in order to understand, interpret, maintain and apply high-quality reporting standards. But besides these, there is also a need for talented accounting professionals. This talent is extremely useful and should be used in the implementation of auditing and reporting standards, contributing to their effectiveness and efficacy (Solomon and Trotman, 2003).

As we have observed so far, there are three major factors that influence the power of the standards of audit and financial reporting, but in addition we may find a number of factors which have an impact on SARS, like the corporate governance, the legal system, the foreign capital (Boolaky and Cooper, 2015).

The quality of corporate governance impacts directly and positively the quality of financial reporting. Corporate governance is analyzed through its components, such as the corporate board's effectiveness and ethical behaviour.

In addition to corporate governance, we can also refer to country-level governance. This is analyzed in the study performed by Bota-Avram et al (2015), where it is highlighted that the good governance has a significant effect on the SARS. The results indicate that the proxies used for the effective governance: the governance efficiency, the rule of law and the normative quality are determining factors of the SARS.

Regarding the relationship between the legal system and SARS, the literature abounds in studies on this subject. Between the audit and financial reporting and legal tradition of a country, there is a direct connection (David and Brierley, 1985; Salter and Doupnik, 1992; Nobes, 1998; Francis et al, 2005; Nobes and Parker, 2008).

David and Brierley (1985) refer to several legal systems when they classify legal traditions, including the law systems (common law and civil law). Nobes (1998) uses the legal traditions in order to classify the accounting systems of the various countries and claims that the common-law countries use the Anglo-Saxon accounting model, while the civil law countries use the Roman model.

La Porta et al (1998) have developed an index which measures the level of disclosure of information in a country. Subsequently, this index has been used by La Porta et al (2000) and Chen et al (2011) to quantify the impact of the legal system on the quality of the financial reporting. Boolaky and Cooper (2015) sustain that the legal variables, such as the judicial independence and the efficiency of the legal framework at the macroeconomic level, are determining factors of SARS. Judicial independence is the extent to which the justice system in a country is independent of political influences, citizens' or companies influences (WEF, 2009). Therefore, a country with an independent justice system will not compromise its standards of audit and its financial reporting. In consequence, this has a direct impact on the SARS (Boolaky and Cooper, 2015). The efficiency of the legal system refers to the settlement of disputes and challenges of actions and governmental regulations (World Economic Forum, 2009). This means that the auditors and those responsible for preparing the financial reports shall ensure that they carry out their work in accordance with the highest standards used in the process of auditing and financial reporting, in order to minimize the risk of dispute.

The size of the foreign market of a country, as well as the prevalence of foreign capital in the national organizations, influence the strength of auditing and reporting standards from that country (Boolaky and Cooper, 2015). Trading partners mutually imitate each other's practices of financial reporting, as to facilitate the comparative analysis.

Furthermore, the preponderance of foreign capital can exert pressure on more than one of the categories of entities in the direction to adopt international standards of accounting practice and reporting. This is often encountered in countries where multinational companies or their subsidiaries activate. These companies tend to adopt the principles and practices of the parent company and to standardize at the international level the audit and financial reporting system (Boolaky and Cooper, 2015). Therefore, it is considered in the literature that there is a direct positive connection between the external market size and SARS, as well as between the prevalence of foreign capital and SARS.

CONCLUSIONS

The strength of auditing and reporting standards is influenced by a series of factors which were deeply analyzed in the literature. The results of the studies (Boolaky et al, 2013) show that the institutional infrastructure, the development of the capital market and the level of education and training, all together play an important role in shaping the strength of the auditing and reporting standards in a country.

SARS is an intensively studied indicator, and it is quantified at country-level by the World Economic Forum in the Global Competitiveness Reports published annually. Also, SARS is directly related to the financial reporting quality, being an influencing factor of this. The more powerful is the auditing and reporting standards, the higher the level of qualitative financial information is revealed by the companies that apply those standards.

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