

audit

FINANCIAR

Anul XIV, nr. 143 - 11/2016

11/2016

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- The development of a corporate governance assessment model for the Romanian public sector



- Transpunerea noului regulament al Uniunii Europene privind auditul în legislația națională din Croația
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Revistă lunară editată de
**Camera Auditorilor Financieri
din România**

Str. Sirenelor nr. 67-69, sector 5,
București, OP 5, CP 83

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Academic Keys;

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Marcă înregistrată la OSIM,
sub nr. M2010 07387

Telefon: +4031.433.59.22;

Fax: +4031.433.59.40;

E-mail: revista@cafr.ro;

<http://revista.cafr.ro>;

facebook.com/revistaauditfinanciar

ISSN: 1583-5812,

ISSN on-line: 1844-8801

Tipar: SC Print Group Serv SRL

Str. Baicului nr. 82, sector 2, București

e-mail: office@printgroup.ro

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audit
FINANCIAR

11/2016

Monthly Journal published by the
**Chamber of Financial Auditors
of Romania**

67-69 Sirenelor Street, District 5,
zip code 050855, Bucharest, OP 5,
CP 83

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ISSN: 1583-5812,

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Printing:

SC Print Group Serv SRL

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București

e-mail: office@printgroup.ro

Transposition of the new European Union audit regulation into the Croatian national law

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Abstract

The audit reform in the EU resulted in the adoption of the new regulatory framework. The European Parliament adopted Directive 2014/56/EU amending the Directive 2006/43/EC on statutory audit in the EU and the EU Regulation No. 537/2014 containing requirements that relate specifically to the statutory audit of public interest entities. Each Member State needs to transpose the Directive into its national legislation and also ensure its implementation. Within the framework of transposing the Directive into the national regulation, each Member State had many options that allowed them to tailor the provisions of the national law according to their needs and specific aspects of the national audit markets. However, the number of options brings risks that are connected to additional audit procedures and inefficiencies in the process of performing audit with potential effects on the quality and cost of audits. The aim of this article is to analyse the most important (not used) options of the Directive and Regulation according to the Croatian national legislation. In that sense, the article provides information about the definition of statutory audit and the subjects of statutory audit as well as the definition of public interest entities in Croatia. In addition, the audit profession in Croatia is analysed in the context of the “European audit passport”. The results of this research can be a base for future comparisons between Croatia and the other EU Member States. Finally, the implementation of these provisions will answer the question: Does the implementation of different options bring convergence or divergence within the single EU audit services market?

Keywords: Transposition, Regulation 537/2014, Directive 2014/56/EU, Croatia, audit profession, Audit Act.

JEL Classification: M42.

To cite this article:

Sever Mališ, S. (2016), A comprehensive conceptual profile on control, *Audit Financiar*, vol. XIV, no. 11(143)/2016, pp. 1213-1226, DOI: 10.20869/AUDITF/2016/143/1213

To link to this article:

<http://dx.doi.org/10.20869/AUDITF/2016/143/1213>

Introduction

The audit reform in the European Union (EU) had as a consequence, among others, the adoption of a new regulatory framework. The European Parliament adopted Directive 2014/56/EU amending the Directive 2006/43/EC on every statutory audit (hereafter referred to as “the Directive”) in the EU and the EU Regulation No. 537/2014 (hereafter referred to as “the Regulation”) containing requirements that relate specifically to the statutory audit of public interest entities. Both the Directive and the Regulation were published in the Official Journal of the EU on 27 May 2014 and came into force on 16 June 2014. Each Member State has had two years to adopt Directive into their national legislation, and the provisions of the Regulation became applicable as of 17 June 2016 onwards. From that time all the provisions in national legislation which are in contradiction with the Directive and Regulation are null and void.

According to the official web sites of the European Commission (2016), only 11 Member States have adopted and transposed the provisions of the Directive into national legislation so far. In other words, each Member State needs to transpose the Directive into its national legislation and also ensure the implementation of the Regulation. Within the framework of transposing the Directive into the national regulation, the Member States have many options that allow them to tailor the provisions of the national law according to their needs and specific aspects of the national audit markets.

On the other hand, Member States carried forward a long tradition of a variety of local corporate governance laws and regulations and the options are a necessity in that sense. However, divergence in the choices of Member States can increase complexity and costs on business in the unique European market, especially for cross-border operating companies. Disruption due to different legislative frameworks could lead to additional audit procedures and inefficiencies in the process of performing the audits, with potential effects on the audit quality and costs.

Croatia became a member of the EU on July 1st, 2013, after a long process of adopting European regulations into national legislation. However, due to the recent changes of the European audit legislation, Croatia has the complex task to transpose the audit provisions into national legislation. This process of transposition is still not finished in Croatia, although the transposition

deadlines has passed. The Ministry of Finance published the Proposal of Audit Act in August 2016 and all the interested parties were invited to give their criticism and suggestions in order to improve its content. The Proposal contains provisions regarding the transposition of the Directive, and also some provisions that are the result of deficiencies noticed on the audit market in Croatia. The aim of this article is to analyse the most important (not) used options of the Directive and Regulation according to the proposed national legislation in Croatia.

1. Key audit issues in Croatia in the context of the new EU audit regulation

Subjects of statutory audit. The Directive allows Member States some options in order to tailor their law provisions according to the specific aspects of their audit market. Among others, the most important options of the audit Directive refers to the definition of statutory audit. According to the article 2 of the Directive 2014/56/EU, Member States can define the subjects, other than those required by EU law, that are required to perform statutory audits. Statutory audit means an audit of annual financial statements or consolidated financial statements in so far as it is:

- a. Required by EU legislation;
- b. Required by national law concerning small undertakings;
- c. Voluntarily carried out at the request of small undertakings, and which meets the national legal requirements that are equivalent to those for an audit under point (b), where national legislation defines such audits as statutory audits. This option did not exist under the Directive 2006/43/EU. Namely, when that Directive passed, audits of small undertakings were required by the 4th and 7th Directives, subject to a Member State’s option to provide and exemption. Points (b) and (c) of the article 2(1) of the Directive ensure that small undertakings are still covered by the Directive even through the Accounting Directive no longer applies to the audits of small undertakings.

Until the 1st of January 2016, in Croatia, the subjects of statutory audit were set in the Accounting Act (2007) and Auditing Act (2008). According to the Accounting Act

(2007) that was in force until the year 2016, statutory audit refers to the individual and consolidated annual financial statements of:

1. Large and medium-sized entities,
2. Entities whose securities are listed or are in the preparation for listing on the organized capital market, and
3. Entities under special regulations.

The conditions set in the Audit Act (2008), on the other hand, included the auditing of annual financial statements and consolidated annual financial statements of:

1. Joint stock companies,
2. Limited partnerships and limited companies if their total revenue in the previous year exceeded 30 million HRK (approximately 4,000,000 Euro). In the year 2014, 2,865 companies satisfied those conditions, which means that their financial statements were the subject of statutory audit (Sever Mališ and Brozović, 2016).

The Croatian Parliament adopted a new Accounting Act in 2015 and once again defined the subjects of statutory audit. This new Accounting Act (2015) entered into force on the 1st of January 2016. According to the new Accounting Act (2015), the subjects of statutory audit are:

1. Individual and consolidated annual financial statements of public interest entities as well as large and medium-sized entities that are not public interest entities;
2. Consolidated financial statements of parent companies of large and medium sized entities;
3. Individual and consolidated financial statements of joint stock companies, limited partnerships and limited liability companies if they meet at least two out of the following three criteria: total assets 15,000,000 HRK (approximately 2,000,000 Euro), total revenues 30,000,000 HRK (approximately 4,000,000 Euro), average number of employees 25;
4. Entities whose securities are listed or are in the preparation for listing on the organized capital market, and
5. Entities under special regulations (Table 1).

Table 1. Subjects of statutory audit in Croatia	
Until January 1 st , 2016.	After January 1 st , 2016.
Accounting Act (2007) Audit Act (2008)	Accounting Act (2015)
<p>Statutory audit refers to individual and consolidated annual financial statements of:</p> <ol style="list-style-type: none"> 1. Large and medium-sized entities, 2. Entities whose securities are listed or are in the preparation for listing on the organized capital market, and 3. Entities under special regulations (Accounting Act, 2007). <p>and</p> <p>Statutory audit refers to individual and consolidated annual financial statements of</p> <ol style="list-style-type: none"> 1. Joint stock companies and 2. Limited partnerships and limited companies, if their total revenue in the previous year exceeds 30 million HRK (approximately 4,000,000 Euro) (Audit Act, Art. 6a). 	<p>The subjects of statutory audit are:</p> <ol style="list-style-type: none"> 1. Individual and consolidated annual financial statements of public interest entities as well as large and medium-sized entities that are not public interest entities; 2. Consolidated financial statements of parent companies of large and medium sized entities; 3. Individual and consolidated annual financial statements of joint stock companies, limited partnerships and limited liability companies if they meet at least two out of the following three criteria: <ul style="list-style-type: none"> • Total assets 15,000,000 HRK (approximately 2,000,000 Euro); • Total revenues 30,000,000 HRK (approximately 4,000,000 Euro); • Average number of employees 25. 4. Entities whose securities are listed or are in the preparation for listing on the organized capital market, and 5. Entities under special regulations. <p>In addition, according to the Croatian Non-profit Organization Act, each non-profit organization that reported total revenue exceeding 10 million HRK (approximately 1,3 million Euro) is a subject of the statutory audit. Financial statements of non-profit organization operating with between three to ten million HRK (approximately between 400,000 to 1,3 million Euro) are the subject of the review engagement (Non-profit Organization Act, 2014).</p>

Source: Accounting Act, 2007; Accounting Act, 2015; Non-profit Organization Act, 2014.

In addition, according to the Croatian Non-profit Organization Act (2014), each non-profit organization that reported total revenue exceeding 10 million HRK (approximately 1,3 million Euro) is a subject of the statutory audit. Financial statements of non-profit organization operating with between three to ten million HRK (approximately between 400,000 and 1,3 million Euro) are the subject of the review engagement.

Definition of public interest entities. The most recent definition of public-interest entities in the EU is included in Article 2 point 13 of the Directive 2014/56/EU and is as follows: public-interest entities means: “(a) entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State, (b) credit institutions; (c) insurance undertakings or; (d) designated by Member States as public-interest entities, for instance undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees”. In the legislative text, the definition of public interest entities in itself has not significantly changed as compared to the 2006/43/EC Statutory Audit Directive or the 2013/34/EU Accounting Directive. However, the identification of public interest entities and thus their definition is now crucial to determine the entities that are within the scope of the Regulation (EU) No. 537/2014 for the specific requirements regarding statutory audit of public-interest entities. In other words, according to the Directive, each Member States has the option to define the public interest entities. Croatia used this option and included the definition of public interest entities into the new Accounting law (2015) that enter into the force on January 1st, 2016 (Table 2). Public interest entities are defined as:

- Large entrepreneurs;
- Companies whose securities are listed on any organised securities exchange in an EU Member State;
- Companies which the Croatian government has listed in the register of legal entities of special national interest;
- Credit institutions;
- Croatian Bank for Reconstruction and Development;
- Electronic money institutions;
- Insurance and reinsurance companies;

- Pension fund management companies, pension funds (both obligatory and voluntary) and pension insurance companies;
- Leasing and factoring companies;
- Investment fund management companies, investment funds, alternative investment funds,
- Retirement plan funding companies;
- Stock exchanges, the central depository and clearing companies, investment companies, multilateral trading facility operators, central register operators, settlement system operators and investor compensation fund operators (Accounting Act, 2015).

Although some countries have implemented the minimum requirements, Croatia has included a number of other entities into the definition of public interest entities. Among other European countries, the rules are stricter in Croatia, Italy, Romania and Slovakia (FEE, 2014, p. 8). Therefore, the major segment of public interest entities definition includes large entities. Due to the fact that all large companies are public interest entities, they must observe specific requirements regarding the statutory audit. It means that these entities must comply with more rigorous requirements for the statutory audit performance, which include stricter rules for independence and objectivity of audit firms, mandatory rotation of audit firms, restrictions on non-audit services and, among other requirements, more detailed reporting. In other words, it should be noted that the Regulation should apply not only the statutory auditors and audit firms carrying out the statutory audits of public interest entities, but also to the public interest entities.

On the one hand, these additional requirements complicate tendering of small and medium sized audit firm on the audit market of public interest entities. On the another hand, some large companies are not interested in applying these additional requirements towards the public. There are many advocates of the fact that large enterprises should be excluded from the definition of public interest entities. Although the changes of definition are being discussed within the framework of the Directive's implementation, the Ministry of Finance will make the final decision with regard to whether the definition of public interest entities will be changed in the new Audit Act.

Directive 2014/56/EU art. 2 p. 13	Accounting Act (2015)
<p>“(a) entities governed by the law of a Member State whose transferable securities are admitted for trading on a regulated market of any Member State, (b) credit institutions; (c) insurance undertakings or; (d) designated by Member States as public-interest entities, for instance undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees.”</p>	<ul style="list-style-type: none"> • Large entrepreneurs; (if they meet at least two out of the following three criteria: <ol style="list-style-type: none"> 1) total assets 15,000,000 kunas (approximately 2,000,000 euro), 2) total revenues 30,000,000 kunas (approximately 4,000,000 euro) 3) average number of employees 25 • Companies whose securities are listed on any organised securities exchange in an EU member state; • Companies which the Croatian government has listed in the register of legal entities of special national interest; • Credit institutions; • Croatian Bank for Reconstruction and Development; • Electronic money institutions; • Insurance and reinsurance companies; • Pension fund management companies, pension funds (both obligatory and voluntary) and pension insurance companies; • Leasing and factoring companies; • Investment fund management companies, investment funds, alternative investment funds, • Retirement plan funding companies; • Stock exchanges, central depository and clearing companies, investment companies, Multilateral Trading Facility operators, central register operators, settlement system operators and investor compensation fund operators.

Source: Directive 2014/56/EU, art. 2, p. 13; Croatian Accounting Act, 2015.

Auditing profession in Croatia. The minimal requirements for certified auditors did not significantly change in the process of audit reform. According to the Directive „a natural person may be approved to carry out a statutory audit only after having attained university entrance or equivalent level, then complete a course of theoretical instruction, undergone practical training and passes an examination of professional competence of university final or equivalent examination level organised or recognised by the Member States concerned (art. 6 of the Directive 2006/43/EU). However, except theoretical knowledge, a candidate

shall complete at least three years of practical training. At least two thirds (two years) should be completed under the mentorship of statutory auditors approved by any Member States (**Table 3**). It can be emphasized that some Member States addressed the requirement of a minimum two years of practical training by establishing the register of trainees. This register should, among other tasks, document the time the candidates spent on professional training. The aim of forming this register is to regulate the audit market, and to protect employers and candidates in their rights and obligation in the process of appointment as a certified auditor.

Table 3. Conditions for certified auditors according to the regulatory framework of the EU

Educational qualifications Art. 6. 2006/43/EU	Minimal requirements for certified auditors Art. 10. st. 1 Directive 2014/56/EU	Continuous education Art 13. Directive 2014/56/EU
A natural person may be approved to carry out a statutory audit only after having attained university entrance or equivalent level, then complete a course of theoretical instruction, undergone practical training and passes an examination of professional competence of university final or equivalent examination level organised or recognised by the Member States concerned.	In order to ensure the ability to apply theoretical knowledge in practice, a test of which is included in the examination, a trainee shall complete a minimum of three years' practical training in, inter alia, the auditing of annual financial statements, consolidated financial statements or similar financial statements. At least two thirds of such practical training shall be completed with a statutory auditor or an audit firm approved in any Member State.	Member States shall ensure that statutory auditors are required to take part in appropriate programmes of continuing education in order to maintain their theoretical knowledge, professional skills and values at a sufficiently high level, and that failure to respect the continuing education requirements is subject to appropriate sanctions.

Source: Directive 2014/56/EU; Directive 2006/43/EU.

To summarize, the basic prerequisites for entering the audit profession according to the demand of the EU Directive on statutory audit are: formal high university degree, practical experience as well as the examination of professional competence. However, **Table 4** shows that selected countries, including Croatia implemented more rigorous measures for entering the auditing profession than it is requested by the Directive. Slovenia and Slovakia require a minimum five years of experience in the field of accounting and auditing. According to the

Proposal of Audit Act (2016), Croatia requires, among other criteria, at least six years of practical training. These demands are actually in contradiction with the efforts of the EU to reduce the barriers for entering the integrated EU service market. However, due to the fact that auditors act in the public interest, this makes understandable the efforts of Member States to allow entering the profession only for the professionals with a sufficient level of knowledge and practical experience.

Table 4. Conditions for “certified auditors” in selected EU countries

Slovenia	Slovakia	Croatia
<ul style="list-style-type: none"> • A master degree or equivalent level of education; • At least five years of practical experience in auditing in the last eight years in an audit firm, as a certified auditor; • Practical training and passed the examination for certified auditor; • No withdrawal of licence of certified auditor in past; • No criminal records; • Active knowledge of Slovenian language. 	<ul style="list-style-type: none"> • Full legal capacity; • Good reputation; • Second-level university degree; • At least five years of practical training in the area of accounting; • Took part in continuing education of assistants to statutory auditors; • Submitted to the authority officially certified copies of certificates and licences from other Member States and third countries held by the applicant, including the name of the issuing authority and their numbers; • Passed the examination of professional competence. 	<ul style="list-style-type: none"> • Professional or university undergraduate or university integrated undergraduate and graduate master degree with at least 300 ECTS or second level university degree; • Passed the auditor's exam; • At least three years of practical training in auditing services under a certified auditor's guidance after passing the examination; • Good reputation.

Source: Systematization of author according to National Council of the Slovak Republic, (2015), Ministry of Finance Slovenia (2016), Proposal of Audit Act (2016).

The certification/licence to perform statutory audits is usually time limited. This is in compliance with the EU regulation where “statutory auditors are required to take appropriate programmes of continuing education in order to maintain their theoretical knowledge, professional skills and values at a sufficiently high level, and that failure to respect the continuing education requirements is subject to appropriate sanctions” (art. 13, Directive 2014/56/EU). It is important to stress out there was no licensing system for statutory auditors in Croatia. In other words, according to the Auditing Act (2008) that is still in force, the conditions for getting the license of certified auditors are:

- High level university degree;
- Three years of practical training in auditing out of at least two years of practical training under the mentorship of certified auditors with licence in any Member State;
- Passed the auditor’s exam;
- Good reputation.

One of the most important issues of auditing profession is dealing with the licensing of certified auditors in Croatia. According to the new Proposal of Audit Act (2016), the licence has to be renewed, which requires a continuous education in the field of accounting and auditing. The extension of the licence to perform statutory audit is usually connected with the requirement for continuous professional development according to the rules of body in charge with the oversight of the audit profession. The licence of certified auditors can be renewed after completing at least 120 hours of

continuous education in a period of three years (Proposal of Audit Act, 2016). There will be performed a special examination if the auditor does not meet this requirement of 120 hours (Proposal of Audit Act, 2016).

2. Key options in the proces of transposing the EU audit regulation into croatian legislation

2.1. Selected options of the Directive (2014/54/EU)

Approval of auditors from another Member State.

Another important issue on new proposed legislation is enabling statutory auditors and audit firms to provide services in a Member State other than that in which they were approved. The elimination of barriers to the development of statutory audit services between Member States can contribute to the integration of the Union audit market. However, the Directive gives the option about whether a statutory auditor seeking approval is to be subject to an adaption period or an aptitude test. According to the Proposal of Audit Act (2016) statutory auditors seeking approval in Croatia will be subject to an aptitude test. Aptitude tests will require from statutory auditors adequate knowledge of legislative rules of Croatia, including company law, fiscal and social law.

Approval of auditors from another Member State	Audit reporting	National auditing standards	Public oversight body
Art. 14	Art. 28	Art. 26	Art. 32
The host Member State shall decide whether a statutory auditor seeking approval is to be subject to an adaptation period... or an aptitude test	Member States may lay down additional requirements in relation to the content of the audit report.	Member States may apply national auditing standards, procedures or requirements as long as the Commission has not adopted an international auditing standard covering the same subject-matter.	4a. Member States shall designate one or more competent authorities to carry out the tasks provided for in this Directive.
Croatian solution			
Aptitude test	No additional requirements	Applying International Auditing Standards (IFAC)	Oversight body: Croatian Financial Services Supervisory Agency

Source: Directive (2014/54/EU), Proposal of Audit Act (2016).

Additional reporting. Although the Directive provides the opportunity for each Member State to impose additional requirements to the content of the audit report, in Croatia the content of the report is prescribed in the Accounting Act (2015) as presented in **Table 6**. Due to

the fact that statutory auditors in Croatia must comply with the International Auditing Standards and the Accounting Act (2015), there probably will be no additional requirements for the form and the content of the audit report in the new Auditing Act.

Table 6. The structure and form of the audit report according to the Accounting Act in Croatia

The independent auditor's report includes:

1. Introduction that sets the financial statements subject to audit, together with the applicable financial reporting framework;
2. Description of the scope of statutory audit stating the auditing standards in accordance with which the statutory audit was carried out;
3. The auditor's opinion which clearly expresses whether the annual financial statements give a true and fair view of the undertaking's financial position in accordance with this Law and the Croatian financial reporting standards or IFRS or whether the annual financial statements are in accordance with the company law if the regulation requires such an opinion. The auditor's opinion may be positive, qualified or adverse, or the auditor can give disclaimer of opinion if he/she is not able to express an opinion;
4. Highlighting the questions and other issues that were in the interest of the auditor without expressing a qualified opinion, if so required by the International Auditing Standards;
5. Opinion about the compliance of the management's report with the annual financial statements for the same business year;
6. Opinion whether the management's report is prepared in accordance with this Law;
7. A statement as to whether, based on the knowledge and understanding of business of the entrepreneur and its environment, as acquired during the audit mission, the auditor has identified significant misstatements in the annual report and, if any, a description of the nature of such errors.

Source: Accounting Act, 2015.

National auditing standards. To ensure the high-quality of statutory audits within the EU, all audits should be performed under the same "rules of the game". According to the FEE (2015) publication, not all the Member States have yet adopted the International Auditing Standards, although the FEE (2015) noted that significantly more countries adopted ISAs voluntarily, as compared to 2013. Although the Directive (2014) requires Member States to apply the International Auditing Standards issued by the European Commission, these standards are not yet adopted. The European Commission has a five-year period to adopt these standards. Member States have an option to enforce additional national audit procedures or requirements but only if they stem from specific national legal requirements relating to the scope of statutory audit. In other words, these audit procedures and standards can be imposed in national legislation only

if they have not been covered by the adopted International Auditing Standards. Croatia has a long tradition of applying the International Auditing Standards; therefore, applying national auditing standards is not an option.

Simplifications for SMEs. Although the EU recognised the central role played by small and medium-sized enterprises in the Union's economy and aims at reducing administrative and other burden that complicate their operations, some provisions of the Directive are not in the function of reducing costs. In that sense, the Directive provides numerous options for each Member State to simplify the requirements for the audit of small entities. However, according to **Table 7**, in the Proposal of Audit Act (2016) there are no simplified requirements for the audit of small entities.

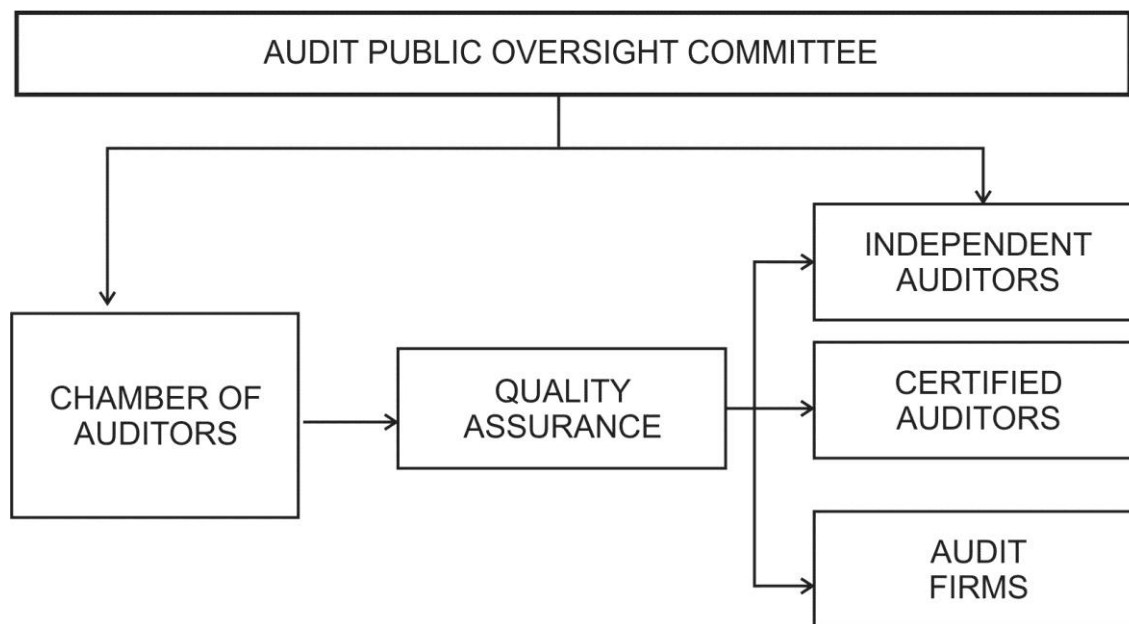
Table 7. Selected simplifications for audit of SMEs		
Preparation for the statutory audit and assessment of threats to independence	Internal organisation of statutory auditors and audit firms	Proportionality
Art. 22b	Art. 24a	Art. 26
Member States may provide simplified requirements for the small entity audits.	Member States may provide simplified requirements for the small entity audits.	Member States may take measures in order to ensure the proportionate application of the auditing standards to the statutory audits of small undertakings.
Croatian solutions		
No simplified requirements	No simplified requirements	International Auditing Standards (IFAC)

Source: Directive 2014/56/EU, Proposal of Audit Act, 2016.

Principles of public oversight. Another important issue of the EU audit reform refers to the systems of auditing public oversight. The public oversight of statutory auditors and audit firms encompasses the approval and registration of statutory auditors and audit firm, the adoption of standards in respect of professional ethics and internal control of audit firms, continuing educative and systems of quality assurance, as well as

investigation and sanctions for statutory auditors and audit firms. The Directive (2014) highlights that the independence of public oversight authorities is a core prerequisite for integrity, efficiency and orderly functioning. In that sense, to fulfil the demands of the Directive, and especially the Regulation (2014), there will be significant changes in the Croatian system of public oversight.

Figure 1. Current organization of the public oversight system in Croatia



Source: Auditing Act, 2008.

Currently the tasks set up in the Directive (2006), and according to the existing Auditing Act are performed by the Croatian Chamber of Auditors under the surveillance of the Audit Public Oversight Committee founded by the Ministry of Finance (Figure 1). However, due to the changes in the audit legislation as a result of the Directive and Regulation, the system of public audit oversight should be reorganized. It is necessary to organize a system of public oversight of statutory auditors and audit firms and to designate a competent authority responsible for such oversight. Although the Member States can designate one or more competent authorities to carry out the tasks provided in this Directive and Regulation, taking into the consideration the size of the audit market in Croatia the Ministry of Finance appointed the Croatian Financial Services Supervisory Agency (CFSSA) (<http://www.hanfa.hr/>). In other words, according to the Proposal of Audit Act (2016), the tasks and responsibilities for the public oversight of statutory auditors and audit firms will be taken over by the CFSSA. Member States are able to delegate or allow competent authorities to delegate the tasks of those competent authorities to other authorities. It is currently not clear what responsibilities and tasks the CFSSA will delegate, because of the very intensive negotiation process with the Croatian Chamber of Auditors. However, regardless of the delegated responsibilities, the competent authority should bear the ultimate responsibility for the oversight of the audit profession.

2.2. Selected options of the Regulation (2014/537/EU)

Restrictions on non-audit services. Independence is a basic prerequisite for achieving the public interest role of auditors. However, the provision of non-audit services can compromise the auditor's independence and increase the risks of conflicts of interests. The Regulation provides a "black list" of non-audit services and prohibits the provision of certain non-audit services to audit clients such as tax, consultancy and advisory services. However, Member States have an option to allow the provision of certain tax and valuation services under the prescribed requirements. It is important that, according to the Proposal of Audit Act (2016), Croatia used the option to allow provision of certain tax services under the conditions set in the Regulation but only if:

- a. They have no direct or have an immaterial effect on the audited financial statements, separately or in the aggregate;
- b. The estimation of the effect on the audited financial statements is comprehensively documented and explained in the additional report to the audit committee; and
- c. The principles of independence are complied with by the statutory auditor or the audit firm.

However, the provision of valuation services including valuations in connection with actuarial services or litigation support services is not allowed under some conditions. In other words, that means that this option is not used (Table 8).

The Member States also have an option to prohibit other services that those prescribed, but there are no additional prohibited non-audit services in the Croatian Proposal of Audit Act (2016). Therefore, the audit firms and statutory auditors can provide non-audit services to their clients if they do not audit their financial statements. Except statutory audits, the audit firm can perform, in the framework of their business activities, services from the following areas:

1. Finance and accounting;
2. Financial analysis and control, including due diligence;
3. Tax and other business consultancy ;
4. Valuation of companies, assets and liabilities;
5. Litigation support services;
6. Business evaluation of investment projects;
7. Expert seminars and education; and
8. Publication of experts papers (Proposal of Audit Act, 2016).

The provisions of the Regulation apply only to the statutory auditors and audit firms carrying out statutory audits of public-interest entities and public interest entities according to the European legislation. However, according to the proposed audit legislation in the Croatia, the "black list" of non-audit services will apply in performing all statutory audits. Therefore, it can be concluded that Croatia applied more rigorous requirements for the regulation of non-audit services.

Regulation 537/2014		Croatian solution		
Prohibition of the provision of non-audit services. Prohibition of non-audit services shall mean: (a) tax services relating to: (i) preparation of tax forms; [...] (iv) identification of public subsidies and tax incentives unless support from the statutory auditor or the audit firm in respect of such services is required by law; (v) support regarding tax inspections by tax authorities unless support from the statutory auditor or the audit firm in respect of such inspections is required by law; (vi) calculation of direct and indirect tax and deferred tax; (vii) provision of tax advice; [...]		Member States may allow the provision of the services referred to in points (a) (i), (a) (iv) to (a) (vii) and (f), provided that the following requirements are complied with: (a) they have no direct or have immaterial effect, separately or in the aggregate on the audited financial statements; (b) the estimation of the effect on the audited financial statements is comprehensively documented and explained in the additional report to the audit committee; and (c) the principles of independence laid down in Directive 2006/43/EC are complied with by the statutory auditor or the audit firm		Allowed under the requirements
(f) valuation services, including valuations performed in connection with actuarial services or litigation support services;		Not allowed		
Prohibition of the provision of non-audit services.	Art. 5	Member States may apply more stringent requirements.	No stringent requirements	
Prohibition of the provision of non-audit services	Art. 5	Member States may prohibit other services where they consider that those services represent a threat to independence.	No additional prohibited audit services	

Source: Regulation 2014/537/EU, Proposal of Audit Act, 2016.

Mandatory rotation of auditors and audit firms. As per the Regulation, public interest entities need to appoint their auditor or audit firm for a minimum of one year and a maximum of ten years. However, Member States can extend the maximum duration period in specified circumstances. In that sense, Member States are provided with an option to:

- Set the minimum duration to more than one year; and
- Set the maximum duration to less than ten years.

The results of research conducted on the sample of listed Croatian companies showed that the average audit tenure is shorter than the maximum of 10 years as set in the EU regulation. The average audit firm tenure for listed companies in Croatia in the seven-year period is 3.58 years, and it depends on the industry. The *Construction* industry is characterized by the longest average audit tenure of 5.25 years (Sever Mališ and

Brozović, 2016). Additionally, there is no correlation between the length of the audit tenure and the size of the listed company. The main limitation of the study is the length of the analysed period, which covered only the last seven years. A longer timeframe would allow for more representative conclusions. However, it can be concluded that the “limits” for mandatory audit duration are set very broadly and that implementation of the new legislative should not cause any significant “shocks” on the audit market in Croatia. The proposed legislative solution in Croatia sets the minimum duration of the audit engagement to one year and the maximum duration to ten years, although in the existing laws applied in Croatia there are demands for a duration of the audit engagement shorter than ten years. For instance, according to the Credit Institution Act (2015, art. 170) an audit firm may audit the financial statements of a particular credit institution for no more than seven consecutive years.

Member States are also given two separate options to extend the maximum duration of a renewed audit engagement – by imposing “tendering” or “joint audits” (Table 9). By enabling one of these options, the same auditor may stay in place for a total period of maximum:

- 20 years or
- 24 years.

Some professional organizations are warning that Member States which do not take up these duration

extension options will significantly limit the options and flexibility for businesses, their audit committees, boards and shareholders (FEE, 2014b). Due to the number of options available to Member States, the extent to which these are exercised will significantly impact regulatory convergence. Diverging the minimum and maximum duration of the audit engagements in different Member States will generate practical difficulties, potentially increasing costs, especially for business operating across the borders (FEE 2014b).

Table 9. Duration of audit engagement

Basic requirements	Options - Regulation 537/2014		Croatian solution
a) Initial engagements.	Require that the initial engagement referred to in paragraph 1 be for a period of more than one year;		1 year
b) A maximum duration of 10 years.	a) May be extended to the maximum duration of:	(a) 20 years, where a public tendering process.	20 years
		(b) 24 years – joint audit.	20 years
	b) Set a maximum duration of less than 10 years for The engagements referred to in the second subparagraph of paragraph 1.		10 years
Key audit partners rotate every:	7 years		7 years
Cooling-off period:	3 years		3 years

Source: Regulation 2014/537/EU, Proposal of Audit Act, 2016.

These risks are possible to mitigate if the Member States adopt the “basic” options. However, it is rational to expect that some Member States will adopt these options according to their needs and attitudes. In that sense, in the Proposal of Audit Act (2016) Croatia used the option for the extension of the maximum duration of the audit engagement to a maximum duration of 20 years in the case of a public tendering process and 20 years (not 24 years as in Regulation) for the joint audits. The concept of joint audit is one of the possibilities to reduce audit market concentration in the provision of audit services. However, only the implementation of these provisions in practice will show if, in the future, these measures for reducing audit market concentration are sufficient. The auditors do not have a lot of experience with joint audits, although these measures were strongly supported by small audit firms in Croatia.

Conclusions

The implementation of the Directiva and Regulation into national legislative should result in a more secure and harmonised audit environment. However, due to

the number of available options, each Member State has the unique opportunity to create a regulatory framework that is the most appropriate to the environment in which the certified auditors, audit firms and subjects of statutory audit activate. Any new regulation is essentially setting up new and stricter rules, especially when the provisions are defined and need only to be transposed into the national legislation. The process of implementing the new regulatory framework is always under the influence of different stakeholders. These stakeholders are questioning how to use all the mechanisms at their disposal to create the “rules of the game” according to their interests or needs. They need to evaluate whether the options from in Directive and Regulation are sufficiently adapted to the current business environment and whether there are other opportunities to adopt some additional solutions allowed by the European legislation. Although the options offer a certain “freedom”, they also carry certain risks. Due to the number of options, their extension to the Member States could impact regulatory convergence, especially to the cross-border operating companies

and audit firms. The adoption of different options by Member States could generate practical difficulties in terms of their implementation and potentially increased costs and reduced audit quality. In that sense, Member States must carefully consider the effects of applying different options.

The aim of this research was to provide information about the current audit environment in Croatia, while highlighting some key issues on the transposition of the Regulation regarding the statutory audit of public interest entities and the European Directive on the statutory audits of annual accounts and consolidated accounts. Croatia did not yet finish the process of transposing the Directive into national legislation, although the transposition deadlines have passed. However, the intensive work of the Ministry of Finance resulted in the Proposal of Audit Act (2016).

All the stakeholders are invited to give their comments and suggestions in order to improve the content of the existing proposal. Despite ongoing debate and negotiations on the provision of a new auditing law, this article provides information regarding the options that were selected from the Directive and Regulation. Some changes can be expected when the final Audit Act will be adopted by the Croatian Parliament. The most significant changes are expected with regard to the organizing and performing of the public audit oversight in Croatia. Because of uncertain results of the negotiation about organizing and financing the competent authority for public audit oversight, the provisions regarding the public audit oversight topic in this article are modestly represented. In that sense, the financing and organization of oversight activities will be an interesting topic for further research and comparisons.

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The development of a corporate governance assessment model for the Romanian public sector

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Abstract

Corporate governance is an essential component of business management, and has acquired a particularly important momentum in the private sector, in the context of the economic crisis and financial maneuvers which are questionable in terms of legality. The same imperative need to develop corporate governance is also identified in the public sector, given the large number of stakeholders and their heterogeneity, the need for accountability, efficiency, performance, transparency and sustainability. By using a qualitative research approach, a set of ideas on corporate governance was presented, as published in the specialized literature; also, a model was proposed for the assessment of corporate governance in the Romanian public sector. In the current context, the development of such a model complements the informational valences in the literature regarding the corporate governance, allows the identification of the deficiencies in the governance of Romanian public institutions, and creates the potential for the development and implementation of a governance code dedicated to the public sector.

Keywords: Corporate governance, assessment model, public institution, stakeholders, Romania.

JEL Classification: M48, L38, G34, H83.

To cite this article:

Ștefănescu, A. and Tănase, L.G., (2016), The development of a corporate governance assessment model for the Romanian public sector, *Audit Financiar*, vol. XIV, no. 11(143)/2016, pp. 1227-1234, DOI: 10.20869/AUDITF/2016/143/1227

To link to this article:

<http://dx.doi.org/10.20869/AUDITF/2016/143/1227>

Introduction

The premise of the research is the limited transparency of financial and nonfinancial public sector information in Romania, in the context of public resources cuts, the imbalance of the public services demand and supply in terms of quality, quantity and cost, suspicions of corruption and public funds fraud, and the institutions' reduced or inexistent performance. All these aspects point to the need to implement a mechanism in order to assure stakeholders about the effectiveness, credibility and sustainability of public sector institutions.

The objective of the current research is to build an assessment model for the corporate governance in the public sector. We believe that this approach will identify some real gaps in the public sector governance in Romania and it will contribute to the development of a corporate governance culture, through the development and implementation of a code of governance, either voluntarily or by regulation.

The article is structured as it follows: the first section is dedicated to the literature review on corporate governance, and it is followed by a section describing the research methodology. The following section includes the research results; the paper ends with the conclusions section.

1. Research methodology

The conducted research is qualitative in nature. Thus, approaches and dimensions of corporate governance concept were presented, both in the private and public sectors, in relation to the national and international specialized literature. They were complemented by the development of a model for the assessment of governance in the public sector, given the particularities of the institutions within this sector.

2. Conceptual approaches of corporate governance

From a conceptual point of view, the agency theory (Jensen and Meckling, 1976) had an important impact on the corporate governance in the private sector. In the specialized literature, the concept of governance was approached from multiple perspectives. Having as a premise the contractual relationships underlying the functioning of an entity, Jensen and Meckling (1976)

believe that the relationship between shareholders (principal) and entity's managers (agent) is generating conflicts because of the divergent interests they may have. Thus, corporate governance is the interface which, through its mechanisms, mitigates the information asymmetry between the principal and the agent. The role of corporate governance is to promote ethical behavior and transparency, to stabilize the balance of power between the shareholders, directors and management, to prevent fraud and improve the confidence entrusted by people and society to the business environment (Matei and Drumașu, 2014).

From a different perspective, corporate governance refers to the way companies are managed and controlled (The Committee on the Financial Aspects of Corporate Governance, 1992). Corporate governance is a set of structures, rules, procedures and mechanisms for managing and controlling an organization (Yapa, 2014). From another perspective, corporate governance is a system of internal and external entities' examinations, ensuring that they fulfill their responsibility towards all stakeholders and act in a responsible manner in all the areas of their businesses (Sison, 2008).

In terms of the typology of corporate governance mechanisms, Charreaux (1994) identified two categories, namely external and internal mechanisms. External mechanisms are the goods and services market, the banking and financial services market, the labor market, the legal, political and regulatory environments. Internal mechanisms include the control exercised by the shareholders, the mutual supervision among leaders, the formal and informal control implemented by the subordinate employees and board of directors.

In terms of effectiveness, a governance system is effective if the level of satisfaction of an interested party can only be improved by reducing the level of satisfaction of another (Charreaux, 1996). Pitseys (2010) believes that good corporate governance has allowed for the first time a different model for the entity's human resources management.

In terms of the principles of corporate governance, the following were identified in the specialized literature: company openness and information dissemination in order to improve the level of trust; integrity (of the financial statements and people); ethical values; responsibility; competencies/skills; transparency; risk

assessment and management; internal control; communication; monitoring; regulatory compliance; segregation of responsibilities; protection of shareholders' rights and their equal treatment; encouraging cooperation between the company and the stakeholders; providing reliable and timely information etc. (Matei and Drumașu, 2015).

In Romania, corporate governance in the private sector was conceptually outlined and normalized in the year 2000 for the private sector. In 2001 the first code of corporate governance was adopted. The implementation of corporate governance was a difficult attempt, considering the following obstacles (Feleagă, 2008):

- “The absence of detailed analysis concerning the relationship between owners and managers;
- Weak involvement of other parties participating in the decision-making processes;
- Lack of a conceptual framework for an efficient market and its societal implications;
- Questionable involvement of auditors in promoting corporate governance;
- Failure of reforms to implement an accounting system in line with the international developments;
- The weakness of the control mechanisms for sincere, relevant, reliable, comprehensive, comparable and meaningful financial information”.

Studies in the specialized literature regarding the development level of corporate governance in Romania revealed that most companies listed on the Bucharest Stock Exchange do not meet the recommendations of the governance code regarding the independence of directors and members of the audit committee, and their degree of transparency it is much lower than that of other European companies (Feleagă et al., 2011). From the perspective of the relationship between corporate entrepreneurship and corporate governance, the results of research on nonfinancial companies listed on the Bucharest Stock Exchange showed that corporate governance promotes entrepreneurship in Romanian companies (Albu and Mateescu, 2014).

Unlike the private sector, the conceptual nuances about corporate governance in the public sector are relatively limited at the international level. However, the international literature offers a portfolio of exhaustive approaches, comparative and multidimensional, on which we rely in our research.

From the perspective of governance in the public sector versus the private sector, Yapa (2014) defines the specific coordinates of the two sectors and argues that in the public sector citizens or their representatives may monitor the use of resources, and the information about public institutions should be disseminated widely in order to substantiate the decision-making processes.

Governance mechanisms in the public sector include (Almquist et al., 2013):

- Structure, which provides clarification of responsibilities;
- Approaches for improving the skills to fulfill duties; and
- Tools such as internal control and external accountability.

Grant et al. (2007) include among the elements of governance: direction setting, strategic alignment, risk management, performance management, control and compliance, relationship management, management of changes and value management.

Mutiganda (2013) developed three governance policies: coercive governance, performance-oriented governance and governance for the mission. Coercive governance monitors compliance with rules and regulations. Performance-oriented governance focuses on results and monitors accountability through quantitative and non-quantitative data. Governance for the mission envisages fulfilling objectives without making a profit.

From the perspective of good governance, Mandeli (2016) developed the following specific standards: transparency, accountability, participation, responsiveness, efficiency in public resource management, audit, law enforcement, disclosure and efficiency. The study of Mandeli (2016) also reveals that information transparency would increase the accountability of public officials and therefore would lead to the enforcement of laws and decrease in corruption. A similar idea is supported by Sukmadilaga et al. (2015), who mention the criteria for good governance in the public sector: participation, respect for the law, transparency, responsiveness, consensus orientation, equity, efficiency and effectiveness, accountability and strategic vision. Good corporate governance reduces the risk of low performance (Edwards and Clough, 2005).

Almquist et al. (2013) argue that for an effective system of governance it is important to establish the appropriate

performance measurement tools to provide internal and external stakeholders with the relevant information they need and the assurance that the supplied financial and nonfinancial information is accurate through internal and external audit and also through the hiring of persons with appropriate knowledge and experience in leadership and control.

In Romania, the approaches on corporate governance in the public sector are limited. In terms of the perspective of public healthcare system, empirical research shows that at the level of the national bodies within the European Union countries, the information provided to the public on corporate governance is extremely limited. The only countries that exhibit concerns in this direction are the UK and Ireland. Most official websites of institutions in the public healthcare sector provide information about the organizational structure, leadership and responsibilities of the institution concerned (Germany, Belgium, Bulgaria, Cyprus, Denmark, Finland, Greece, Hungary, Latvia, Lithuania, Malta, Netherlands, Poland Sweden, Czech Republic and Romania), and in some countries (Cyprus, Finland, Latvia and Romania) the existence of an internal audit department within the investigated institutions was found (Ștefănescu et al., 2012).

Also, studies on the transparency of financial information for the central public administration and public hospitals under the Ministry of Health revealed a significant limitation thereof (Ștefănescu and Țurlea, 2013; 2014).

In the context of promoting transparency in the public sector, Nistor and Deaconu (2014) believe that the e-governance system facilitates the interaction between public institutions and people, simplifies bureaucratic procedures, provides information and improves transparency. Among the information that should be included are: regulations about the organization and functioning of public institutions, organizational charts, financial statements, budgets, procurement documents, program, ongoing projects, contact information and the possibility to translate the information in at least one foreign language.

For the Romanian lawmakers, concerns for the development of a referential dedicated to corporate governance in the public sector are missing or are in a project stage. Currently, the issues are covered by default by applying a legislative portfolio issued by the authorities. At the opposite pole there are the public

enterprises, for which there is a clear regulatory framework (Law no. 111/2016).

The research carried out shows that the presented conceptual approaches converge to corporate governance mechanisms, the need for good governance, its coordinates and impact, as well as the relationship between corporate governance and performance.

3. Assessment of corporate governance in the Romanian public sector

The approach of developing a model for the assessment of corporate governance in the public sector is based on the ideas presented as a result of the literature review and on the specific mechanism of public institutions' organization and functioning.

The proposed model for the assessment of corporate governance in the public sector is structured on five criteria, tailored to the specificities of the public sector institutions: organization, activity, control/supervision, financial and nonfinancial reporting, transparency (see Table 1). Each criterion is rated on a scale from 0 to 100 points, based on the degree of achievement, and represents 20 percent of the total score.

In analyzing compliance with the criteria that define good governance for public sector entities in terms of *organization*, the following coordinates will be considered: structure, regulations, objectives and strategies, integrity. *Structure* refers to elements that define the public institution: organizational chart's availability on the institution's website, the publication or availability of information relating to the existing departments within the public institution and their managers, the disclosure of information about the management team and the board members, published contact information and working hours, along with other information regarding the organization of the public institution, that may be relevant to the stakeholders. In terms of *regulations*, for an effective system of governance we believe that there should be considered the disclosure of information and documents such as: the public institution's organization and functioning regulations, regulations and internal procedures specific to the public institution's activity, information regarding

the board of directors, including procedures for appointing its members, the members of the board, together with their roles and responsibilities, as any other information useful to the general public. In order to provide the stakeholders with trust about the sustainability of the institution and, by consequence, about its services, it is mandatory to provide information on the institution's *objectives and strategies*, including: general objectives of the public institution, the development strategy etc. Also, good governance

should be based on the principles of *integrity*. Integrity confirmation can be promoted through: the adoption and publication of a code of ethics, publication of declarations of assets and interests, providing information on the monthly salary of the management team and board of directors' members, the existence of a board of ethics, the disclosure of information about the ethics board's composition and information on its activities, declarations of incompatibility and conflicts of interests.

Table 1. Model for the evaluation of corporate governance in the public sector

No.	Evaluation criteria	Score	%	
1.	Organization	➤ Structure	0-100	20
		➤ Regulations		
		➤ Objectives and strategies		
		➤ Integrity		
2.	Activity	➤ Services	0-100	20
		➤ Public acquisitions		
		➤ Logistics		
		➤ Human resources		
		➤ Projects		
3.	Control/supervision	➤ Internal/managerial control	0-100	20
		➤ Internal audit		
		➤ Financial audit		
4.	Financial and nonfinancial reporting	➤ Budget	0-100	20
		➤ Financial statements		
		➤ Reports disclosing financial and nonfinancial performance		
5.	Transparency	➤ Website	0-100	20
		➤ Relations with stakeholders		
TOTAL		X	100	

Source: Authors' processing.

The second criterion for assessing corporate governance in public sector is *activity*, which includes the following elements: services, public acquisitions, logistics, human resources, projects. The *services* offered by the public institutions can aggravate conflictual relationship between the institutions and the stakeholders. Given the downward trend of public resources with a negative impact on the supply – demand ratio for public services and also on the value

for cost ratio, good governance requires continuous notification of stakeholders about the full details of the offer of free and paid services. Also, good governance involves credibility regarding the efficient management of public resources. As *public acquisitions* are a vulnerable component in the public sector, we believe that, in order to eliminate suspicions regarding the use of public resources, stakeholders should be informed of the annual procurement plan and its degree of realization, the monthly value of purchases and their nature, data about the suppliers of goods and services. In order to

support stakeholders' decision making processes, the institution should provide information on *logistics* or the existing facilities used for the rendering of public services. As *human resources* play an important role in the public sector, the stakeholders may be potential employees, and the institution should ensure the transparency of the recruitment process. Last but not least, good governance requires a realistic perspective by informing stakeholders about the ongoing and completed *projects*.

The fourth criterion for assessing corporate governance in the public sector is *control/supervision*, including the following directions: *internal control/managerial internal control*, risk management, internal audit, and financial audit. Given the managerial function carried out by the *internal control/managerial internal control*, the disclosure of its existence and responsibilities assures stakeholders with regard to: the economic, efficient and effective administration of the public resources; the reliability of internal and external information; compliance with regulations, internal policies and procedures of public institutions. Additionally, in order to provide information to stakeholders in an objective and independent manner about the control of operations, about the efficient and effective public revenues and expenditures, about objectives' fulfilment by means of evaluating the processes of risk management, control and governance inside the institution, stakeholders must also be informed of the details about the *internal audit*. From this perspective, public institutions must disclose the structure of the internal audit committee, its responsibilities and the schedule of the meetings. Since the existence of an internal audit committee within public institutions is limited to meeting certain criteria, in the absence of such a committee the institutions will disclose information about the internal audit department. Institution's credibility, as it is perceived by the stakeholders is enhanced by the *financial audit* performed by the Romanian Court of Accounts. The dissemination of the financial audit reports will inform stakeholders about the true and fair view of the information presented in the financial statements, the irregularities found, and the measures to be taken to eliminate irregularities.

Financial and nonfinancial reporting also contributes to the mitigation of the information asymmetry between the public institution's management and the stakeholders. The variety of the stakeholders in the public sector,

together with their importance determines, for good governance, the necessity to publicly disclose the budget, the financial statements and the reports on financial and nonfinancial performance. To reliably support the set objectives, the institution must provide interested parties with information on the resources allocated and their respective destination, in accordance to the approved *budget*. Based on the full set of quarterly reports and annual *financial statements*, stakeholders are informed in a manner that is understandable, relevant, reliable and comparable about the public institution's financial position, financial performance and cash flows. In addition, the publication of *reports on financial and nonfinancial performance* informs stakeholders on how the institution has acquired the resources and whether it used them economically, efficiently and effectively to achieve the objectives in their best interest, and, respectively, on the institution's degree of involvement in economic, social and environmental activities.

The fifth criterion of analysis of corporate governance in the public sector, *transparency*, has two dimensions, namely the website and the relations with stakeholders. The institution's *website* is the fastest way to disseminate reliable and timely information to stakeholders. From this perspective, good governance must consider the following aspects: permanent website availability, easy navigation, publishing of timely and relevant information, continuous update of the information, the translation of website information in a foreign language. *Relations with stakeholders*, either directly or indirectly, assures them about the responsibility that managers of public institutions have assumed.

Conclusions

The research carried out proves that the conceptual approaches regarding corporate governance are varied, but they interfere with regard to the following coordinates: the mechanisms for effective governance, the need for policies specific to good governance, and the correlation between corporate governance and performance. Moreover, investigating corporate governance in the Romanian public sector revealed its limitations, both in terms of its conceptual development and specific regulations. From this perspective, we consider the development of a model for the assessment

of governance in the Romanian public sector as a useful item. Structured in five evaluation criteria specific to the organization mechanism for the public sector (activity, control/supervision, financial and nonfinancial reporting and transparency), the model identifies the weak spots of good governance in the public sector and responds to the real information needs of the stakeholders regarding the efficiency and effectiveness of public resources management, accountability, transparency, financial nonfinancial reporting, performance, and sustainability.

We believe that one of the limitations of the current research is the difficulty of implementing the model for the assessment of corporate governance in the public sector at an international level, which affects the comparability of corporate governance. Also, it is known that at an international level, the corporate governance

culture is heterogeneous, mainly due to the conceptual and regulatory peculiarities specific to the public sector.

As future research directions, we intend to perform a test of the proposed evaluation model for the assessment of corporate governance in public sector institutions in Romania.

Acknowledgement

This work was financed through the Partnerships Program in Priority Areas – PNII, developed with the support of MEN-UEFISCDI, project no. 334/2014, project code PN-II-PT-PCCA-2013-4-0873, project title “A New Model for Corporate Risk Assessment: a Scientific Tool for Knowledge Based Management”.

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The profile of the internal auditor in the Romanian banking sector

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Abstract

Internal audit in the banking industry is one of the most debated topics nowadays. The paper's objective is to examine the profile of the internal auditor in the banking industry of Romania. The research design is empirical in nature. The researchers use the development of job announcements for the position of internal auditor in the Romanian banking industry. The announcements are classified according to: language of the job announcement; geographical area of the employer; the internal auditor's tasks; the internal auditor's professional requirements; education and qualification; practical experience; personal attributes; age; salary etc. The results of the research consist in the current profile of an internal auditor in a Romanian bank. The research fills in an important gap in the Romanian academic literature, which lacks studies regarding the internal audit in the banking industry.

Keywords: Internal audit, banking, profile, Romania.

JEL Classification: M42, M48.

To cite this article:

Țurlea, E. and Mocanu, M., (2016), The profile of the internal auditor in the Romanian banking sector, *Audit Financiar*, vol. XIV, no. 11(143)/2016, pp. 1235-1245, DOI: 10.20869/AUDITF/2016/143/1235

To link to this article:

<http://dx.doi.org/10.20869/AUDITF/2016/143/1235>

Introduction

The foundation of a highly developed and capital-intensive economy is considered to be a sound banking industry. All economic areas can be significantly affected by disorders in the banking industry, as Hartmann-Wendels (2010) states. In no other sector are the interdependencies and the potential consequences of the individual corporate collapses as far-reaching and unforeseeable as in the financial sector (Țurlea et al., 2010). Similarly to companies from other industries, banks must face challenges such as: attracting outside funding in the context of increasing competitiveness on capital markets, facing competition in labour and product markets, and dealing with managerial self-interest and asymmetric information which potentially lead to corporate governance issues (Bushman, 2014). However, compared to other sectors, banks have more visibility in society and have a higher product involvement (Fatma et al., 2014). The banking sector is unique in other respects, as well as extraordinarily complex, so that additional considerations need to be introduced.

First of all, banks display in their balance sheets a significantly higher leverage, whereas according to Acharya et al. (2014), debt commonly comprises around ninety percent of a bank's capital structure. Further, it is generally considered that banks are inherently less transparent than non-financial firms (Flannery et al., 2004, 2013; Morgan, 2002). This inherent opacity presumably comes from the fact that private information unavailable to those outside the bank is the foundation of investment decisions that eventually impact the assets on bank's balance sheets. Consequently, due to high leverage, subsidized deposit insurance, government guarantees and lack of transparency, banks engage in risk taking that may be considered excessive by society (Jensen and Meckling, 1976; Macey and O'Hara, 2003).

Additionally, banks play two critical roles in today's economy, as emphasized by Johannisova and Wolf (2012): creating money and shaping the investment scenery. First, regarding the money creation process, most of the money is currently in circulation because a government, a bank, a business, a family, an individual etc. took out a loan. When repaying this loan, the money supply diminishes by the amount repaid (plus part of the interest), unless the bank provides again a loan of

identical amount (plus part of the interest). Second, banks shape the investment landscape, because they decide whether to grant or to withhold a loan. In this way, they implicitly support certain areas, industries, and projects, which will be the ones chosen to go ahead.

At the same time, banks play a disciplinary role, by assessing firm quality and enforcing creditor rights upon companies (Qian and Yeung, 2014). The research of Ivashina et al. (2009) demonstrates that bank's informational role improves value creation in merge and acquisition activities, while Qian and Yeung (2014) show that inefficiency in banking negatively impacts corporate governance not only through its own failure in monitoring firms but also by diluting the market's monitoring role. More precisely, when a firm can easily access non-disciplinary bank loans, the potential reputation loss and the subsequent higher cost of equity capital become less significant for the controlling shareholder. Hence, the controlling shareholder is more likely to expropriate minority shareholders. In other words, banking, and more specifically efficient banking, is critical for corporate governance.

Banks are particularly important for small firms, as demonstrated by the survey of Aaboen et al. (2006). This survey carried out in the particular case of the high-tech industry shows that firms are likely to have a strong link with banking institutions. As a result of these links, most of the firm's capital supply is from banks, and there are strong ownership links between banks and industry. The study reveals that small high-tech firms consult most frequently private sector organizations (banks) and families.

Caprio et al. (2007) point out the fact that well-functioning banks promote growth. When funds are efficiently mobilized and allocated by banks, the cost of capital decreases, while at the same time capital accumulation and productivity growth are accelerated. Moreover, banks play an important role in governing firms, due to their status of major creditors and occasionally as major equity holders. The research of Krosznera and Strahan (2001) focuses on the active bank involvement in firm management. Their results show that generally bankers activate on the boards of companies in which shareholder – creditor conflicts are likely to be relatively unimportant. Typically, such firms are stable and large and have a low level of short-term financing in their capital structure and a high fraction of

tangible assets, sometimes even prior to the appointment of the banker onto their board.

Given the central role played by the banking sector, and the complexities of bank regulation and governance, banks have been the focus of vast academic literatures, as very thoroughly demonstrated by the recent literature reviews of Bushman (2014) and Beatty and Liao (2014). The literature related to the banking sector comprises several academic fields, applies various research designs, encompasses both theoretical and empirical research, and focuses on within country, as well as across country issues. Bushman (2014) actually claims that the demand by economists and policy makers for powerful, insightful accounting research in banking has probably never been higher than it is in the present times.

In this wide landscape of various studies of the banking sector, the present paper focuses on internal auditing. The purpose of an audit is to compare what is to what should be (Lee, 2008). According to the definition provided by the Institute of Internal Auditors (IIA,), internal auditing is “an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.” This definition widens the scope of internal audit to evolve from its traditional compliance auditing to a stage where it is regarded as a value adding service to organizations (Suleiman and Dandago, 2014).

In accordance with the IIA Corporate Governance Model, which is built as an analogy to a four-legged stool, internal audit is one of the “legs” of the stool, additional to the board, the external audit and the management. From all these governance pillars, only the board and the internal auditing have daily and direct contact over the entire year with the company (Gras-Gil et al., 2014). The role of internal auditing is (1) to perform assessments that offer assurance over the proper design and effective operation of governance structures and processes and (2) to provide advice on potential improvements to governance structures and processes. Internal auditing plays the role of assessor, advisor, advocate and catalyst and is therefore one of the key cornerstones of effective corporate governance.

Having in view the importance of the banking system correlated with the significant position of internal auditing in banks, it is surprising that a thorough national and international literature review shows that research is rather scarce in this area. The present paper intends to fill in this gap by constructing the profile of the internal auditor in the Romanian banking system. Choosing the banking sector is first of all due to its importance for the economy, as presented in the above paragraphs. The paper is structured as follows. First of all, the research design is presented. Secondly, a short review of the relevant literature is carried out by the authors, in order to create the context of the results. Third of all, the results of the research are detailed. Last but not least, the fourth section debates the results and draws the conclusions of the study.

1. Literature review

The literature regarding the banking sector includes a variety of studies on the topic of corporate governance. Sharma (2014) assesses the extent of mandatory corporate governance disclosure by banks and finance companies listed on Nepal Stock Exchange. Caprio et al. (2007) assess the impact of the ownership structure of banks and shareholder protection laws on bank valuations while controlling for differences in bank regulations. The typical challenges faced by the banking sector in terms of corporate governance are examined by Kraysenbuehl (2003), who formulates recommendations and warnings. The specifics of corporate governance in the banking and financial services industries are also analysed by Thakor (2007), as well as by Mehran (2004) and more recently, by Turlea et al (2010). The external and internal corporate governance activity observed at Japanese banks over 1985-1996 is investigated by Anderson and Campbell (2004). The Austrian cooperative banking system is in the center of Gorton and Schmid (1999), who test the hypothesis that corporate governance becomes less efficient as the degree of separation of ownership and control increases. Adams and Mehran (2012) address a long-standing gap in the literature by analysing the relationship between board governance and performance using a sample of banking firm data that spans 34 years.

However, at international level, the specific topic of internal audit in the banking sector (as part of corporate

governance) has received less attention in the academia. Gras-Gil et al. (2014) examine whether the structure and characteristics of the internal audit function affect the quality of financial reporting, whereas the sample is made up by the internal audit departments of 47 Spanish banks. An integrated audit approach of rule-based and case based reasoning is applied by Lee (2008) to data of internal audits of a bank. Suleiman and Dandago (2014) establish the extent to which internal audit functions (IAFs) are outsourced by the consolidated conventional banks in Nigeria, addressed in the country as deposit money banks. At national level, the literature on internal audit in the banking industry is also scarce. Relevant are the papers: Stanciu (2010) on the particularities of bank capital adequacy process audit; Mățiș and Palfi (2009) on the evolution of non-performing loans and the role held by the internal audit of banks in limiting them; Rusu and Rusovici (2006) on how the internal auditing is performed in banks; Dobroțeanu and Dobroțeanu (2006) regarding the relationship between internal auditing and internal control in banking sector.

In conclusion, few are the papers written in Romania on internal audit in the banking sector. Even fewer are the empirical ones. The present research aims at filling in this literature gap by adding valuable knowledge on the internal audit function and on profile of the internal auditor as professional in Romania.

2. Research design

The research design is empirical in nature. The research searched the archive of two job portals: www.bestjobs.ro, and www.ejobs.ro. These are the most known and accessed job portals in Romania. Their archive expands over the period 2011-2014, for www.bestjobs.ro and 2005-2014 for www.ejobs.ro. Of interest for the research were only the jobs in the area of internal audit of banks, therefore, the keywords after which the search took place were: “audit” & “bank” and “auditor” & “bank”, whereas the audit of information systems has been excluded. Only the title of the job announcement, which contains the position and the employer, has been searched for these keywords.

The sample consists in 17 different banks, out of which only 14 belong to the classification performed by the National Bank of Romania. 12 out of 14 are commercial banks with a majority of foreign capital, and the

remaining two are subsidiaries of foreign banks. Together, their net assets amount to 129.308,70 billion RON, in accordance with the balance sheet as of 31.12.2013. Thus, the authors consider the sample representative, as it corresponds to a market share of 36% in the Romanian banking sector.

The main hypotheses of this empirical research are the following:

- H1: Special qualifications are a condition for the activity as internal auditor.
- H2: A candidate for an internal auditor position should have a university degree in a subfield of economics.
- H3: Good knowledge of the minimal norms on internal auditing belongs to the internal auditor’s profile.
- H4: Communication skills are considered to be essential for an employee in internal audit.
- H5: Internal auditors in banks must have availability for business travels.

The choice of these hypotheses was made given previous research. Nowadays, the main knowledge, abilities and competencies required for internal auditors are not limited to just technical skills and knowledge. Harrington and Piper (2016) present the results of the 2015 Practitioner Survey carried out by the Global Internal Audit Common Body of Knowledge – a survey that intends to provide a comprehensive view on the activities and traits of internal auditors worldwide. According to this survey, the members of the internal audit departments studied accounting (57%), internal auditing (42%), finance (32%), business management (27%), external auditing (23%), and economics (22%). This focus is considered by Harrington and Piper (2016) to be relatively narrow, therefore threatening to restrict the skills available to CAEs. According to the survey, CAEs are nowadays seeking to increase skills in analytical/critical thinking (64%), communication skills (52%), accounting (43%), risk management assurance (42%), information technology – general (38%) and industry-specific knowledge (35%).

As highlighted by Stanciu (2016), critical thinking was placed first for good reason. Critical/analytical thinking skills are needed in every step of the internal auditors’ work, starting from risk assessment, the selection of audit procedures and ending with the auditors’ opinion and recommendations. Secondly, good communication skills are vital, as they help internal auditors to identify

the stakeholders' expectations, to collect the necessary information during audit engagements, to build strong relationships with both colleagues and managers, to clearly communicate their findings and recommendations. The third place is taken by accounting knowledge, which, in most cases, represents the professional background of the internal auditors.

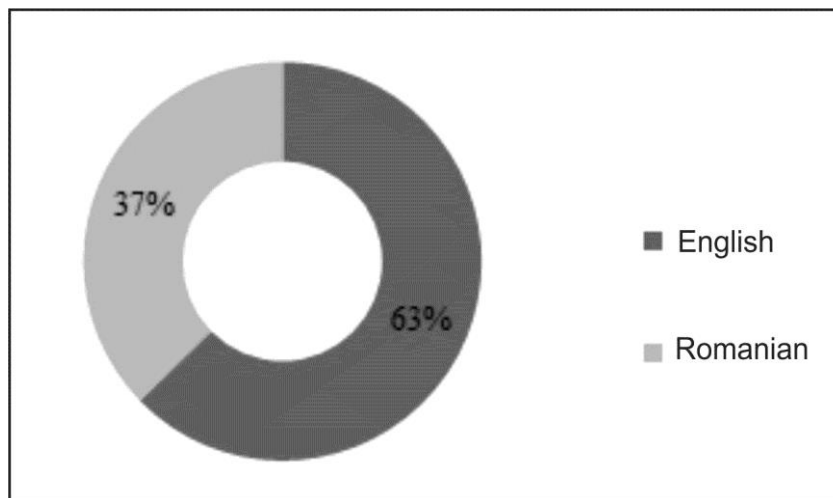
Another relevant study that underlines the importance of the so-called "soft" skills of internal auditors is that of Fanning and Piercey (2014). They ground their research on the findings of the practitioner literature, which indicates that internal auditors often adopt a "policeman approach". Such an attitude can be explained by the fact that, unlike external auditors, internal auditors lack client services incentives. However, this "policeman approach" can lead to negative interpersonal relationships with managers. Fanning and Piercey (2014) find that managers agree more with an internal auditor who is both likable and uses a thematically organized argument, irrespective of the fact that information supports or not the auditor's position. Internal auditing is a "relationship and communications business" in which

information is communicated within an organizational context to influence managers (Dittenhofer et al., 2010). Kachelmeier (2010) explains that companies are not the ones that make accounting decisions, but people are in fact the ones who run the decision-making process. People's decisions are shaped by the behavioural interactions of individuals within the social environment of their firms. On this background, the significance of internal auditors' soft skills becomes obvious

3. Results and discussion

Following this data collection, a number of 67 job announcements resulted. These announcements have been published by 17 different banks, out of which all 17 disclosed their name. With two exceptions, the jobs' location was the capital of Romania, Bucharest, where the head office of the banks is located. The language of 63% of the jobs postings was English, while the rest of 37% of the announcements were in the national language – Romanian (Figure 1).

Figure 1. Language of job postings



Source: Authors' processing.

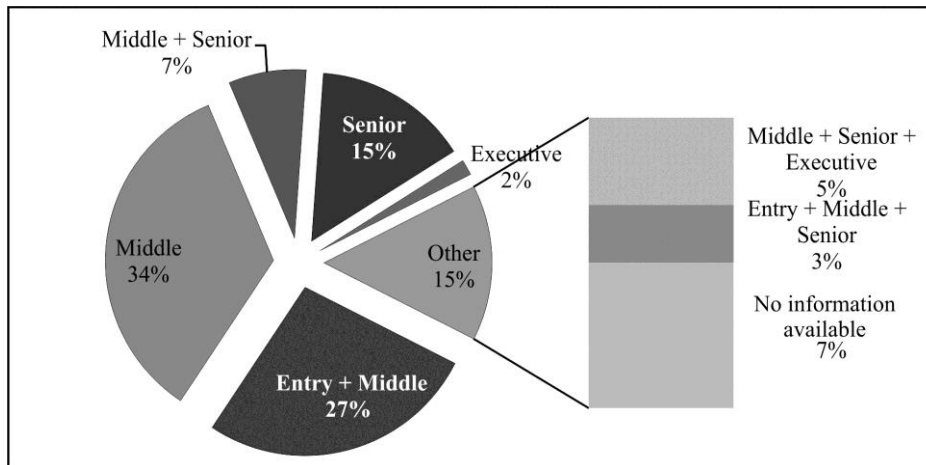
When posting a job, an employer has to choose the required experience level for that job, in order to ease up the search process for the candidate. There are mainly four possible levels: entry (0-3 years of experience), middle (3-5 years), senior (over 5 years)

and executive. 23 out of 67 jobs are middle-level, and 10 are senior-level, only one out of 67 are executive-level, while for five no information is available. The other 28 jobs left are mixed: 18 are mentioned as both entry and middle-level, five jobs

are middle and senior-level, while three are middle, senior and executive. In case of two jobs, all three

levels (entry, middle, and senior) are present (Figure 2).

Figure 2. Experience levels of analysed jobs

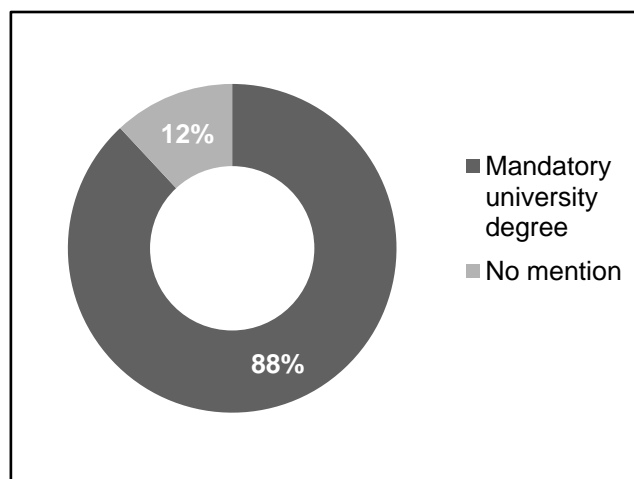


Source: Authors' processing.

In case of seven job announcements, nothing about the qualification requirements was mentioned. In only one case, high-school graduates were accepted. However, according to all of the remaining 59 jobs, a university degree was mandatory. Interesting is the type of major required from the job applicants. 84% of the employers wish to hire a graduate in economics. 24% mentioned a

very precise major such as accounting, finance, banks, or audit. By exception, in one case, the candidate could also be a graduate of legal studies. A majority of 60% job announcements require a university degree in economics, without mentioning anything about the major.

Figure 3. Requirement of university degree



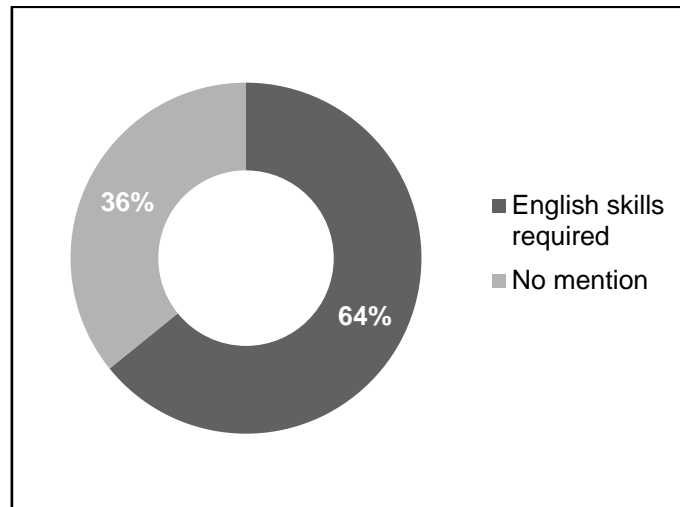
Source: Authors' processing.

In case of a third of the jobs, a further qualification besides the university degree is desired. Such qualifications are the following: ACCA (the Association of Chartered Certified Accountants), CIA (Certified Internal Auditor), CISA (Certified Information Systems Auditor), member of the Chamber of Financial Auditors of Romania (CAFR), Member of the Institute of Internal Auditors (MIIA), Certified Financial Specialist (CFS), Certification in Control Self-Assessment (CCSA), ICAEW Chartered Accountant (ACA), Certified Fraud Examiner (CFE), Certified Financial Services Auditor (CFSA), CECCAR Chartered Accountant (Corpul Expertilor Contabili și Contabililor Autorizați din

România). In just three out of 23 cases, such a qualification is a must and not only a plus.

More than half (64%) of the job announcements include among the requirements English language skills. 74% of these jobs require specifically advanced English skills. Proficiency is required explicitly both in written and in oral communication by almost half of the employers who expect candidates to know English. 7% say nothing about language skills, but as the majority of these jobs are written in English, the requirement is, in our opinion, somehow intrinsic. No other languages are mentioned as being a plus if known by the candidate.

Figure 4. Explicitly required English skills



Source: Authors' processing.

Solid computer skills are also part of the internal auditor profile. More than half of the jobs (more precisely 58%) require computer skills. The job postings are so not specific about the exact software the candidate should be proficient in. Just about 25% of the announcements mention Microsoft Office and only around 10% refers to Excel.

Regarding the technical knowledge/skills, 12% of the jobs require “accounting competence”, whereas five announcements refer to accounting in general and three mention explicitly International Financial Reporting Standards knowledge. Besides accounting, the internal auditor should also understand the financial, operational, market and credit risk; should

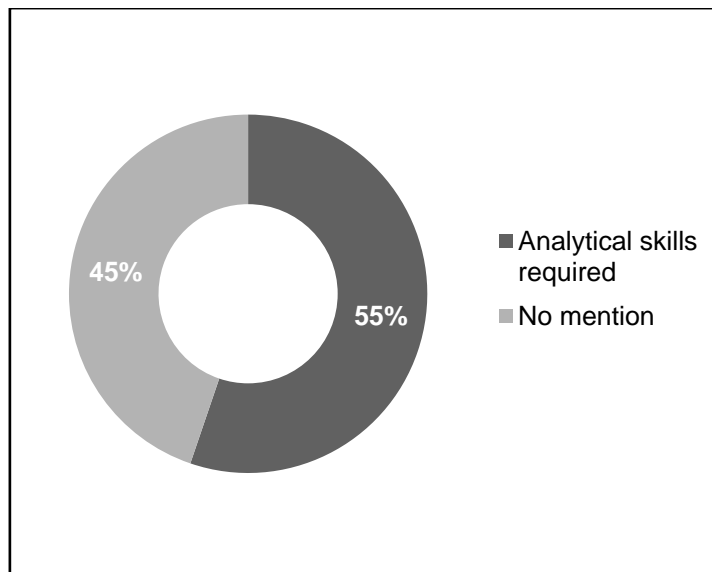
have a good understanding of the banking governance and organization, of its products, and services; should have the knowledge and skills for credit and financial analysis.

“Comprehensive knowledge of auditing practices, procedures and principles”, “ability to design world class audit programs”, “familiarity with relevant professional standards as well as laws and regulations”, good knowledge of International Standards on Auditing – in other words, internal audit knowledge and competence, are a must for about a fifth of the banks. Good risk assessment skills are also among the specific skills that belong to an auditor (they are included in 7% of the jobs).

A quite interesting request for the internal auditor-to-be is the willingness and interest for continuous professional learning and improvement – request made in 12% of the analysed job announcements. Additionally, as the sample investigated in the present research consists only in jobs posted by banks, another requirement is that the candidates are familiar with the legislation typical for the banking sector. Around a third of the announcements (more specifically, 30%) mention this.

Strong analytical skills are without any doubt part of the internal auditor profile in Romanian banks, being mentioned in more than half (namely 55%) of the announcements (**Figure 5**). The ability to make proper decisions in a timely manner is appreciated by none of the employers in the sample. Strong organizational skills are valued by almost half (52%) of the banks. They expect that the internal auditor is well-organized, proactive, goal-focused, and able to work under pressure in order to meet tight deadlines.

Figure 5. Desirability of analytical skills



Source: Authors' processing.

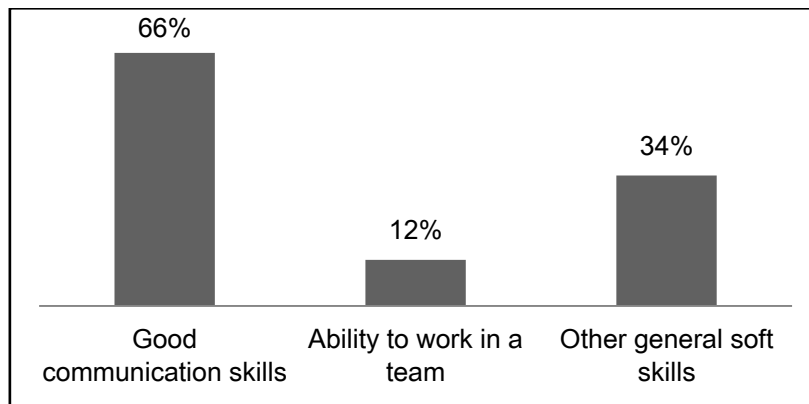
As expected, soft skills are not forgotten when looking for the ideal candidate in an internal audit position (**Figure 6**). Only 12% of the job announcements include general soft skills such as interpersonal skills, negotiation skills, initiative, proactivity, and motivation. Highly appreciated are the communication skills (66% of the jobs), both written and verbal, followed as well as the ability to work in a team (34% of the announcements).

Surprisingly, there are job postings that explicitly mention the expectation of employers regarding the character of their future employees. Integrity and responsibility, besides the professionalism, the objectivity and the reliability, are highly valued. Integrity

is included in 15 job announcements (representing 22% of the sample), while responsibility in slightly more – 18 postings. Some actually mention that the candidate should be aware of the code of ethics for internal auditors. However, more than half (73%) do not include any reference on the candidate's character.

Important for the banks hiring internal auditors is their availability for business trips. More than a third, namely 37% of the announcements include this condition. Moreover, 7% of the total number of jobs in the sample and 20% of the postings that include the availability to travel also mention that the driver's license is a must.

Figure 6. Interest for soft skills possessed by candidates



Source: Authors' processing.

According to the authors' expectations, no job announcement mentions anything about sex, salary or age.

4. Conclusions

The majority of the hypotheses have been confirmed. Regarding hypothesis H1, according to special qualifications are a condition for the activity as internal auditor, it was shown that in case of 30% of the jobs, a further qualification besides the university degree is a much appreciated advantage.

Secondly, the authors postulated that a candidate for an internal auditor position should have a university degree in a subfield of economics. This hypothesis was also validated. 59 jobs mention the requirement of a university degree and more than two thirds (namely 84%) of the employers specifically want an economist.

The third hypothesis which states that good knowledge of the minimal norms on internal auditing belongs to the internal auditor's profile was only partially confirmed by

the empirical research. However, the percentage of banks that explicitly include this in the job announcements is rather low. Only seven out of 67 jobs require good knowledge of internal audit standards. Good skills of risk assessment seem to be equally important for banks, being mentioned by 7% of the jobs.

According to the international trend in internal audit and, most specifically, in the accounting profession, soft skills are not to be ignored. The authors postulated that communication skills are considered to be essential for an employee in the internal audit department. Indeed, almost two thirds of the jobs posted mention good communication skills, both written and verbal.

Fifth, the research also shown that availability to travel is a must for the internal auditor. More than a third of the sample jobs mention among the job requirements that the internal auditor should accept business trips as part of the work duties. 7% of the announcements express the condition that the candidate has a driver's license, meaning that banks may put at the internal auditor's disposal a business car.

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Auditors' and auditees' perception on the internal audit quality

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Abstract

The purpose of this study is to examine the influence of audit planning, fieldwork audit, audit reporting, follow-up action of the audit results, the auditor team competence, and independence of the auditor team on the internal audit quality at the General inspectorate of the Ministry of Finance, Indonesia.

The study uses a research instrument in the form of a questionnaire which is submitted to the auditor team of the Inspector General and the head of office as the auditee in the Ministry of Finance. We also conducted interviews with senior auditors at the General Inspectorate and officials as the auditee at the Ministry of Finance. The sample is analysed by multiple regression analysis.

The results show that the internal audit quality according to the auditor team perception is affected by audit planning, audit reporting, and auditor team competence. Fieldwork audit, follow-up action of the audit results, and the independence of the auditor team do not affect the internal audit quality. From the auditee's perception, the internal audit quality is affected by audit planning, fieldwork audit, and the competence of the auditor team. Meanwhile, the reporting of audit results, the follow-up action of the audit results, and the independence of the auditor team do not affect the internal audit quality at the General inspectorate of the Ministry of Finance.

Keywords: *Internal audit quality, auditor team perception, auditee perception, General Inspectorate of the Ministry of Finance of Indonesia.*

JEL Classification: *M42, M48.*

To cite this article:

Djati, K., Rahmawati, Payamta, and Uzliawati, L., (2016), Auditors' and auditees' perception on the internal audit quality, Audit Financiar, vol. XIV, no. 11(143)/2016, pp. 1246-1252, DOI: 10.20869/AUDITF/2016/143/1246

To link to this article:

<http://dx.doi.org/10.20869/AUDITF/2016/143/1246>

Introduction

This study aims to examine the influence of audit planning, fieldwork audit, audit reporting, follow-up action of the audit results, the auditor team competence, and independence of the auditor team on the internal audit quality at the General Inspectorate of the Ministry of Finance. Auditors have found an auditee action in achieving goals and objectives through test result. Internal audit must identify the goals and objectives of the auditee, establish the significant criteria for achieving them, and examine and measure these criteria to determine how the auditee action has reached its goals and objectives (Dittenhofer, 2001).

The phenomenon of the poor quality of audit in audit practice is affecting the level of stakeholders' satisfaction toward audit performance, as it was the case of the Public Accountant Firm (PAF) Arthur Anderson and Enron in the United States of America in 2001. PAF Arthur Andersen had committed a violation on the ethical principles of the accounting profession, namely it abused the principles of integrity and professional conduct. The firm was not able to maintain and enhance public confidence as a member of the Big Five category, and it did not behave professionally and consistently with its professional reputation, by condoning the hiding and misrepresentation of accounting information while auditing the financial reports. PAF Arthur Andersen also violated the appropriate professional service standards because it did not perform its professional duties properly, or as required by the relevant technical and professional standards.

The emergence of cases in organization causes the moral impact on stakeholders' satisfaction regarding the audit practice and, therefore, the effectiveness of the internal auditor's function existence was questioned (Rezaee et al., 2003). DeAngelo (1981) states that audit quality is indicated by the auditor's ability to find the violation in the client's accounting system and to report it.

The General Inspectorate, as the internal auditor in the Ministry of Finance, is functioning as the responsible internal audit structure of the government in overseeing the internal control of the state's finance. The scope of this supervision includes the budgeting process, administration, and the state's financial reporting. These controlling areas cover the state finance in the state budget - APBN (Anggaran Pendapatan dan Belanja

Negara) as well as the state's finance that is separate from APBN. Therefore, the quality and performance of the internal audit performed by the General Inspectorate are important because their existence is part of the governmental internal auditor's function that will keep record of all of state's assets (so there will be no problem in maintaining it) and is responsible for development and supervision of the Government Internal Control System (GICS).

There are various factors affecting the audit quality from the various segments of different dimensions associated with the auditing process (Mock and Samet, 1982; Gibbins and Wolf, 1982; Chow et al., 1987; Sutton and Lampe, 1990; Sutton, 1993), namely: audit planning, fieldwork audit and reporting of audit result. Sutton (1993) examined the factors that are affecting the quality of auditing in the USA. The result of analysis showed that there were 19 attributes that affected audit quality, classified in three categories: audit planning, fieldwork audit and administrating/reporting.

Although there have been a lot of studies about the internal audit quality in association with organizational performance, there is a limited number of studies that examine the internal audit quality in relation to the auditing process in the public sector. This study is intended as an extension and a development of previous studies, by examining if the audit quality is affected by audit planning, fieldwork audit, and reporting of auditing results (Mock and Samet, 1982; Sutton and Lamp, 1990; Sutton, 1993).

1. Literature review

Internal audit is a business activity which was introduced as profession since the establishment of The Institute of Internal Auditors (IIA) in the 1940s, in the USA. The concept of internal audit is also used in public and governmental institutions. This is due to the fact that governments handle public resources and they should be accountable for the use of these resources efficiently, economically, and effectively in the process of achieving their objectives. The government is responsible for the observance of laws and regulations. Government is also responsible for creating and maintaining an effective control meant to ensure the achievement of its goals and appropriate objectives, protection of the resources, compliance with laws and regulations, the disclosure of the data obtained, and the disclosure of a true and fair view of government information. The audit report of the

government becomes the most important element of public control and government accountability (Dittenhofer, 2001).

The quality of audit involves the compliance of professional standards. The results of the audit process are the financial statements which provide an accurate representation of economic realities, benefit from assurance services and contribute to the efficient risk management of the company. To benefit from all these qualities, the audit process must be implemented independently of the auditee, allowing the auditor to have the sceptical position recommended in the course of the audit mission (Christensen et al., 2013). Knechel et al. (2013) focus on four dimensions of audit quality: audit input (expertise), audit process (consideration of auditor and audit practice), outcome (reporting) and contextual (period of auditor working). Francis et al. (2011) argue that the quality of audit framework includes inputs, processes, the audit firm itself (expertise in the business industry), the market and audit industry (market competition), the economic consequences of the audit results (publication of auditor's opinions).

The quality of audit must also be identifiable and measurable by the auditee. The level of audit quality must be built from the beginning of the audit implementation until the moment of reporting and making the final recommendations. Therefore, the indicators used to measure the quality of audit are the quality of processes, namely whether the audit is done carefully, according to procedure, while continuing to maintain a sceptical attitude on the auditor's part. There is a lot of feedback regarding the quality of audit that is separated from auditing standards. One of the most important feedbacks is related to the auditor's personal attributes such as auditor skills and experience, ethical values, and the general mindset. Other inputs are auditor perception and audit tenure. The audit companies need to attract high quality individuals with technical skills and interpersonal skills that are necessary to maintain or improve the audit quality (Duff, 2004).

The audit process can be seen as the activity of collecting and evaluating evidence to support information/report that serve the auditee, to increase the users' assurance that the auditee's report can be used as a basis for decision making. In general, the internal audit process can be categorized in audit planning, fieldwork audit, audit reporting, follow-up action audit (Tim Penyusun Modul Program Pendidikan Non Audit Sektor Publik, 2007).

2. Research methodology

Based on the review of specialized literature, we defined the research direction in the field, by referring to the possible correlation between audit planning, fieldwork audit, audit reporting, follow-up action of the audit results, the auditor team competence, and independence of the auditor to the internal audit quality from the auditor's perception. We also intend to test new hypotheses, such as the existence of correlation between audit planning, fieldwork audit, audit reporting, follow-up action of the audit results, the auditor team competence, and independence of the auditor to the internal audit quality from auditee perception.

The analysed population is made up to 66 leaders of the auditor teams from the General Inspectorate of the Ministry of Finance and 208 auditees from the Ministry of Finance. By using the Slovin formula for the size of the sample we determined the final sample of 151 of the auditees from the Ministry of Finance. In the data collection stage, we used a questionnaire with closed questions. For processing and interpreting the data, we used the SPSS software (*Statistical Package for the Social Sciences*), version 20.0.

The research hypotheses that we intend to test are the following:

- H1: There is a positive influence between *Audit planning* and *Internal audit quality*.
- H2: There is a positive influence between *Fieldwork audit* and *Internal audit quality*.
- H3: There is a positive influence between *Audit reporting* and *Internal audit quality*.
- H4: There is a positive influence between *Follow-up action* of the audit results and *Internal audit quality*.
- H5: There is a positive influence between the *Auditor team competences* and *Internal audit quality*.
- H6: There is a positive influence between *Independence of the auditor* and *Internal audit quality*.

3. Research results

3.1. Descriptive analysis of variables

A first analysis reveals the fact that for the observed sample, the mean degree of dissemination of the information on internal audit quality from the auditor team's perspective has values between 2.60 and 5.00, for 68.1% of the sample (Table 1). On the other side,

from the auditees' perception, the mean degree of dissemination of the information on internal audit quality

has values between 2.40 and 5.00, for 77.7% of the sample (Table 2).

Table 1. Descriptive statistics for the auditors' perception

Variable	N	Min	Max	Mean	Std. Deviation
Audit planning (PL)	66	2.56	5.00	3.9674	0.40859
Fieldwork audit (CO)	66	3.48	5.00	4.1782	0.40222
Audit reporting (RE)	66	3.13	5.00	4.1608	0.46705
Follow-up results (FO)	66	3.00	5.00	4.0606	0.52268
Auditor competence (COM)	66	3.25	5.00	4.0947	0.45312
Auditor independence (IND)	66	3.00	5.00	3.9129	0.45887
Internal audit quality (QU)	66	2.60	5.00	3.8924	0.43864

Source: Authors' processing, based on the SPSS output.

Table 2. Descriptive statistics for the auditees' perception

Variable	N	Min	Max	Mean	Std. Deviation
Audit planning (PL)	107	1.33	5.00	3.6283	0.75273
Fieldwork audit (CO)	107	2.57	5.00	4.1005	0.56350
Audit reporting (RE)	107	2.00	5.00	4.0153	0.71020
Follow-up results (FO)	107	2.50	5.00	4.3598	0.60965
Auditor competence (COM)	107	2.00	5.00	3.9766	0.71501
Auditor independence (IND)	107	2.33	5.00	4.1935	0.69623
Internal audit quality (QU)	107	2.40	5.00	3.8374	0.62819

Source: Authors' processing, based on the SPSS output.

3.2. Testing the research hypotheses

In order to validate the research hypotheses, we applied multiple regression analysis from the auditor's perception, as presented in Table 3.

Table 3. Regression from the auditor's perception

Equation		
$QU_t = b_0 + b_1PL_t + b_2CO_t + b_3RE_t + b_4FO_t + b_5COM_t + b_6IND_t + e$		
Keterangan	Coefficient	Significance
Audit planning (PL)	0.310	0.003***
Fieldwork audit (CO)	-0.069	0.629
Audit reporting (RE)	0.365	0.002***
Follow-up results (FO)	0.091	0.347
Auditor competence (COM)	0.285	0.006***
Auditor independence (IND)	0.074	0.458
F Test	24.171	0.0000***
Adjusted R ²	0.681	

*** Signification on $\alpha = 1\%$

Source: Authors' processing, based on the SPSS output.

From the auditees' perception, we validated the research hypotheses by means of a multiple regression analysis, as shown in Table 4.

Table 4. Regression from auditees' perception

Equation		
$QU_e = b_{0e} + b_{1e}PLE + b_{2e}CO_e + b_{3e}RE_e + b_{4e}FO_e + b_{5e}COM_e + b_{6e}IND_e + e$		
Description	Coefficient	Significance
Audit Planning (PL)	0.113	0.070*
Fieldwork Audit (CO)	0.334	0.003***
Audit Reporting (RE)	0.073	0.388
Follow-up Results (FO)	0.016	0.825
Auditor competence (COM)	0.457	0.000***
Auditor independence (IND)	0.054	0.419
F Test	62.467	0.000***
Adjusted R ²	0.777	

* Signification on $\alpha = 10\%$, *** Signification on $\alpha = 1\%$

Source: Authors' processing, following the SPSS output.

The result show that, from the auditors' perception, *Audit planning*, *Audit reporting*, and *Auditor competence* have a positive relationship with the *Quality of internal audit*. Audit planning plays an important role in the success of the internal audit activities. The optimal audit planning is achieved by involving the auditee and can provide additional value in accordance with the auditee's needs to improve and enhance its performance.

Audit reporting and the *Follow-up recommendations* are means of communication regarding the aspects that need improvements. The final audit report should be

informative and appropriate and should include the result of discussions with the auditee. Furthermore, the *Auditor competence* variable is one of the most important factors of competition within the industry (Carcello et al., 1992). Beattie and Fearnley (1995) argue that one of the key characteristics of audit quality is the auditor's technical competence.

On the other side, from the auditee's perception, the results show that *Audit planning*, *Fieldwork audit*, and *Auditor competence* have positive impacts on *Internal audit quality*. This is due to audit planning, that involves

the fact that the auditee can help the internal auditor to maintain its objectivity at the time of audit planning and implementation and therefore the auditee will be assisted in solving the problems with which he is faced. Additionally, the results show that fieldwork audit has a significant positive effect. This is in accordance with the result of previous studies which state that the quality of internal audit procedure is included in the ability to implement audit (Sprakman, 1997; Xiangdong, 1997; Fadzil et al., 2005).

Auditor competence in this study also has a positive influence on internal audit quality. The results show that one of the key characteristics of audit quality is the auditor's technical competence. The Auditor team competence variable is influencing internal audit quality, which means that, in implementing its assignments, the General Inspectorate teams have sufficient audit experience and expertise.

Conclusions

Starting from the results in specialized literature, we tested six research hypotheses regarding the

perception related to the correlation between audit planning, fieldwork audit, audit reporting, follow-up action of the audit results, auditor team competence, and independence of the auditor to the internal audit quality, from the auditor's perspective. At the same time, we tested the same correlations from the auditee's perception.

Statistical tests showed that, with certain restrictions concerning the normal distribution of the variable, for the analysed sample, the research hypotheses are confirmed from the auditor's perception: there are positive significant correlations between *Internal audit quality* and *Audit planning*, *Audit reporting*, and *Auditor competence*, respectively. From the auditee's perception it was confirmed that there are significant positive correlations between *Internal audit quality* and *Audit planning*, *Fieldwork audit*, and the *Auditor competence*.

As future research directions, there could be considered extending the analysis to a larger sample and identifying regression models that would explain better or in more detail the quality of internal audit.

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A comparative study of the different costing techniques and their application in the pharmaceutical companies

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Abstract

After its induction in the 19th century, the pharmaceutical industry covered a long way and now it became one of the most successful and influential industries in the world, with both praise and controversy on its part. The current study is performed on the pharmaceutical firms working in the Punjab (Pakistan). Like the other profit-driven organizations, the main aim of the pharmaceutical firms is to earn the maximum profit. The profitability also depends on the costing system. The current paper evaluates the costing systems, the level of satisfaction regarding the costing system, the major problems faced during the costing process and the best method of costing in the pharmaceutical sector. The questionnaire was designed for the collection of data from 130 pharmaceutical companies working in the Punjab. For the data analysis, the descriptive statistics and the graphical method were used. The significant result of the study is that most of the organizations used the marginal costing and many managers are satisfied with the costing system which they are using.

Keywords: Pharmaceutical industry, costing system, marginal costing, ABC costing, Punjab.

JEL Classification: M41.

To cite this article:

Aleem, M., Khan, M.H. and Hamad, W. (2016), A comparative study of the different costing techniques and their application in the pharmaceutical companies, *Audit Financiar*, vol. XIV, no. 11(143)/2016, pp. 1253-1263, DOI: 10.20869/AUDITF/2016/143/1253

To link to this article:

<http://dx.doi.org/10.20869/AUDITF/2016/143/1253>

Introduction

The current era is characterized by global competition. This competition forced the manufacturing and services firms to become integrated, more flexible and highly automated to increase their productivity by lowering their costs to survive on the market. It is impossible to sustain the competitive advantages without having the accurate system of cost mechanism (Özbayrak et al., 2004).

There are three major systems of costing:

- (i) Traditional methods,
- (ii) Marginal costing methods, and
- (iii) ABC costing.

The current study is about the costing system used by pharmaceutical companies.

The pharmaceutical companies play a vital role in society, by providing life-saving products to human beings. Within this perspective, this sector explores the development and discovery of new pharmaceutical products, the secure and quick development of the products and finally the production and distribution of these safe and sound products to the end user (Masood et al., 2009).

Mushtaq and Chattha (2008) argue that the scope of pharmaceutical manufacturing is three folded:

1. Research and development;
2. To convert the natural and organic substances into bulk pharmaceutical ingredients through extraction, chemical synthesis and fermentation;
3. To manufacture the final pharmaceutical product.

In Pakistan the first two functions are not performed; only the pharmaceutical products are produced here. There is a wide range of pharmaceutical products and chemical products which are produced by the pharmaceutical companies; these include disinfectants, anaesthetics, muscle relaxants, water soluble salts, antibiotics, anticlotting agents, antihypertensive diuretics, anti-infective, analgesic, vitamins and anti-depressants. The pharmaceutical sector of Pakistan devises, packs and fills a diversity of pharmaceutical products, with unique trade names in the shape of tablets, oral powders for suspension, lotions and ointments, capsules, creams, syrups, ampoules and injectable substances. Lactose, sugar etc. are also used to produce the different products by the pharmaceutical companies, along with the active raw material. Solvents

like methanol, ethyl acetate, di-chloro ethane and methylene chloride, are frequently used to manufacture the pharmaceutical products in addition to the major raw material. The materials for manufacturing the products are frequently imported (Mushtaq and Chattha, 2008).

The pharmaceutical industry is growing in Pakistan. There is a wide range of pharmaceutical products and drugs which are produced and sold by the pharmaceutical companies. Now, the pharmaceutical companies are playing an important role in the Pakistan economy. There are many pharmacy schools which provide quality education to the pharmacy students. The national profession of Pakistan pharmacists is organized as national organizations which control the pharmacy practice in Pakistan and in the Punjab. Punjab's pharmacy council is responsible for conducting the tests and examination. However, the current study is about the costing techniques prevailing in this sector.

Triest and Elshahat (2007) argue that there is scant research available generally on management practices and especially on the accounting practices in non-developed /non-western countries. The reason is the lack of knowledge. Parnell and Hatem (1999) stated that the work of the expatriate manager is well-managed and documented and it is very difficult to apply the western concept in the business environment of non-western countries. There are lots of studies conducted on the costing techniques in the developed counties, but there is scant research available on the costing techniques in Pakistan. In the current era in which costing techniques provide accurate results, it has become a significant problem because different costing techniques provide different costs and profits for the firms. Similar to the other profit driven organizations, the main purpose of pharmaceutical companies is to earn the maximum profit, while the profit can be maximum if there is a proper costing technique for accurate costing. The current paper shows and evaluates the costing system used by the pharmaceutical companies in Punjab, Pakistan. It is based on a survey conducted on the pharmaceutical companies which are working in the Punjab.

The objectives of the study are to:

1. Identify the costing systems that the pharmaceutical companies are currently using;
2. Assess the degree to which managers are satisfied with the different costing techniques;

3. Identify the problems regarding the existing costing systems;
4. Assess how indirect costs are charged to the product.

1. Literature review

First of all, we examined the following questions regarding the costing system in the pharmaceutical sector:

- (i) What is meant by cost model?
- (ii) What is the significance of this model for the pharmaceutical sector?
- (iii) What are the major costing systems?

A cost model is used by the companies to have a better understanding regarding the costs, in order to run their business effectively (Kaplan, 1984). The cost model performs the following functions:

- (i) The assessment of inventory and cost of goods sold;
- (ii) The estimation of the cost of products, services, customers and activities
- (iii) The provision of feedback to the manager about the efficiency of the process.

Hatzis et al. (2011) is of the view that the other purpose of the cost model is to provide useful information for decision making, after getting and analysing of the data. The effectiveness of data is depending on the right information for making the right decision.

Mehmood et al. (2009) stated that in the current era the pharmaceutical sector is becoming a more multifaceted and dynamic environment. There are a lot of changes in this industry, like the amplified buyer cost sensitivity, the new market, the technological advancement and the global competition, which has increased up to uncertain level. The patient's expectations are higher, the healthcare cost has also increased and the incapacity of the economy to meet the increased cost is the major challenge for the pharmaceutical industry. Like other profit driven industries the main objective of the firm is to maximize the profit, while the profit is maximum if there is a proper procedure for the costing; therefore, the costing techniques have a great importance for the pharmaceutical sector.

The main costing systems can be categorized based on the product process and the production processes as follows (Kaplan, 1984; Cooper and Kaplan, 1988).

Product cost. The costing methods concerned with product costing are:

- Variable/marginal/direct costing;
- Full/absorption costing.

Production process cost. The costing methods concerned with the production process cost are:

- Process costing;
- Job order costing.

This article is concerned with the product cost and not with the production process cost. According to Garrison, Noreen and Brewer (2004), in the manufacturing organizations two most common techniques are used for the valuation of the inventory and cost of goods sold. The absorption costing is used commonly for the external purposes and the marginal costing is used for the internal decision making by the management. The two techniques provide a different net operating profit, while the difference may be quite high. Garrison, Noreen and Brewer (2004) define the variable and absorption costing as below.

The absorption costing considers all the manufacturing overhead as part of the product cost, whether it is fixed or variable. In the absorption costing, the per unit cost consists of direct raw material, direct labour and both fixed and variable overhead. It means that in the absorption costing the fixed part of the manufacturing also becomes a part of the product cost, in addition to the variable manufacturing cost. Direct material is a primary part of the product and it can be easily traceable in the product (e.g. wood in furniture, hard drive in the computer); direct labour can be easily traceable in the product, it is called touch labour (e.g. the labour of the carpenter); the manufacturing costs include all costs which were incurred on manufacturing the product, except the direct material and the direct labour (Garrison, Noreen and Brewer, 2004). The natural and organic substances become the material for the pharmaceutical companies and the persons who are directly involved in the production of pharmaceutical product become the part of direct labour. There are the following advantages of the absorption costing (Garrison, Noreen and Brewer, 2004):

- (i) Fixed cost of manufacturing is also recovered;
- (ii) Total cost is recognized;
- (iii) It is useful for pricing decisions and perdition of profitability;
- (iv) It is used for external purposes.

In the variable costing, only that part of the cost is considered in the product which varies with the level of activity. It consists of direct material, direct labour and the variable manufacturing overhead cost. Fixed cost is not considered a part of the product cost in variable costing. The fixed manufacturing cost becomes a part of the period cost, like the administrative and selling expenses, thus in the variable costing the inventory and cost of goods sold does not consist of any fixed cost of production. Variable costing has a number of advantages (Garrison, Noreen and Brewer, 2004):

- (i) Data can be taken directly from the variable costing for Cost-Volume-Profit (CVP) analysis; however, in absorption costing it is not easily available;
- (ii) Profit is not affected by the change in inventories;
- (iii) The manager often assumes that the per unit cost is the variable cost, but in absorption costing both fixed and variable costs are treated in per unit cost;
- (iv) In the variable costing, the fixed cost is clearly shown in the income statement; in this way we can emphasize fixed costs to become truly profitable;
- (v) Variable cost profit is close to the net cash flows;

- (vi) Variable costing provides a better prediction of the profit, because there is no subjective allocation of fixed cost.

Gupta and Parmar (2001) argue that marginal costing approach should also be conceded along with the absorption costing because it represents an effective way to control the cost. They also state that with the help of marginal costing we can also observe those resources which are unproductive because the attention is invited to the fixed cost in the marginal costing.

Pong and Mitchell (2005) argue that different methods of costing provide different net profits, because of differences in the value of stocks. The effect on the profit also depends on the opening and closing stock. If the value of the opening and the closing stock is the same, then the profit is the same under marginal and absorption costing, and if there is no opening and closing stock, then there is also no difference in the marginal and absorption costing profit. How much profit is different in both costing techniques is depending on the following two things:

- The difference between the absorption and the variable cost per unit (level of fixed cost per unit).
- The value of the ending and the opening inventory.

Table 1 provides the potential effect of both costing methods on the profit. No method has a complete negative or positive effect on the profit. If we change the costing method, the profit can increase or decrease depending on the stock adjustment (Pong and Mitchell, 2005).

Table 1. Impact of absorption costing and variable costing on profit		
Stock valuation method	Increase in stock	Decrease in Stock
Marginal costing	Low profit	High profit
Absorption costing	High profit	Low profit

Source: Authors' processing.

A new costing system emerged from the last decade, i.e. the ABC system. The early concept of this system emerged in the sixties and seventies in the USA (McConville, 1993) by the General electric company, and in Germany by the Schlafhorst and Siemens (Ziegler, 1992; Wäscher, 1987). However, a theoretically structured and comprehensive system of ABC was introduced for the first time in the '1980 (Kaplan and Bruns, 1987). In this technique, we established the different activities or the development of activities which show the small group of homogenous tasks in all the

department of factory. It is used for the development of cost estimation when the project can be divided into quantifiable activities, discrete or a work unit (Cooper and Kaplan, 1988; Innes, Mitchell, and Sinclair, 2000). It means that this activity can be clearly implemented when productivity can be measured in units.

For further clarification between ABC and traditional costing system we can differentiate between these two as presented in Table 2 (Karadađ, Samli, and Öztürk, 2009):

Traditional/Absorption costing	ABC costing
Only manufacturing costs are allocated to the product.	The manufacturing and non-manufacturing costs can be allocated to products (some manufacturing costs might not be included in the product cost, it varies from situation to situation).
Administrative, selling and general expenses are considered as a period cost.	Administrative, selling and general expenses can be considered as product costs if they have a direct relationship with the product cost.
The factory over head is charged to production on the basis of a single overhead rate for the entire factory. The base may be direct material cost, direct labour hour, direct labour cost and machine hour etc.	There are many factory overhead costs based on the multiple allocation basis.
Unused capacity costs can be considered as products cost.	Idle capacity costs cannot be considered as product costs.

Source: Authors' processing.

According to Garrison, Noreen and Brewer (2004), the following are the limitations of the ABC costing.

- To implement the ABC system there is need of more resources, hence it is more costly than traditional costing.
- The ABC system provides the numbers e.g. product margins and it odds with the numbers produced in the traditional costing. The managers are used to employ traditional costing to run business operations and traditional costing is frequently used for performance evaluations.
- The data based on the ABC costing can easily be misinterpreted for making decisions, therefore the manager has to care full for making decisions based on the ABC costing, by considering which cost is relevant or irrelevant.
- The ABC method is also not conforming to the generally accepted accounting principles (GAAP), therefore the organization has to prepare the statement on the basis of two methods: one for external and one for internal purposes.

2. Research methodology

The study was conducted on the pharmaceutical companies of Punjab, Pakistan. The questionnaire was used for the data collection from the pharmaceutical companies. In this study the questionnaire of Hatzis et al. (2011) was used for the data collection, after making the necessary amendments to adapt to the Pakistani culture. The questionnaire was designed in the English

language because the target population consists of well-educated people, so they can easily understand an international language. There was a total number of 15 questions in the questionnaire; it took 5-7 minutes for the respondents to complete the questionnaire. Our sample size was of 130 managers/accountants of the pharmaceutical companies which are working in the Punjab. 130 questionnaires were distributed to the respondents in the month of December 2011. A simple random sampling technique was used for distribution of the questionnaires. The data were collected through personally administrated questionnaires. Out of 130 questionnaires 96 were received back. The response rate was 74%. The descriptive and graphical analysis were used for the statistical analysis. The questionnaire was already used by the other researchers, so there is no issue of reliability. A covering letter is also forwarded to the respondents regarding the importance of the study. The most important purposes of the current survey are presented below:

1. What costing system was used and adopted by the pharmaceutical companies in Punjab?
2. Do the pharmaceutical companies have a position for the cost accountant/ manager/accountant for costing?
3. On what basis is the overhead charged to production in the pharmaceutical firms?
4. Do the pharmaceutical companies have standards for costing?
5. Do the companies use the accounting software package that supports the process of costing?

6. What is the major problem faced by the pharmaceutical companies during costing?
7. Up to what extent are the managers satisfied with their costing system?
8. Which one is best system of costing for decision making?

Participants

The participants to the survey are managers or accountants or any persons who are dealing with the costing system in the pharmaceutical sector in the Punjab, Pakistan. The demographic information of the participants is presented in **Table 3**.

Table 3. Participants' demographic profile

Particular	Range	Frequency	Percent%	Cumulative Percent
Gender	Male	84	87.5	87.5
	Female	12	12.5	100
	Total	96	100	
Age (years)	18-24	6	6.2	6.2
	25-31	45	46.9	53.1
	30-38	26	27.1	80.2
	36-45	12	12.5	92.7
	42-52	5	5.2	97.9
	above 52	2	2.1	100
Education	Undergraduate	7	7.3	7.3
	Graduation	18	18.8	26.0
	Master	65	67.7	93.8
	M. Phil/PhD	6	6.2	100.0
Job Experience (years)	1-6	91	41.4	41.4
	7-13	51	23.2	64.5
	14-20	37	16.8	81.4
	Above 20	41	18.6	100.0

Source: Authors' processing.

Demographics are not the part of analysis in the current study. It is just included in the paper to disclose the composition of the participants/respondents. **Table 3** shows the gender discrimination. The male respondents are 88% and female are only 12%. Males are dominating in Pakistani society. The reason of the low participation of women in manufacturing is that in Pakistani culture the males are supposed to earn money, and women are supposed to look after the home affairs and not earn money themselves. However, this trend is changing with the passage of time and females are also getting education and joining the public and private sector. However, the 12% participation of females is very low as compared to USA or any Western country (Bashir and Khattak, 2008).

The majority of the respondents are in the age of 25-30, which shows that young people are involved in the pharmaceutical sector; however, **Table 3** shows that all

age groups are included in our sample. It is also clear that most respondents hold a master degree and are also experienced in the pharmaceutical sector. The different age group, both type genders, low to high qualification personal and experienced respondents show that the data is the true representation of the population involved in the costing activities in the pharmaceutical sector.

3. Costing systems

Table 4 shows the outcomes of the analysis regarding the costing system in the pharmaceutical sector, which is the main objective of this survey. **Table 4** indicates that the majority of the pharmaceutical sector is currently using the marginal costing system for the cost estimation, which is very important for the internal costing. The ABC system is used in very few firms due to its complexity. 35 out of the 96 respondents use the

absorption costing (37%), 47 respondents (49%) use marginal costing, and 14 firms are using the ABC

system, meaning 15% approximately.

Costing systems	Frequency	Percent
Absorption Costing	35	36.5
Marginal costing	47	49.0
Activity based costing	14	14.6
Total	96	100.0

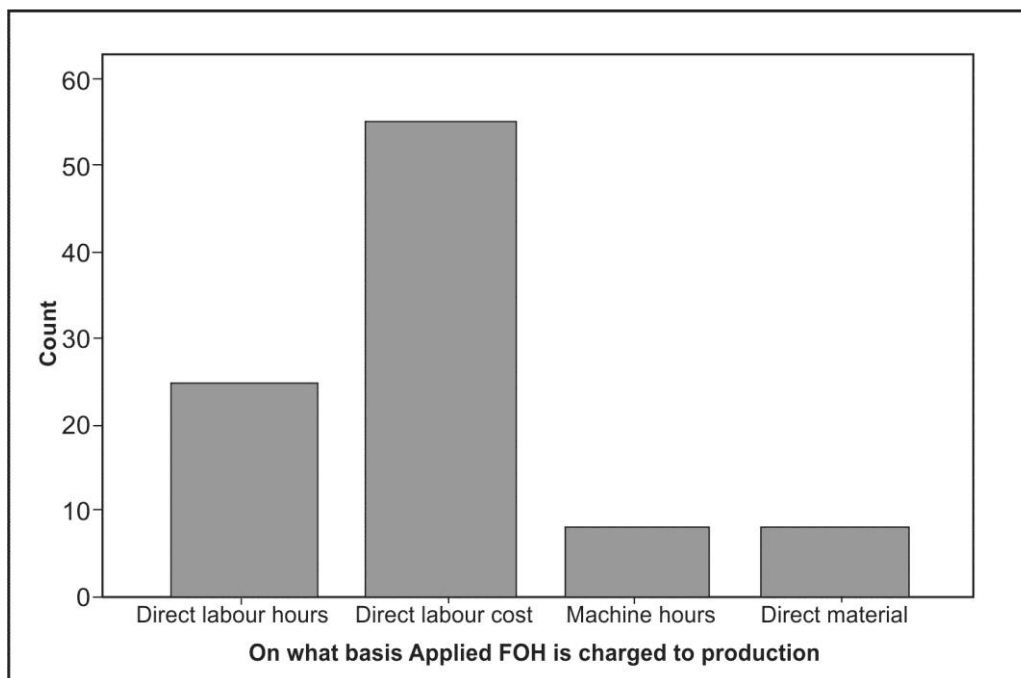
Source: Authors' processing.

Indirect costs

The manufacturing cost is charged on a different basis in each sector. The basis of absorbed manufacturing overhead may be the direct labour hours, direct labour cost, machine hours, material cost, prime cost and conversion cost, etc. However, in the pharmaceutical sector the manufacturing cost is charged on the basis of

the direct labour cost, as per the survey results, because this is a major cost element. The following graph shows that most of the pharmaceutical firms use the direct labour cost as a basis for manufacturing overhead; the machine hours and direct material are used by some firms only.

Figure 1. Indirect costs allocation bases used in the pharmaceutical industry



Source: Authors' processing.

Standard for Cost

The costing system is based on some standards or principles that dictate the manner in which the record of costing is maintained, for managerial decision making. As per the survey results, 75% of the pharmaceutical companies have a standard for costs, and the remaining 25% has no standard for costs.

Accounting Manager

Most of the pharmaceutical companies have the position of cost accounting manager, who manages the organization's costing system. 66% of the companies have the position of the accounting manager and 34% of the organizations have no proper set up of accounting manager and the costing system is managed by other categories of employees.

Accounting software

In the current era of technology, most organizations use the accounting software for keeping the accounting records. 74% of the pharmaceutical companies use a cost accounting software for the costing system, while

26% of the pharmaceutical companies use no software for the costing process.

Problems in the costing system

In the pharmaceutical sector, the following problems were examined regarding the costing system:

- Incorrect allotment of indirect costs,
- Complexities in the raw data assembly process,
- Delays in the gaining of accurate costing information.

The most important problem which the pharmaceutical companies face in terms of the costing system is the incorrect allocation of indirect costs, according to the managers' answers to the questions in the survey. 54 respondents argue that the major problem is the incorrect allocation of indirect costs, 20 respondents are of the view that the delay in gaining the accurate costing information is the major problem and 23 respondents are of the view that the main problem in costing consists in the complexities in the raw data assembly process. The following table shows the managers' responses regarding the problems faced by the pharmaceutical sector.

Table 5. Costing particularities specific to the pharmaceutical industry

Particulars	Frequency	%
Wrong allocation of indirect cost	53	55.2
Delays in acquisition of right costing system	20	20.8
Difficulties in raw data collection	23	24

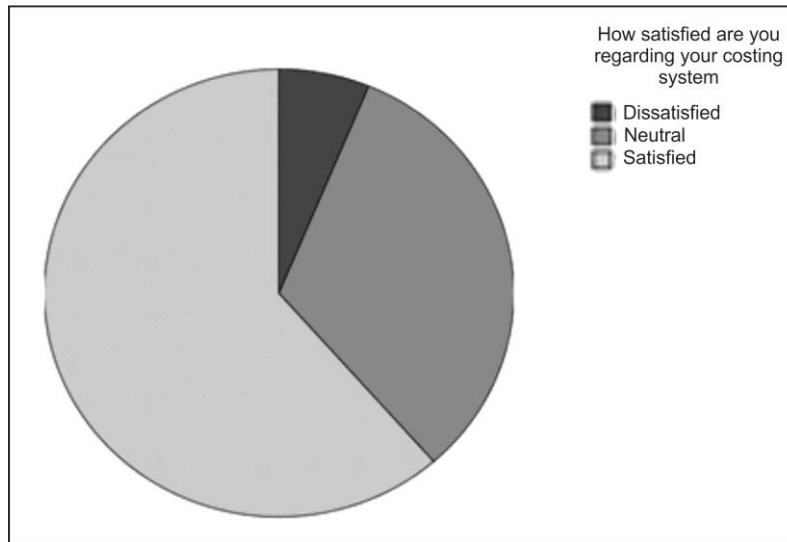
Source: Authors' processing.

Satisfaction level

The other major objective of the survey is to observe the satisfaction level of the respondents regarding the costing systems which they are using in the pharmaceutical sector. Managers may be satisfied with the costing system, or dissatisfied, or neither satisfied nor dissatisfied. The results show that 60% of respondents are satisfied with the system that they

are using, 30% are neither satisfied nor dissatisfied and 10% are not satisfied with the system. It is also observed that the firms which are using the ABC system are most satisfied as compared to those firms who are using the marginal and absorption costing, however the following graph shows the level of the respondents' satisfaction, neutral position and dissatisfaction.

Figure 2. The level of respondents' satisfaction with regard to the costing method they use



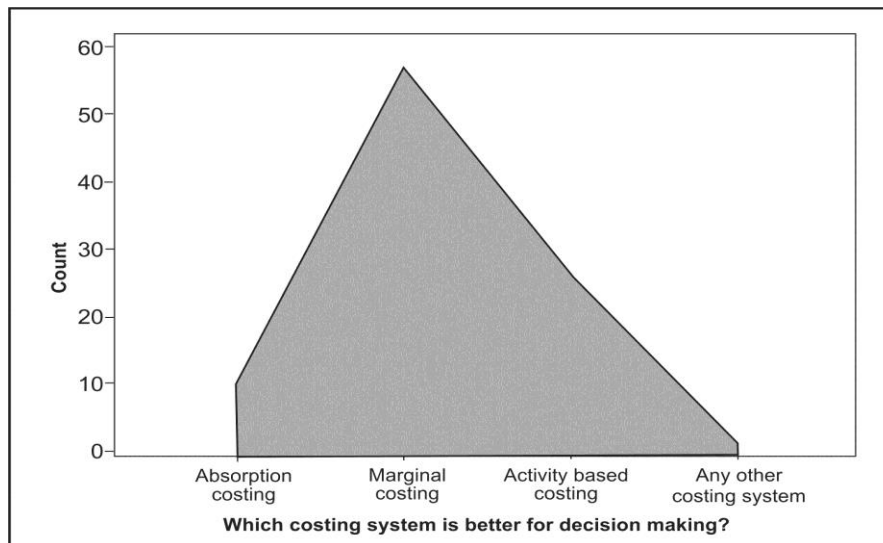
Source: Authors' processing.

Decision Making

The last and most important objective of the research was to show which costing system is better for decision making. Most managers argue that the marginal costing is better for decision making, as compared to absorption costing and ABC costing. 59% argue that

the marginal costing is better, 10% opted for the absorption costing and 28% stated that the ABC system is best suited for decision making. The following graph shows the managers' responses regarding the best suited costing system for decision making.

Figure 3. Costing methods adequate for the pharmaceutical industry



Source: Authors' processing.

Conclusions

In the current era, there is great importance of the pharmaceutical companies, because they deal with the human life. The pharmaceutical companies try to provide quality products along with minimizing the cost. The profit of the organization depends on the costing techniques which the organization uses.

The major objective of this paper was the evaluation and identification of the costing system, and other relevant issues which are of great importance for the costing system used by the pharmaceutical companies in the Punjab (Pakistan). The significant results of the survey were the following:

- Most companies in the Pakistani pharmaceutical industry use the marginal costing, instead of the absorption or ABC costing.

- The managers of the companies that are using the ABC system are more satisfied with the costing techniques, as compared to those using any other costing techniques.
- The companies have standards for costing and also use a software for costing.
- Most managers are of view that the marginal costing is better for decision making as compared to any other techniques.
- The major problem which the organization is facing in the costing system is the incorrect allocation of the indirect cost.

In the future, the study can be conducted to examine the drawbacks and plus points of using any costing techniques in the pharmaceutical companies, as well as the impact on the profit by changing the costing techniques.

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