

## Financial audit – feckless for economic re-launch

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**Abstract.** *The credibility of financial audit suffered an important decrease upon the economic crisis has been released. Even though solutions for its improvement were conferred, such as the Green Paper code, it continues to be a feckless tool for overcoming upon the recent financial crisis. This research provides evidence about the characteristics of financial audit of listed Romanian entities and about the correlation with entities' evolution. The results emphasize that the lack of transparency in financial reporting is a key element to economic re-launch.*

**Keywords:** financial audit, financial crisis, economic re-launch, Romania, transparency.

**JEL Classification:** M42, G01, G10.

## Introduction

Once that financial crisis has been released, there have been numerous doubts related with the credibility and reliability of audit reports. The European Commission, 2010 designed a document, called Green Paper, where several recommendation are made for increasing auditor's credibility. At such, the document emphasizes the supremacy of BIG 4 auditors measured at a global level and it provides evidence that smaller auditors should be encourage to act on the market. It is considered that the financial auditor should take into consideration the risks associated with the auditing activity when presenting their audit report. Consequently, the auditor's report should be more detailed in case that the risks associated with the audited company are higher. Overall, the document considers that there should be higher cooperation between internal and external audit activities, between external financial audit and corporate governance principles. In fact, the document is mainly focusing on transparency.

The literature focuses on two approaches that look at financial auditor's activity. The first approach considers that financial auditors are responsible for the financial crisis as they were not prepared to face huge financial problems (Sikka, 2009). The second perspective is based on the fact that financial auditors have to adapt to the macroeconomic environment and consequently, have to implement new techniques and methods of evaluation in order to develop their activity (Pal, 2010). The explanation is due to the fact that there were important changes in terms of market characteristics considering that the risks that financial auditor took significantly increased, while their credibility sharply decreased. In fact, we think that the opinion that financial auditor provides should ensure a minimum level of financial stability for the audited company.

One main problem that financial auditor may have when searching for a solution for financial disclosure is based on the fact that there is not a standard way of evaluation. It seems that financial auditors tend to look at previous financial statements no sooner than they found a problem in the way the actual financial statements are constructed. Moreover, they tend to appreciate the situation similar with the one found in the past, without considering the present characteristics of the audited firm (Salterio and Koonce, 1997).

The auditor opinion seems to be more reliable if is provided by a company which is part from BIG4. This is because they act at a global level and they tend to ensure higher credibility and transparency to the audit report (Reichelt and Wang, 2010). Consequently, BIG4 entities usually report any problems that can create financial distress due to their reputation and their notoriety. Their audit report can also be linked with the law enforcement and with the amount that financial auditors receive for their auditing activity (Chen et al., 2012). In fact, they have more resources which they can use in order to detect financial disclosure problems (DeAngelo, 1981).

Other elements than can characterize the financial auditors' activity and that can influence the quality of auditing reports are represented by auditors' fees and the switch of financial auditor. The change of financial auditor can be a proxy for quality, as new financial auditors tend to detect, to report and to correct the earning management found at

company level (Hubens, 2012). On the other hand, the change of financial auditor can be seen as a measure upon which the new financial auditor can fail to detect the level of earnings management (Liu and Liu, 2008). For example, the level of earnings management increases when a switch from high quality financial auditor (part of BIG corporations) to a non-high quality financial auditor is implemented. This is due to the fact that there is a change of auditor's initial opinion (Davidson et al., 2006).

Regarding the auditors' fees it is considered that they should be a proxy for quality. On the other hand, higher the auditor's fees are, higher the probability to change them is (Craswell et al., 2002).

The financial auditor's activity is also correlated with the corporate governance principles. It is considered that its role should be increased as this is the way that reliability can be ensured to corporate governance principles (Baker and Owsen, 2002).

Considering these, the present research tries to reveal what are the characteristics of financial auditor that can impact the level of financial disclosure of each entity or what type of corporate governance elements are related with financial auditor's characteristics that can mitigate the value of discretionary accruals.

The rest of the paper is structured as follows: the first part presents some information found in the main literature regarding the correlation between the value of discretionary accruals and the financial auditor or corporate governance elements, the second section refers to the methodology of research, the third emphasizes the results obtained and presents a discussion upon them, while the last part concludes and provides evidence about further research.

## Literature review

There is a vast literature that looks at the correlation between financial auditor and the earnings management process. Part of the earnings management process is considered to be the value of discretionary accruals (Barth et al., 2008). The results of the researches that have already been conducted provide mixed evidence on the financial auditors' characteristics. In fact, the results are mainly correlated with the switching from national accounting regime to the International accounting measures (proxy by IFRS-International Financial Reporting Standards)

First of all, the type of financial auditor seems to be negatively related with the value of discretionary accruals (Gerayli et al., 2011, Chen et al., 2010). Firms that have a high quality financial auditor report less discretionary accruals than those that have a financial auditor that is not part of BIG 4 corporations. Contrary, the existence or not of high quality auditor has no influence upon the value of discretionary accruals in Korea (Jeong and Rho, 2004)

On the other hand, the switch from national regulation to international one is based on higher costs (Houque et al., 2010) and in general no significant difference between the value measure under national regime and international regime can be found on short term

(Sellami and Fakhfakh, 2013 found that the value of discretionary accruals decreased only six years later after the switching to international reporting elements). Other studies consider that the value of discretionary accruals will not decrease even after the adoption of IFRS (Manzano and Conesa, 2014; Yosr, 2013).

Regarding the correlation of auditor's remuneration and discretionary accruals, there seem to be a positive correlation among them. For example, when the company is having a high concentration of its own management, there is found a positive correlation between the value of discretionary accruals and the value of auditor's fees (Gul et al., 2010). The relationship is also valid when there is an increase of chief financial officer's bonuses (Alali, 2011). Moreover, the size of financial auditor tends to be strongly correlated with the persistence of discretionary accruals (Krishnan, 2003; Zhao, 2010). Contrary to their results, Tennander and Olsson, 2010 audit fees influence in a negative way the persistence of discretionary accruals if the company is audited by a BIG 4 entity, while opposite relationship was found when the entity is audited by a non-BIG 4 audit company).

Considering the change of financial auditor, there is also mixt evidence. When the change of financial auditor is known, an interesting phenomenon can be observed. On one hand, there is a decrease in the value of discretionary accruals a year before the change occurs, while no relevant influence upon it of the new auditor can be observed in the year of adoption (Becker et al., 1998). Thus, the new financial auditor can fail to ensure the level of sustainability of the new audited company (Liu and Liu, 2008)

As it was mention, the financial auditor is also correlated with the way corporate governance is implemented at company level. The literature presents that the independence of audit committee is more likely to ensure credibility to financial statements (Yang and Krishnan, 2005; Osma and Noguer, 2007), thus it can be a proxy for reducing the value of discretionary accruals.

Another corporate governance variable that can influence the value of discretionary accruals can be the size of the board of directors. Several studies (Klein, 2002; Xie et al., 2003, Sánchez-Ballesta and García-Meca, 2007) consider that larger board of directors can ensure a higher level of monitoring activities due to the fact that once the board of directors is larger there is higher probability for the entity to have more independence director. The results are contrary to those found by Jensen (1993).

We do not have to exclude the importance of CEO/chair duality. The variable is expected to have a negative influence upon the value of discretionary accruals, but the literature reports also mixt evidence (Davidson et al., 2006, Cornett et al., 2008).

Considering the Romanian market, fewer studies have been conducted upon the value of discretionary accruals. No significant evidence between the value of discretionary accruals computed using Romanian Accounting Standards and International Financial Reporting Standards was detected (Brad et al., 2014) and no influence of auditor type or od the CEO/chair duality was found out (Popa et al., 2014)

### Methodology of research

In order to reveal if the value of discretionary accruals is mitigated considering financial auditor's characteristics and corporate governance variable, data related to Romanian Entities listed on Bucharest Stock of Exchange was manually collected. The companies were selected based on the fact that according to Romanian regulation, the listed entities have to report their individual financial statements using the IFRS approach starting from 2012. Considering the report issued by the Supervision Financial Authority, at the end of 2012, 71 companies have to report using this accounting framework. Based on the fact that the value of discretionary accruals is estimated using the models provided by Jones, 1991, Kotharit et al., 2005 or others and that is computed using several differences among the financial elements, the companies with a negative value of own equity and the entities that were in insolvency were excluded from the sample. As we were also interested in finding the correlation between the auditor's fees and the value of discretionary accruals, we also eliminated the entities for which the value of auditor's remuneration was not found among financial statement notes. Consequently, the dimension of our sample consists of 41 companies (values for the auditor's remuneration were found only for 2011)

Considering the fact, that the model upon which discretionary accruals was estimated is the same used as Kotharit et al., 2005, information regarding the value of current assets, the value of cash components, the value of current liabilities, the value of total debt, the value of income payable tax, the value of revenues, the value of accounts receivables was collected both for 2011 and 2012. Moreover, information about the amount of depreciation, the value of plant, property and equipment from 2012 was also extracted. Other type of financial information was the value of net profit and the value of total assets from 2012.

The value of total accruals is calculated using the formula provided by Leuz et al., 2003. This can be seen in equation (1).

$$TA_i = \Delta CA_i - \Delta Cash_i - (\Delta CL_i - \Delta STD_i - \Delta TP_i) - Dep_i \quad (1)$$

Where

$TA_{it}$  represents the value of total accruals used for company i and reported in year t

$\Delta CA_i$  represents the value of current assets computed for company i considering a change of current assets from year t to year t-1

$\Delta CASH_i$  represents the value of cash elements for company i considering a change of current cash elements from year t to year t-1

$\Delta CL_i$  represents the value of current liabilities for company i considering a change of current liabilities from year t to year t-1

$\Delta STD_i$  represents the value of current debt for company i considering a change of total debt from year t to year t-1

$\Delta TP_i$  represents the value of total tax payable for company i considering a change of the total tax payable from year t to year t-1

$DEP_i$  represents the depreciation of fixed assets for company i for year t.

The value of discretionary accruals is found by subtracting the value of non-discretionary accruals from the value of total accruals. The value of non-discretionary accrual is estimated using Kothar et al., 2005 model. The relationship is presented in equation (2)

$$TA_i = \alpha_0 + \alpha_1 \times (\Delta REV_i - \Delta AR_i) + \alpha_2 * PPE_i + \alpha_3 \times ROA_i + \varepsilon_i \quad (2)$$

Where

$TA_i$  represents the value of total accruals used for company i and reported in year t

$\Delta REV_i$  represents the value of revenues for company i, considering the change of revenues from year t to year t-1

$\Delta AR_i$  represents the value of accounts receivable for company i, considering the change of accounts receivables from year t to year t-1

$PPE_i$  represents the value of property, plants and equipment collected for company I for year t

$ROA_i$  represents the value of return on assets, calculated by dividing the value of net profit to the value of total assets. The indicator is calculated for company i for year t.

As the idea of research is to provide evidence about the impact of financial auditor's characteristics and the influence of corporate governance indicators upon the value of discretionary accruals, we conduct a multiple regression model. The dependent variable is the value of discretionary accruals. Both dependent variable and independent ones are scaled by total assets. Considering the independent variables, several indicators were included into the analysis.

When the financial auditor's characteristics are encountered, we took the value of total auditor's fees for year 2011. The variable was coded *LOGAF*, considering the fact that logarithmic value of total assets have been used. Another variable is form by the type of financial auditor. The variable is coded *DAUD* and is a dummy variable. The variable has value 1 if the financial auditor is part of BIG 4 companies, while the variable has value 0 if the financial auditor is not considered to be a high quality one. We also took into account if the financial auditor changed. The variable that we used is also a dummy variable, is coded *DCHG* and it takes value 1 if the financial auditor changed and value 0 if the financial auditor did not change. The variable takes value 1 no matter what is the type of new financial auditor.

Considering the corporate governance elements, we also included some individual characteristics. One of these was the CEO/Chair duality. The variable *DCEO* takes 1 if the CEO of the company is different from the chairman of the board of directors. When the CEO of the company is the same person as the chairman of the board of directors, the variable took value 0.

We also considered the type of management system that the entity has. As a fact, if only few companies from Romanian market have a two tier management system, we decided to code the variable *DSYST*. Our variable took one if the entity that has a one tier management system, otherwise it took 0. The problem with the one tier management system is that in these case the CEO and the chairman of the board of directors can be or

not the same person, while in the case of two tier management system, there is automatically a difference between CEO and the chairman of the board of directors.

We also consider the number of executive members from the board of directors. The variable was compute considering the average values of the numbers of executive directors that the company has (the average value was calculated only when the company had a variable number of executive members from the board of directors). For coding, we used the name *EXM*. Another variable is the existence of audit committee, which is a variable that can establish the correlation between corporate governance principles and the financial auditor. As this variable is also a dummy one, the way of computed it is similar with the way the other variables were computed. As a fact, the variable, *DCOMT* took value 1 if the companies reported in its corporate governance document the existence of audit committee. Otherwise, the variable took value 0.

We also included the level of indebtedness calculated as the value of total debt divided by the value of total assets (the value of total debt plus the value of own capital and which was coded *LEV*). For the level of indebtedness, the data was quantified using financial data from 2012.

The model upon which the research was conducted is presented in equation (3)

$$DA_i = \alpha_0 + \alpha_1 \times LOGAF_i + \alpha_2 \times DAUD_i + \alpha_3 \times DCHG_i + \alpha_4 \times DCOMT_i + \alpha_5 \times DSYST_i + \alpha_6 \times DCEO + \alpha_7 \times LEV_i + \alpha_8 \times EXM_i + \varepsilon_i$$

Where *DA* is the value of discretionary accruals calculated using financial information from 2012.

## Results and discussions

In order to detect if there is any significance upon the value of discretionary accruals considering financial auditor's characteristics or corporate governance principles, we firstly analyzed the correlation matrix that exists among variables. The correlation matrix is presented in table 1.

**Table 1.** *The correlation matrix*

Element	DA	LOGAF	DAUD	DCHG	DCOMT	DSYST	DCEO	LEV	EXM
DA	1								
LOGAF	-0.373**	1							
DAUD	-0.122	0.157	1						
DCHG	-0.197	0.121	0.044	1					
DCOMT	0.129	-0.047	0.013	0.076	1				
DSYST	-0.015	-0.346	-0.196	-0.287***	-0.336**	1			
DCEO	0.016	-0.065	0.077	0.211	0.133	-0.249	1		
LEV	-0.283***	0.268***	0.013	0.076	-0.046	0.187	-0.215	1	
EXM	-0.055	0.071	0.425***	-0.025	0.186	-0.127	0.195	-0.233	1

Where \*\*, \*\*\* states for the level of significance at 5% and 10%.

From Table 1, it can be observed that there is no significant high correlation between variables. The highest correlation is found between the number of executive members and

the type of financial auditor. It seems that larger the number of executive members from the board of directors is, highest is the probability of having a financial BIG4 financial auditor. Between the value of discretionary accruals and the independent variables, there seems to be no significant higher correlation, so they can be considered proper proxies for estimating it. The results are provided in Table 2.

**Table 2**

Dependent Variable DA divided by total assets					
Constant	0.5690	0.7002***	0.6562	0.7227***	0.7371***
LOGAF	-0.1597***	-0.1937**	-0.1931**	-0.2003**	-0.1973**
DAUD	-0.0208	-0.0386			
DCHG	-0.0876	-0.0990 (p=0.1802)	-0.0978 (p=0.1870)	-0.0965 (p=0.1988)	-0.1003 (p=0.1030)
DCOMT	0.0312		0.0208		
DSYST	-0.0921	-0.1417 (p=0.1584)	-0.1182	-0.1365 (p=0.1845)	-0.1374**
DCEO	-0.0121			-0.0092	
LEV	-0.1395				
EXM	-0.0009				-0.0071
Rsquared	23.70%**	21.17%	20.62%	20.38%***	20.69%***
DW	1.80	1.77***	1.88***	1.85***	1.85***

Where \*\*, \*\*\* states for the level of significance at 5% and 10%.

As the model where the independent variables were the logarithmic value of total assets, the type of management system and if there has been or not a change of financial auditor was the best, it form the basis for estimating the influence of the other independent variables. Moreover, the value of logarithmic auditor's fees was preferred to be used in estimation instead of the value of indebtedness as it conferred better and significant results. Each model was also checked for heteroscedasticity using the White test. In case the heteroscedasticity is found (for model five, where the number of executive members from the board of directors is included), the equation was estimated using White's heteroscedasticity-consistent covariance matrix estimator (White, 1980). The use of this correction increases the relevance and significance of the coefficients and of the entire model. Moreover, probabilities that are under 20% are also provided in Table 2 as the number of observation is relative small. Thus, the risk of rejected the null hypothesis can be increased.

Considering this, it could be seen that the value of auditor's fees is negatively related with the value of discretionary accruals. It seems that higher the value of auditor's fee, measured a year above, lower the future value of discretionary accruals is. As auditor's remuneration can be a proxy for Big 4 companies (in general, BIG 4 companies perceive higher audit fees due to their reputation (Campa, 2013), it can be said that there is an important probability that the presence of an auditor from BIG4 or of on auditor with a sort of reputation (like BDO) can mitigate the value of discretionary accruals. Opposite to this conclusion, the existence of an auditor which is especially form BIG 4 seems not to influence the value of discretionary accruals. We can than formulate that only the value of auditor's fee influence in a negative way the value of discretionary accruals. The fact that highest the value of auditor's fee is, the lower is the value of discretionary accruals can

provide evidence that the auditor's remuneration could be correlated with other variables that were not included into our analysis.

The existence of the audit committee seems not to have any influence upon the value of discretionary accruals. From our, point of view, the presence of audit committee should increase the level of transparency. It seems that for Romanian companies, there is no relevance that the existence of audit committee has an influence upon the value of discretionary accruals.

If we increase the risks associated with null hypothesis, that the coefficient associated to a variable is zero, to at least 11%, we find that the change of financial auditor a year before, influence in a negatively way the value of discretionary accruals. Our results are opposite with the results found by Becker et al., 1998.

Another variable that is statistically significant from zero and that has an influence upon the value of discretionary accruals is the type of management system that the company has. It seems that companies that have a one tier management system report less values of discretionary accruals for the Romanian market. This result is somehow confusing as a one tier management system is characterized by less transparency than a two tier management system.

In accordance with the results that refers to the management system, is also the result regarding the CEO/chair duality. Even though the coefficient is not statistically significant from zero, it seems that Romanian companies have lower value of discretionary accruals if the CEO is a different person from the chairman of the board of directors.

Considering, the number of executive members from the board of directors, the coefficient is also not statistically significant from zero. If it was, than it seems that higher the number of executive members from the board of directors is, lower the value of discretionary accruals is. That should be reliable as while the number of executive members is increasing, they can assign activities to smaller committees, which could conduct to higher transparency.

Overall, the transparency for the Romanian market is ambiguous and so are the results considering the value of discretionary accruals.

## Conclusions

The purpose of this article was to provide evidence about the influence of financial auditor's characteristics and of the corporate governance indicators upon the value of discretionary accruals. The assumptions upon which the research was conducted were based on the fact that higher transparency should be correlated with a lower value of discretionary accruals. We consider that transparency should be a key element for financial re-launch.

Considering these, the research was conducted using a sample of 41 companies that are listed on the Bucharest Stock Exchange and that have to provide their individual financial statements using the International Financial Reporting Standards.

The results are mixt and reveal that there is still lot of transparency upon the Romanian market. While the value of auditor's fees seems to influence the value of discretionary accruals, no proper conclusion can be formed considering the type of financial auditor or the change of it. As a fact, higher the financial auditor's fees are a year above, lower the value of discretionary accruals is. On the other side, no statistically significant relationship can be extracted upon the other variables. Even though the same negative relationship seems to exist, the coefficients are not relevant for our research. If the coefficient would have been significantly different from zero, than the change of financial auditor and the high qualify auditing process, done by an auditor from BIG4, would have decreased the value of discretionary accruals.

Moreover, the existence of the audit committee provides also mixt evidence. This is because we considered that the existence of the audit committee should be a sign of higher transparency, thus we have expected to find a negative relationship between this variable and the value of discretionary accruals. Opposite to our assumptions are the results. Even though there is no statistically relevance for the coefficient associated with this variable, a positive relationship seems that is more reliable for Romanian market. In our opinion, this is a problem of transparency at national level.

Other transparency problems seem to be related with corporate governance variables. As a fact, a one tier management system affects negatively the value of discretionary accruals. We consider on the other hand, that a two tire management system should provide more transparency than a one tier management system. Consequently, the results are surprising.

Nevertheless, even though the CEO/chair coefficient is not valid, the evidence is that for Romanian market, the lack of CEO/chair duality seems to influence in a negative way the value of discretionary accruals. The lack of statistically relevance could be associated with transparency problems.

Considering the number of executive managers from the board of directors a negatively insignificant relation was found between it and the value of discretionary accruals.

There is also a problem the value of indebtedness seems to not influence the value of discretionary accruals. The models were also tested considering a lag value, but no relevant conclusions were obtained.

Several problems were encountered in this analysis. One of it is the fact that data have been collected manually and that the dimension of our sample is still reduced.

Overall, our results suggest that there is a lack of transparency on the Romanian market and thus, this is an impediment to the economic re-launch. In order to improve our analysis, the analysis should be conducted on a larger sample models of simultaneous equations could be used as there could be interdependency between the variables

encountered into the model. Moreover, we have to conduct the analysis considering other factors that can impact the value of discretionary accruals.

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