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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 Piata Romana Square, Bucharest Distruct 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.

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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

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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 fees (Tsui et al, 2001). The explanation is due to the fact that the company is associated as having a lower corporate risk. On another research conducted by Desender et al, 2009 the results prove that the CEO/chair duality influences in a negative way the auditor's remuneration.

Regarding the Romanian market, only few studies looked at the corporate governance elements. One of them is the study conducted by Dobre et al, 2012a who proved that the existence of audit committee and the existence of information related with corporate governance mechanism influence the type of auditor, which is another measure to provide evidence about the auditor's activity. Another research is conducted by Dobre et al, 2012b where they found positive correlation between audit fees and managers' remuneration.

3. Methodology of research

The idea of research is to provide evidence about the relationship between financial audit and corporate governance elements. The existing literature is focusing either on multiple regression models, either on binary models (where the dependent variable is represented by the type of auditor) or either on simultaneous equations models. Our research is conducted using a simultaneous equation model, as we consider that interdependencies between financial audit and corporate governance variables exist. The research is conducted upon the companies that are listed on the Bucharest Stock of Exchange.

In order to select the companies that we included into our database, we picked all entities that have to report their individual financial statements using IFRS approach from 2012. According to Romanian Financial Supervision Authority, 71 companies have to report their individual financial statements using the new accounting regime. From the initial sample, we excluded the companies that had a negative value of their own shareholder capital between 2010 and 2012 (which included both the transition period to the IFRS measures and the year of adoption). We also excluded the companies that were in insolvency between 2010 and 2012 and the companies that did not present information related to auditor's remuneration. In the end, our sample encounters 41 companies.

Our aim was to conduct the analysis on most recent data. Unfortunately, no enough information about auditors fees was found for 2012 and 2013, so consequently, the model was implemented using information from 2011. The data have been collected from individual company's site, both from their financial statements and from the corporate governance document.

In our analysis, we include several proxies to measure corporate governance impact upon the financial audit. According to some studies (Cheng, 2008, Yermark) , the size that the supervisory board has and the existence of audit committee have an impact upon the audit risk and also upon the effort that financial auditors do during an auditing process. Considering this, we include in our analysis the existence of the audit committee (DCOMT) that takes 1 if the company has an audit committee and 0 otherwise. For the supervisory board, we use as proxy the number of executive directors that the company has (NOEXB). By analyzing individual financial statements, we observe that some entities do not have exactly a number established for the executive members from the board. Thus, in order to obtain a reliable estimation we establish the mean of the number of executive members that the company has.

We also included the type of management system that the company has as a dummy variable (DSYST). As a fact, if an entity has a one tier management system than the value of DSYST is 1, otherwise if the company has a two tier management system than the value of the dummy variable is 0. Another variable that is also correlated with the corporate governance principle is the difference among CEO and chairman or the CEO/chair duality. We consider that its influence can be measured using a dummy variable that we coded DCEO. We conferred 1 if the person that is CEO is different from the person which is the chairman of the company.

Considering the auditor characteristics two variables have been used such as the value of audit fees (measured though the logarithmic value and coded LOGAF and the type of auditor that the company has, measured by using a dummy variable (the variable was coded as DAUD). The variable took 1 if the auditor was a company from BIG4: PricewaterhouseCoopers, KPMG, Ernst & Youngand Deloitte Touche Tohmatsu, otherwise the variable took 0.

We also considered some individual variables such as the percent of shares that the major shareholder has (PCT) the return on assets (which serves as proxy for profitability and which is coded ROA), the size of the company (measured though the logarithmic value of total assets- coded LOGTA) and the indebtedness ratio (measured as the ratio between total debts that the entity has and the value of shareholders' own capital-which is coded as LEV). All variables were calculated using financial data a year before our analysis is conducted.

As we have mention before, the model upon which we conduct the research is a simultaneous equation model, which has two equations. Its structural form is presented in equation (1) and equation (2)

$$\begin{cases} LOGAF_i = \alpha_0 + \alpha_1 * DSYST_i + \alpha_2 * DCEO_i + \alpha_3 * DCOMT_i + \alpha_4 * DAUD_i + \alpha_5 * NOEXB_i + \varepsilon_i & (1) \\ NOEXB_i = \beta_0 + \beta_1 * PCT_i + \beta_2 * ROA_i + \beta_3 * LEV_i + \beta_4 * LOGTA_i + \beta_5 * LOGAF_i + \beta_6 * DSYST_i + & (2) \\ + \beta_7 * DCEO_i + \mu_i & \end{cases}$$

Where ε_i and μ_i are the error terms of the system and i is from 1 to 41

Each equation of the system is over-identified due to the fact that the number of endogenous variables (which are LOGAF and NOBEX) minus one is less than the number of variables that are missing from each equation.

In order to determine the un-bias value of the coefficients, the model is estimated in two stages: firstly, the reduced form of the equation was estimated and secondly, the fitted values are used as proxy for the endogenous variables in the structural form.

The hypotheses upon which the research is conducted are:

H1: There should be a negative correlation between the type of system and the auditor's fees, but this correlation depends on the size of the company.

H2. There is a negative relationship between the CEO/chair duality and the auditor's fees.

H3. There is a negative relationship between the existence of the audit committee and the auditor's fees.

H4. : There is a positive relationship between the type of auditor and the auditor's fees.

H5: There is a negative correlation between the number of executive directors and the auditors' fees.

4. Results and discussions

As it was mentioned, the purpose of this analysis is to provide evidence about the correlation between the financial auditor's characteristic and the corporate governance variables. For revealing this aspect, firstly the correlation matrix has been pointed out. The correlation matrix is presented in table 1.

Table 1. The correlation matrix

Element	LOGAF	DSYST	DCEO	DCOMT	DAUD	NOEXB	PCT	ROA	LEV	LOGTA
LOGAF	1									
DSYST	-0.343**	1								
DCEO	-0.097	-0.245	1							
DCOMT	-0.026	-0.350**	0.173	1						
DAUD	0.147	-0.192	0.061	0.029	1					
NOEXB	0.062	-0.125	0.186	0.201	0.4219*	1				
PCT	0.149	0.212	0.063	-0.325**	0.147	0.086	1			
ROA	-0.069	0.032	0.049	0.165	-0.171	-0.051	-0.136	1		
LEV	0.132	0.131	-0.241	-0.099	0.037	-0.263	0.094	-0.090	1	
LOGTA	0.481*	-0.355**	0.160	0.254	0.133	0.415*	0.207	0.019	-0.053	1

As it can be seen in table 1, the size of the company has more than one correlation above 0.4. It seems that larger the company is, higher the auditor's fees are. Another correlation is found between the size of the company and the number of executive directors. In order to provide evidence if this is a good estimator, both the model where it (LOGTA) was included and the model were it was excluded is presented in table 2. Another important correlation is found between the auditor's type and the number of executive members from the board.

According to the estimation procedures, we expect to have better results in case the size of the company is excluded from the analysis. The results are presented in table 2.

Table 2. The correlation between audit fees and corporate governance variables

Element	Model where the size of the company was included	Model where the size of the company was not included
Constant	4.8448*	5.3409*
DSYST	-0.5765*	-0.5329*
DCEO	-0.2125*	-0.1457*
DCOMT	-0.1952*	-0.1135*
DAUD	-0.1536***	0.0704**
NOEXB	0.1510*	0.0007
R squared	65.48%	75.73%
DW	2.32	2.52
Heteroscedasticity	Yes	No

From table 2, it can be seen that the model that better fits the results is the model where the size of the company was not included. The explanation is due to the fact that higher values are associated with R-squared and moreover, in the second model, there is no evidence of heteroschedasticy .

From table 2, it can be seen, that all variables have the coefficients statistically significant from zero. The results provide evidence that the existence of the one tier unit system negatively affect the amount that the financial auditors receive. Also, when the companies' size is taken into consideration, the sign of the coefficient does not change. Thus, our results rely on H1.

Considering the CEO/chair duality, significant negative correlation with the auditor's fees was detected. In other words, if the CEO of the company is not the same as its president, than we expect to have higher transparency in reporting. Consequently, the risk associated with the auditor's activity is mitigated, so fewer fees are paid to financial auditor as part of remuneration contract. Based on this, hypothesis H2 is true.

Regarding the existence of the audit committee, the results provide evidence that the hypothesis H3 has to be valid. The presence of audit committee and its activity is considered to mitigate the audit risk that financial auditor encounters. The results are in accordance with the results found by Cohen and Hanno, 2000.

As the literature reveals, there is a positive relationship between the type of auditor and the auditor's fees. The justification comes from the fact that BIG4 auditors are more inclined to report fraud due to their reputation (Michaely and Shaw, 1995). As a fact, H4 is valid.

When it comes to the number of executive directors from the board and the auditor's remuneration, no statistically significant assumption could be made for Romanian companies. Even though the sign associated with the number of executive directors from the board is positive, it is no statistically significant from zero. Due to this, H5 is rejected.

The results are similar with the results obtained by Voeller et. al, 2013 when the existence of audit committee and the type of auditors are encountered. Considering that we have replace the number of supervisory members with the number of executive board, same positive relationship was obtained, but no statistically relevant

5. Conclusions

The purpose of this research was to point out the correlation that exists between the financial audit and corporate governance variables for Romanian companies. Initially, information on a sample of 71 companies was collected, but due to negative value of their own capital, due to lack of data regarding auditor's remuneration or due to the fact that some of them have opened their insolvency procedure, the research was conducted using a sample of only 41 companies. When it comes to data, the analysis was implemented using financial information for 2011. The data was modelled using a simultaneous equation model. We consider that there is interdependency between financial audit variables and corporate governance indicators.

The results present some particular features of the Romanian companies. First of all, there is a positive correlation between the type of the auditor and the fees they receive for their audit process. That means that high quoted auditors ask for higher fees for their audit activities.

We also found negative influence of corporate governance variables upon the auditor's remuneration. As a fact, if a company has one tier management system then the amount received by auditors is also smaller than the fees that they get when the company is having a two tier management system. Negative correlation was also detected between the value of auditor's fees and the existence of the audit committee. The explanation comes with the fact that the existence of the audit committee mitigates the risks associated with auditing activities, thus the auditor's remuneration has to be smaller.

Similar conclusions were obtained considering the CEO/chair duality. As a fact, if there are two persons that hold the CEO and the president position, then the amount that the auditors received is smaller than in the case where only one person has both position. As there is higher transparency and lower risk when the CEO differs from the company chairman, the managers give smaller fees to financial auditors.

Regarding the number of executive members from the board, no reliable conclusion could be subtracted from our analysis, as the coefficient associated with it is not statistically significant from zero.

The lacks of the research are related with the lack of transparency for Romanian companies, considering that they do not report the auditor's remuneration, with the fact that the data have been manually collected and with the small dimension that our sample has.

Future research aims to determine the influence of other corporate governance measures such as the impact of supervisory board, the way the internal audit process is conducted upon financial audit using both a simultaneous equation model and a model that is based on other techniques of estimation : such as binary models.

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