CORPORATE GOVERNANCE AND EXTERNAL AUDITORS: HIGH AUDITING QUALITY

Issam MF SALTAJI, PhD Lecturer
Athenaeum University of Bucharest
E-mail: createmyworld@mail.ru

Abstract:

In the last decades, many companies are collapsed besides related frauds are more highlighted around the world. That affects the credibility of the financial and operational reports, which is supposedly supported by good governance practices. That stirs a number of regulatory institutions to present several codes that strengthen transparency and disclosures requirements in the financial reports and in the light of that the audit quality and governance standards practices are concerned by academicians and researches, therefore, the evidence of the practices of corporate governance and audit quality is presented in developed economies and they becomes a significant need nowadays. The article presents a guideline to investigate the relationship between audit quality and corporate governance.

Keywords: *Corporate Governance, External Auditing, High auditing quality, Agency problems*

JEL Classification: *M4, M2. M1*

1. Introduction

Corporate governance is considered as developments' key of the capital market, and due to the World Bank report; improving Corporate Governance in Emerging Markets (2011), good practices of corporate governance decease the frauds in the emerging markets and that reduces the capital cost, in addition, manages the developments of the capital markets. Due to Adeyemi and Temitope (2010); the weakness of governance codes is likely the factor that is blamed for the failure of corporate governance. Besides that, there is a debate that is important and considerable nowadays, which presents the need for governance practices (McConmy & Bujaki;

2000), besides, setting guideline that strengthen governance practices (Cadbury; 1992). Accordingly, the integrity of the international financial markets are highly concerned (Millstein; 1999). The board of directors affects the quality of the financial reports that are an important impact for investors (Levitt; 2000) and that decreases the adverse of earnings management and financial reports (Beasley; 1996 & Dechow, et al, 1996, McMullen; 1996). In addition, the external auditors have their roles over all in order to improve the credibility of financial reports (Mautz and Sharaf; 1961; Wallace; 1980). The auditing quality is based on the auditing profession throughout standards that ensures independency and transparency (Blue Ribbon Committee; 1999). Due to that, the relationship between governance practices and high quality reports is highlighted by plenty of researchers especially in the United States of America (McMullen; 1996 & Abbott, et al; 2000).

Therefore, successful auditors never lose observation over the importance of continuously developing and estimating the structure of corporate governances, also the decision of a certain company to adopt governance mechanisms is influenced by fundamental characteristics due to the activities of that company. Still, the main function of corporate governance is to ensure the high quality of financial reports (Cohen, Wright & Krishnamoorthy; 2004); and in order to achieve that the audit committee oversees the process and procedures of financial reports in the light of integrity and credibility of the reports. In the light of Deloitte Report (2013), the audit committee is considered as "a key fulcrum of any company", thereby determining the efficiency of this committee is assuming strongly important.

2. The role of external and internal auditors in corporate governance:

Corporate governance is that mechanisms and procedures applied by companies in order to reduce the transaction and agency costs. That means; the idea of corporate governance becomes from the separation between two functions; management and ownership. Auditors enroll importantly as ears and eyes of shareholders besides other stakeholders in order to instill the trustable level in the financial markets through auditing quality. In the case of ENRON scandal was due to auditors certainly Arthur Andersen and the later analyses reached a conclusion that external investors misled about the income statement of the company. In the light of that, the failure was in the protection set for investors and shareholders that were included in Generally Accepted Accounting Principles and Statements on Auditing Standards besides Generally Accepted Auditing Standards. Individuals in Enron studied that set in order to serve their benefits; accordingly, they bolstered the balance sheet with inflated assets and hiding liabilities. That could be achieved without the Auditor; David B. Duncans. The external auditors of Andersen were close personally to certain some partners in ENRON and that broke an essential principle called independence.

Corporate governance has its role in solving agency problems and balance between the interests of stakeholders; maximizing the company value in the light of social and environmental responsibilities. Due to that, a good measure that may contribute to the efforts of corporate governance is the involvement of external auditors; Act Sarbanes Oxley, also, these auditors should minimize the monitoring costs through facilitating situation whereby executives are motivated to be held accountable. Hereby, the internal cost is defined as these process influenced by the board of directors and executives besides other factors, these process serves the auditing objectives that include auditing quality. Due to that, the relationship among the weakness points of internal auditing and the audit committee is an important subject for investigating, thus, the auditing committee does not only play a role to assure the quality of financial reports also assures accountability and in the meantime, that serves the governance mechanisms.

3. High auditing quality and corporate governance

The trust in financial reports is sustained by the high quality of auditing services that increase the financing possibility (Lin & Liu; 2009), in addition, the high quality of auditing services is related to the lower cost of capital (Pittman & Fortin; 2004). In the light of that, these services are significant for these companies that look to increase the financial capital, and due to previous researches, the auditing quality is strongly related to companies complexity and corporate governance (Hay et al; 2006). An important mechanism of corporate governance is auditing that plays in certifying the financial information (Coffee; 2002), also, governance perspectives include better control in order to reduce the need for high auditing quality (Hay et al; 2006).

Due to that, the relationship between high auditing quality and corporate governance can be shaped by two perspectives; the first perspective; a better control will reduce the need for high auditing quality, the second perspective; strengthening governance mechanism “control” will strengthen the efficiency of auditing and due to that the auditing quality will be increased. That means; the different role between the internal auditor and the external auditor should be highlighted separately since the quality of auditing reports is strongly related to the governance mechanisms, accordingly, auditing mechanisms of corporate governance are significantly important (Mersland & Strom; 2009).

Basically, reducing the agency conflicts and false information among stakeholders is a significant object of external financial reports (Healy & Palepu; 2001 and Hope et al; 2008), and that is related to the reports' quality, thus, the main concern of auditing is to reflect a high quality of financial reports (Boone et al; 2010). In 2009, Liu and Lin assumed that high auditing quality will be effected only when the agency costs are reduced , due to that, the auditing quality has different dimensions (Lin & Wang; 2010). Governance mechanisms can be divided into two important parts: the internal part focuses on monitoring governance activities and create stakeholder value, also it includes independent directors, audit committee, management, internal controls and internal audit, the external part focuses on monitoring the company's activities and ensures the interests of internal stakeholders, and this part includes; financial markets, state and federal law and regulations, and shareholders proposals. After all, the company's size must not be ignored since it is considered as an important factor that affects the auditing quality. Therefore, the size of companies will decide if the quality of internal auditing is acceptable and if there is a need for an external auditor and here, the need for big auditing companies is issued as a key solution for high auditing quality. The relationship between the company's size and auditing quality is tested by Colbert and O'Keefe in 1995, and Dies and Giroux in 1992 to ensure the negative relationship among them. Furthermore, the independence of auditors as one of governance perspective is to ensure the auditing quality; therefore, an independent auditing committee ensures the independence of external and internal auditors through being free from managerial influences in order to encourage them to be transparent on the all issues before reach an advanced level. In the light of that, assuring that financial reports are free-bias is significantly related to the qualifications of auditors and that means, the auditing value is related to the external stakeholders who examine the quality of financial reports. Due to the statistic study that done by Hajha and Jahntigh in 2013 to test the relationship between the directors' independence and auditing the quality; there is a positive relationship presented in the following table:

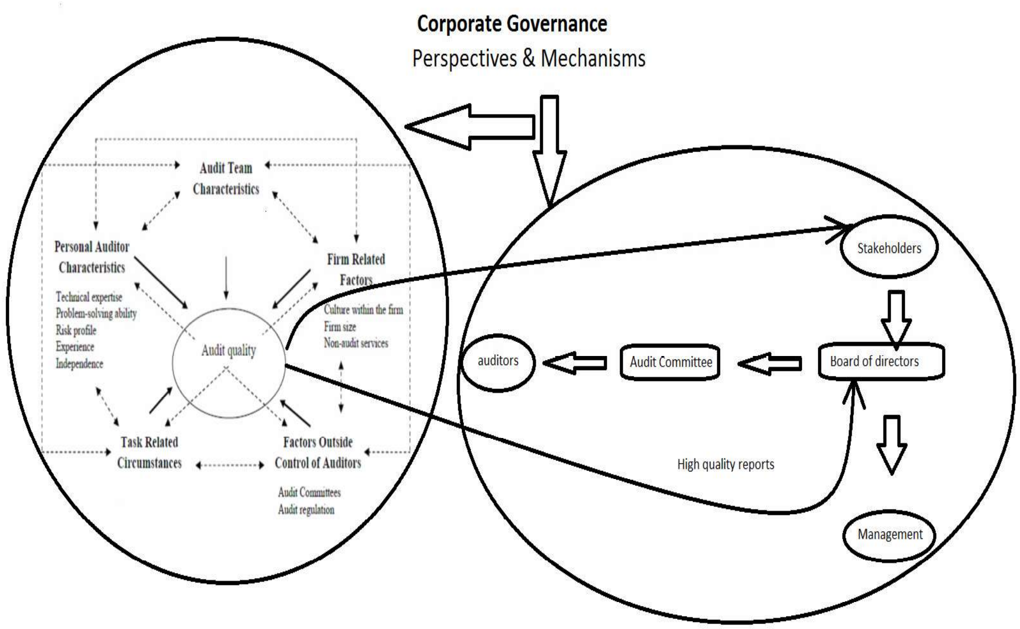
RESULTS OF REGRESSION BETWEEN BOARD INDEPENDENCE AND AUDIT QUALITY

The significance level -With	Statistics t	Coefficient	Variable name	Symbol	Type variable
_	_	_	Quality Audit	Y	Dependent variable
000/0	024/11	544/103	Alpha	α	Constant
000/0	300/6	*5065/0	Asnqlal board	X1	Variables Independent
092/0	686/1-	311/0-	Financial Leverage		Variables Control
621/0	726/17	*126/22	Company Size		
_	_	703/1	Camera Watson		
000/0	_	163/51	Statistics F		
_	_	57/0	The correlation coefficient	R	
_	_	32/0	The coefficient of determination	R Square	
_	_	32/0	The coefficient of determination Adjusted	Adjusted R Square	

This table shows that the variables of BOD and financial leverage is p-value <5%, which has a significantly related to the auditing quality, besides, constant quantity of company's size on auditing quality is variable like other factors; that proofs the relationship between the size and the need for external auditor.

4. Conclusion

The need for auditing is a result of the agency theory and later the conflicts among the interests of stakeholders, and after the financial crisis, this need is strongly highlighted. In addition, the perspectives of corporate governance always assure independence of directors and auditors, in the meantime, the audit committee plays a significant role to report to the directors and shareholders, and the external auditors should confirm these reports for stakeholders in order to sustain the confidence in the financial reports. In the light of that, the relationship between high audit quality and corporate governance is an integrated relationship. The governance mechanisms ensure high auditing quality but theses relationship can take different shapes; strengthening control and that reduce the external auditing cost or assuring the independence of external auditors.



Relationship between Corporate Governance and Audit Quality

Resource: Author and Hardies & Breesch & Branson (2011)

References

- Abbott Lj, Park Y & Parker S (2000); the effects of audit committee activity and independence on corporate fraud. Managerial Finance pp. 26, 55-67.
- Adayemi, S.B. and Temitope, O.F. (2010). Audit Quality, Corporate Governance and Firm Characteristics in Nigeria. International Journal of Business and Management, 5(5).
- Beasley M S (1996); An empirical analysis of the relation between the board of director composition and financial statement fraud; Accounting Review 71(10); Pp.443-465.
- Blue Ribbon Committee (1999); Report and Recommendations of the Blue Ribbon Committee on improving the effectiveness of corporate audit committee, New York, NYSE and NASD.
- Boone, J. P., Khurana, I. K., & Raman, K. K. (2010). Do the Big 4 and the Second-tier firms provide audits of similar quality? Journal of Accounting & Public Policy, 29, 330-352.

- Cadbury Committee (1992); Report of the Committee on the Financial Aspects of Corporate Governance; London: Gee and Company Ltd.
- Coffee, J. C. Jr. (2002). Racing Towards the Top? The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance. Columbia Law Review, 102, 1757-1831.
- Cohen, J., Wright, A. and Krishnamoorthy, G. (2004). The Corporate Governance Mosaic and Financial Reporting Quality. Journal of Accounting Literature, Pp.87-152. 6
- Dechow, P.M., Sloan, R.G., & Sweeney, A.P. (1996). Causes and consequences of earnings manipulation: An analysis of firms subject to enforcement actions by the SEC. Contemporary Accounting Research, 13(1), 1-36 DeFond, M. L., & Jiambalvo, J. (1991). Incidence and circumstances of accounting errors. The Accounting Review, 66(7), 643–65
- Deloitte (2013). Centre for Corporate Governance India. Retrivered from http://www.corpgov.deloitte.com/site/in/audit-committee/internal-external-audit/
- Hahiha Z and Jahantigh K (2013); the relationship between corporate governance and audit quality monitoring tools in listed companies in Tehran Stock Exchange; Journal of Social Issues & Humanities, Volume 1, Issue 2; ISSN 2345-2633; Pp.61-70.
- Hardies, K., Breesch, D., Branson, J. (2011). Are Female Auditors Still Women? Analyzing the sex differences affecting audit quality. available at: http://ssrn.com/abstract=1409964
- Healy, P. M., & Palepu, K. G. (2001). Information asymmetry, corporate disclosure, and the capital markets: A review of the empirical disclosure literature. Journal of Accounting & Economics, 31, 405-440
- Hope, O.-K., Kang, T., Thomas, W., & Yoo, Y. K. (2008). Culture and auditor choice: A test of the secrecy hypothesis. Journal of Accounting & Public Policy, 27, 357-373.
- Hay, D. C., Knechel, W. R., & Wong, N. (2006). Audit Fees: A Meta-analysis of the Effect of Supply and Demand Attributes. Contemporary Accounting Research, 23, 141-191.
- Levitt A (2000); Speech by SEC Chairman: Remarks Before the Conference on the Rise and Effectiveness of New Corporate Governance Standards; Federal Reserve Bank, New York; available at: www.sec.gov/news/speech/spch449.htm on 19/10/2009.
- Lin, J. W., & Hwang, M. I. (2010). Audit Quality, Corporate Governance, and Earnings Management: A Meta-Analysis. International Journal of Auditing, 14, 57-77.
- Lin, Z. J., & Liu, M. (2009). The impact of corporate governance on auditor choice: Evidence from China. Journal of International Accounting,

Auditing & Taxation, 18, 44-59

- Mautz, R. K., & Sharaf. H.A. (1961). The Philosophy of Auditing. American Accounting Association. Sarasote McConomy, B., & Bujaki, M. (2000). Corporate Governance: Enhancing Shareholder Value. CMA Management, 74(8), 10-13.
- McConomy B & Bujaki M; (2000); Corporate Governance: Enhancing Shareholder Value, CMA Management 74(8); Pp. 10-13.
- McMullen D.A. (1996). Audit committee performance: an investigation of the consequences associated with audit committees. Auditing: A Journal of Practice & Theory, 15(1), 87–103.
- Mersland, R. & Strøm, R. Ø. (2009). Performance and governance in microfinance institutions. Journal of Banking & Finance 33, 662–669.
- Millstein I M (1999); Introduction to the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committee; Business Lawyer 54(3); Pp. 1097-1111.
- Pittman, J. A., & Fortin, S. (2004). Auditor choice and the cost of debt capital for newly public firms. Journal of Accounting & Economics, 37, 113-136.
- S Vitols, ‚Corporate Governance versus Economic Governance: Banks and Industrial Restructuring in the US and Germany' 1995 < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=607641> (last visited 29 June 2009)
- Wallace, W.A., (1980). The Economic role of the audit in free and regulated markets, Touche Ross & Co. Aid to Education Program.