Emerging Markets Queries in Finance and Business

The interaction between financial audit and corporate governance: evidence from Romania

Laura Brad*, Florin Dobre, Radu Ciobanu, Iulian Viorel Brasoveanu

Bucharest University of Economic Studies, 6 Piața Romana Square, Bucharest Distract 1, 010374, Romania

Abstract

In order to conduct a quality financial audit both information about financial indicators and about the corporate governance that a company has are mandatory. This study presents the correlation between financial audit and corporate governance of the entities that are listed on the Bucharest Stock of Exchange that had to comply with IFRS approach. Using a simultaneous equation model, positive influence is detected between financial audit, proxy by audit fees, and the type of auditor and negative effect is found between the existence of audit committee, the non-existence of CEO/chair duality and the one tier management system.

Keywords: financial audit; corporate governance; Romania; simultaneous equation model; IFRS

1. Introduction

Prior research in the fields of accounting and finance has provided little evidence about the corporate governance elements. In fact, the corporate governance policies have been differently tackled on research paper. The most common approach of corporate governance is based on the agency theory. The agent theory was

* Corresponding author

E-mail address: laura_brad2004@yahoo.com
firstly introduced by Jensen and Meckling, 1976 and it considers that the manager act according to their self-interest, even though this behaviour can create losses to shareholders. As a fact, the purpose of corporate governance is to design contractual mechanisms for controlling for this type of behaviour. The idea behind it is that the members from the board should be independent from management team in order to ensure the control and the supervision of the activities the managers do (Cohen et al, 2000).

The second approach upon which the corporate governance relies on comes from management and it encounters a resource dependence perspective (Boyd, 1990). According to this theory, managers and the board of directors help each other in developing strategies and policies. The members from the board have the ability and the knowledge to provide access or to attract external financing resources.

The last approach of corporate governance denies its fundamental role. The perspective is based on managerial hegemony and thus, the role of corporate governance is only symbolic as it cannot be used for controlling and monitoring activities (Kosnick, 1987). According to this perspective, the board’s functions are limited to regulatory requirements and to increase management’s compensation (Core et al, 1999).

One main problem of these views is related with the fact that there is no reference at financial auditor as being important in corporate governance. Thus, the present research tries to detect the correlation between financial auditor characteristics and the corporate governance elements considering the Romanian market.

The remain of the paper is structured as follows: firstly, a short literature review is presented considering the correlation between financial audit and corporate governance variables, after that the section corresponding to methodology of research is revealed, being followed by a section where the results are discussed. The paper ends with conclusions and recommendations and with presenting future perspectives of research.

2. Literature review

In general, when the correlation between financial audit and corporate governance is encountered, the relation that is frequently researched is how the corporate governance variables affect financial audit. In several studies, a proxy for financial audit is audit fees. The relationship between auditor’s remuneration and other corporate governance variables significantly depend on board characteristics (the type of control that the board of directors exert considering the controlling and the monitoring activities). For example, O’Sullivan, 2000 found that larger the proportion of non-executive directors is, higher the audit fees are, while Gul and Tsui, 2001 report positive correlation between audit fees and high cash flow. Carcello et al., 2002 proved that the audit remuneration depend on the board independence. It seems that as the board is more independent, it is more inclined to pay higher fees to external auditor. Opposite to them, Maug and Schneider, 2008 find no evidence to support the correlation between audit fees and the independence of the board of directors. In another research conducted by Mitra et al, 2007 the results emphasize that a company is more inclined to pay higher audit fees if it has a diffused institutional ownership.

Negative results were found by Frankel et al, 2002 who point out that the existence of non-audit services can affect auditor independence and can encourage the appearance of discretionary accruals. On the other hand, Larcker and Richardson, 2004 consider that these particular elements can appear if the company has a weak governance system. Moreover, it seems that auditor’s reputation mitigates this kind of practices.

Regarding other elements of corporate governance and their correlation with the auditor’s fees, an important role is given to the audit committee. Researches such as those conducted by Abbott et al., 2003 or by Gaynor et al, 2006 report a positive relationship between the existence of the audit committee and the amount the auditors receive for their auditing activity. Similar results were detected by Voller et al, 2013, Steward, 2006, while other researches such as the one conducted by Cohen and Hanno, 2000 consider that the risk associated with the auditor’s activity should be mitigated once the existence of audit committee is revealed.

Another corporate governance variable is the one that encounters the duality between the CEO and the chairman of the company. The literature reports that firms with independent corporate boards pay lower audit
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