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AUDIT REPORTING AND CORPORATE GOVERNANCE: LINKS AND IMPLICATIONS

Theoretical article

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Abstract

Financial scandals of the last decade have had a negative effect upon the trust and perception of investors regarding auditor responsibility and their part in fraud and error detection. As a result of legal conditions and regulations, audit firms in some jurisdictions have recently started to compile transparency reports, which contain information regarding corporate governance compliance of audit firms. This study aims to investigate if corporate governance has a significant effect on audit reporting and audit quality. Thus, our starting point is the definition of corporate governance, with an emphasis on the transparency principle for efficient corporate governance. We aim to analyse how this principle influences the quality level of the audit report, through a qualitative study. Keeping in mind that corporate governance in audit firms is considered to have a noteworthy effect on audit quality, we expect to find that regulatory bodies expect more transparency from these firms, therefore increasing competitiveness among audit firms concerning audit quality.

1. INTRODUCTION

Corporate governance is a topic of great interest and momentum in nowadays economic context, having been extensively discussed in specialised scientific work from different angles, this being why diversity resides permanently. There are, indeed, a number of definitions in the literature that lead towards controversy due to differences of opinion. Therefore, in our quest of defining the concept of corporate governance, we have preferred an evolutionary approach.

A corporation is the adjective meaning “of relating to a society” and is an organisation created and incorporated by a group of shareholders who have ownership rights of the company. An elected Board of Directors appoints and oversees the management of the corporation. The Oxford English Dictionary defines “governance” as the act, manner or fact of governing, power or control; the word has Latin origins, which suggest the notion of “direction”. Governance deals with the processes and systems by which an organisation or the society operates. The term “good corporate governance” was first mentioned in 1932 by Adolf Berle and Gardiner Means in their now-famous **agency theory.**

An audit of financial statements is a complex, professional and independent analysis which offers an opinion with regards to the true and fair representation of the entity’s position, its operations and its financial performance, in accordance with the applicable framework for financial reporting. Through this examination, the responsibility of the auditor is high because the audit report is a key argument in users decision whether to invest or not in a company (Cordoș & Fülöp, 2013).

Great financial scandals such as Enron’s and WorldCom’s have had a great impact upon the audit profession and the audit mission has gone through a challenge because of the public’s perception of the auditor responsibility and independence. This is because not only the companies were involved in these scandals, but also audit firms, such as Arthur Andersen who had issued unmodified opinions in Enron’s audit reports, reports which certified that the company’s financial situations were free of fraud. Shortly after Enron’s demise, the audit firm’s reputation was tarnished and the reason for this is simple: how could clients still trust an audit company which did not uncover fraud or even worst, participated in it (Cordoș & Fülöp, 2013)?

To reach the objectives of this study with the main theme “audit reporting and corporate governance”, we have chosen a deductive approach, starting from theoretical aspects, but also an inductive approach because we rely on observation and induction. We commence from concepts like “corporate governance”, “efficient corporate governance”, “transparency” and “auditors reporting”. We’ve started with the conceptual definition of corporate governance and efficient corporate governance, by reviewing regulations set by standard-setting boards and articles from international databases. For the second part we reviewed literature in this field found in databases, books and specialized magazines. The objective of this steps was to determine several discussion themes for our study.

2. CONCEPTUAL DELIMITATIONS REGARDING CORPORATE GOVERNANCE

Over time, the concept of corporate governance has been discussed and developed by different authors, each trying to give a specific approach regarding the definition.

Mallin Christine, the founder of the Corporate Governance Research Centre within the Birmingham Business School, presents in a 2006 study the evolution of corporate governance in different countries. The author believes that corporate governance has gained an increasingly large profile in the last decade. Interest for corporate governance includes countries and continents in which the framework is not only applied to large public companies, but also to a wider range, including state enterprises and family companies.

Adrian Cadbury (1992) suggests that the corporate governance concept can be defined as the "the system by which companies are directed and controlled". This definition seems simple and brief, but clearly conveys the importance of control within the company. Thus, this is because it excludes all external elements such as markets, banks and advisers, elements which in practice greatly affect how each system (for instance, national) works. The word “system” includes both formal and informal structures, but also and relationships, and thus, in our opinion, makes up for an adequate definition of corporate governance, also keeping in mind that it brings up one aspect which we are concerned about: systemic inadequacies.

A much detailed definition was given by the **Organisation for Economic Cooperation and Development** (OECD, 2004), which stated that corporate governance “specifies the distribution of rights and responsibilities among the different participants in the organisation – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making” (OECD, p. 11).

Mallin believes that through the two definitions it is easy to understand why corporate governance is essential for companies, investors and stakeholders, being a subject that has a pan-European appeal. Worldwide, the concept is fundamental for well-managed companies as it helps assure that its assets are secured and are not subject to expropriation by either individuals or groups from the entity. Therefore, long-term applicability of corporate governance principles helps the entity become more sustainable (Mallin, 2006, p.3).

The World Bank defines corporate governance as a set of laws, rules, regulations and codes of conduct voluntarily implemented, which allow an entity to attract the resources is needs to conduct its activity (The World Bank, 1998, p.7). **IFAC** has released a more general definition, namely: corporate governance is a set of practice of the Board and executive management, which aims to secure strategic direction, the achievement of goals and objectives, the accountability of financial resources and the risk management of the entity (Fülöp, 2012).

Each state has a more or less specific approach to corporate governance, thus there is a number of different models, namely: the principles-based model and the rules-based model. Currently, a question that arises is which model is better, more effective and will become more used in the world. Will the world align towards the Anglo-American model of governance (Hansmann & Kraakman, 2001)? Is there convergence in corporate governance, globally (Hopt el al, 1998; Gilson, 2001)?

3. THE SWITCH TO EFFICIENT CORPORATE GOVERNANCE

An efficient corporate governance system is based on a combination between the internal and external environment, with the scope of maximising corporate performance, minimising risk and the protection of investors and stakeholders interest. The Organisation for Economic Cooperation and Development (OECD) has established a set of basic principles which should guide the functioning of corporate governance systems in every country. The 2004 OECD Principles consider that the base for an efficient corporate governance framework is: market efficiency and transparency, the law and the division of responsibilities between authorities.

The management of the entity requires an effective corporate governance system in order to protect shareholders' interests. For any corporate governance system to be effective, it is vital for it to provide real-time information. The management and disclosure of information alone cannot be considered an efficient corporate governance system; it is much more essential to make an accurate assessment of the internal control (Themistokles & Evaggelos, 2008).

Transparency and good corporate governance are a first step to protect minority interests in the company and also to promote an efficient and operative business environment within the stock market (Fülöp, 2012). Corporate transparency can be defined as the large-scale availability of relevant and reliable information regarding a company's performance, financial position, investment opportunities, governance framework, value and associated risks. Bushman et al. (2004) developed a pattern for measuring the corporate transparency. The authors identified three categories of measures to improve corporate transparency:

1. The quality of corporate reporting: the intensity, the financial reporting framework and audit quality;
2. The information about purchases;
3. Information broadcasting process.

Transparency and disclosure of information are two efficient practices of corporate governance and functional stock markets. Through transparent information, the shareholders and the general public can assess management performance. Although in countries from Southern and Eastern Europe transparency and disclosure can be considered a weak link of corporate governance, there are legal requirements for disclosure. In Romania, for instance, the Companies Law, the regulations of the National Securities Commission (the CNVM, now the ASF) and even the stock exchange listing pre-requisites, require the submission of audited annual financial statements of entities (Huludeț, 2009).

The concept of corporate governance has received new meanings because of financial events that have affected finance and world economies (Fülöp, 2013). Before these events, corporate governance was regarded as a system which offers assurance that the management team do not take decisions based on own interest which could lead to a decrease of shareholders value. Currently, corporate governance must be and is understood in a much broader and complex sense; it is perceived as a system which ensures optimal use of resources for the benefit of shareholders, and subsequently to fulfil expectations of the society and the public.

Thus, the objectives of a good corporate governance are:

1. Strengthening the management and supervisory responsibility;
2. Achieving a balance between skills, experience and independence of the management, to suit the scale of the companies' operations;
3. Establishing of a code to ensure integrity;
4. Protecting the integrity of financial reporting;
5. Risk management and internal control;
6. Disclosure of relevant and material issues;
7. Identifying the needs of shareholders.

Wells (2009) defines efficient corporate governance as responsible management to ensure the sustainability of the company. According to Wells, effective corporate governance can be achieved if the Board of Directors establishes mechanisms for assessing internal controls over financial reporting, for decreasing vulnerability to fraud and misconducts and by demonstrating integrity and pleading for corporate responsibility.

In order to respect the transparent information principle of all interested parties, equal importance needs to be given to both financial and non-financial information. This requirement is highlighted in a study conducted by the McKinsey consulting firm in 2001, regarding the opinion on corporate governance of institutional investors in emerging countries

(Asia, South – East Europe and Latin America). The study shows that investors consider non-financial information regarding corporate governance as important as financial information regarding investment decisions (Robu et al, 2004).

At the entity level, an important role in meeting the transparency of provided information principle is divided between the internal audit, the Audit Committee and the external audit, as shown in studies by DeZoort et al. (2002) and Porter (2009).

4. AUDIT REPORTING AND THE LINK AND IMPLICATIONS TO CORPORATE GOVERNANCE

Corporate governance is essential in today's business world. Special attention is given to the importance of corporate governance and transparency in decision-making (Wu, 2002; Palmrose & Scholz, 2002), especially after Enron's demise and the massive manipulation of financial statements and the link of this scandal to audit reporting.

Several changes in accounting, financial reporting and audit have been designed to provide protection to investors. This is also achieved by imposing a liability tax on a company's managers (Crowther & Jatana, 2005). In essence, an audit is used to offer the necessary assurance to investors when they rely on financial statements. More specifically, the role of an audit is to reduce the asymmetry of information with regards to accounting and to minimise residual loss resulting from the potential opportunism of management. In order to produce beneficial results, efficient qualities of an audit mission are imperative because the audit quality perceived by the users of the financial statements is at least as important as the effectiveness of the audit.

International Standards in Audit (the ISA's) establish that a financial audit concludes with an opinion on whether the financial statements of a company provide a "true and fair view and present fairly all material aspects" of an entity's operations and financial position, in accordance with the applicable reporting standards, international or national (Bunget, 2010). An audit is a comprehensive examination of financial information and reports of a company, performed through audit procedures and resulting in a series of audit evidences. This process is completed with an audit report, which expresses an opinion (unmodified, modified, contrary or disclaimer of opinion) regarding the compliance of aforementioned information with a reporting framework. In this regard, the auditor is responsible that the collected data is sufficient and accurate (Tiron et. al, 2009). The objective of any audit mission is to ensure users about the reliability of the provided information (Domnişoru, 2011).

One important aspect which needs to be stated is the fact that the auditor does not offer absolute assurance regarding his stated opinion, only reasonable assurance – this is by far the most important complication of audit reporting. Because of this, several questions regarding actual audit responsibility and audit quality are raised. Also, because of the current form of the audit report, but also because of the audit expectation and communication gap, the need for transparency and quality improvement of the audit report are being brought into discussion by the IAASB with 2011 and 2013 Exposure Drafts regarding audit changes that are to come (Cordoş & Fülöp, 2013).

With regards to a better understanding of the actual situation of the company, also reflected in opinion stated in the audit report, Sercu et al. (2006) conducted a study in which they find that the aftermath of the Enron scandal is that auditors review financial statements more carefully. A result is that modified opinions appeared more often. It is concluded that although companies have suffered from these scandals because auditors have become more thorough, the overall effect was positive as the audit activity regained investor confidence.

ACCA's Ian Welch (2010) conducted a study with contributions of stakeholders from 10 countries which analyses the role of audit in ensuring confidence in financial reporting, but also how audit could bring an additional contribution if it were to provide more information to stakeholders, through an extension of audit mission purpose. Proposed topics in this direction are an analysis of corporate governance framework compliance, transparency of information, risk management, even the business plan of the analysed company – thus, more focus on non-financial information and relevant information for the future. The **Technical Committee of the International Organisation of Securities Commissions** (2009) also studies the current form of the audit report, with its positive and negative aspects, and possible changes that could be operated, such as: changes in layout and the used language and the addition of more facts such as discussions between the auditors and management – the so called audit black box – in order to improve transparency.

Audit quality and the need for change are brought into discussion because of changes in regulation brought by the Sarbanes Oxley Act and also by the PCAOB and IAASB. The importance of the audit report is high and shareholders fears must be removed by the evolution of the report in accordance to the globalised economy. Is there a need for standards, both auditing and financial, with a global application (Wedemeyer, 2010; Kueppers & Sullivan, 2010)?

Audit quality is influenced by auditor independence. Wallman (1996) and Francis (2004) argue that an assessment of auditor independence should concentrate more on branch or department level than at the entity level, because most decisions in audit regarding a particular client are performed within each branch, separately. Failure to respect the independence principle can lead and has led to audit failures (Law, 2007).

Kranacher (2011) and Cieselski & Weirich (2012) outline the idea of changes that will occur in the financial reporting, promoted by the IAASB and PCAOB: the opportunity of development in the audit report by including a detailed analysis of the auditor. The authors start from the fact that the audit activity is considered more and more just an item on a checklist, as reports have the same structure, the same opinion, with nothing to differentiate them. They propose several additions such as auditor discussions with the management, explanatory paragraphs, and the assurance provided by auditors on other non-financial information. Carcello (2012) tested this hypothesis in a quantitative study, and the conclusions are surprising: 91% of interviewed users consider the audit report, in its current form, a formality.

Proposed changes by the IAASB would bring benefits to users, such as more transparent and accurate information. But these improvements would also generate additional costs and lead to a degree of inconsistency and inability to compare reports for companies in the same sector of activity, according to Gundi (2012).

An increase of the importance of audit within corporate governance can be seen in both international literature, from which we have tried to extract the most relevant ideas, but also from the analysis of the good corporate governance code issued by the OECD, which has paid increased consideration to the audit function in each newer edition.

A failure in the audit function can occur because of many reasons: undetected irregularities during the audit tests (Arens et al, 2008) or if the auditor's independence is impaired (Law, 2007). Presenting financial reports in a timely manner is a basic requirement of a well-functioning stock market – any unjustified delays escalate shareholders and potential investors' uncertainty (Citron et al., 2008; Phillips & Freeman, 2003). Moreover, posting audit reports in a timely manner can enhance investors' decisions and reduce information asymmetry in the market (Owusu-Ansah & Leventis, 2006).

A series of studies identify that the audit function, with its three components – internal audit, external audit, and the Audit Committee) is a base function of corporate governance (Anderson, Francis&Stokes, 1993; Blue Ribbon Committee (BRC), 1999; Institute of Internal Auditors [IIA], 2002). Tricker (2009) addresses the fact that the audit must become once-more the "watchdog" it used to traditionally be. The role of audit should be expanded to increase corporate control in the benefit of both stakeholders and the society.

Weaver (2008), Dimitriu (2010) and Manolescu et al. (2010) analyse the importance and role of communication between the external auditor and those in charge of corporate governance. These studies underline the importance of communication by considering that the "communication with those charged with governance should be seen a crucial product in audit reporting". Thus, the management can be informed regarding any problems that might have occurred in the audit mission; also, the management have the opportunity to fix potential problems in order to improve the financial reporting process. Hence, we note the importance of communication between various functions within the company in order to obtain better results.

Another important issue studies by Dobroțeanu, Dobroțeanu & Răileanu (2010) concerns the independence of auditors in the context of corporate governance. The study results indicate that the creation of audit committees can lead to securing the independence of internal auditors. Also, the authors show that regulations offer a degree of independence to external auditors, but there are still some doubts regarding this because the auditors are hired by the management, but should work in the interest of shareholders: this could be a cause for suspicion regarding independence.

One direct implication and effect of corporate governance on audit reporting can be considered the revision of standards put forth by the **International Audit and Assurance Standards Board** (IAASB), the regulating body of International Standards for Audit (ISAs). The IAASB's primary concern in the last years has been the clarification of auditing standards, with a focus on audit reporting and audit quality. Starting with the "Clarity Project", in 2009 the IAASB has revised all current audit standards to improve quality, comprehensibility and clarity (IAASB, 2009).

Starting with 2011, the international regulating body for audit and assurance has released several invitations to comment on proposed new regulations for audit and assurance, such as the 2011 consultation paper "Enhancing the Value of Auditor Reporting: Exploring Options for Change", the 2012 invitation to comment "Improving the Auditor's Report" and the most recent 2013 invitation to comment on new exposure drafts for several ISAs, with the title "Improving the Auditor's Report". While in the 2011-2012 period, the primary concern had been the audit information and expectation gap, the 2013 exposure drafts bring the discussion regarding auditor communication with those charged with corporate governance. The main concern has been the improvement of communication and to clarify some specific matters in the working relations between the external auditor and the internal auditor – all these aspects are now more obviously included in the proposed *ISA 260 – Communication with those charged with governance* (IAASB, 2013). Furthermore, the proposed *ISA 700 – Forming an opinion and reporting on financial statements* brings a new report section "Key Audit Matters" which "are those matters that, in our professional judgment, were of most significance in our audit of the financial statements" (IAASB, 2013: ISA 700 Revised, p.27), with matters selected form discussions with those charged with governance. This new proposed section suggests an even more direct implication and impact of corporate governance on audit reporting.

Regarding the need of more transparency in audit missions, the IAASB has released a 2014 Feedback Statement on Audit Quality, in which it reaffirmed its desire and goal to improve audit quality by making audit missions more transparent to users.

5. CONCLUSIONS

Given the proposed objectives of our study, our scientific approach was based on a deductive approach, from general to particular. Our starting point was the definition of corporate governance from the perspective of different regulating bodies and corporate governance codes. We have started from the definition provided by the Cadbury Committee, at a international level, and the definition proposed by the OECD, at European level.

The undertaken research is continued with conceptual boundaries of effective corporate governance. Hence, we conclude that an effective corporate governance can be achieved by transposing the transparency principle, which implies disclosure of accounting information of the company. Keeping the same focus, we have outlined the importance of audit in corporate governance. In our approach, we have started from the study of literature that highlights audit importance in the context of corporate governance.

As final remarks, from our conducted qualitative study we have reviewed the main contributions on this topic, but there are still some research areas that have been insufficiently analysed and which need our attention in the future: research on the transparency of audit and audit reporting in the context of corporate governance.

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