

Melinda Timea FÜLÖP
Babeş-Bolyai University, Faculty of Economics and Business Administration
Mirela-Oana PINTEA
Babeş-Bolyai University, Faculty of Economics and Business Administration

EFFECTS OF THE NEW REGULATION AND CORPORATE GOVERNANCE OF THE AUDIT PROFESSION

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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, firm performance and their part in fraud and error detection. The audit firms play an important role in the capital markets by verifying that auditors provide reliable information to the decision makers. The characteristic elements of the new economy require economic entities new performance standards that go beyond economics. These works' aim is to explore the implication of the new regulation and corporate governance on the audit profession and audit quality. This study contributes to the literature as it provides a better understanding on how the auditor and audit firms react toward the additional requirements.

1. INTRODUCTION

A relatively new approach in the literature and the practice in Romania represent the role of corporate governance decisions. Thus, we consider crucial to increasing our attention on the concept of corporate governance. In particular, addressing the role of the audit function and application of the code of corporate governance is also important. The audit function in corporate governance has a significant practical importance.

There are many studies on the international level in these areas of research. The topics are broad due to the financial crisis that swept the global economy. This has led to a continuous need for improvement in the area of governance and audit function.

In the last decade, especially during the financial crisis and the great financial scandals, the European Commission launched a broad consultation process among EU member states on:

- the role of financial audit;
- the independence of the members;
- the transparency of the information provided in the audit report;
- issues related to the transparency principle in the context of corporate governance;
- corporate governance transition to effective corporate governance and
- corporate governance impact on audit reporting.

Therefore, we note the ongoing transformation of the current economic environment that is increasingly oriented to globalization.

2. RESEARCH METHODOLOGY

The literature defines the methods of scientific insight as a road or a "path" to follow in research in order to achieve the objectives, information and training. The processes, techniques and tools used in scientific incursion are part of the method, viewed as supporting elements or concrete ways to exploit it (Gray et al. 2007; Dunbar & Weber, 2014).

To reach the objectives of this research, our scientific approach is based on a deductive approach (Gray et al., 2007). It starts from the theory. The study is also based on an inductive approach (Lesage & Wechtler, 2012), because we rely on observation and induction.

In order to score significant developments in corporate governance and audit reforms, we will appeal to cross the methods. This will be materialized through investigative procedures, observation, comparisons and testing of concepts, ideas and theories existing in the field of corporate governance and audit.

We subscribe to the idea that the end of a scientific approach is a new beginning for further developments and new approaches in research.

Therefore, this study ends with some relevant conclusions.

3. THE EVOLUTION OF CORPORATE GOVERNANCE AND AUDIT FUNCTION

We started our research from the basic definition pronounced by Méndez-Picazo et.al. (2012). According to Méndez-Picazo et al., (2012) corporate governance represents the modality to manage the entity.

Economic theories are the basis for both adequate leadership and control.

According to the *Agency theory* founded by American economic literature in the early 70's, the owners of a company and its directors sign a representation agreement when the first designate the last as agent mates to represent them in a particular decisional domain. Agency theory developed by Berle & Means (1932) leads to dissociation between administration and control.

Corporate governance is in the current economic context a topic of great interest, being a generally debated subject in scientific specialized economic areas, where there can be found a diversity of definitions (Tricker 1984; Cadbury, 1992; The World Bank; Hofstetter 2002; OECD, 2004; Keasey et al., 2005; Mallin 2006; Tricker, 2009; Braithwaite 2010). The concept of 'good corporate governance' was first mentioned in 1932 by Adolf Berle and Gardiner Means in their famous agency theory. Mallin (2006), the founder and director of the Research Center of Corporate Governance at Birmingham Business School had an outstanding contribution in the field of corporate governance. Therefore in his Handbook on International Corporate Governance Country Analyses (2006), he presents the evolution of corporate governance in different countries, by highlighting the growing role of corporate governance in the last decade. Interest in corporate governance manifests itself at the level of large international corporations and the state enterprises and non-profit partners.

Many studies are focused on various correlations between the elements of corporate governance and audit function, of which we remind: the relationship between internal audit and corporate governance (Moeller 2004; Broadley 2006; Coram et al. 2007; Verlag 2007, Gennaro 2007 Sarens et al., 2009, Sarens & Abdolmohammadi 2010, Susmanschi, 2012), the relationship between audit committees and corporate governance (Bertschinger & Schaad, 2003; Collier & Zaman, 2005; Goodwin-Stewart & Kent, 2006, Edwards et al. 2008; Fülöp, 2013), the relationship between external audit and corporate governance (Francis, 2004; Barton 2005, Gordon & Woodbine, 2010; Baker et al., 2010; Coram et al., 2011; Gray et al., 2011) and the implications of transparency principle on corporate governance

(Bushman et al., 2004, Themistokles & Evaggelos 2008, Porter, 2009).

4. CURENT CHALLENGES IN AUDITING

The economic turmoil resulting from the 2008 global crisis continues. A number of international bodies from the most affected jurisdictions by the fallout are now looking at different activities in the capital markets that may need reform to prevent such economic meltdowns in the future. The activities under investigation include auditing, which is the subject of this paper.

To begin with, the research has taken an interest in the role that culture plays in financial reporting. Social norms and culture can influence the value judgements and attitudes of accountants and auditors, which in turn impacts how accounting and auditing systems have developed and are practiced in different countries (Gray, 1988).

Most of the changes in accounting, financial reporting and auditing, have been determined by the need to protect the investors. In essence, the audit is used to provide the necessary protection to investors when they relied on audited financial statements. Moreover, the audit role is to reduce the asymmetry of accounting information.

For decades, the audit profession has been overwhelmed with a series of polemics, which led to the need of essential reform and developments.

The reforms regarding accounting profession are discussed for several years. They were motivated by the fact that, as things developed in the last decade, it highlighted a number of shortcomings in the economic and financial system stability. Audit reforms have gained force in recent years, especially after the scandals and the collapse of the large corporations such as Enron, WorldCom, Lehman Brothers and Barings Bank. Lack of proper disclosure of information was often regarded as one of the major causes of the late financial crisis, negatively affecting public confidence in the reporting of the entity.

One of the basic requirements of an efficient market is an efficient audit process. In achieving this one essential condition, is to obtain a true and fair view of the financial position and performance of the entity. For the financial statements to present fairly, in all material aspects, the financial position and performance, is necessary a methodological approach structured in successive, well-defined stages. Another condition is to take into account any changes that have occurred to these assertions during the financial year, but also consider the impact of these changes to the entity's future. At this stage, the auditor analyses the appropriateness of the entity's use of the going concern basis of accounting (Martens et al., 2008).

The audit quality and the need for change are brought into the 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 shareholder's fears must be removed by the evolution of the report in accordance to the globalised economy. There is a need for audit and financial standards with a global application (Wedemeyer, 2010; Kueppers & Sullivan, 2010).

Thus, a challenge in this research area is a better distinction between the management, the audit committee, and auditor roles in the disclosure and discussion of going-concern uncertainties. Related to this, the Financial Accounting Standards Board (FASB) has proposed that management report on their company's ability to continue as a going-concern (FASB 2008, 2011), and most recently have reaffirmed their interest in requiring going-concern disclosure as part of GAAP by directing their staff to continue researching this area for their future consideration (FASB 2012).

The nature of the possible revisions to the audit report included in the PCAOB Concept Release, the IAASB May 2011 Consultation Paper and the June 2012 IAASB Invitation to Comment suggested these standard setters are now trying a different approach.

IAASB (2011) determines three factors as the most important that influence on audit quality. The three factors are shown in Figure 1, which explains how the audit quality is affected by context factors, inputs of the audit process and output of the audit process.

In a similar vein, the European Commission indicated in its Green Paper on Audit Policy (European Commission, 2010) that it is important to clearly define what sort of information to be provided to stakeholders by the auditor as part of its opinion and findings. This would not only imply reviewing the audit report but also considering additional communication on audit methodology explaining to what extent there has been substantive verification of the audited company's balance sheet'. Based on this Green Paper, the European Commission (2010) released a regulatory proposal in which they intended to expand the content of the audit report to provide more information to stakeholders.

The European Commission also made efforts to reform audit policy arising from lessons learned from the global financial crisis, including proposed regulation and directives that partially address the content of public auditors' reports as well as auditors' reports to audit committees.

The proposed reforms in relation to the former include: the content of the audit report disclosed to the public is expanded so that it explains the methodology used, especially how much of the balance sheet has been directly

verified and how much has been based on system and compliance testing, the levels of materiality applied to perform the audit, the key areas of risk of material misstatements of the financial statements, whether the statutory audit was designed to detect fraud and, in the event of a qualified or adverse opinion, the reasons for such a decision (European Commission 2011).

At international level, the International Accounting Standards Board (IASB) is currently involved in a project with the objective of clarifying the disclosure requirements about the assessment of going concern in IAS 1.

The ISA 700 - Independent auditor's report standard - regulates how the auditor will express their opinion and how the audit report will be compiled. In order to form an opinion, the ISA 700, through articles 11 to 15, states that the auditor should:

- obtain sufficient evidence to support its conclusion (ISA 330);
- assess whether the financial statements present fairly, in accordance with the applicable financial reporting framework (IAASB, 2009):
 - that accounting policies are applied in accordance with the reporting framework;
 - that financial statements offer reasonable accounting estimates;
 - that financial statements provide relevant, reliable, comparable and understandable information;
 - that the financial statements contain the correct language and offer clarifying information, sufficient for the users to understand the operations carried out.

Specifically, the IAASB's work plan on improving the auditor's report culminated in an Invitation to Comment (ITC) in 2012 and, in 2013, an Exposure Draft (ED) outlining suggested changes to the international auditing standards ISA 700 and 720 (IAASB 2008a, 2008b). In their strategy and action plan document for 2012-2014, the IAASB states: "Our top priority is, and will continue to be, our work on Auditor Reporting, in the public interest" (IAASB 2012a).

The exposure draft issued by IAASB (2013) proposes amendments to:

- revised ISA 700 Forming an Opinion and Reporting on Financial Statements;
- revised ISA 705 Modifications to the Opinion in the Independent Auditor's Report;
- revised ISA 706 Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report;
- revised ISA 260 Communication with Those Charged with Governance;

- revised ISA 570 Going Concern and
- to create a new proposed ISA 701 Communicating Key Audit Matters in the Independent Auditor's Report.

An exposure draft has been published in March 2014. Other new proposals include a revision of the audit report, in order to increase the level of disclosure provided by the auditors. It includes an explicit statement on whether the use of the going concern basis of accounting, by the management, is appropriate (IAASB, 2012, 2014). Recent EU legislation like Regulation No. 537/2014 and Directive 2014/56/EU do not necessarily approach the going concern on audit reporting topic, but the European Commission continuously analyses audit reforms and works with the IAASB to reform audit policies.

In June 2014, IAASB decided to reach an agreement on the overarching reporting standard, ISA 700 and reached an agreement on the scope of proposed ISA 701. In this meeting also IAASB proposed new requirement in ISA 570. To enhance the auditor's work effort in relation to disclosures, when events and conditions may cast significant doubt on the entity's ability to continue as a going concern. Moreover, it considered the implications of proposed enhancements resulting from its auditor reporting project on ISA 800, ISA 805 and ISA 810, such as provided in the exposure draft.

Coram et al. (2011) evaluated the new audit report using a verbal protocol study with 16 financial analysts who performed a company valuation based, in part, on a set of audited financial statements. Their results indicate that, consistent with prior research, users only briefly examine the audit report. However, there is little evaluation of audit reports by the analysts beyond determining whether the audit report was qualified or unqualified. This finding persists whether the audit report is based on ISA 700 or SAS 58.

Lin and Tepalagul (2012) analyzed the relationship between auditor independence and the audit mission quality. Based on two assumptions (as the auditor's mandate is extended, the independence and quality of the report will be affected and if appointments are longer, the auditor will better understand the company, will have better expertise and develop a more conclusive opinion) they noted that the mandate of the auditor, in terms of both audit firms and individual auditor, but especially in terms of actual auditor, has a notable influence on the quality of audit reports, so that rotation of auditors (auditor either partner or audit firm) is justifiable. Aschauer (2013) examined the effect of familiarity between auditors and reviews on the independence and quality of the audit engagement. From statistical data, the authors found that auditor rotation has a neutral effect on the quality perceived by users regarding audit missions and, in fact, would cause additional costs

for companies. Also, customers trust puts the auditor in a vulnerable position, but the authors concluded that in the context of the audit, trust equals no familiarity.

The main purpose of an audit is to increase the confidence of users of financial information while the auditor should express an opinion on the financial reports in accordance with the applicable financial reporting framework.

The external auditor has a role in improving the efficiency of corporate governance by enhancing the credibility of the information provided through financial reporting as transparent. This is justified by the fact that external auditors were sometimes seen as "gatekeepers" to monitor managerial behaviour on behalf of all stakeholders (Kueppers & Sullivan, 2010), while in their absence maintaining an adequate structure of corporate governance may be jeopardized.

Therefore audit quality and audit reporting have a longer history (Francis, 2011). This is not surprising because audit quality is the reason of the audit market: audit is worthless without public confidence in audit quality (Maijor & Vanstraelen 2012).

Moreover, in the literature, audit quality is assessed through audit firm size (Barako et al., 2006; Chau and Gray, 2010; Al-Shammari and Al-Sultan, 2010). Tanyi et al. (2013) conducted an analysis of the effect of changing the audit firm, be it a company from the "Big 4" or not, on the quality of the audit report. The study confirms that an impairment appears in the quality of the audit in the first year after the auditor's change. The impact can be attributed to the fact that the auditor does not know the client and is even more significant if it is an audit firm outside the "Big 4" group where there is a greater impairment, attributed to less experience and limited resources.

Presenting financial reports in a timely manner is an essential requirement of a well-functioning stock market – any unjustified delays escalate shareholders and potential investors' uncertainty (Phillips et al. 2003; Krishnan, 2005; Owusu Ansah & Leventis, 2006; Citron et al., 2008; Tiron-Tudor et al., 2009; Lawrence et al., 2011 and Fülöp, 2013).

Regarding the need of more transparency in audit missions, the IAASB has released in 2014 a 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

Audit reporting has a long history, both in terms of changes to the audit report, and as a subject of academic research. Recently regulators and standard setters have revised the audit report in response to the financial crisis.

This article provides a synthesis of recent research related to the audit report and the effect of new regulations. The article mainly focuses on recent research, that emphasis on the benefits of having similar auditing standards across countries, as this is believed to enhance consistency of practice and thus improve the comparability of financial statements across borders.

Corporate governance has been a concern for the governments of many countries. Many corporate governance laws have been issued in the last decade so as to monitor and organize the relation between the management and their external auditors, particularly in listed companies. The new rules and regulation assist the audit regulators in assuring the quality of auditor's performance.

It is important to acknowledge that the audit profession has a problem, and explain how regulators are working to assure the minimum acceptable level of audit quality and independence. The high number of multinational clients has led the Big 4 networks to work globally.

In further research is needed to analyse the views of the audit clients regarding foreign auditors and to what extent this affects the relation among the audit firms and their clients. Comparative studies can be conducted among different cultures from different countries.

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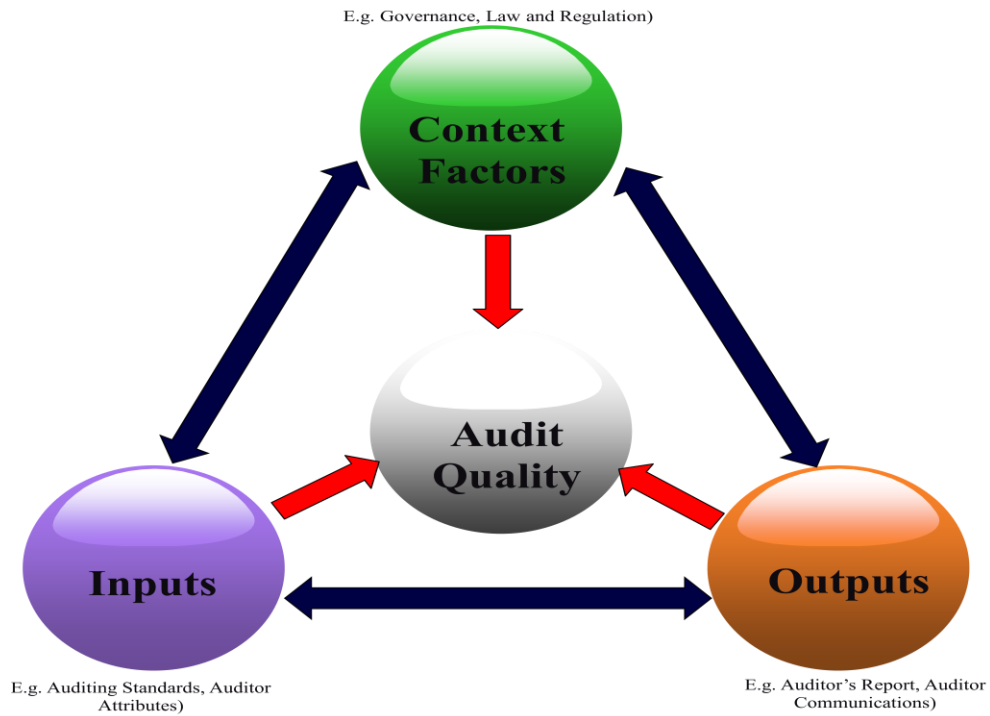
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Figure 1 Important Influences on Audit Quality



Source: IAASB (2011) Audit quality: An IAASB perspective

