

audit FINANCIAR

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- Revista „Audit Financiar” – prezență constantă și pertinentă în slujba profesioniștilor în contabilitate și audit
- „Audit Financiar” Journal – a constant and pertinent presence for supporting accounting and audit professionals



- **Angajamentul pentru interesul public al auditorilor**
- **Auditul public intern – realități românești**
- **„Decalajului așteptărilor” în misiunile auditorilor**
- **Raportarea evenimentelor ulterioare**
- **Selecția auditorului la companiile cotate la bursă**
- **Calitatea auditului intern în sectorul bancar**

- **Commitment to public interest in audit**
- **Public internal audit – the Romanian reality**
- **“Expectations gap” in the engagements provided by auditors**
- **Reporting of subsequent events**
- **Auditor Selection at the listed firms**
- **Internal auditing quality in the banking sector**

Contribuie adoptarea IFRS la protejarea investitorilor minoritari?

Does IFRSs adoption contribute to the protection of minority investors?

Premiile revistei „Audit Financiar” / “Audit Financiar” Awards

Consiliul Camerei Auditorilor Financiari din România a stabilit premiile publicației „Audit Financiar” pentru anul 2018:

- Prof. univ. dr. Victoria Stanciu, pentru articolul „**Auditul public intern – conștientizarea și asumarea necesității. O investigare a realității românești**”.
- Prof. univ. dr. Adriana Tiron-Tudor și drd. Alexandra Ardelean, pentru articolul „**Angajamentul pentru interesul public al auditorilor – imperativ al consolidării încrederii în profesie**”.

The Council of the Chamber of Financial Auditors of Romania granted the awards of “Audit Financiar” Journal for the year 2018:

- Univ. Prof. Victoria Stanciu, Ph.D., for the paper “**Public internal audit – the awareness and necessity assumption. An investigation of the Romanian reality**”.
- Univ. Prof. Adriana Tiron-Tudor, Ph. D. and Alexandra Ardelean, Ph. D. Student for the paper “**Commitment to public interest in audit – an imperative of strengthening trust in the profession**”.



Premiile au fost înmânate de către dr. Ciprian Teodor Mihăilescu, președintele Camerei Auditorilor Financiari din România, în deschiderea manifestării prilejuite de sărbătorirea Zilei Naționale a Auditorului Financiar, care s-a desfășurat la Hotel Novotel din București, în ziua de 26 octombrie 2018.

Le felicităm pe câștigătoare!

The prizes were handed over by the president of the Chamber of Financial Auditors of Romania, Ciprian Teodor Mihăilescu, Ph. D., in the opening session of the event organized to celebrate the National Auditor's Day, which took place at Novotel Hotel in Bucharest, on 26 October 2018.

Congratulation to the winners!



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- the article must mention the title, the research methodology used, authors' contributions, the imperfect on the accounting profession and the references;
- an Abstract is compulsory, which must be written at the 3rd person plural, presenting the subject of the research, the main problems and authors' contributions;
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Assessment criteria for articles: innovative input, topicality, importance and relevance for the subject matter; the quality of the research methodology; clarity and pertinence of the presentation and argumentation; the relevance of the bibliographic sources used; contribution made to the research in the area.

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COLUMN

„Audit Financiar” Journal – an constant pertinent presence for supporting accounting and audit professionals

*Ciprian Teodor Mihăilescu, PhD,
President of the Chamber of Financial Auditors of Romania*

Dear readers,

"Audit Financiar" Journal is a constant and pertinent presence in the mass media of its domain and at the same time an evidence of the involvement of those who have coordinated CFAR over the time.

The first issue of „Audit Financiar” journal was published a decade and a half ago, at the initiative of the then President of the Chamber of Financial Auditors of Romania, Professor Florin Georgescu, PhD.

From the very beginning, the objective of this journal was to support the efforts of the Chamber of Financial Auditors of Romania to ensure a high quality of audit profession in compliance with international standards and relevant European rules, in order to assert the reputation of this profession both internally and internationally.

Starting with the launch in 2012 of „Practici de Audit”, a very implicitly professional biased

journal, the Council of the Chamber has settled a specialized profile for the „Audit Financiar” journal in relation to the scientific research, mainly in the field of accounting and financial audit, but also in other related fields, such as corporate governance, financial analysis, professional training, accounting management, management software, and so on.

Over the years, „Audit Financiar” emerged as a reputational journal in audit profession and in academia, being indexed in important international databases, thus becoming known and recognized worldwide in terms of relevant scientific research.

Outstanding personalities in the fields of auditing and accounting, from Romania and abroad, academia and experienced professionals in the audit field brought their contribution to this journal, as well as many young researchers who have found in this journal a welcoming host for articles

written based on a scientific research undertaken for the purpose of boosting their reputation as auditors or doctoral candidates.

The fact that this bilingual quarterly journal triggered the interest of a significant number of foreign authors, who have been honoured to entrust the results of their own scientific research to the „Audit Financiar” journal stands as eloquent proof of its outstanding value.

The high degree of expertise was ensured by the direct involvement of the Scientific Editorial Board in the consistent development and application of the editorial programmes, as well as by the exigency and professionalism of the editorial teams, who aimed to rigorously observe the quality standards in deciding whether to accept or not the publication of the articles submitted by authors.

As the Council of the Chamber of Financial Auditors of Romania established, in the

forthcoming period, the journal shall maintain and deepen its traditional editorial path by means of a close cooperation with the academia in Romania and other countries, too. At the same time, a stronger emphasis shall be placed on the publication of articles focusing on current scientific research topics, of real benefit for the Romanian financial auditors who expect to find ideas and solutions for the issues the audit profession is facing at home and abroad.

We have full confidence that the Scientific Editing Board, the editorial team and its contributors shall lead this journal on an upstream trend in terms of increased quality and in-depth topics, in order to stimulate scientific research in the field of auditing and accounting in general.

We wish all of them succes!

The mission of the Chamber of Financial Auditors of Romania (CFAR), the publisher of “Audit Financiar” Journal, is to build on a solid ground the identity and the public recognition of the financial audit profession in Romania, having as a main objective the sustainable development of the profession and its strengthening, in accordance with the Auditing Standards and with the Code of Ethics and professional conduct, by fully assimilating the International Standards on Auditing and the Code of Ethics issued by the International Federation of Accountants (IFAC), that will allow the Romanian financial auditors to provide high quality services, for the public interest, in general, and for the business community, in special.

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Commitment to public interest in audit – an imperative of strengthening trust in the profession

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Abstract

The auditing profession is based on serving the public interest and the exact knowledge regarding the public interest notion is a condition of its advancement. The professions' commitment to support public interest is factual, a condition of its presence. The individual interest should not be predominant over the public interest and the reconciliation between them is conditional on the application of ethical and professional standards according to the public's expectations. The ethical values promoted by the ethics code guide the auditors when a conflict arises. Thus, the Ethics Code of the profession protects as much the public interest as the private interest. The study conducted by IFAC in 2010 enables to analyse the position of member bodies in order to outline the significance of the public interest and its association with the auditing profession. The definition of the public interest confers homogeneity to a notion with a broad sense and its evaluation is done through three criteria among which the costs and benefits analysis is the main criterion. The statistical analysis performed, whose starting point was the IFAC study regarding the public interest framework, confirms the extensive meaning of the public interest significance as well as the evaluation criteria. Following the statistical analysis, the appreciation of the public interest definition as 'too large' does not meet consensus among the majority of participants to the study. At the same time, the mediation between criteria and their re-ranking represent the main elements of dissension. The authors conclude that the trust generated by defending the public interest is reflected upon strengthening the legitimacy of the profession.

Keywords: ethics, public interest, private interest, evaluation criteria, ethical conduct

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1. Introduction

The auditors as professionals, through the expertise they put at the disposal of society, act as its trustees. The agency relationship aimed to supervise the interests of society is founded on trust and it legitimizes the position that the auditors have in society, which is of 'agents of trust'. Moreover, trust forms the foundation element that the profession lies upon, therefore it is not so disproportionate to assert that in the event that this foundation is shaking then the whole profession is to suffer. Once the doubt settles regarding the willingness and the competency of auditors to represent in an equitable manner the public interest according to the auditing standards, the utility of the profession is questioned along with its continuity.

The audit decision appears to be inhibited by the clarification of what the public interest means. Indeed, as the field literature pointed out (Davenport and Dellaportas, 2008), the notion of public interest is not specifically explained and this admits interpretations. Most of the time, the public interest is assimilated with that which brings most benefits to the most part of society¹. It results that the elements which bestow utility on the large public represent on the whole the public interest. However, unanimity regarding this notion is yet to be adopted and in order to standardize its attached connotations, IFAC (The International Federation of Accountants) advanced a framework to define the public interest and had the initiative to consult its members in this regard. In the third section of this study, we bring into consideration a statistical approach in order to examine the manner in which the definition submitted by IFAC generates general agreement among its members.

The IFAC initiative is justified by the fact that very few research studies were reported to directly discuss the notion of public interest and those who considered it are not consensual (Baker, 2005; Davenport and Dellaportas, 2009). At the same time, the notion is rather dispersed among practitioners so that an organism such as IFAC feels the need to submit a homogenous definition. For that reason, the IFAC initiative is salutary and necessary especially because of its association with the auditing profession.

¹ Fogarty, T. J., & Rigsby, J. T. (2010). A reflective analysis of the "new audit" and the public interest. *Journal of Accounting & Organizational Change*, 6(3), 300-329.

1.1. The research methodology and the objectives of research

The public commitment of auditors regarding the public interest is accomplished by means of the audit quality which implies the respect of the ethical values of the profession. The conduct which is not based on the public interest produces uncertainty and undeniably untrust. The research topic is the *repercussion of auditors assuming the commitment to consider the public interest in a priority manner while conducting an audit and more precisely the impact of this commitment in strengthening the trust in the profession.*

To that effect, we discussed the notion of public interest applied in audit. The object of promoting the public interest is to consolidate the position of the profession. The *presentation of support* was built on differentiating the private and the public interest by highlighting the imperativeness to prioritize the public interest. The next step was encompassed by the statistical analysis that we conducted in the second part of the paper. Practically, we analyzed from a statistical point of view the key points of the IFAC study, namely the probability that a majority of respondents admit the impossibility to define the notion of public interest, as well as the consideration of the evaluation criterion which is the costs and benefits analysis as the main criterion to determine the public interest.

With regards to the methodology of the empirical analysis performed in SPSS v20, we tested the value of the variable P_I_Def (the public interest definition issued by IFAC) so as to obtain statistical evidence in order to establish the research hypothesis and to invalidate the null hypothesis. Thus, by an analysis type One-Sample T Test, we divided the mean of the sample values formed of 13 observations by 1. The tested value of 1 refers to the mean of observations P_I_Def and more precisely it equalizes with the presumption that P_I_Def is mainly considered to be too large. The Alpha value is 0.05 and a *p* value smaller than the Alpha value is sufficient evidence to reject the null hypothesis.

We adopted the same working method, respectively we proceeded to the perimetric analysis One-Sample T Test in order to establish if the variable P_I_Crit (the public interest evaluation criteria) presents as main objection the election of the three criteria selected by IFAC. The result reached by means of the significance test indicates that the mediation between criteria along with

the reconsideration of ranking the criteria are likely to form the main opposing vectors since we invalidated the null hypothesis.

The paper is structured in three sections. The first part includes the introduction, the research methodology and some debates in the field literature. The second part designates the auditors referring to the public interest. In the third section we presented the IFAC vision regarding the public interest. The research ends with the conclusions section.

1.2. Some debates in the field literature

The notion of public interest was the object of the study conducted by Neu and Graham (2005), when its most significative representations expressed in the field literature were surveyed. Likewise, Parker (1994) defines the public interest as designating a large spectrum of actors interested by the audit result. Davenport and Dellaportas (2009) bring into attention the fact that the notion of public interest does not hold a concordant meaning for both the profession and the general public. O'Regan (2010) conducts an investigation regarding the self-regulation of the profession with regards to the public interest and he points out its limits because it does not find echo with the public it wants to protect. Lee (1995) considers that the private interest, especially the financial interest, is of priority for the members of the profession and that the public interest embodies first and foremost the method to protect it. Nevertheless, finding a just equilibrium between the private and public interest is more than a prerequisite for the profession, it is an obligatory passage (Tiron, 2013).

Dellaportas and Davenport (2008) expose through the functionalist theory how the commitment of the profession is to serve the public interest and that between the private and the public interest is no disagreement. This allegation is contradicted by Bédard (2001) and Parker (1994) for whom the public interest is brought forward just as long as it serves the private interest of the members of the profession. Bédard (2001) supports the fact that the priority is to protect the reputation of the profession and not to serve the public interest.

Notwithstanding, the relationship of trust that the profession forms with society is based on a set of rules of conduct and to respect the ethics code is a manner to protect the private interest along with the public interest

(Fisher et al., 2001). The ethics code of the profession is perceived by Parker (1994) as the umbrella under which the autonomy to auto-regulate is conserved and even more, that the ethics code services as much the public interest as the private interest. However, the study conducted by Davenport and Dellaportas (2009) strengthens the faith that an ethics code will consolidate the public interest and not the private interest, especially since the profession accepts by its intermediary a commitment towards society.

Davenport and Dellaportas (2009) bring into discussion the functionalist view regarding the profession where the public well-being, which it serves by means of a commitment sustained by social obligations, represents the end goal of the profession. The ideal of public interest is interpreted by the manner in which the members of the profession understand to enlarge the professional accountability by considering the wide interests of the community. The dual role of auditors, disputed by the commercial side of the audit practice on the one hand and by the assumption of protecting the public interest on the other hand, may acquire stability only through the advocacy of the public interest. To this effect, the study of Davenport and Dellaportas (2009) confirms the fact that breaches of the public interest have a very low frequency. A contradictory result of the study is that in case of dilemma the private interest is favoured which does not present consistency with the commitment to the public interest. Thus, it is pointed out the necessity that auditors extend the commitment to the public interest by adopting a remarkable ethical conduct.

A new approach on audit was exhibited by the study performed by Fogarty and Rigsby (2010) who analyze the abilities of the auditors to serve the public interest because ultimately the object of the audit reconceptualization is the fulfilment of its social role. Moreover, the auditing process gains legitimacy through the application of external regulation and the commitment to the public interest is confirmed as the biggest responsibility of the profession (Ardelean, 2013).

2. The association of auditors with the public interest

The auditing profession was always connected with the service for the public interest. The fact that a restraint number of professionals trained accordingly are designated to represent the wide public interest

represents a signal with regards to the aspiration of society to avoid to be reached by any prejudice because of default of competencies or motivation.

The research conducted by Neu and Graham (2005)¹ aims the type of commitment between the public interest and the accounting and auditing profession. The conclusion of the study they conducted establishes that there are few researches which actually debate about the connection between the profession and the public interest, especially by considering the objective of the profession as it was declared within the Ethics Code to serve the public interest. But the question we may ask is how is this interest protected? Or do we only have in front of us an assertion intended to ensure its self-regulation? We aim to find some answers in the course of this study regarding these questions.

The auditing profession is positioned so as to represent the public interest, a quality inherent to its professional status. The action oriented towards what brings benefits to the wide public is the very object of its existence. Through self-regulation, the profession understands to be the one to decide upon the manner in which it fulfils this aspiration. But since the well-known scandals which shook the profession, the self-regulation made way to external supervision. To this end, the independent supervision is likely to trigger more accountability from auditors². Therefore, the obvious concern displayed by the bodies which represent the profession and which are entrusted with its regulation such as IFAC to advance the public interest within the activity of auditors is significant in that it strengthens the position of the profession and signals the efficiency of self-regulation. All the more so since the Ethics Code issued by IFAC specifies that the public interest needs to be at the core of the profession's activity.

The **commitment** regarding the public interest means more than the search for recognition or social legitimacy. To support the commitment of the profession to protect the interest of society is related to the accountability it holds. At the same time, it is justified by the status the profession holds in society, the responsibility toward the

public interest being an intrinsic component of the profession, founded on the public's expectations. Ethics supported by an ethical conduct presents a capital importance for auditors in order to outline accepted practices. For that matter, they do not admit frequent breaches of the public interest. The study conducted by Davenport and Dellaportas (2009) indicates that the attitude of the members of the profession concords with the expectations of the public which is a satisfying signal regarding auditors.

The critical interpretation concerning the manner in which the auditors relate to the public interest promotes the fact that the commitment of the profession is altogether declarative and on the surface since its goal is to offer a barrier to advocate the private interests of auditors³, being them financial or of another nature. On the same line are placed the efforts of the profession to officialise the commitment to the public interest by adopting an ethics code. Other detractors disclose the fact that an ethics code is indeed favourable to reach the private interest against the public interest⁴. Such a view seems distorted when the role of the ethics code is appreciated as ensuring legitimacy and being at the same time an efficient approach to consolidate the self-regulation of the profession⁵. Likewise, Dellaportas and Davenport (2008) ponder that the role of a code of ethics is to guide the profession to serve more efficiently the public interest. To this end, the functionalist theory professes the harmony between the private and the public interest, proceeding to declare that they support each other mutually. We share this view because only by attaining the harmony between them, the private interest as well as the public interest can be fulfilled.

The crises which revealed the importance of the individual interest were fuelled by the neglect of the public interest. The consequence was that the public trust subsided in which concerns the competency and the volition of auditors to represent its interests on the grounds of the fiduciary contract between them. Thus,

¹ Neu, D., & Graham, C. (2005). Accounting research and the public interest. *Accounting, Auditing & Accountability Journal*, 18(5), 585-591.

² O'Regan, Philip (2010). Regulation, the public interest and the establishment of an accounting supervisory body. *Journal of Management & Governance*, 14(4), 297-312.

³ Lee, T. (1995). The Professionalization of Accountancy: A History of Protecting Public Interest in a Self-Interested Way. *Accounting, Auditing and Accountability Journal*, 3(3), 48-69.

⁴ Fisher, James; Gunz, Sally; McCutcheon, John (2001). Private/Public Interest and the Enforcement of a Code of Professional Conduct. *Journal of Business Ethics*, 31(3), p. 194.

⁵ Parker, L. (1994). Professional Accounting Body Ethics: In Search of the Private Interest. *Accounting Organization and Society*, 19, 507-525.

the renewal of the commitment towards the public interest is very probable to result in the consolidation of trust in the profession. The consideration as a priority of the public interest does not have to be perceived as an aspiration driven by critics but rather as the real goal of the audit. By establishing this legitimate objective, the profession strengthens its authority which was understood as such given the IFAC initiative to this effect. Thus, the examination of the public interest relevance discloses the accepted commitment of the profession to serve it not with the aim of avoiding sanctions but to acknowledge a real acceptance of auditors with regards to the responsibilities pertaining to them.

2.1. Antagonism and complementarity between the public interest and the private interest

Up to this point we featured what is the public interest, consequently we should specify that the references to the public interest are mainly related to the manner in which the profession protects the status it enjoys or the source of its revenues. Many times, the auditors are confronted with an ethical dilemma which supposes to make a choice likely to oppose the private and the public interest. To balance the two in order to reach an equilibrium is an exercise of ethics and more precisely it is required *to discard the private interest if this is detrimental to the public interest*.

Nevertheless, our belief is that between the two should not arise conflictual situations and consequently, placing them on opposing sides of the balance is pointless as long as the objective of the auditing activity is to serve the public interest. To balance them is necessary in order to limit the perception of domination of the private interest. This perception is rather an appearance or a fear expressed by those who want to promote the public interest, all the more so that in practice the disclosures of breaches regarding the public well-being are rare and much-publicized.

The manner in which the public expects the auditors to answer when conflicts of interests arise is anticipated by the ethics code of the profession. Notwithstanding, the effective method to protect the public interest may be *opposed to the clause of confidentiality* attached to the principle of professional conduct. With regards to this aspect, Davenport and Dellaportas (2009) point out that

the principle of confidentiality may be antagonistic to the duty of guardians of the public interest the auditors are called to fulfil. If the opposing character between these two obligations emerges, the dilemma will be solved by the obvious resolution that the auditors will honour their obligation to the public interest despite the importance attached to the clause of confidentiality. This is because to serve the public interest is the foundation on which is built the ethics code of the profession and it is the measure of evaluating the ethical conduct. The primacy attached to protecting the public interest needs to be upheld even if the principle of confidentiality is a contractual obligation for auditors since this is the way that a disaster involving the profession to be avoided. Furthermore, the priority to respect the public interest is highlighted by the ethics code.

The harmony between the private and the public interest may be obtained only conditional to the auditors acting as arbiters between the requirements of the client and the expectations expressed by the public¹. The convergence between them will be realized by the action of the auditors which is consonant with the contractual obligations to the client without causing prejudices to the public interest. Moreover, the alignment between the private and the public interest is placed on the curve of expectations from the auditing profession since this supposes the dismissal of conflicts undermining profoundly the validity of an audit. The consequence of duty fulfilment regarding the advancement of the common good is the strengthening of the prestige and of the influence of auditors and thusly of their legitimacy as agents qualified to produce value to the wide public.

The well-being of society is without doubt a priority up against the financial interest of the client. Given that auditors are called to act as trustees of society, they emerge as guardians of its interests. To this end, they will commit to their public duty high ethical and technical competencies. The specification that most of the time technical competencies are not enough if not duplicated by irreproachable ethical competencies is very much viable. More and more the auditors are associated with the image of professional experts and less with that of agents of society. This fact does not encompass the whole dimension the auditors enclose given that the

¹ Fogarty, T. J., & Rigsby, J. T. (2010). A reflective analysis of the "new audit" and the public interest. *Journal of Accounting & Organizational Change*, 6(3), 320.

commitment to society is an integral part of the profession.

The emergence of a conflict between the private and the public interest has as a consequence disapprovals or sanctions if it is not solved by considering and giving priority to the public interest. The authority spread by the action oriented towards the common good is supported by involving the public in these topics, as well as by the adopted regulation¹. This perspective is put forward by the well-known disclosures of scandals which burst once the public interest is disregarded which explains their low frequency. Indeed, the credibility image an audit bestows is highly important to the profession and it is the reason why direct breaches of the public interest are avoided. Thus, the neglect of the public interest will only produce discontentment and the exposure of auditors to such offences is risky because it brings into discussion the utility of an audit. In order to prevent such a scenario, the profession together with the regulatory bodies take measures to consolidate the public interest in audit.

Nevertheless, the investigation conducted by Davenport and Dellaportas (2009) shows that the auditors are presumed to support rather their own interest or that of their clients than the public interest. This result may be alarming and when it confirms it supports the critics issued with regards to the promotion of the private interest. However, such an inclination is recommended to be modelled so that the public interest be the priority and any conflict between the two may only be solved in this manner. This does not mean that the auditors cannot follow their own interests which is normal as long as the objective is constructive for the whole of society, but that such an approach does not have to generate conflictual situations regarding the public interest. Undoubtedly, the values of good and justice need to be promoted by the profession in order to create value for the society.

Thus, by protecting the interests of their clients, the auditors do not interfere ineluctably against the public interest, even if through this action they protect their own interest. Most of the time, the private interest represents a step towards building the common good. To favour the

private interest cannot be accomplished without complying with the public interest and to follow the individual interest needs to bring value to the profession in terms of reputation and statute. Such an approach will **consider the individual interest as complementary to the public interest and not in an antagonistic manner**. This view is supported by the functionalist theory which advocates the concord and not the contradiction in order to achieve common good. The balance between private and public interest is likely to comfort the authority of the profession².

Consequently, the primordality of the public interest is unquestionably the privilege of professionals such as auditors and the unequivocal application of the common good is part of the mandate they received from society³. Such a framework signals that the individual interest does not have its place if it is contrary to the public interest because it would cause damages to the profession's reputation with negative effects on the trust it inspires.

2.2. Strengthening the trust in the auditing profession

Despite the fact that the public trust was tried repeatedly, the consequence of the adoption by the profession of the ethics code is to surpass this aspect. The improvement of the perception regarding the auditors considering in a consequent manner the public interest is due to the fact that the profession highlighted its commitment within the ethics code and to the relatively rare direct breaches of the public interest. Thus, the ethical approach and the reliability it imprints outlines the ethical profile of auditors and their inclination to answer adequately to the requirements of non-arbitrary representation of the public interest.

The trust in the profession is related to perceptions of conduct and a conduct which is not centred on public interest does not produce trust. The unacceptable conduct, which advances the individual interest even if this is contrary to the public interest causes *in fine*

¹ Bédard J. (2001). The disciplinary process of the accounting profession: protecting the public or the profession? The Québec experience. *Journal of Accounting and Public Policy*. 20(4/5), 399–437.

² Tiron Tudor, Adriana (2013). Balancing the Public and the Private Interest? A Dilemma of Accounting Profession. *Procedia – Social and Behavioral Sciences*, Volume 92, 930-935

³ Ardelean, Alexandra (2013). Defining the public interest in relation to the accountancy profession: Some perspectives. *Analele științifice ale Universității Al. I. Cuza din Iași. Secțiunea Științe economice*, 60 (2), 223-240

damages to the profession¹. Without a doubt, the ethical conduct guided by the values described within the ethics code triggers recognition regarding the audit action which aims the common good. The profession's credibility is a condition of the impulse provided by auditors which supposes focus on their role as guardians of the public interest.

Thereby, the direct consequence of applying the public interest in audit is the strengthening of trust in the profession. The positive perception that the interests of a great number of users are represented contributes greatly to this favourable result for the auditors. More so since the legitimacy of auditors in society is founded on trust. To this effect, the IFAC initiative is called to support the capital of trust of the profession by advocating high quality ethical and professional standards. At the same time, it was demonstrated that high professional standards generate quality in audit which, if perceived as such, consolidates the validity of an audit². This fact denotes that the adoption of ethical regulation is reflected positively by the fact that the influence of the client is thusly minimized. Also, it was asserted³ that the limitation of the import of private interests may be achieved by the public being part of the debate which will trigger exterior regulation to those established by the profession. But the fact that the profession and the regulatory bodies (i.e. IFAC) choose to advocate serving the public interest in order to maintain and strengthen the trust of the wide public shows an aspiration to act voluntarily in order to keep the self-regulatory prerogative that the profession holds.

By actively contributing to the social well-being, the auditors oversee to maintain the essential relationship of trust with the public. The possibility that by following preeminently the individual interest the trust bestowed by the public is lost is not only a speculation but a fact supported with evidence every time a scandal involving the auditors occurs. It is well known that trust recovery supposes ethical conversion and an approach which

places at its core the public interest is likely to fulfil this desideratum.

3. The IFAC vision upon the Public Interest

Even if the public presents broadly a heteroclit profile, the definition provided by IFAC acknowledges similar interests. Thereby, through its association with the auditing profession, the public interest refers to the benefit of the auditing services that all social actors enjoy. Specifically, in the IFAC conception: *"We consider that the public interest is the sum of the benefits that citizens receive from the services provided by the accountancy profession, incorporating the effects of all regulatory measures designed to ensure the quality and provision of such services"* (IFAC, 2010).

In relation with the accounting and auditing profession, the public comprises a more extensive spectrum than the investors or the capital market because it encompasses all parties interested by the audit report. A definition of the public which comprises the parties towards which the auditors are accountable, regardless if there is or is not a contract, is almost all-inclusive. This is because the audit opinion affects directly or indirectly all stakeholders. Also, the clarification proposed by IFAC regarding the public delimitates a heterogenous ensemble of audit beneficiaries.

The definition recommended by IFAC regarding the public interest produces the great advantage that it displays an uniformity of this concept which is now understood in the same way by the profession and by the public. The establishment of a standard averts the ambivalence of the manner the members of the profession interpret the public interest which is in fact an integral part of the ethical and professional conduct. To include the public interest within the ethics code of the profession highlights the endeavour to promote this principle as a guideline through which the auditing activity is coordinated.

¹ Dellaportas, Steven; Davenport, Laura (2008). Reflections on the public interest in accounting. *Critical Perspectives on Accounting*, 19(7), p. 1081.

² Idem.

³ Bédard J. (2001). The disciplinary process of the accounting profession: protecting the public or the profession? The Québec experience. *Journal of Accounting and Public Policy*. 20(4/5), 399–437.

⁴ IFAC (2012), Public Interest Framework for the Accountancy Profession, Policy position no. 5, http://www.ifac.org/sites/default/files/publications/exposure-drafts/ED-Reg-Public-Policy_IFAC-Definitional-Framework-of-the-Public-Interest.pdf

3.1. The IFAC definition regarding the Public Interest – Statistical analysis

Starting from the analysis of the framework published by IFAC in November 2010 titled „*IFAC Policy Position Paper 4 – A Public Interest Framework for the Accountancy Profession*”, based on the answers received from the member bodies, we aim to carry out an investigation regarding the homogeneity of the answers related to the public interest, to the role of the ethics code and to the ethical values. Our approach is supported by endorsing a precedent study published under the title: “*Defining the public interest in relation to the accountancy profession: Some perspectives*” (Ardelean, 2013), whose aim was to discuss the pattern of the IFAC framework and to analyse the ensuing comments.

The 30 answers through which the IFAC members expressed their opinion with regards to the definition attached to the public interest provide relevant information regarding the manner it was perceived by the IFAC members along with some correspondent topics. Out of the total of 30 opinions, a number of 13 answers devise comments concerning the definition of the public interest in the form provided by IFAC, namely 43.33%. The comments expressed reveal skepticism and critical appreciation for the deficiencies and the expansion of the definition. The

remaining answers (a percent of 56.67%) display accord with the IFAC definition, which offers support that this is indispensable and opportune.

In order to perform the empirical analysis, we defined two variables namely the variable “ID Respondent” along with the variable “Public Interest Definition”. These variables analysed with the statistical program SPSS v20 show an acceptable level of fiability, rated at 0.499 (Table no. 1), when considering that the values of the interval are allocated between 0 and 1. This Alpha value of Cronbach indicates a satisfactory level of homogeneity between the respondents and the classification of the public interest definition for which was expressed an opinion.

Table no. 1. Fiability between variables, in SPSS v20

Reliability Statistics	
Cronbach's Alpha	N of Items
.499	2

Source: Own projection

In regard to the public interest definition, a percentage of 43.33% of respondents communicated a comment (N=13), when the rest of the respondents approved the IFAC framework on the whole.

Table no. 2. The Distribution of answers regarding the public interest definition, in SPSS v20

ID Respondent * Definition Public Interest Crosstabulation							
		Count					
		Public Interest Definition					
		Too large	Impossible to define	Need to specify	Counterproductive	Contextual to the profession	Total
ID Respondent	CIMA	0	1	0	0	0	1
	FEE	0	1	0	0	0	1
	JICPA	0	1	0	0	0	1
	CIFPA	1	0	0	0	0	1
	NASBA	1	0	0	0	0	1
	ACCA	0	1	0	0	0	1
	Joint Bodies Australia	0	0	0	0	1	1
	IBR-IRE	0	0	0	0	1	1
	AIA	0	0	1	0	0	1
	APESB	1	0	0	0	0	1
	AICPA	0	0	0	0	1	1
	ICAEW	0	0	0	1	0	1
IDW	0	0	1	0	0	1	
Total		3	4	2	1	3	13

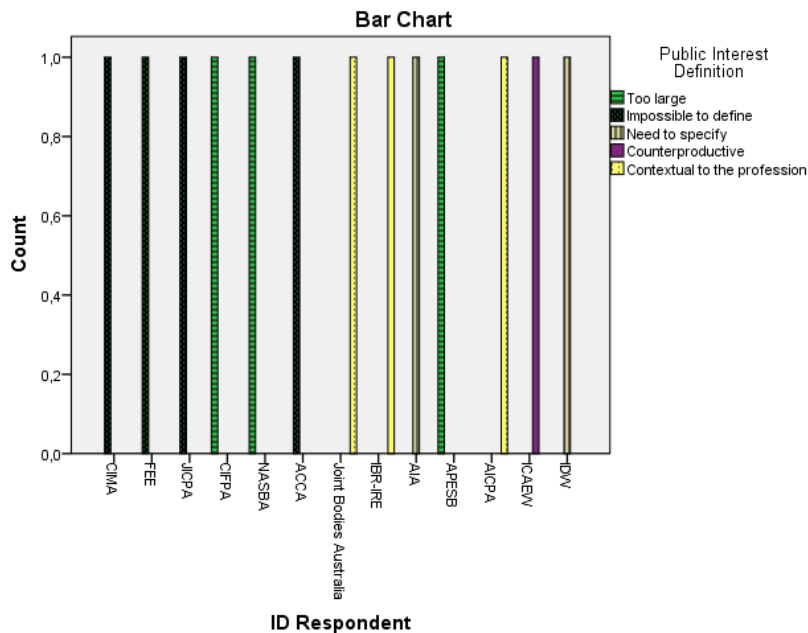
Source: Own projection

In Table no. 2 we completed a crosstabulation between variables in order to reveal the option of each respondent, so that a nominative point of view is expressed regarding the public interest definition (the answer is marked with 1). We specify that we classified the definition succinctly as “too large”, “impossible to define”,

“counterproductive” or “contextual to the profession” or we distinguished the phrase “need to specify”.

To this effect, Figure no. 1 is revealing for the type of comment expressed by respondents regarding the public interest definition in the form advocated by IFAC.

Figure no. 1. The answers regarding the public interest definition per IFAC member, in SPSS v20



Source: Own projection

In order to know if one of the 5 types of classification with regards to the public interest definition submitted by IFAC indicates a preference and can clearly detach from the others, we performed a frequency analysis. Thus, the frequency table for the variable “Public Interest Definition” (Table no. 3) indicates that a majority of IFAC members consider the definition advanced for the public interest to be “impossible to define” (a percentage of 30.80%). The proportion of those who qualify the IFAC definition as “contextual to the profession” is close to that comprised of members who esteem this definition as “too large” (of 23.10%). In fact, these two visions, that which implies a characterization of the public interest

definition as too broad and that which evaluates it as restrictive and applicable to the profession are somehow opposed. Finally, just a small part (7.7%) recognize it as “counterproductive” and do not agree with this definition. These results point to the fact that the definition advanced by IFAC is met in a relatively critical manner, it appears to be quite controversial since it is considered particular to the profession or too broad.

Furthermore, we remarked on some proximities between the 5 types of classifications we established. If we stop at only two categories we will have on one hand the classification of the IFAC definition as “impossible to define”, “counterproductive” and “contextual to the profession” in the first category and on the other hand

the qualification of the IFAC definition as “too large” and “need to specify” in the second category.

The interest to group the classes regarding the IFAC definition resides in the fact that the first category (which

would sum up 61.5% cumulatively) would be dominant in relation with the second category (which would sum up 38.5% cumulatively).

Table no. 3. The frequency of the types of classification regarding the public interest definition, in SPSS v20

Public Interest Definition		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Too large	3	23,1	23,1	23,1
	Impossible to define	4	30,7	30,7	53,8
	Need to specify	2	15,4	15,4	69,2
	Counterproductive	1	7,7	7,7	76,9
	Contextual to the profession	3	23,1	23,1	100,0
	Total	13	100,0	100,0	

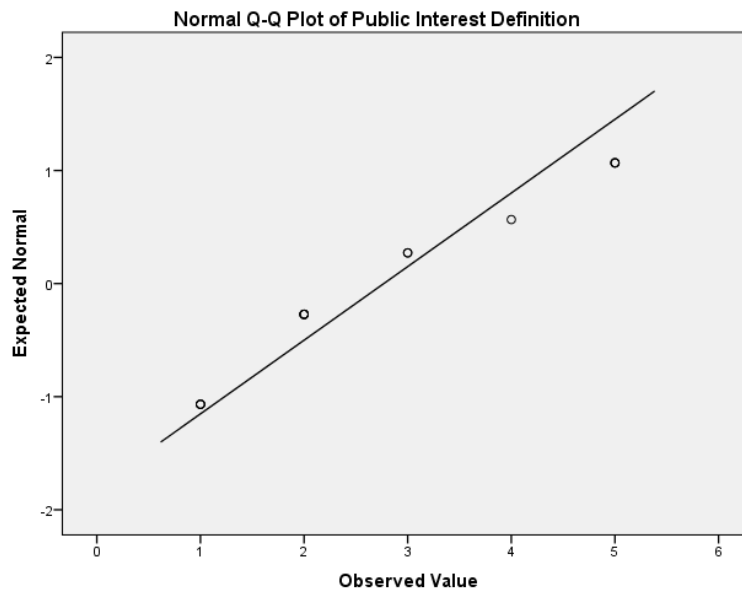
Source: Own projection

The sample characteristics

In order to examine the normal distribution of the Def_I_P variable we will perform a normality test type Q-Q plot (Figure no. 2). The aim is to observe to what degree the Def_I_P variable conforms to a normal distribution. By observing the disposal of points which correspond to classes of categories previously determined with regards to the public interest definition,

the disposal seems to be approximately uniform and linear, the points being disposed relatively close to the line. Given the fact that the data of the sample regarding the z value for *skewness* (it is of 0.74) and for *kurtosis* (it is of -1.064) which come within the interval $-/+1.96$ show that these do not differ significantly from normality and we can assume that these are approximately normally distributed.

Figure no. 2. The normal distribution of the Def_I_P variable, in SPSS v20

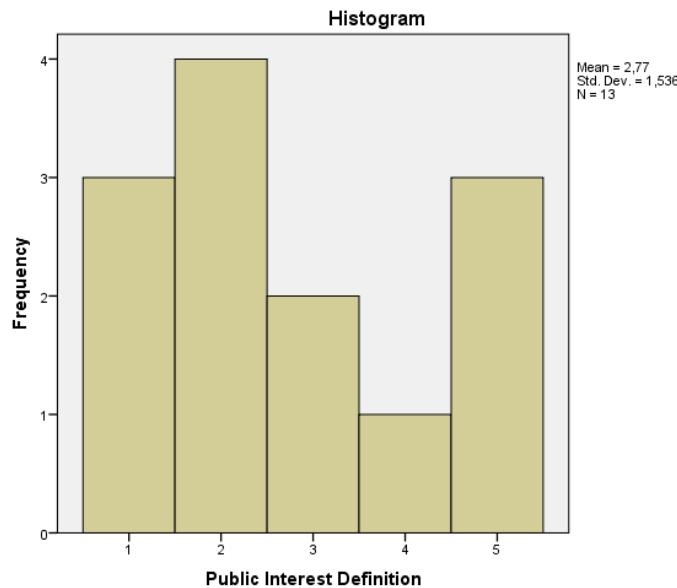


Source: Own projection

The histogram is consistent with the affirmation that the variable knows an approximately normal

distribution (Figure no. 3).

Figure no. 3. The histogram of the normal distribution of the Def_I_P variabile, in SPSS v20



Source: Own projection

Given that the 13 observations form the sample which is used to analyse the types of comments issued by the IFAC members regarding the public interest definition, we address the question if the mean of these observations is significant for the type of additional answers that could be issued regarding the IFAC definition. Thus, if other comments were to be expressed it is interesting to establish if these would be similar with those which form the sample or if these additional comments would not be analogous to those which show a mean of 1 (assimilated to a too large definition of the public interest as advocated by IFAC). Since we do not know the variance of P_I_Def we will use an analysis type **T Test One-Sample**.

Furthermore, we specify that we established the following codification for the IFAC definition:

- value 1 to classify the definition as "too large"
- value 2 to classify the definition as "impossible to define"
- value 3 to classify the definition as "counterproductive"

- value 4 to classify the definition as "contextual to the profession"
- value 5 to classify the definition as "need to specify".

Given that the IFAC definition is perceived as insufficient, as too comprehensive or as issued only to be applicable to the profession, we selected an analysis type T-Test in order to invalidate ($H_{0(a)}$) or to confirm the research hypothesis (H_1) which we specified, respectively:

H_1 : The IFAC definition is associated significantly with the impossibility to define it

$H_{0(a)}$: The IFAC definition is considered significantly to be too large

more precisely: $H_1: \mu \neq 1$; $H_{0(a)}: \mu = 1$, where $\mu = P_I_Def$ and $\alpha = 0.05$

In order to test the research hypothesis, we compare the parameters of the options expressed (1, 2, 3, 4 or 5) with the value 1 which corresponds to the option „too large”. To this effect, by the intermediary of an analysis type

One-Sample T Test we compare the mean of observations with the agreed upon value (respectively 1). The result of the test One-Sample T Test includes two tables (Table no. 4 and Table no. 5) that we interpret hereinafter.

Table no. 4 refers to the name of the variable under analysis (Public Interest Definition), to how many observations were considered (respectively 13 answers) and to their mean. The mean of 2.77 was calculated on the basis of the sample described above.

Table no. 4. The results of the analysis T Test One-Sample based on the sample, in SPSS v20

One-Sample Statistics				
	N	Mean	Std. Deviation	Std. Error Mean
Public Interest Definition	13	2,77	1,536	,426

Source: Own projection

Table no. 5 displays values based on the tested hypothesis which reveal that the public interest definition is too large $P_I_Def = 1$). The test parameters are t (the test), df (the degree of freedom), Sig. 2-tailed (the significance) and the Mean Difference. Sig. 2-tailed is the level Alpha associated with the value t . We specify that the value Sig. equals the value p and if Sig. (value p) is smaller than 0.05 (alfa) we will reject the null hypothesis.

Value t is 4.153 thus different from 0, while value df is 12 which coincides with the forecast because normally df equals the number of observations minus 1 ($n-1$), thus 12 in the present case. Hence the significance level is lower than 0.05 because it shows value 0.001 which allows us to invalidate the null hypothesis $H_{0(a)}$ that enunciates that the public interest definition is mainly considered to be too large. This means that $P_I_Def \neq 1$.

We may concede that the equation may be profiled as:

$$t(12) = 4.153, p = 0.001$$

In other words, we are 95% sure that the public interest definition is not recognized by the majority of respondents as too large. On account of the fact that the mean of the sample is 2.77, we may acknowledge that $P_I_Def > 1$. Thus, we know in proportion of 95% that other additional observations would show a difference between the sample mean and the P_I_Def mean that would be placed between 0.84 and 2.70.

Likewise, the difference mean between the sample mean (of 2.77) and the P_I_Def mean (of 1) is 1.769. We have a different mean because the Alpha value is smaller than 0.05 and trust is high that we have enough evidence against the null hypothesis.

Table no. 5. The results of analysis T Test One-Sample based on the research hypothesis, in SPSS v20

One-Sample Test						
	Test Value = 1					
	T	df	Sig. (2-tailed)	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
Public Interest Definition	4,153	12	,001	1,769	,84	2,70

Source: Own projection

The T Test analysis, by comparing the mean $P_I_Def = 1$, clarified that this is different from the mean of the sample set at 2.77. The invalidation of the null hypothesis was corroborated by establishing some significant statistical differences between the sample

and the analysed variable as a result of determining the research hypothesis which stood at the basis of the T Test result.

The rejection of the null hypothesis was validated by establishing some statistical differences between the

sample and the variable under analysis consequent to enouncing the research hypothesis which underlay the T Test result. If we would have determined that the null hypothesis would take the value 2 (thus close to the sample mean of 2.77), this would have been accepted based on a Sig. 2-tailed greater than Alfa of 0.05; at the same time, a value 3 for the null hypothesis could not have been invalidated for the same reasoning.

Through the analysis type T Test, we looked to confirm the hypothesis expressed H₁ according to which “The IFAC definition is associated with the impossibility to define it”. It is to be expected that other additional comments will be situated between the interval 0.84 and 2.70, when the mean of the sample considered is 2.77. These additional comments will register values higher than 1, but not greater than the sample mean.

3.2. Criteria of assessing the Public Interest – a statistical analysis

The IFAC members issued opinions regarding the validity of the criteria chosen to assess the public interest. The three criteria seem to be valid and are approved by the majority of respondents. At the same time, the role of these criteria is to form the basis of regulation and of evaluation of the public interest and for these reasons they are likely to be applied to the profession (Ardelean, 2013). The addition of the cultural and ethical diversity is positively appreciated.

First, we recall that the three evaluation criteria of the public interest are:

- *Criterion 1: Consideration of costs and benefits for society as a whole*

- *Criterion 2: Adherence to democratic principles and processes*
- *Criterion 3: Respect for cultural and ethical diversity*

Considering that the probability is low that the requirements of the three criteria are met simultaneously and at the same extent within the audit activity, it is mandatory to establish the prevalence of one of them. To favour one criterion to override the others (in the present case the first criterion of the three proposed by IFAC) would create the conditions for the clarification of the evaluation and action process of an audit. Generally, the first two criteria are acknowledged as part of the guiding principles, whilst the third criterion is appreciated as necessary to further build the profession.

The 10 observations that we hold for the empirical analysis (N=10) equal with the opinions of the IFAC members which disagree with or present skepticism for the chosen criteria. For this reason, we distinguished three groups with regards to the negative comments concerning the assessment criteria. The first group refers to the „criteria choice”, the second group concerns the „mediation among criteria”, while the third group relates to „criteria re-ranking”.

The frequency table (**Table no. 6**) shows that the highest percentage (of 50%) is composed of respondents who referred to the “criteria choice” through the opinions expressed. The opinions that may be matched with “mediation among criteria” display a percentage of 30%, while the comments that encourage a “criteria re-ranking” register a percentage of 20% of answers.

Table no. 6. The frequency of critical appreciations regarding the public interest criteria, in SPSS v20

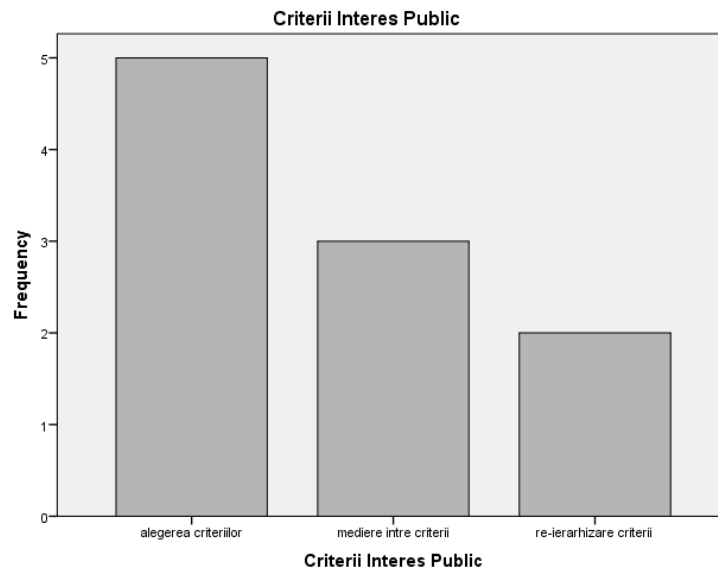
Public Interest Criteria					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	criteria choice	5	50,0	50,0	50,0
	mediation among criteria	3	30,0	30,0	80,0
	criteria re-ranking	2	20,0	20,0	100,0
	Total	10	100,0	100,0	

Source: Own projection

The choice of the evaluation criteria regarding the public interest along with the position the IFAC members

adopted, through their critical constructive answers, are reflected in **Figure no. 4**.

Figure no. 4. The histogram of the categories of opinions regarding the public interest criteria, in SPSS v20



Source: Own projection

Furthermore, through a cross-table (Table no. 7) we reveal for which class of assessment criteria regarding the public interest the IFAC members raised an objection. This occurred either by

expressing some doubts concerning the choice of the three criteria, or by signifying disagreement with one or more criteria selected.

Table no. 7. The options of respondents regarding the public interest criteria, in SPSS v20

Public Interest Criteria * Respondents Public Interest Criteria Crosstabulation												
Count		Respondents Public Interest Criteria										Total
		CA Canada	CIMA	CNDCEC	CNDCEC Italy	Grant Thornton	ICAEW	ICAS	IDW	Joint Bodies Australia	Victoria Univerity New Zealand	
Public Interest Criteria	criteria choice	0	1	1	1	1	1	0	0	0	0	5
	mediation among criteria	0	0	0	0	0	0	1	1	1	0	3
	criteria re-ranking	1	0	0	0	0	0	0	0	0	1	2
Total		1	1	1	1	1	1	1	1	1	1	10

Source: Own projection

By virtue of the 10 answers which enounce objections relative to the three evaluation criteria, we

endeavour to determine if other opinions are probable to express the same categories of

objections. The sample mean is 1.7, yet based exclusively on observing this mean we cannot determine what would be the most frequent objection that could be formulated by additional opinions. That is why an analysis type One-Sample T Test would bring light regarding the probability that other opinions rally the objection regarding the criteria choice ($P_I_Crit = 1$).

The research hypothesis and the null hypothesis are enounced as follows:

H_2 : The mediation among criteria and the ranking of the evaluation criteria regarding the public interest

according to IFAC are contested by a majority of respondents

$H_{0(b)}$: The choice of the evaluation criteria regarding the public interest according to IFAC is contested by a majority of respondents

respectively: $H_2: \mu \neq 1$; $H_{0(b)}: \mu = 1$, where $\mu = P_I_Crit$, and $\alpha = 0.05$

Considering the sample, the observations mean ($N=10$) is compared with value 1 which corresponds to objections mainly made with regards to the criteria choice. Thus, the sample mean is 1.7 (Table no. 8).

Table no. 8. The results of the analysis T Test One-Sample based on sample, in SPSS v20

One-Sample Statistics				
	N	Mean	Std. Deviation	Std. Error Mean
Public Interest Criteria	10	1,7000	,82327	,26034

Source: Own projection

Consequent to the hypothesis testing, we obtained a t value of 2.689, a df value of 9 (that is $N-1$) and a p value (Sig. 2-tailed) of 0.25. Given that the value of the significance level is smaller than 0.05 ($p < 0.05$),

we will **reject the null hypothesis $H_{0(b)}$** according to which the criteria choice represents the main opposing aspect in relation to the evaluation criteria regarding the public interest (Table no. 9).

Table no. 9. The results of the analysis T Test One-Sample based on the researched hypothesis, in SPSS v20

One-Sample Test						
	Test Value = 1					
	T	df	Sig. (2-tailed)	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
Public Interest Criteria	2,689	9	,025	,70000	,1111	1,2889

Source: Own projection

Thus, the T Test analysis denotes that the **$P_I_Crit \neq 1$** and the equation emerges as: $t(9) = 2.689$, $p = 0.025$

The difference mean is 0.7 and this value indicates the difference between the sample mean of 1.7 and the objections mean which is 1, according with the $H_{0(b)}$ hypothesis. We are 95% assured that other objections would be placed on the interval 0.1111 and 1.2889, but they would not surpass the mean sample value of 1.7.

4. Conclusions

Due to the efforts deployed by the profession along with the regulation bodies, its ethical level is perceived as high. The Ethics code issued by IFAC contributed decisively to outline an ideal image regarding what is expected from the auditors. Moreover, the Ethics Code offers real ethical guidance to the members of the profession when ethical dilemmas arise mainly through the injunction to serve the public interest. This is the duty of the profession and by applying this principle it can be

acknowledged that the authority of auditors comes reinforced. Thus, the Ethics Code offers elements of support as much to the public interest as to the private interest. Especially that an active commitment to the public interest is stimulated by the ethical values that the Ethics Code promotes.

The empirical analysis type T Test One-Sample based on the 13 observations produced sufficient statistical evidence to assert that this sample was not identified with a mean of 1, respectively the appreciation as too large of the public interest definition is not widely considered to be too extensive. Thus, we conclude that the sample deviates sufficiently from the P_I_Def mean so as to consider the constants of parameter different from 1. Since the sample mean is not evidence in itself to invalidate the null hypothesis, the significance test allows us to gain inferential support against the null hypothesis. Thereby, additional comments regarding the public interest definition are probable in proportion of 95% to register values between 0.84 and 2.70.

Considering that the sample mean is 2.77, these comments will not register higher values than the mean of the sample investigated.

Also, the parametric test One-Sample T Test was the statistical method through which we validated the research hypothesis that enunciates that the mediation between criteria as well as the re-ranking of them form the main objections to express when addition opinions are provided. Based on the significance test we rejected the null hypothesis which enounced that the criteria choice regarding the public interest would have been the main dissension of hypothetical future opinions. Therefore, additional answers would be situated within the interval 0.1111 and 1.2889, the upper limit being lower than the mean of the sample under investigation.

In **Table no. 10** we present a summary of the research hypothesis under investigation and whose result was detailed above.

Table no. 10. Recapitulation of the valid research hypothesis	
Summary of research hypothesis	
The research hypothesis established	Result
H1: The IFAC definition is associated significantly with the impossibility to define it	<i>Sustained</i>
H0(a): The IFAC definition is considered significantly to be too large	Rejected
H2: The mediation among criteria and the ranking of the evaluation criteria regarding the public interest according to IFAC are contested by a majority of respondents	<i>Sustained</i>
H0(b): The choice of the evaluation criteria regarding the public interest according to IFAC is contested by a majority of respondents	Rejected

Source: Own projection

With a view to fulfil the aspiration to harmonize the public interest with the private interest, the profession recognizes that through the statute the auditors hold they have unwritten obligations towards the public whom they represent in front of their clients. Consequently, the public bestows trust on auditors which represents an intangible benefit and the very source of their presence on the capital market as actors whose duty is to consider with priority the interests of the wide public. Any deviation from this role is severely sanctioned through manifest skepticism and even untrust in the volition and the capacity of the profession to serve the societal interest to the detriment of their own interests.

Likewise, to serve the public interest and to place this goal at the core of the auditing activity equates with an

assertion concerning the prerogative of the profession to retain the essential elements for self-regulation, at least with regards to this fundamental aspect. The ethical values encourage a consistent ethical conduct which attests the commitment for the common well-being. Consequently, the strengthening of the ideal of irreproachable representation of the public interest results in growing trust and more legitimacy for the auditing profession.

The dilemma between the public and the private interest is solved by their harmonization and the immediate effect is that the public trust is enhanced by their alignment. The societal good comes as a priority so that the balance will bend in favour of the public interest if a conflict of interests arises. Thus, by promoting

excellence of auditing services as much regarding the professional competences as the applied ethical principles, the auditors pursue to serve inexorably the public interest. Their commitment expresses the categorical pledge of the profession for principles and

ethical values. As a conclusion, the primacy of the public service is tightly bonded on the ethical values of the auditors, while high ethical standards will support the commitment of auditors towards the public interest even to the detriment of their own interest.

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Public internal audit – the awareness and necessity assumption. An investigation of the Romanian reality

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Abstract

Public internal audit is asked to provide assurance that the public money is well managed and the existing resources are directed, efficiently and in line with the law, towards the real problems and in respect with the public interest. The research objective was to provide an insight in the status of Romanian public internal audit by identifying its strong points and weaknesses and suggesting a set of measures aiming at improve the public internal audit and willing to help in the implementation of a strong public internal audit function. The author's investigation has scientific and practical implications aiming at attenuate the gap in the previous research, enriching the literature on the topic and suggesting ways of improvement of the public internal audit function in Romania.

Key words: public internal audit, UCAAPI, public sector, compliance, Romania

JEL Classification: M42, M480

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Introduction

The public sector needs strong governance aiming to direct the public entities' activities on an effective, efficient and transparent path providing "reasonable assurance that the objectives will be met and the operations are carried out in an ethical and accountable manner, reducing the risks of corruption" (Rosa et al., 2014:830). Internal audit is one of the functions sustaining the governance structures to improve risk management and operations and achieve the established results using efficiently the allocated resources and instil confidence among stakeholders. Public entities are using public money and, in many cases, EU funding. This is the reason why the citizens and stakeholders expect high quality public services and from the public entities' management part accountability and transparency in the public money use. In this context, public internal audit has an important role, and stakeholders' expectations are very high.

Public internal audit is asked to provide assurance that the public money is well managed and the resources are directed towards the real problems and public needs in an efficient manner and in the respect of the law. A strong public internal audit can help the public entities' management to improve the standards of governance, better manage the risks, strengthen the internal control systems and met the established objectives in a more effective use of resources. It is generally accepted and declared the importance and need of a strong public internal audit in Romania. The question is if there are ensured the conditions and resources for its implementation? Are all the public entities' managers aware of the importance of a strong public internal audit and its support in objectives' achievement and in the improvement of the internal control and operations? Through the performed research the author tried to respond to all these questions and to identify the real state of public internal audit in Romania.

Despite of the importance of the Romanian public internal audit (PIA) for researchers, professionals and stakeholders, the interest for this research topic was not constant. The causes are diverse but the weak transparency in the field is, in our opinion, one of the most important. There are no numerous public internal audit reports published as a result of the permissive legislation on this aspect. The main sources of information are represented by the annual reports issued

by the supervision Romanian entity in the field (UCAAPI), reports that are available with large delay – being subject of analyze of international bodies before being published (as for example at mid of 2018 the last available report is the 2016 report) and the reports of the Romanian Court of Accounts.

The analysis performed is based on the standards and best practice rules issued by the prestigious professional international bodies, Institute of Internal Auditors (IIA) and International Organization of Supreme Audit Institutions (INTOSAI). The author's research aim is to contribute to the existing empirical literature on the Romanian public internal audit and suggest ways to improve the professional field and practice of public internal audit.

General frame of public internal audit

Internal audit mission is to provide a risk-based objective assurance, in regard of risk management and internal control system, offering a clear image of the effectiveness and efficiency of the processes and activities, and to suggest recommendations for the activities' improvement and objectives' achievement (IIA et al, 2017). To achieve its role, public internal audit should benefit from the management support, which is considered to be "the internal audit foundation" (Alzeban, 2014). INTOSAI emphasized in its documents that, internal audit "has evolved from an administrative procedure with a focus on compliance, to an important element of good governance" (INTOSAI Gov 9140:3). In this respect, internal audit succeeded to gain an important role in the entities' life, being a real support for the management in the effort to improve risk management and operations and achieve the stated objectives using efficiently the existing resources and ensuring a sustainable development.

This extended and significant role of internal audit (IA) is the result of conjugated and permanent effort of the international professional bodies that ensured professional frameworks and standards, asking the practitioners to implement (in a creative and beneficial way) the general framework to the real conditions, facing the challenges of change, and responding in a more appropriate way to the stakeholders' expectations. Multiple conjugated factors are implied in the internal audit success (in achieving its attributions and responsibilities): chief executive of internal audit (CAE) vision and expertise, the internal auditors experience

and training, continuous and strong communication between IA and board members (or any other equivalent structures), audit committees and all the entities' employees, continuous support from the top management part (allocated resources for IA inclusively) etc.

The quality increase of the public internal audit (PIA) activities implies a schedule of successive phases, which is recommended by IIA in its document *Internal Audit Capability Model*. The implementation of this model it is a "challenge for public administration in Romania, because we consider that PIA function is only at the first level, with some exceptions (Macarie & Moldovan, 2017).

There is a stringent need for the management support in regard with public internal audit function. This support is reflected by the allocated budgets for internal audit function that ensure motivated and experienced staff, high-level specific trainings, dedicated software acquisition and, not the last, the quality and continuity of the communication with PIA structures. The management support implies the link towards "enhancing the relationship with external auditors, and having independent internal audit department" (Alzeban, 2014). It also implies clear reporting lines, functionally to the Board of Directors and administratively to senior management (Steinbart, P.J. et al, 2012). CAE (Chief of Internal Audit) must also establish free and unfettered access to the chief executive (or equivalent) and the chair of the audit committee, if the committee exists. Good and continuous communication inside and outside of the public entity is one of the keys in PIA's success.

The independence and objectivity of PIA are essential for the credibility of its assurance (INTOSAI Gov 9140). Stating, in the PIA's chart the need of its independence and attaining this goal (by the means of its implementation, reporting lines and communication) are essential for PIA's attributions' achievement.

IIA and INTOSAI gave a special attention to the public internal audit by the provided standards, documents and guidelines. The quality of the internal auditors work in public entities is essential taking into consideration the specific of these entities, which are using public money

and having the obligation to offer services of good quality to the collectivities they serve.

Insights regarding the state of the Romanian public internal audit

The research objectives and methodological coordinates

The main objective of the author's research was to design an image regarding the state of Romanian public internal audit by identifying its weak and strong points and suggesting a set of measures aiming at improve the Romanian public internal audit and help building strong public internal audit functions in Romanian public entities.

Our research started from the understanding, based on personal experience and practice, that there is a certain gap between the public internal audit visions and requirements stated by the international professional organizations on one hand and the regulatory frameworks and the implementations of the public internal audit in Romania on the other hand. We also believe that the public internal audit in Romanian still needs significant improvements aiming at consolidate its role and increase its visibility based on its contribution to the entities' objectives achievement.

A strong public internal audit is in the benefit of the public entities and their management as well as of the stakeholders – citizens being important component. In this regard our investigation has scientific and practical implications coming to fill the existing gap in the previous Romanian research, enriching the research literature on the topic and providing suggestions for the public internal audit function strengthen.

The research followed two main paths: the qualitative research on public internal audit area that requested an enlarged review of the Romanian and foreign scientific literature, international professional standards and good practice recommendations and an empirical study path on the state of Romanian public internal audit that requested a large documentation on the Romanian regulatory framework on the public internal audit and its implementations and results. The empirical study is based on the annual reports in regard with Romanian public internal audit issued by the specialized Romanian supervision entity (UCAAPI) in 2016 and 2015. Other different annual public internal audits reports were analyzed – reports issued by public entities (when those

reports were published by the auditees – it should be mentioned that there is no compulsory requirement that the annual public internal audit reports to be published by the public entities). There were collected important information from different public documents as for example the PIA's strategy for 2018-2020, PIA's charts published on the sites of different central public entities (mainly ministries), procedures, guidelines published by public entities etc.

Results and conclusions of the empirical study

The research reveals several sensitive points in the PIAs' structures functioning, the most important being presented in this chapter, in which we have tried to emphasize the causes, the negative impact of these weak points and possible means of the negative impact limitation and, per consequence, means for PIA function improvement in the Romanian public entities.

The public internal audit (PIA) function should be implemented in all public entities according with the legislation. The 2016 report of UCAAPI (on public internal audit) emphasizes that the function is implemented in 79% of the public entities, not all the implemented PIA functions being functional. There are 81 entities in the central public administration where PIA function is not implemented and also more numerous cases in the local public entities. It shouldn't be forgotten that we are speaking about an imperative request of the law!

Also, it should be mentioned that the public internal audit function in a hierarchical organizational structure should perform missions in the subordinated entities if there is not implemented a PIA function, these cases not being counted in the abovementioned 79%. Only if in three consecutive years in the subordinated entities the PIA function of the above hierarchical structure have not been performed audit missions, it is considered that the PIA is organized but is not functional in the subordinated entities (the most numerous cases being registered in the local administrative structures). Maybe it is more honest to recognize the real situation that the PIA function is not implemented if the missions are performed by the up hierarchical structures.

Taking into consideration the understaffing of the most numerous PIA structures, the extension of the responsibilities over the auditable universe of the hierarchical subordinated structures determinates the

overload of the PIA function in the upper hierarchical structure and the impossibility of covering the auditable universe in the three years according with the regulations. PIA' strategy for 2018-2020 underlines the fact that "in the PIA department's implementation, in 88% of the cases, it was considered just the legal obligation of ensuring the function construct, without having in view its functionality"¹ (UCAAPI, 2017:10). This reflects a formal alignment at the imperatives of the regulations, and a gap of awareness in regard with the PIA function's necessity and its effective implementation. There are diverse and numerous possible explanations for this situation, some of them being underlined by UCAAPI in its report. In our opinion there is no real awareness on the need and importance of PIA function implementation at the level of the local administrative unites and public institutions' management and a high pressure on the public entities' budgets that determined, in some cases, the PIA structures' abolishment when restructuring the public institutions – the public internal auditors being assigned to other organizational structures (UCAAPI, 2016:5). It cannot be omitted the regulatory restrictions in regard with the number of job positions in the administrative units, those on different organizational structures and the ones in regard with the proportion between the number of public internal auditors and the total number of personnel, proportion that is not very well articulated with IIA's requirements (Urton et al., 2010). The dimension of the PIA organizational structure is very important for the effectiveness of the function, fact that stimulated the Romanian researches' interest for the topic (Dascălu, 2016). Other causes for not implementing PIA functions can be represented by the shortage of public internal auditors, lack of motivation for the existing ones to continue their activities in the public entities (see the number of the vacant PIA positions and the outgoing flow reflected by all the UCAAPI's reports), the public entities' management assumed non-compliance with the law (being no applicable penalties because of the law's (no. 672) inconsistencies – fact that determine this attitude from the management part), the UCAAPI's limited empowerment to interact with the public entities' management on PIA issues aiming at rapid solving the non-compliance issues etc. As long as the law is not providing clear penalties in case of the non-compliance (clear nominalization of those in charge with the non-

¹ Author's translation

conformities identification and penalties apply) there will be no visible changes in the attitude of the public entities' management in regard with PIA implementation. The law no. 672/2002 contains penalties in case of non-compliance, but there are no clear specifications in regard with the entity entitle to establish them; the law states that the superior hierarchical structures should nominate the representatives in charge with the non-compliances identification and penalties apply. But these superior hierarchical structures themselves are in many cases in non-compliance positions and, as a result, the penalties cannot be applied. These unclear issues exist from the moment were the law was issued 16 years ago and, in our opinion, in this large frame of time it was room for correcting the law as a response to the existing signals and the limitations emphasized by the practice (the law was updated on other issues). Even if the UCAAPI report on 2015 specified the need of a decision of the Ministry of Public Finance (MPF) in order to solve this regulatory gap, the measure was not implemented and the law remains inoperable on this issue. The author remains convinced that the MPF's specialists are aware of the need of PIA and are also interest in its implementation. In these circumstances, it is hard to understand the delay in the law correction. We also take into consideration a possible ineffective communication inside the Ministry of Public Finance or a prioritization of the issues inside the ministry that was not favorable to the PIA. Nevertheless, there are numerous situations in which the practitioners signal the impediments generated by the regulations which are not articulated with the realities in the Romanian economy or uncorroborated articles between different laws; and the laws' review process, in most of the cases, is very long.

UCAAPI report on 2016 underlines that numerous public entities (182 in total) opted for the PIA function's outsourcing, being signed contracts for these services. This solution is not in compliance with the law, fact being underlined starting with 2015 UCAAPI's report (when 222 public entities opted for this solution). The law update on this issue was performed in 2012 (the Government Act no. 26/2012) being, in the author's opinion, enough time for the entities' alignment to the new requirements. Even if the number of the entities in non-compliance with this law decreased in 2016 comparing with 2015, the problem remains (the entities' management is aware and still accept the non-compliance), reflecting that the law is ignored from both parts (public entities and companies providing the

services) as a result of the non-operable law's penalties. In our opinion, **the law respect in its spirit is essential**, furthermore the implementation of a real, strong governance which would not underestimate the importance of a public internal audit. Just with this kind of approaches we can consolidate in a real manner the public entities and we can ensure that their activities will be performed transparently and responsible in relation with the stakeholders.

At national level, half of the structures of PIA (55%) cannot cover the entire audit universe in three years, as the regulation requires (UCAAPI, 2017). The author considers that the definition of the internal audit universe for API can be a generous debate subject. The impossibility to cover the internal audit universe in the time frame establish by the regulations is the consequence of the understaffing of PIA's structures, the insufficient training of the internal auditors, the CAEs expertise, limited usage of dedicated software applications (that could provide efficiency and the quality increase in the public internal auditors' work). The lack of audit committees in many cases, is a determinant factor in this issue taking into consideration its role in the coordination and monitoring of internal audit function.

The annual report on PIA's activity is compulsory for the public entities, UCAAPI providing in time the requirements aiming at ensuring uniform reporting structure that offers the base for data aggregation. Even so, the 2016 annual aggregated report issued by UCAAPI is based on less than 50% of the public entities (43% to be more precise) that should provide them, not all the reports responding to the entire set of information required. As a result, the UCAAPI report is far from reflecting truthfully the real state of public internal audit, even if it signals significant real problems and the weak points are analyzed. The UCAAPI report remains poor mainly on qualitative aspects recommended by IIA for the evaluation processes of internal audit structures. We appreciate as useful the information regarding APIs' contribution (at the local and central level) to the improvement of systems and operations, the efficient use of the public money and public assets, the limitation of fraud and corruption, the use of advanced techniques in audit (mainly based on IT tools).

In our opinion, the role of UCAAPI, as coordination and supervision entity on PIA implementation and activity, requests activities with rapid finalization and real implication in PIA's implementation, part of UCAAPI's

initiatives being proved to be insufficient. Some cases of non-compliance are emphasized year after year by UCAAPI (even if there is a decrease of the number of non-compliances in regard with some of the issues) reflecting a slow evolution in the state of PIA function, limited visibility and feeble impact of the PIA function. The regulatory inconsistencies, already mentioned, are the cause of this slow evolution next to the communication and interaction problems in regard with the management of the public entities. This fact is underlined by the missing of reaction to the notes and attention flags issued by UCAAPI.

If there is a generally admittance of the importance and need of PIA, why there is no more commitment for its implementation and strengthen? Why the actions have no effective visibility and finalization? These questions must not remain rhetorical, imposing corrective actions. The actions should focus on legislation update, aiming at solve the already signalled problems by UCAAPI and practitioners, implementation of a solid discipline in PIA field and rigor in the management of the public entities.

The diminished public entities' management interest in PIA (see the numerous cases were PIA function is not implemented or is performed with limited resources) could have multiple causes: limited financial resources, the management's insufficient awareness on the need of PIA, the PIA insufficient support provided to the management materialized in recommendations for the internal control and risk management improvement and objectives' achievement. Were the public internal auditors' work is not focus on public entity's major problems and the results of the missions still reflect compliance approach, and, as a result, the activity is still focusing on compliance issues or less important problems without providing substantial recommendations for the processes and operations' improvement, more efficient use of resources and objectives' achievement, the management is not filling the real support of PIA function and, as a result, a there is formal collaboration and the missing support of the management. In central public entities PIA function is more solid and visible (noting that in 2016 there were 10 ministries in which PIA function was not implemented), more implied in the entity's problems and providing recommendations for the activity's improvement.

In some public entities, two auditors form PIA departments. This organizational structure is not in compliance with the regulations (it is permitted by Law

672/2002 republished but is not corroborated with Law 161/2003); it is a compromise solution that cannot solve the real problem. In this situation it cannot be nominated the CAE (because of the non-compliance with the regulation) and a public internal auditor, not remunerated for this work, performs the CAE's attributions. This "solution" reflects the effort of some of the public entities to implement PIA function. In 2016 report, UCAAPI expressed its openness to initiate discussions with the National Agency of Civil Servants aiming at solving this legal problem. In the two years frame, already closed, there is no change. The UCAAPI strategy for 2018-2020 emphasizes that there are numerous cases in which just one job position was approved for PIA function (UCAAPI, 2017). In addition to the important issue of the compliance with the regulations there is the effectiveness problem. How can an understaffed public internal auditor team respond to the expectations, sometimes not having the needed expertize and training? Can we expect, in these circumstances, to be covered, in the three years frame, the audit universe and the function's visibility ensured based on its recommendations and support offered to the management?

The weaknesses reflected by the annual reports on PIA are not limited to the organizational matters. They also imply qualitative and sensitive issues and performance aspects of PIA.

A sensitive issue is the one in regard with the PIA's independence. UCAAPI reports emphasize cases of non-compliance with the regulations in regard with CAEs' dismissal or their approval on the job, as well as cases of public internal auditors' implication auditable activities. An important significance has the fact that one third of the annual reports on 2016 received by UCAAPI does not provide information on the independence of PIA. If the reported cases of breaking the ethical rules are just a few, the numerous reports that did not reported information on this topic should be a flag alert. We appreciate as beneficial the use of the good practices that showed their efficiency in time. The whistleblowing applications at UCAAPI and the top hierarchical organizational levels could provide the means for public internal auditors (in the subordinated structures) to report cases of independence affectation or the ethical issues. The independence can be affected by the limitation of the auditors to include in the audit plan or/and to perform certain missions or determine

them “missing” some objectives in their missions, or their limitation access to documents, information or persons. In the situation in which there are not numerous audit committees implemented (the regulations imposing a small number of entities to have audit committees – and not in all these cases the audit committees exist) that CAEs should address, the whistleblowing applications could provide their utility. For the independence limitations the UCAAPI report does not request detailed information, even if this information is important to reveal the real independence of PIA function. This information could be provided by whistleblowing applications.

The UCAAPI report emphasizes issues in regard with the knowledge and understanding of specific concepts for IA – managerial control system for example and acquiring risk-based approach. This fact is the result of the slightly knowledge of some public internal auditors (reflected by the data in the UCAAPI’s report in regard with public internal auditors initial training – academic training) as well as the ones in regard with the continuous training. These problems induce the limited performance at the level of some PIA structures and the unproductive relation registered sometimes between management and public internal auditors.

The quality assurance and improvement program, according with the UCAAPI’s reports, was issued by 64% of the entities, but the worst fact is UCAAPI’s conclusion that this program, in many cases, is formal, “without being an effective document for the self-assessment and PIA function’s development”¹ (UCAAPI, 2016:13). This is another issue reflecting insufficient knowledge in regard with the professional framework as a result of the non-adequate selection of the public internal auditors and continuous learning programs that are not always focusing on key elements. CAEs have the attribution to prepare and apply the quality assurance program. The 2016 report of UCAAPI emphasize that 25% of CAE positions are free, 81% of CAEs have a five year experience, 86% have economic academic studies, 54% are not members in the national professional bodies and 93% are not members in international professional bodies. All these aspects can explain the existing quality of quality assurance programs and defined vision for PIA ensured by CAEs and suggest CAEs’ inadequate existing profile comparing with the importance of the function. CAE is

asked to define the strategy for the function development anticipating trends in the requirements and expectations of the stakeholders and the need to implement evolved techniques and methods (IT-based inclusively – necessary in the case of proactive techniques in fraud identification) aiming at improve PIAs’ results and its better alignment to the organizations’ requirements. Even if these quality assurance programs are correctly and coherent stated, the high rate of CAEs’ turnover cannot ensure the implementation and/or evolvement processes’ continuity. Another cause can be the PIA budgets.

If the number of recommendations is significant (with the mention that the number of the recommendations not implemented is too high – being registered an incorrect understanding of the term “not implemented”, according with UCAAPI’s report), the number of the findings (a bit more than 500) cannot convince on the PIA missions’ efficiency. If we corroborate the findings of PIA structures with the ones of the Romanian Court of Accounts we can retain another understanding of the real state.

The documentation included, as we already mentioned, an extended set of public documents on strategies, PIA charts, procedures, frameworks etc.

We analyzed PIA charts (when the documents had public access) for the ministries, as central administrative structures having significant PIA resources and evaluation role over the subordinated structures. We appreciate that, not in all cases, the chart was issued in line with the best practice requirements, synthetized by IIA recommendations. The (direct) reference, in the chart, mainly at the Law 672 and less to the IIA recommendations is visible and not quite beneficial and this conclusion is sustained by the fact that the law offers a general frame that cannot cover all the aspects and procedural elements. Including procedures’ elements in the chart is not suited for this document. In many analyzed documents the form of presentation seems to be more important than the content (to be seen the excessive number of pages – in many cases a good chart has 2-3 pages). The reporting paths, coordination and monitor elements (where the audit committee exists) should be more clearly defined. The auditable universe should be more detailed. The requirements of the law 672 in regard with the “source and usage of the public funds and public assets’ administration” could provide the possibility to include in

¹ Author’s translation

PIA's auditable universe assessments in regard with fraud and corruption prevention and identification (based on the public interest on the topic and the responsibilities emphasized by IIA on this subject).

PIA strategy for 2018-2020 has the merit to emphasize the UCAAPI's conclusions on PIA's weak points and good aspects, threats and opportunities. The document offers more space for the synthesis of the 2016 report's conclusions than the space allocated for the directions of PIA development. Even so, the document has the merit to retain the main objectives and their implementations paths (sometimes being drawn in general lines, being needed more elaborated details). For increasing the implementation rate of PIA structures, the strategy retains the need of strengthen of the collaboration for the function implementation. The objective to increase the rate of PIA structures' implementation is corroborated with the one in regard with the management' awareness on PIA importance. It is omitted the fact that there are financial and regulatory constraints in regard with the number of public internal auditor jobs for example. These aspects are not retained in the strategy. The objective of legal base consolidation does not retain the update of the Law 672. There are not clear measures for public internal auditors' attraction, being known the significant number of unoccupied PIA positions. For the entities obliged by the regulation to have internal audit committees and being not complied with the request, the strategy states the objective to guide the entities in this regard, at the PIA structures' request, by issuing methodologies for the audit committees' establishment. Why not the direct implication of UCAAPI in solving the problem by dialog within the Ministry of Public Finance and with the public entities?

The strategy has no mentions in regard with the need to increase the use of IT tools, to implement modern methods in public internal audit (issues that could solve – in some limits- the understaffing problem) and could increase the quality and efficiency of the auditors' work. The strategy is not making reference to the internal audit capability model, recommended by IIA. Its use could facilitate the evolution process of the PIA structures and

provide correct evaluation criteria for the assessment of the evolution stage of PIA structures.

Conclusions

A high performance public internal audit function creating new value cannot be realized without professionals with experience and a profound understanding and openness towards the new elements in profession and a good knowledge of the public sector. Internal audit, next to professionalism, requires rigor and discipline. These elements, together, ensure the function's success, its visibility inside the organization, being known the fact that the recommendations and the problems emphasized by IA help to the organization's support and the objectives' achievement in an efficient way. Well-prepared professionals, with experience should be remunerated accordingly. We cannot have performance with a limited number of employees with weak experience, with a frail professional profile and missing the motivation. INTOSAI standard (Gov 9140) underlines the need of an adequate remuneration based on the responsibilities and the importance of the job. The new remuneration frame for the public entities is a step forward in solving this problem and an important element in the specialists' motivation to look towards public internal audit.

There are premises for a strong public internal audit construction: a consistent regulatory framework needing just some updates, already implemented structures and experience that can direct towards the correct path of the implementation process of PIA function in all the public entities, focus and structures for continuous training of the public internal auditors, a new remuneration system that can motivate the auditors etc. We consider that there is a need for more willingness at the Ministry of Public Finance management and central and local administrative structures to strengthen the PIA function. An effort to improve rigorously the regulations, adequate budgets for PIA function, real independence of public internal auditors (not just declared), rigor, discipline and responsibility; these are, in our opinion, the ingredients for a successful public internal audit in Romania. The Romanian internal public audit needs significant improvements aiming at consolidate its role and increase its visibility by the contribution provided for the public entities' objectives' achievement.

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Development of approaches to definition, classification and evaluation of "expectations gap"

**in the broader context of
engagements provided by
certified auditors**

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Abstract

The conceptual definition of "expectations gap" considering all engagements governed by the International Standards is hereby proposed. There is elaborated the chain of study of the level of users' satisfaction with the engagements provided by certified auditors. There is considered the algorithm for the consideration of the information needs of the users of the results of the auditor's work while performing different types of engagements, classification and characteristics of information needs. There are analyzed the expectations of the users of engagements provided by certified auditors. There are grounded the characteristics of the different levels of service («desired» and «minimum» services, and the «zone of tolerance») while performing engagements provided by certified auditors. There are substantiated the five levels of the gap (in formation of expectations of users, in knowledge, in standards, in service and communications), the causes of their occurrence and ways of overcoming them. A distinctive feature of the proposed model is the selection of two components of the "gap in the formation of expectations" and "gap in communication": level of society and level of interaction of auditors with intended users, responsible party and management. The research findings will serve as the basis for determining the directions of development of the engagements provided by certified auditors (audit, review, other assurance engagements, related services) and improving its quality.

Keywords: assurance engagements, expectations gap, user information needs, user expectations

JEL Classification: R14, D18, P2

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Introduction

In the professional literature on audit there is often used the term "differences in expectations" or "expectations gap" which means: (1) the discrepancy between the audit information provided by auditors and the expectations of the users of financial statements; (2) the discrepancy between the public opinion about the essence of the audit and the possibilities of a real audit process, limited to a certain scope. The need to identify the causes of this gap and their ways of elimination in the sphere of auditing is an extremely topical scientific problem.

Auditors work within the framework of legislation, according to particular International Standards on Auditing (ISA), which require them to express their opinion on whether the financial statements have been prepared in all material respects in accordance with the applicable conceptual framework. ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* emphasizes that the auditor's opinion only enhances the degree of confidence of intended users in the financial statements (paragraph 3). In paragraph 5 of ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* it is stated that due to the inherent limitations of an audit, there is an **unavoidable risk** that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISA. These provisions of the international standards quite vaguely define the requirements for auditors and generally **do not meet the expectations of users**. This is the very case, according to R. Adams, when the gap (i.e. differences, discrepancy) in the viewpoints arises: the auditors consider their goal in collecting reliable evidence and expressing their opinion on the financial statements and refer the detection of errors to the by-product of the audit, and users of the audit report consider that the duty of the auditor consists, first of all, in the identification of errors (intentional or accidental), and also in the preparation of such audit tests that will ensure the detection of abuses and inconsistencies (Adams, 1995, p. 379). This problem has not been resolved yet. Users believe that auditors have to identify all errors, frauds or misstatements in the financial statements. But in the International Standards on Auditing this duty is limited to terms "reasonable assurance" and "material misstatements". For example, in ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of*

Financial Statements is indicated: "The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management... An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatements, caused by fraud or error" (§ 4, 5).

There is an important aspect which should be noted: the problem of the "expectations gap" is mainly considered in relation to the audit of financial statements or audit engagements. But at the current stage of development of audit activity, it is necessary to take into account the significant transformations that took place in the structure of international standards (the introduction of the concept of "assurance engagement") and the types of engagements performed by certified auditors. Therefore, the issue of "expectations gap" is less considered in relation to other engagements considering their specific nature. In addition, it is important to investigate the "expectations gap" problem, given the set of engagements that:

(1) are currently governed by the International Standards on Quality Control, audit, review, other assurance and related services issued by the International Auditing and Assurance Standard Board (IAASB), International Federation of Accounting (IFAC), and include:

- audit of historical financial information;
- review of historical financial information;
- assurance engagements other than audit or review of historical financial information;
- related services;
- are not governed by Standards of IAASB;
- different types of consulting/advisory services;
- other services.

In view of this, we believe that it is necessary to pay attention to a comprehensive study of the gap in expectations, considering the whole range of engagements provided by certified auditors.

1. Literature review

The expectations gap has been acknowledged since the 1970's and studied extensively by academics and professionals.

The "expectations gap" and its components have been elaborated and presented by Porter (1991, 1993), Humphrey, Moizer & Turley (1992). These components were also analyzed in the textbook "Montgomery's Auditing" (1997, pp. 31-32). It focuses on users' expectations which are classified into reasonable and unreasonable ones, and their perceptions which in turn are presented as realistic and unrealistic, and the "expectations gap" is presented in the form of two components: (1) the gap between expectations and requirements (standards); (2) the gap between requirements (standards) and results. It is underlined that unreasonable expectations and false (irrational, unrealistic) perception of the results of the work performed can undermine the users' confidence in the auditor, and the information audited by the auditor can count as much as real errors in the audit work.

The review of the audit expectations gap literature from 1974 to 2007 was presented by Aljaadi (2009). A detailed study of modern concepts of audit expectations gap is also presented in the works of Salehi (2011, 2016), Ojo (2016).

The study of the perception of other assurance engagements is presented in Roebuck, Simnett & Ho (2000). The general issues of the relationship between assurance and expectations gap are analyzed by Dando & Swift (2003). A detailed study of expectations gap in the greenhouse gas emissions assurance context is presented in the paper of Green & Li (2011); the issues of reducing the expectation-performance gap in assurance of Global Reporting Initiative (GRI) Sustainability Reports in Brazil – are presented in a dissertation of Renzo Mori Junior (2014).

There is a lot of research on this subject and each study provides an exhaustive structure of the "expectations gap" and the ways to reduce it, but we consider expedient to analyze the "expectations gap" in the context of the whole range of engagements provided by certified auditors.

2. Scientific research methodology

The research was carried out on the basis of the theory of scientific knowledge using a systematic approach of the study of the phenomena and processes of auditing and assurance. To achieve the goal set in the work,

there was used a complex of general scientific methods (analysis, synthesis, induction, deduction, abstraction) and relevant methods (systematization, generalization, review, comparison) of the research. The methodological basis of the study is the dialectical method which allowed studying the "expectations gap" in the modern system of socio-economic relations, to identify its problems and ways of reducing it. On the basis of the comparative analysis method, there were assessed the information needs of the users of the results of the auditor's work. There was applied the modeling method in developing the algorithm in consideration of the information needs of the users of the results of the auditor's work and the model of "expectations gap" in the context of the entire range of engagements performed by the auditor. To summarize the causes of different levels of "expectations gap" when perceiving engagements provided by certified auditors as professional services and ways to reduce them, there were used the method of system analysis, as well the historical and logical methods. Using the methods of analysis and synthesis, conclusions derived on the necessity and possibilities of practical application of research results.

The content analyses were used to evaluate the components of the "expectations gap". Several research techniques can be used to perform the content analysis. These techniques include (Krippendorff, 2004, pp. 44-45): (1) pragmatic content analysis; (2) semantic content analysis (designations analysis and attribution analysis); (3) sign-vehicle analysis.

It should be noted that the problem of the "expectations gap" exists in any kind of services, and marketing specialists pay enough attention to its research. Such an interpretation of the "expectations gap" arising in the process of performing audit engagements is close to the theory and practice of marketing services, within which methods have been developed to enable the assessment of the quality of services from the point of view of consumers. The logic of these methods is relevant, first of all, for all services because their quality is difficult to be assessed based on objective criteria, which is also true for auditing. Such methods include:

- (1) "Gap" model which reflects the basic requirements for the expected quality of services (Zeithaml, Berry, & Parasuraman 1998);
- (2) "SERVQUAL" model (acronym of "service quality") shows that the quality of service that is received is

determined by the difference between consumers' expectations and really perceived quality (Parasuraman, Berry, & Zeithaml, 1988);

- (3) "Zone of Tolerance" model (Johnston, 1995).

3. Elaboration of the "expectation gap" MODEL, based on the information needs and expectations of users

3.1. The chain of study of the level of user satisfaction with respect to engagements provided by certified auditors

Understanding the necessity to take into account the needs of the users leads to the consideration of the process of performing audit, review or other assurance engagements and related services as a communication process. This process can take various forms and can be presented:

- (1) as an **action** (one-way signal transmission without feedback);
- (2) as an **interaction** (bilateral process of information exchange);
- (3) as a **communication** process in which participants continuously act as both source and recipient of information.

In the theory of communication, a significant number of models are applied. Their development pursues the greater consideration of the recipient's activity and social dependence, both in the content and in the form of communication (Sharkov, F., 2002, pp. 28-34).

This statement is fully applicable to the process of performing the engagements by certified auditors. Therefore, when determining the causes and essence of the "expectations gap" in the sphere of audit activities we should focus on the process of performing and presenting the engagements as professional services. This requires the study of two issues:

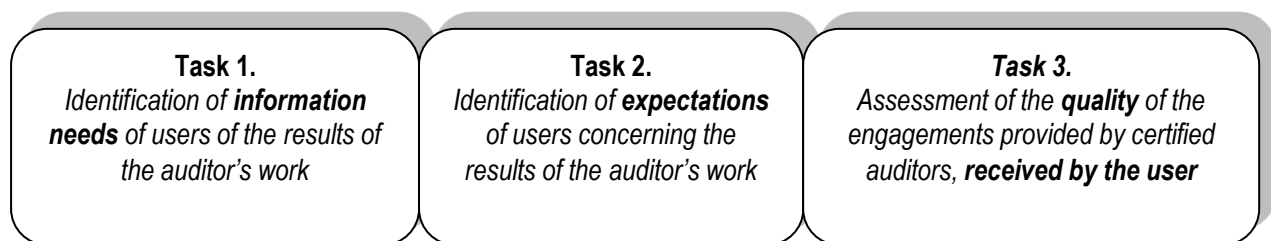
- (1) what the users will receive;
- (2) how it will be presented to them.

When conducting a survey of the level of satisfaction and the reasons for the occurrence of "expectations gap" the following tasks should be solved:

- (1) to identify the expectations of users;
- (2) to assess the quality of the service they received.

However, these two tasks do not fully characterize the process of identifying the "expectations gap" in the audit. The information needs of users as a basis of forming the expectations remain outside the sphere of vision. Therefore, this process should envisage three stages of successive solution of the following tasks (**Figure no. 1**).

Figure no. 1. The chain of study of the level of users' satisfaction with engagements provided by certified auditors



Source: Compiled by Authors

3.2. Identifying the information needs of the users of the results of the auditor's work

The first task is to identify the information needs of the users of the results of the auditor's work. As a

basis, it is possible to apply the algorithm for investigating the impact of the needs of different entities and their consideration when developing the audit requirements (Table no. 1).

Table no. 1. Algorithm for consideration of information needs of the users of the results of auditor's work	
Main stages of analysis	Issues to be investigated
Identification of entities interested in the audit function as a public institution	Which groups of entities cooperate with auditors? Which groups of entities use the results of different types of engagements provided by certified auditors? Which groups of entities are most interested in changes in audit requirements and relevant changes in legislative and regulatory acts?
Identification of the range of information needs of different groups of users	What are the information needs of these users? How do these needs relate to the goals and strategies of the users themselves?
Establishing the relationship between the interests of users and nature of engagements provided by certified auditors	How do the identified information needs generate the demand for engagements provided by certified auditors, and the results of their work?
Identification of the need to amend the legislative and regulatory documents related to audit activities, and the nature of these changes	What impact will the meeting of certain information needs have on the content of legislation of the auditing activities?
Identification of the need to amend other legislative and regulatory acts, the essence of these changes	What impact will the meeting of certain information needs have on the content of other legislative and regulatory documents?

Source: Compiled by Authors

Let us consider the information needs of the users of the results of assignments for the audit of financial statements in more detail. The identification of information needs of the users of audit results should occur in combination with the information needs of the users of the financial statements but taking into consideration that the needs of the users of the audit reports are somewhat different, it only increases the degree of their trust in information. For example, for the existing and potential owners or/and shareholders of a company it is important to assess the effectiveness of the company's activity. Such information needs for each group of users can be combined under the name the "general information need". The financial reporting should provide information on the profitability of the company, the directions of profit distribution, ways to increase the amount of dividends. If they are viewed as users of audit results, their information need is to obtain the auditor's opinion on the reliability of financial statements in order to reduce information risk in assessing the current and potential activities of the

company in terms of ensuring effective dividend policy, management effectiveness, performance of duties of the management in accordance with the specific goals and objectives.

In addition, depending on the correlation of information needs about the results of the audit and the requirements of the audit standards, the legislative and regulatory documents, it is possible to identify the basic and specific information needs which form the general information need. The *Basic information needs* correspond to the information that meets the main objective of the audit, that is, the auditor's information on whether the financial statements have been prepared in all material respects in accordance with the applicable conceptual framework. The users with *specific information needs* necessitate additional information that details or complements the main purpose of the audit, for example, in the information on the results of the assessment of compliance with the principle of business continuity.

It should be taken into account that the specific information needs of the specific groups of users are often the main priority for them. These specific information needs can be further classified. Depending on the content of the specific information needs, there can be identified the information needs related to the financial reporting audit process, and those that are not included in the scope of the audit procedures provided for in the audit standards, but require extended and additional procedures not provided for by the standards.

The first group includes, for example, information about:

- (1) the risks of fraud in accounting and financial reporting (ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statement);
- (2) internal control (ISA 315 Identification and Assessing the Risks of Material Misstatement

through Understanding the Entity and its Environment);

- (3) the appropriateness and relevance of applying fair value in the valuation of assets (ISA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures);
- (4) transactions with related parties (ISA 550 Related parties);
- (5) existence and impact of events after the balance sheet release date (ISA 560 Subsequent Events).

The second group can include the need for predictive appraisal of the financial condition, assessment of the management effectiveness, assessment of the compliance with the requirements of all legislative and regulatory documents affecting the financial and economic activities of the entity, etc.

Table no. 2. Characteristics of the information needs of the potential creditors as users of the results of audit engagement	
Needs	Characteristics
<i>General information need</i>	Identification of the appropriateness of granting a loan and the ability of a company to timely repay the interest and principal loan amount.
<i>Basic information need of the user</i>	The auditor's opinion on whether the financial statements used to assess the company's solvency are prepared in all material respects in accordance with the applicable financial reporting framework
<i>Specific information needs that can be met as part of the implementation of procedures provided for by the International Standards</i>	The opinion of the auditor (with the aim of increasing the degree of confidence in the result of their own assessments) about: <ul style="list-style-type: none"> - probability of bankruptcy of the company (the company's compliance with the principle of business continuity); - compliance with the requirements of legislation in the process of financial and economic activity directly affects the identification of significant amounts and disclosure of information in the financial statements of the company; - risks of material misstatement of financial statements that are identified in the process of obtaining the understanding of the business entity and its environment, including the internal control system; - facts of fraud identification; - subjectivity when management determines accounting estimates in the process of preparing financial statements; - state of the company's internal control system; - litigations relating to the company that may lead to the risk of material misstatement of financial statements, the procedure for pre-trial settlement of a dispute, the payment of penalties.
<i>Specific information needs that cannot be met in the framework of the implementation of the procedures provided for by the International Standards</i>	The opinion of the auditor (with the aim of increasing the degree of confidence in the result of their own assessments) about: <ul style="list-style-type: none"> - current and predictive levels of the financial position of the company from the point of view of the expediency of granting a loan, identifying loan conditions and guarantees for loans, including assessment of the structure of the company's assets, its financial stability and solvency, liquidity of current liabilities, analysis of the composition, structures and ratio of accounts receivable and accounts payable, estimation of settlements on previously received short-term and long-term loans and borrowings; - compliance with the requirements of legislation which does not significantly affect the financial statements but relates to the financial and economic activities of the company; - management effectiveness; - other lawsuits that do not deal directly with the financial statements but concern the financial and economic activities of the company, the procedure for pre-trial settlement of the dispute, payment of penalties.

Source: Compiled by Authors

In **Table no. 2**, for example, there are presented the characteristics of the information needs of such a group of external users as potential lenders that do not have direct connection with the enterprise, but have direct interest in its activities.

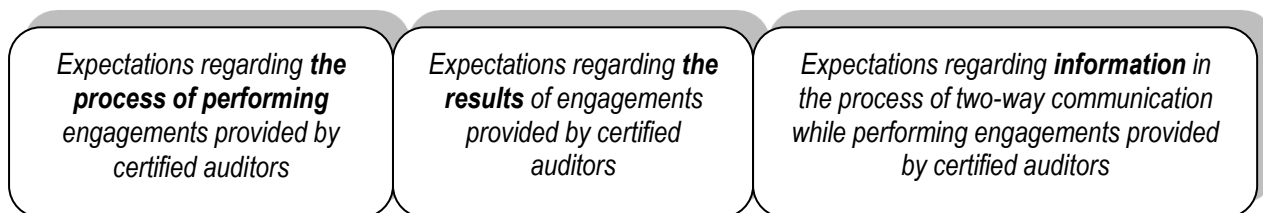
Such classification is useful for the analysis of the information needs of the users of other engagements: review of historical financial information, assurance engagements other than audit or review of historical financial information, and related services.

3.3. Identification of the expectations of users concerning the results of the auditor's work

The second task involves identifying the expectations of users about the service. According to Bychkova & Ityglova (2008, p. 20) the clients of audit firms may

have high expectations regarding the audit of financial statements and think that the auditor should absolutely guarantee the reliability of the reporting on the results of the audit. To be noted that the users of the professional opinion of the auditor, in addition to their needs, form their own expectations regarding the quality of the audit of financial statements which are related to the fact that the adoption of economic decisions based on the professional judgment of the auditor does not lead to negative consequences in the future and presents them in the form of two groups: expectations regarding the audit process and expectations regarding the results of the audit (Bychkova & Ityglova, 2008, p. 20). It is important to add to this classification the expectations of informing about the process and results of the audit. Therefore, we can represent the users' expectations comprehensively (see **Figure no. 2**).

Figure no. 2. Expectations of the users of engagements provided by certified auditors



Source: Compiled by Authors

The expectations of users in terms of compliance with the existing standards can be causally relevant (reasonable) and in this case it is necessary to improve the standards and work of auditors, that is, to follow the path of professional improvement. Other expectations may be unrealistic (causally irrelevant). In relation to them it is necessary to improve communication links with users in order to manage their expectations in respect of the requirements, and the impossibility of changing standards, to be ready for misunderstandings and to try to overcome the consequences of such misunderstandings.

At the same time, the addition of the requirements to the "overstated" group should take into account the specific situation in which the engagement is carried out, its

objectives and users. As an example, we may consider the situation with the definition of the level of materiality. This issue in the context of investigating the role of auditing standards in reducing the expectations gap was emphasized by Ojo (2016). If an initiative audit of individual elements, accounts or financial reporting items, is carried out in accordance with ISA 805 *Specific Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of Financial Statement*, for example, such items of financial reporting as current obligations for settlements with the budget, the customer's requirements to establish a sufficiently low level of materiality are causally relevant because: (1) they are due to the

existing liability for tax, administrative and criminal legislation: (2) and they must complete the tax reporting in certain monetary units. Such a requirement of the user, which is the consequence of its need to have information about the maximum number of errors or any other inconsistencies, distortions in order to prevent the imposition of fines on the business entity by the fiscal authorities, is causally relevant and should be considered in the work of auditors.

On the contrary, the requirement to establish an extremely low level of materiality when conducting a mandatory audit is causally irrelevant since materiality is linked to the economic decisions of users made on the basis of financial statements. The range of key users of the results of mandatory audit includes those individuals who rely on financial statements as the main source of information and cannot require other reports compiled in accordance with their needs. Therefore, the materiality when conducting a mandatory audit should be established on the basis that the indicators of the financial statements are prepared and provided on the basis of a certain level of materiality. In this case, the auditor must prove and justify the inexpediency of setting overstated requirements.

Another example is the assessment of the financial condition of a company. If, during the performance of engagements for auditing financial statements within the framework of international auditing standards, users make a requirement to assess in detail and forecast the financial condition of the company, such expectations are causally irrelevant, since the performance of engagements for auditing financial statements provides for checking only the compliance with the principle of business continuity. The auditor should explain the unrealistic nature of these requirements and propose to perform the assessment and forecasting of the financial condition within the framework of the assignment of providing other assurance, if the appropriate assessment criteria are

agreed with the customer, or within the framework of consulting services. On the other hand, if users expect that after auditing financial statements the auditor will inform them about the results of the assessment of the company's compliance with the principle of business continuity, such expectations should be recognized as causally relevant, since such duties are expressly provided for by the current ISA 570 *Going Concern*.

In the theory and practice of marketing (Zeithaml, Berry, & Parasuraman, 1993, pp. 1-12; Pashchuk, 2005, pp. 148-149), expectations are presented in the form of various elements, in particular:

- (1) the desired service (the service that customers hope to receive with the level of a combination of what, in the opinion of the buyers, may be, and what is given to them in the context of their personal needs);
- (2) proper service (maximum, the lowest level of expectation, minimum level of service which the buyer will take without significant dissatisfaction);
- (3) expected service (the level of service that customers actually expect to receive);
- (4) tolerance zone (located between the desired and the appropriate level of service and is represented by a certain interval in which users do not pay special attention to the process of providing the service, but if the service exceeds the specified range they react either positively or negatively).

For example, taking into account possible information needs, the desired service for audit engagement can be formed on the basis of the general information need. The identification of the minimum level of service in audit should be formed considering the need to apply the concept of reasonable (sufficient) confidence to the audit process which establishes the limited opportunities inherent in the audit and affects the ability of the auditor to detect distortions in the financial statements. According to ISA 200 *General*

objectives of the independent auditor and the conduct of an audit in accordance with *International Standards on Auditing*, an audit is designed to provide sufficient (relevant) assurance that the financial statements, as a whole, are free from material misstatement (paragraph 11a). Therefore, the appropriate level of engagements, provided by certified auditors, is a certain level of reasonable (sufficient) confidence that consumers

of audit services perceive as minimal. The zone of tolerance covers the interval of expectations between the characteristics of the desired and the minimum service.

The relationship between the minimum and desired level of engagements provided by certified auditors, as well as the characteristics of the tolerance zone, are shown in **Figure no. 3**.

Figure no. 3. Characteristics of different levels of service while performing engagements provided by certified auditors

The minimum level:

- (1) the user receives information only about the results of the engagements;
- (2) only the basic information need of the user is satisfied;
- (3) satisfaction of the basic information need occurs at the level of reasonable (sufficient) confidence with a corresponding identification of the level of materiality that users perceive as the minimum possible;
- (4) the user received the information only after the completion of the engagements;
- (5) the information is passed on time; the appropriateness of the data is ensured.

Tolerance zone:

the interval of expectations which in one way or another is taken into account:

- (1) the need to provide information on the actual process of performing engagements, and not only on their results;
- (2) the need to meet the specific information needs;
- (3) the need to meet the user requirements for the level of materiality;
- (4) the need to provide information in the process of performing the engagements and on-time.

Desired level:

- (1) the user receives information not only about the results of the engagements but also about the process (stages, applied procedures, etc.);
- (2) the general information need of the users about the results of the engagements is satisfied, and this general information need involves the basic information needs and specific information needs that require procedures within the framework of *International Standards* and extended supplementary procedures;
- (3) the satisfaction of the basic and specific information needs takes place considering the requirements of the users in terms of the level of materiality;
- (4) the user receives information both during the performing of the engagement and at its completion;
- (5) the transfer of information occurs in a timely manner in order to ensure the appropriateness of the data.

Source: Compiled by Authors

3.4. Problems of evaluation the quality of the auditor's work as perceived by the users

The third task is to evaluate the perceived quality of the service. One of the main differences between goods and services is that it is more difficult for customers to assess services. All services can be placed in a certain interval, starting with the criterion "easy to assess" and ending with the criterion "difficult to assess", depending on how important the attributes of searching, experience or

trusting are. Such a classification of benefits is proposed in the theory of transaction costs in interpreting the costs of measurement, which are carried out both before the acquisition of goods (ex ante) and after (ex post). They are based on three categories of benefits:

- (1) experienced (have extremely high ex ante measurement costs and low ex post costs);
- (2) research (have low ex ante measurement costs and low ex post costs);
- (3) trusting (have extremely high ex ante measurement costs and high ex post costs) (Korneichuk, B., 2007, pp. 136-137).

The information that becomes the subject matter of assurance engagements and is the result of assurance engagements relates to trusting goods. This group of services is characterized by two specific features:

- (1) there is an extraordinary complexity of particularization of the positive result;
- (2) this positive result does not always receive an identical assessment from different consumers and different specialists.

In general, there is a tendency to consider most of the services to which engagements provided by certified auditors belong, namely, as trust assets. Thus, it is emphasized the importance of the trust attribute for

consumers (compared to such attributes as searching and experience), reflecting two main differences between goods and services:

- (1) the lack of sense of performing the service;
- (2) and the lack of clarity of the assessment of what was invested and received which often causes quality control problems.

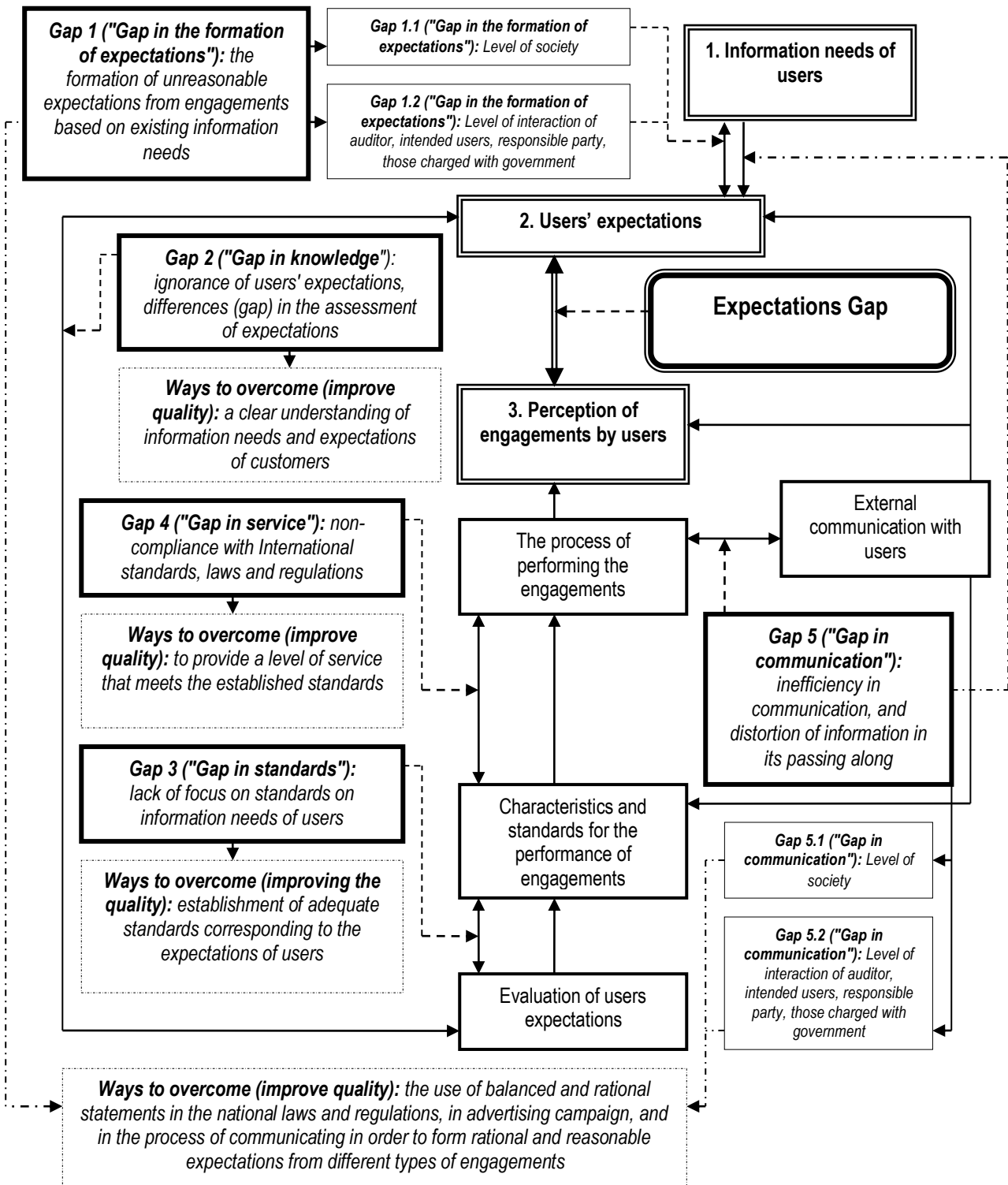
The differences between the users' expectations and what they believe to have received are:

- (1) in the deviations of the work of auditors from the existing standards which requires its improvement;
- (2) in the unrealistic perception of the results of engagements provided by certified auditors, and a distorted understanding of the essence of the different types of engagements which requires users to pay special attention to the process of informing about its content.

4. "Expectation Gap" model in engagements provided by certified auditors

The "expectation gap" model in engagements provided by certified auditors is presented in **Figure no. 4**. It shows the presence of several (five) gaps and the main ways to overcome them. In the professional literature there were suggested different ways of reducing the "expectations gap" and these measures should be classified according to the levels of the "expectations gap" shown in **Figure no. 4** and they should be expanded according to the types of engagements provided by certified auditors.

Figure no. 4. A model of "expectations gap" in the engagements provided by certified auditors



Source: Compiled by Authors

5. Analysis of the causes of different levels of "expectations gap" and ways of reducing it

Summary of the results of the study of the causes of the appearance of different levels of

"expectations gap" and possible ways of their elimination are given in Table no. 3.

At the moment, the main focus on developing ways to improve the quality of performance of various engagements provided by certified auditors, is to reduce the "gap in service" in order to ensure compliance with the standards.

Table no. 3. Causes of different levels of "expectations gap" when perceiving engagements provided by certified auditors, as professional services and ways to reduce them		
Gap Level	Causes of certain levels of gap	Ways to decreasing the gap
Gap 2. The gap between the awareness and perceptions of the auditors of the interests, needs and expectations of users (" Gap in knowledge ")	Lack of interaction with users in identifying their needs and expectations.	The allocation of users by the results of different types of engagements provided by certified auditors, the creation of the system to study their interests, needs and expectations. Analysis and assessment of users' needs by the results of engagements provided by certified auditors, their understanding of the main goal and by-effects.
Gap 3. The gap between the standards of work of auditors and the interests, needs and expectations of users with absolutely correct understanding of them (" Gap in standards ")	Fears of assuming big obligations, underestimation of own capabilities, understating requirements in standards, regulatory and legislative documents. The lack of clear methods for performing different types of engagements provided by certified auditors (primarily for other assurance engagements) that would limit the possibility of abuse of the right to apply "professional judgment" without a clear explanation of what lies at its base. Low quality of the legislation regulating auditor's activity and discrepancy among various legal acts.	Improvement of the legislation on audit issues, taking into account the information needs of users. Establishment of the audit management system that would ensure that user requirements are taken into account. Improving the quality of the system of legislative and regulatory documents of audit activities.
Gap 4. The gap between audit standards and the actual level of service (" Gap in service ")	Low level of internal system of quality control of engagements provided by certified auditors (at the level of the certified auditors and audit firms). Absence of a clear system of responsibility of auditors in cases of inadequate performance their professional duties.	Development of external and internal standards of the quality system. Increasing of requirements for the independence of auditors. Establishment of clear recommendations for identifying the extent of the auditor's responsibility.

Gap Level		Causes of certain levels of gap	Ways to decreasing the gap
Gap 1. The gap between the client's expectations, its subjective understanding of the essence of engagements provided by certified auditors, and the real characteristics of various engagements provided by the standards (" Gap in the formation of expectations ")	Gap 5. The gap between the information about the nature of the audit and the quality of the engagements provided by certified auditors, which is passed along by the auditors, their actual state (" Gap in communication ")	Gap 1.1 ("Gap in the formation of expectations") Gap 5.1 ("Gap in communication") <i>Level of society</i>	Absence (insufficiency) of transparency within the audit system. Insufficient level of quality of legislative and normative documents on providing information on the nature of engagements and their function. Insufficient level of public awareness of fundamental differences between different engagements provided by certified auditors.
		Gap 1.2 ("Gap in the formation of expectations") Gap 5.2 ("Gap in communication") <i>Level of interaction of auditor, intended users, responsible party, those charged with government</i>	Lack of close two-way communication with the client and the management of a company which is the subject to an audit. Insufficient level of informativeness of audit reports, reports on the results of other engagements (other assurance engagements, related services). Low information support of contracts on performance of engagements, provided by certified auditors, concerning the rights and duties of auditors, etc.

Source: Compiled by Authors

But other reasons are also important: the "gap in the formation of expectations" and the "gap in communication", the gap in the awareness of auditors and their perception of users' expectations ("gap in knowledge"). Overcoming this gap should lead to the change in the standards of work and accordingly to the narrowing of the "gap in standards".

In this case, the two gaps (the first "gap in the formation of expectations" and the fifth "gap in communication") actually have similar reasons (that is shown in **Table no. 3**) but it is the presence of the fifth gap that generates a vicious circle, the result of which is:

- (1) fixing the primary overstated or generally incorrect expectations of the users of the results of engagements;
- (2) formation of the new overstated or distorted expectations.

If we consider the complexity of engagements provided by certified auditors, in general, then the

significant impact is the lack and shortcomings of clarity in the users' understanding the nature of different types of engagements and the lack of clear recommendations on the delineation and identification of audit, review and other assurance engagements, related and consulting services.

The lack of understanding the differences among users of the different types of engagements provided by certified auditors very often leads to the formation of the wrong expectations of users and their dissatisfaction with the results of the auditor's work.

A distinctive feature of the proposed model is the selection of two components of the "gap in the formation of expectations" and the "gap in communication":

- (1) the level of society (macro level), and
- (2) the level of interaction of auditors with the intended users, responsible party and those charged with government (management personnel).

The first level (component) prevails at this stage in Ukraine, where the introduction of the audit concept has taken place recently (in comparison with other countries). The reasons for the gap in communications at the macro level that exists at this stage of social and economic development of the country and determines the distortion of the public opinion about the engagements provided by the certified auditors, are as follows:

- (1) incomplete consistency between the provisions of the Ukrainian legislation on auditing and the International Standards of Quality Control, Auditing, Review, Other Assurance and Related Services;
- (2) insufficient awareness of the differences between audit engagements, review engagements, other assurance engagements, related services and other services (for example, consulting);
- (3) misuse of the terms "audit" and "auditor" in the practice of other government and non-government bodies without taking into account the existing world practice and experience;
- (4) arbitrary use of the term "audit" in the normative and legislative documents that relate to entirely different issues.

It is also necessary to draw attention to the shortcoming of using the term which would summarize all services provided by the auditor. The term "audit services" is used in the Ukrainian legislation and regulations. The same term is sometimes used in foreign publications, in particular, Tritschler (2014). But its application does not allow users to immediately perceive the difference between the engagements performed by the auditor and the ones regulated by the International Standards of the IAASB. Therefore, in the title of the article we deliberately used the term "engagements provided by certified auditors".

In the context of these proposals, it is advisable to draw attention to the developments of other countries and international organizations. In particular, the Federation of European Accountants has been offered the Survey on the Provision of Alternative Assurance and Related Services across Europe which analyzes the differences between different services. In November 2015, the Australian

government (the Department of Finance) issued guidance on the delimitation of the concepts of "audit and assurance" (Resource Management Guide No. 210 Clarification of the Terms "Audit" and "Assurance"), the purpose of which was to provide detailed recommendations for users about these elements. They provide the analysis of the various situations and issues arising from the use of terms "audit" and "assurance" and suggestions on how to avoid them. They contain only a few examples, but qualitative bases can be used to develop recommendations for choosing the optimal type of engagement for a particular user, considering his/her information needs and expectations.

The effect of education on reducing the expectations gap (primarily, "gap in formation of expectations" and "gap in knowledge") is very important. This issue is widely discussed by Siddiqui, Nasreeen, & Choudhury-Lema (2009), Bui, & Porter (2010), Ihendinihu, & Robert (2014), Cordos, Fulop, & Tiron-Tudor (2016). This issue is also extremely relevant for the Ukrainian education system.

If a specific engagement is used as the basis (audit of historical financial information; review of historical financial information; assurance engagements other than audit or review of historical financial information; related services), then in order to determine ways of eliminating the "expectations gap" it is possible to distinguish its levels depending on the stages of the task (Table no. 4).

While agreeing the terms of the assignment and carrying it out, the reason for the gap is the lack of sufficient communication between the auditors and the management, the customer, insufficient attention to the information needs and expectations of users. Overcoming it will eliminate the causally unreasonable expectations, as well as the shortcomings in the performance indicators that are allowed, but which do not exist in reality. As a result, it will reduce the "gap in communication". The narrowing of this gap is strongly influenced by the improvement of public awareness of the principles and standards of auditing in order to build public confidence that professional standards and national legislation adequately take into account the requirements of users.

Gap levels	Stages of performing the engagement		
	Agreeing the terms of the assignment	Completing the engagement	Provision of final documents (reports, additional information)
Gap 1.2 "Gap in the formation of expectations"	Insufficient level of quality of the legislative and regulatory documents on providing information on the characteristics of different engagements and their functions. Absence (or insufficiency) of the communication links in the process of agreeing the terms of the assignment.	Low information content of contracts on the characteristics of different goals, rights and duties of auditors, etc. Absence (or insufficiency) of the communication links in the course of the assignment.	The difficulty in presenting the information in reports. Low informativeness of reports, presence of inadequate, veiled statements about the nature and characteristics of different engagements.
Gap 2. "Gap in knowledge"	Insufficient attention to information needs and expectations of the users or their misunderstandings	Insufficient attention to the needs of users regarding the audit process or their misunderstanding.	Insufficient attention to the needs of the users regarding the content of documents, the order of their presentation and disclosure. Failure to understand these needs.
Gap 3. "Gap in standards"	Lack of responsiveness in the contract and standards of the users' requirements	Lack of responsiveness in the standards of the users' requirements for the process of carrying out the assignment	Lack of responsiveness in the standards of the users' requirements for the process of carrying out the assignment
Gap 4. "Gap in service"	Inconsistency of the content and structure of the contract with the existing requirements of the legislative and normative acts	Inconsistency in the process of fulfilling the engagement to the established standards	Inconsistency of the content of reports with the requirements of standards, legislative and regulatory documents. Inconsistency in the process of submission and disclosure of auditors' reports.
Gap 5.2 "Gap in communication"	Insufficient information content of contracts on the characteristics of different goals, rights and duties of auditors, etc. Low level of quality of the legislative and regulatory documents on providing information on the characteristics of different engagements and their functions. Absence (or insufficiency) of the communication links in the process of agreeing the terms of the assignment.	Absence (or insufficiency) of the communication links in the course of the assignment.	The difficulty in presenting the information in reports. Low information content of reports, presence of inadequate, veiled statements about the nature and characteristics of different engagements.

Source: Compiled by Authors

It is particularly important to inform the users of the final documents (reports) about what they can expect. If it is,

for example, a statutory audit, then its requirements should be covered in special legislative documents

regulating the activities of a certain economic entity. The contract terms are important while carrying out the initiative engagements. At the stage of presenting the results of the engagements, it is important to ensure the qualitative characteristics of the reports, in particular, completeness, relevance, comprehensibility, as well as the process of submitting them to the users and officially publishing them, if necessary.

6. Conclusions

The results of the research of the «expectation gap» problem in the audit only show possible ways of solving this complex problem which undoubtedly is relevant and important. After all, engagements provided by certified auditors cannot exist on their own. These exist in the form of professional services that have certain demands and must satisfy the requirements of the users to help increase the importance of auditing and assurance in the society.

It is advisable that the study of the reasons for the "expectations gap" in the audit to be carried out with the help of methods that allow assessing the quality of services from the point of view of their consumers. Their modification in accordance with the specific features of engagements provided by certified auditors as professional services allowed formulating three tasks to be investigated: (1) identification of the information needs of users by the results of the auditor's work; (2) identifying the users' expectations with respect to the services that in one way or another take into account the need to provide information about the audit process itself, the need to meet "specific" information needs, the users' requirements for the level of materiality, the need to provide information in the process of auditing; (3) assessment of the quality received.

The expectations of the users that characterize the "standard", "minimal" quality of engagements provided by certified auditors, and the "tolerance zone" are specified to some extent that takes into account the need to provide information about the process of the engagement itself, the need to meet "specific" information needs, the users' requirements for the level of materiality, the need

to submit information in the process of performing the engagements.

The proposed method makes it possible to determine the reasons of the five levels of the expectations gap in the engagements provided by certified auditors:

- (1) *gap in the formation of expectations* (the formation of overstated and/or reasonably irrelevant expectations);
- (2) *gap in knowledge* (the gap in the auditors' awareness and perception of the interests, needs and expectations of the users as a result of ignorant or mistaken perception by auditors of what the users expect to receive, which leads to the gap between the expectations of clients and the perception of auditors of such expectations);
- (3) *gap in standards* (inability and/or reluctance of auditors to establish the quality standards that meet the expectations of clients with their absolutely correct understanding);
- (4) *gap in service* (insolvency of an auditor to ensure the quality of service that meets the established standards);
- (5) *gap in communication* (inconsistency of information about the nature of the audit, review, other assurance engagements, related services and other services, performed by auditors, their actual characteristics, as provided by the International Standards of Quality Control, Auditing, Review, Other Assurance, and Related Services).

The importance of overcoming gaps in formation of expectations, knowledge and, first of all, in communication has been grounded, since its presence creates a vicious circle, the result of which is the fixation of primary overstated or, in general, incorrect expectations of the users of engagements provided by certified auditors, the formation of new overstated or distorted expectations. Therefore, it is important to inform users about the fundamental differences between the different types of engagements provided by certified auditors.

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Reporting of subsequent events in financial statements – between obligation and necessity

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Abstract

The article aims to highlight the importance of reporting of subsequent events in financial statements, the factors that influence their reporting and the implication in statutory audit. The purpose of the article is to research the theoretical and legal basis which regulates the accounting and audit of subsequent events, but also research practical cases on this subject. The case study was based on the study of the 62 companies, listed on the Bucharest Stock Exchange, from which were analyzed the financial statements and the independent auditor's reports, grouping the subsequent events which was found, depending on their type and the domain in which that company operates, and were compared the types of events that occurred in each domain of activity. From empirical research resulted that reporting of subsequent events can be influenced by various factors such as: the auditor's category, the audit opinion, the performance and the size of company. The main conclusion which resulted from the study case is that the subsequent events are more frequent presented in financial statements of an entity, influencing in some cases the auditor's opinion related to these financial statements.

Keywords: subsequent events, financial statements, audit opinion, audit evidence

JEL Classification: M40, M41

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Introduction

The financial statements of an entity reflect the financial position of the enterprise at the end of financial year. So, if subsequent events appear after the moment which proves the conditions existing at that date, it is necessary to reflect them in the financial statements because information can be a useful decision base for those interested in assessing the financial position of an enterprise.

The importance this chosen topic is based on the requirements of financial reporting frameworks and on the need of financial statements to provide a true and fair view of the performance and the financial position of an enterprise to be audited and lead to an unqualified opinion.

The article is considering the analyses of the main accounting and audit regulations regarding the reporting of subsequent events and shows the implications of recording on not recording them from the point of view of the financial auditor.

Considering that the subsequent events are not based on the current year's accounting records, but on the next year's accounting records or other events that do not generate accounting records, it is necessary to identify the factors which influence the reporting of these events, because they can occur, but are not always considered relevant to be presented in the notes of the financial statements, but the information can be useful to their users (Michel, 2015).

In order to analyze the status of reporting of subsequent events were analyzed 62 companies listed on the Bucharest Stock Exchange (BSE). The entities were classified on different areas, according to their scope of activity and an analysis of the information from financial statements, manager reports and audit reports was made.

Following systematization of the information, subsequent events have been identified and if these events had an impact on the financial statements a comparison of events in each industry, grouped by type of events, has been made.

Starting from the results of this analysis, in the second stage, was tested the empirical relationship between the factors that could influence the reporting of subsequent events, so were selected the following variables: the auditor's category, the auditor's opinion, the entity's performance and their size.

The research will contribute to the development of specialty literature, because provides an analysis of the availed data of reporting of subsequent events by the listed companies in Romania, from a perspective oriented to the importance and necessity to present these operations in the financial statements.

The article is structured as follows: the following section contains a summary of the relevant literature on subsequent events, while the second section describes the research methodology. The third part presents the results of the study together with our comments. The last section includes the final conclusions, the limits of the study and future research directions.

1. Literature review

The subsequent events are governed by two important standards, respectively: ISA 10 *Events after the reporting period* and ISA 560 *Subsequent events*. It is known that there is a strong relationship between accounting standards and auditing standards.

ISA 10 groups these subsequent events into two categories: events that already existed at the reporting date and events that occurred later than the reference date.

The second standard specifies the steps that a financial auditor should follow in determining the significance of these events. ISA 560 classifies events after the reporting date into three categories, depending on their moment of appearance, respectively: events that occurred until the date of the audit report, events occurred after the report but not after the release of the financial statements and events occurred after the release of the financial statements. Depending on when events occur, the auditor revises and sometimes changes the opinion, which will be expressed in a new audit report.

If ISA 10 is the international accounting reference, in the Romanian system, Minister of Finance Order no. 1802/2014 for the approval of the Accounting Regulations on individual annual financial statements and consolidated annual financial statements (OMFP 1802), regulates the issue of subsequent events that occur after the balance sheet date, which was harmonized with international stipulations.

The literature is not very extensive in this domain, most researches have been carried out at an international

level. In Callings' (2012) vision, the audit of subsequent events remains a key element in the audit process, so the auditor has the responsibility for collecting the evidence to ensure that all subsequent relevant events have been considered.

The audit of subsequent events was considered a difficult field to be audited, because was found in a study by Chung et al. (2013) that about one third of the inspection reports of securities and stock market regulators have identified deficiencies in this area.

Herda and Lavelle (2014) foresee that auditors have to investigate subsequent events, to evaluate the impact of any uncovered event on the financial statements and to ensure that the events that are occurring are solved in adequately mode.

Janvrin and Jeffrey (2004) suggest to the auditors to form an opinion from the initial balance sheet based on historical evidence (evidence of events occurring at the balance sheet date). At the end of fieldwork, auditors should seek evidence from events after the balance sheet date before finalizing their opinion. The same authors specify that auditors generally follow the proposed audit procedures for search evidence to justify subsequent events, but the frequency with which the auditors find subsequent evidence of the events using a single procedure was low. In addition, auditors are more likely to seek and find evidence of subsequent events when exist minimal historical evidence and when assessing outstanding account balances, which have impact on the financial statements as a whole, not just on a material account.

Latif and Jaber (2015) lists a series of procedures that the auditor can use in the analysis of subsequent events: tracking company policies, especially at the subsequent events, reading the minutes of board meetings and of the competent committees that help to complete the audit of subsequent events, the requesting to management contingent debts, changes in capital and accounting estimates, the request to management the situation of subsequent events, investigating any other auditor with regard to the subsequent procedures and treatment of the branches. The authors recommend companies to shorten the period between the balance sheet date and the issuance of the audit report, thus reducing the occurrence of a new unusual subsequent event.

Ozdemir and Gokcen (2016) have conducted an investigation on the audit of subsequent events, which was applied to 108 independent auditors from Turkey. Most of the auditors who responded to the investigation activity are working in an international audit company and are aged between 26 -40 years. The auditors said that the information on subsequent events are important enough to influence independent auditor opinion and investments decisions. In addition, they consider them important enough to affect all financial statements.

Janvrin and Jeffrey (2004) have developed a questionnaire concerning the frequency of discovery of subsequent events during the audit engagement, having 46 auditors' respondents. About half of them said that they have been confronted with subsequent events and in all cases the requirements of ISA 560 have been respected.

Latif and Jaber (2015) has sought answers to two important questions in their case study: if the auditor was committed to complying ISA 560 in the treatment of subsequent events before and after the audit report, and if the auditor's experience may influence the professional judgment in terms of compliance with the standard. The questionnaire was applied to 189 auditors from Jordan. 69,4 % said that the auditor was responsible for complying the treatment recommended by ISA and 60 % had over 10 years of experience in this field.

The Romanian authors who studied the themes of subsequent events were more concerned with the practical aspects and formulated opinions to clarify the application of standards and regulations in the field. Botez (2014) believes that the responsibility to adjust the financial statements by highlighting the impact of subsequent events was primarily the entity's leadership. The author also specifies that the entity does not have to prepare the set of financial statements based on the principle of continuity activity as long as this hypothesis was not suitable.

Cernuşca (2016) considers that the subsequent events include those events which occurred until the

date on which the annual financial statements are authorized for issue, approved by a board of directors, administrators or other leading organs, according to entity's organization, for their submission for approval, in accordance with the legal provisions in force.

In the point of view of the authors Lazăr and Duinea (2011), the subsequent events also occur in the context of the principle of continuity of activity which the accounting regulations provide that an entity start from the premise that they are operating based on the principle of continuity of activity. The principle requires a company to continue its business normally, without the presumption that would lead in liquidation or significant reduction of activity.

The date of completion of the audit report is the date on which the auditor dated his report. The auditor's report must not be issued before: the time at which the auditor has obtained sufficient and adequate audit evidence on which to base his opinion on the financial statements; the period of obtaining evidence that a complete set of financial statements has been prepared, on which the management of the entity has assumed responsibility (Moldovanu, 2009).

In the opinion of Caloian (2007) the moment when the auditor discovers subsequent events is very important, because, depending on this factor, it is distinguished: events reported to the auditor previous to the audit report preparation, they influence the audit report and the expressed opinion, the auditor

having the possibility to change the initial opinion, and events brought in attention of the auditor following the issuance of the audit report to the management of the audited company, in which case the auditor don't can change his opinion, but will do all he can to inform the users of financial statements about the new information obtained after the publication of this report.

2. Research methodology

For this case study, were studied 62 companies listed on Bucharest Stock Exchange (BSE), with non-financial activity. Based on the annual reports published for the period 2016 – 2017 the companies were grouped on 9 sectors of activity and the financial statements and auditor's reports were analyzed over a period of two consecutive years, respectively 2016 and 2017, highlighting subsequent events that occurred after the reporting date, and the measure to which the auditor took these into account when expressing his opinion.

The reporting of subsequent events can be influenced by several factors, which have been econometrically tested, in the relationship between the dependent variable – subsequent events and independent variables: the auditor's category, the auditor's opinion, the financial result obtained and the size of the company. **Table no. 1** shows the way of representing these indicators.

Table no. No. 1. Description of variables	
Variable	Representation mode
Subsequent events (Es)	1 – if any subsequent events were reported 0 – if they have not been reported
The auditor's category (Ca)	1 – if the auditor falls into the Big 4 category 0 – if they do not fit
The auditor's opinion (Oa)	1 – if the auditor's opinion was unqualified 0 – if the opinion was qualified
Financial result of the company (Rf)	1- if the company obtain profit 0 – if the company obtain a loss
The company size (Sc)	1- if the company was in the category of large companies 0 – if the company was part of the small and medium sized enterprises group (SMEs)

Source: Own projection, 2018

The regression equation will be linear by multifactorial type according to the following formula:

$$Es = \alpha_{it} + \beta_1 Ca + \beta_2 Oa + \beta_3 Rf + \beta_4 Sc + \varepsilon_{it} \quad (1)$$

To determine the power of explaining the proposed model, the testing of hypothesis will be done by more models with all independent variables included, as well

as testing only with variables whose statistical significance will be more relevant.

3. Results

Due to the diversity of subsequent events published, in order to show the categories of events with the most significant repeatability, in **Table no. 2** was made a classification of the type of events, as well as the sectors in which companies are doing their business.

Table no. 2. Type of subsequent events			
Type of subsequent events	Company	Year	Industry
Litigations and provisions	OMV PETROM S.A.	2016	Mining and quarrying
	ELECTROARGES S.A.	2016	Manufacturing
	S.N. NUCLEARELECTRICA S.A.	2016	Electricity, gas, steam and air conditioning supply
	C.N.T.E.E. TRANSELECTRICA	2016	Electricity, gas, steam and air conditioning supply
	SOCIETATEA ENERGETICA ELECTRICA S.A.	2016	Professional, scientific and technical activities
	COMELF S.A.	2017	Manufacturing
	PETROLEXPORTIMPORT SA	2017	Wholesale and retail trade; repair of motor vehicles and motorcycles
	SOCIETATEA ENERGETICA ELECTRICA S.A.	2017	Professional, scientific and technical activities
Extending loan contracts	ROMPETROL WELL SERVICES S. A	2016	Mining and quarrying
	ROMPETROL RAFINARE S.A.	2016	Manufacturing
	STIROM S. A.	2016	Manufacturing
	TURBOMECANICA S.A.	2016	Manufacturing
	ALUMIL ROM INDUSTRY S.A.	2016	Wholesale and retail trade; repair of motor vehicles and motorcycles
	SIF HOTELURI S.A.	2016	Accommodation and food service activities
	ROMPETROL WELL SERVICES S.A	2017	Mining and quarrying
	ALUMIL ROM INDUSTRY S.A.	2017	Wholesale and retail trade; repair of motor vehicles and motorcycles
	SIF HOTELURI SA	2017	Accommodation and food service activities
	SOCIETATEA ENERGETICA ELECTRICA S.A.	2017	Professional, scientific and technical activities
Requests for the opening of insolvency proceedings	ELECTROMAGNETICA SA	2016	Manufacturing
	ROMCAB S.A.	2016	Manufacturing
	PREBET S.A.	2017	Manufacturing
Sale of assets	ELECTROPUTERE S.A.	2016	Manufacturing
	ELECTROPUTERE S.A.	2017	Manufacturing
	MECANICA CEAHLAU S.A.	2017	Manufacturing
	OLTCHIM S.A.	2017	Manufacturing
	ROMCARBON S.A.	2017	Manufacturing
Financing contracts	S.N.G.N. ROMGAZ S.A.	2016	Manufacturing
	ALRO S.A.	2017	Manufacturing
	ROMPETROL RAFINARE S.A.	2017	Manufacturing
	S.N.T.G.N. TRANSGAZ S.A.	2017	Transportation and storage

Type of subsequent events	Company	Year	Industry	
Changing activity sections	ARMATURA S.A.	2016	Manufacturing	
	S.N.G.N. ROMGAZ S.A.	2017	Extractive	
	AEROSTAR S.A.	2017	Manufacturing	
	TERAPLAST S.A.	2017	Manufacturing	
	S.N.T.G.N. TRANSGAZ S.A.	2017	Transportation and storage	
Profit distribution	CARBOCHIM S.A.	2016	Manufacturing	
	CONTEC S.A.	2016	Manufacturing	
	MECANICA CEHLAU S.A.	2016	Manufacturing	
	TURISM FELIX S.A.	2016	Accommodation and food service activities	
	CARBOCHIM S.A.	2017	Manufacturing	
	TURISM FELIX S.A.	2017	Accommodation and food service activities	
	OLTCHIM S.A. S.A.	2016	Manufacturing	
Changing reorganization plans for the activity and staff	ARMATURA S.A.	2017	Manufacturing	
	OMV PETROM S.A.	2017	Mining and quarrying	
	UZTEL S.A.	2016	Manufacturing	
	ZENTIVA S.A.	2016	Manufacturing	
	S.N.T.G.N. TRANSGAZ S.A.	2016	Transportation and storage	
	ELECTROMAGNETICA S.A.	2017	Manufacturing	
	GRUPUL INDUSTRIAL ELECTROCONTACT S.A.	2017	Manufacturing	
	MECANICA CEHLAU S.A.	2017	Manufacturing	
	S.N. NUCLEARELECTRICA S.A.	2017	Electricity, gas, steam and air conditioning supply	
	OIL TERMINAL S.A.	2017	Transportation and storage	
	SIF HOTELURI S.A.	2017	Accommodation and food service activities	
	SOCIETATEA ENERGETICA ELECTRICA S.A.	2017	Professional, scientific and technical activities	
	Change of exchange rate or of inflation rate	OLTCHIM S.A.	2016	Manufacturing
		SANTIERUL NAVAL ORSOVA S.A.	2016	Manufacturing
OLTCHIM S.A.		2017	Manufacturing	
SANTIERUL NAVAL ORSOVA S.A.		2017	Manufacturing	
Receipts and payments of receivables and debts	OLTCHIM S.A.	2016	Manufacturing	
	ALTUR S.A.	2017	Manufacturing	
	OLTCHIM S.A.	2017	Manufacturing	
	PREBET S.A.	2017	Manufacturing	
Trading shares	CEMACON S.A.	2016	Manufacturing	
	TERAPLAST S.A.	2016	Manufacturing	
	TURBOMECANICA S.A.	2016	Manufacturing	
	VRANCART S.A.	2016	Manufacturing	
	CONPET S.A.	2016	Transportation and storage	
	CEMACON S.A.	2017	Manufacturing	
	ZENTIVA S.A.	2017	Manufacturing	
	TRANSILVANIA CONSTRUCTII S.A.	2017	Construction	
	NATURA QUATTUOR ENERGIA HOLDINGS S.A.	2017	Financial and insurance activities	
Distribution of dividends	C.N.T.E.E. TRANSELECTRICA	2016	Electricity, gas, steam and air conditioning supply	
	CARBOCHIM S.A.	2017	Manufacturing	
	TURISM FELIX S.A.	2017	Accommodation and food service activities	
Interests and commissions	TURBOMECANICA S.A.	2016	Manufacturing	
Canceled contractual commitments	ALRO S.A.	2016	Manufacturing	

Source: Own projection, 2018

As can be seen in **Figure no. 1**, the subsequent events that occurred most often and almost in all sectors of activity were related on changes in the activity plans, reorganizations, resignations and appointments in management positions. This fact was primarily due to areas of activity which requires a constant concern whit the good running of the business.

The second place was made by extensions of loan agreements, followed by disputes that companies have with various institutions and trading of shares, present in different sectors. A significant share was held by subsequent events related to the distribution of net profit from various destinations, event mainly encountered in the manufacturing and hotel industry.

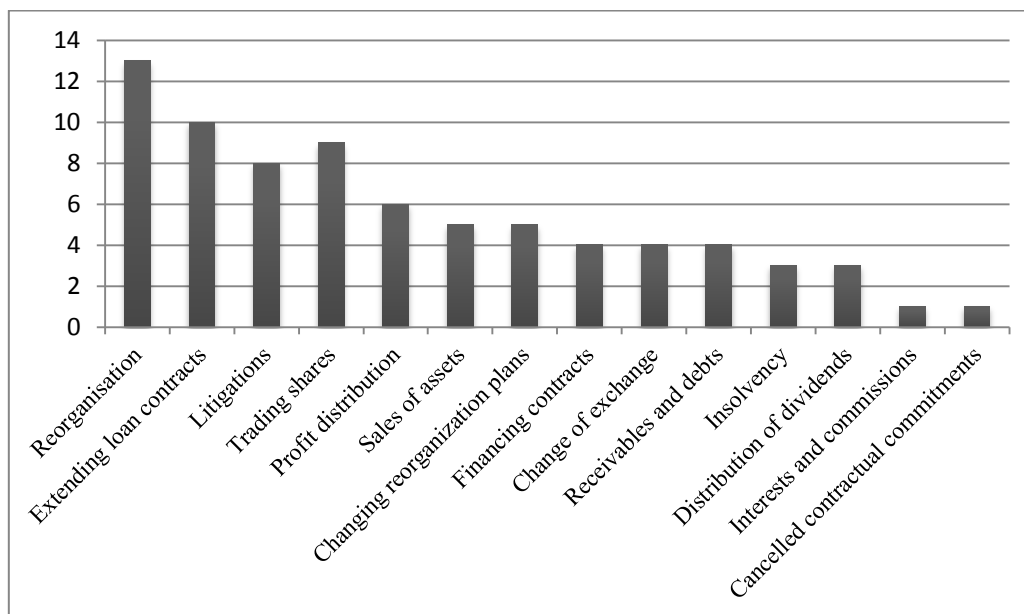
The classification is followed by sales of real estate, encountered only in the manufacturing industry, and

modification of sections of activity in the manufacturing, mining and transport industry.

Less frequent there are: extension of funding contracts, modification of exchange rate and the rate of inflation, following unpaid claims and debts, predominant in the manufacturing industry. Also, the subsequent events related to the opening of the insolvency procedure are met exclusively in the manufacturing industry.

In the second to last place was the establishment and distribution of dividends to shareholders and associates, in most cases calculated from the undistributed profit of the previous year. Once encountered in the companies of manufacturing industry are the interest and commissions of the banking institutions, as well as the cancellation of contractual obligations with suppliers who have not carry out their contractual obligations.

Figure no. 1. Type of subsequent events



Source: Own projection, 2018

Following the analysis there were identified various subsequent events at the companies analyzed in each sector of activity. A comparison is made between subsequent events occurring in each sector for each year, whose graphic representation is in **Figure no. 2**.

The mining and quarrying industry was the only industry in which all three companies included in the studied sample presented after the reporting

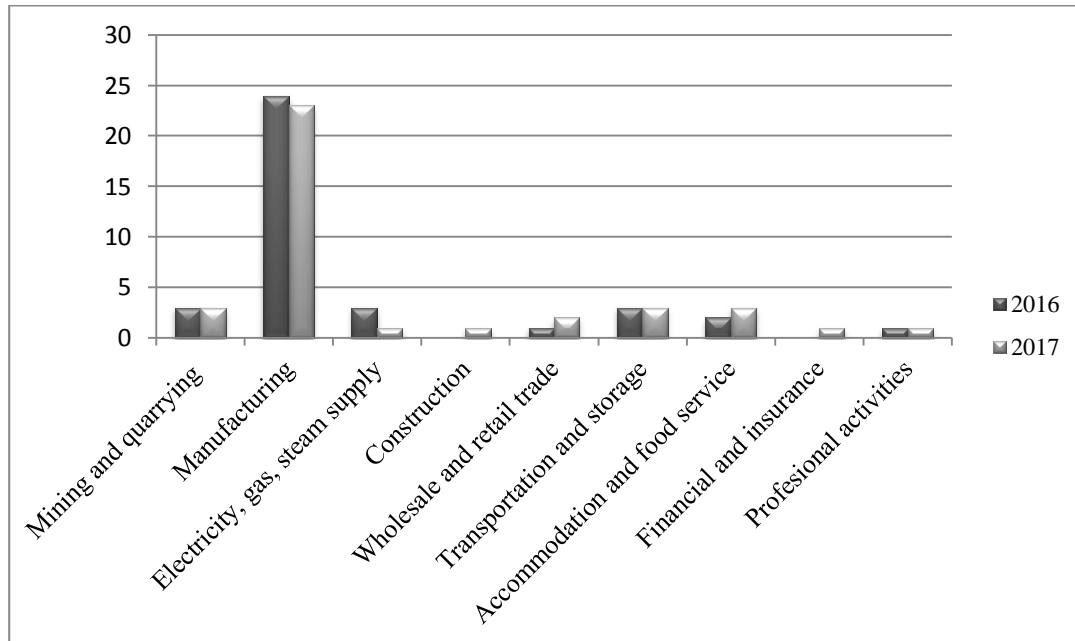
date various subsequent events, both in 2016 and in 2017. In 2016, the main events that occurred were about disputes and extension loan contracts. The next year, the companies registered in addition to the two mentioned events, reorganizations and resignation from leading positions.

Most companies operate in the manufacturing industry, the subsequent events being present in more than a half

of the companies analyzed. Because this industry has more than one object of activity is justifiable that the subsequent events vary. Therefore, in 2016 are present subsequent events related to the profit distribution, sales of assets, cancellations the contractual commitments,

reorganization, change of exchange rate, disputes and even insolvency procedures. In 2017, besides the type of events that have previously occurred, we can take into account: setting up a secondary office and closing a workplace.

Figure no. 2. Frequency of subsequent events by sectors of activity



Source: Own projection, 2018

Companies in the field of energy production and supply, gas, heating and air conditioning also presents subsequent events in both years. Both in 2016 and in 2017, events were referring to litigations, dividends, amendments to the Constitutive Act and last but not least, the removal of an object of secondary activity.

Companies in the construction sector did not register any subsequent events in 2016, and in 2017 the only subsequent event referred to the stock trading.

The companies from trade sector reported events such as the extension of credit agreements in both years, in 2017 also presenting disputes.

In the case of companies in the transport and storage sector, have occurred in both years similar events, regarding the approval of the Revenue and Expenditure Budget and the extension of financing contracts.

Companies from the accommodation and food service activities have obtained events specific to the field of activity, the distribution of net profit being frequent, followed by resignations from management positions and obtaining loan contracts.

Within the financial and insurance industry, a single company was analyzed, which in 2016 did not report any subsequent events, and in 2017 reported as the event the intention to increase the share capital by issuing shares.

A single entity was also analyzed in the professional activities sector, having in 2016 disputes and insolvency proceeding, and in 2017 presented in addition to the previous year resignation from leading positions.

To highlight the factors that influence the reporting of subsequent events a descriptive statistic was made of the indicators analyzed in **Table no. 3**. One can see that out of the total number of observations, 124

(representing the 62 companies for 2 years) an average of 50% of cases reported subsequent events. An average of 35% of the analyzed financial statements were audited by auditors belonging to the Big4 group. On average 81% from the number of observations the auditors issued unqualified opinions.

Table no. 3. Descriptive statistics

Variable	Mean	Standard Error	Standard Deviation
Subsequent events	0.5000	0.0451	0.5020
The auditor's category	0.3548	0.0431	0.4804
The auditor's opinion	0.8145	0.0350	0.3903
Financial result	0.7823	0.0372	0.4144
The company size	0.4677	0.0450	0.5010

Source: Own projection, 2018

From the total number of observations, in 78% of the cases the companies obtained profit, and about 47% of companies ranked as large companies, the difference of 53% being represented by small and medium enterprises.

The correlation between variables is presented in **Table no. 4** which shows that the dependent variable *subsequent events* is in a moderate positive correlation with the auditor type (0.37). From the independent variables the most relevant positive correlations identified are between the type of opinion and the result obtained by the company (0.45), as well as, between the type of auditor and the size of the company (0.31).

Table no. 4. Correlation Matrix

	Es	Ca	Oa	Rf	Sc
Es	1				
Ca	0.3708	1			
Oa	-0.0207	0.0503	1		
Rf	-0.0586	0.1462	0.4520	1	
Sc	0.1616	0.3181	0.1146	0.2596	1

Source: Own projection, 2018

The model was tested with all the independent variables, but also with each variable independently. From the model testing with one variable that had the highest correlation coefficient, the auditor category (Model 1)

showed that there is a strong link between both (Multiple R was 0.63) and that the change of auditor's category may influence with 63% the change in reporting of subsequent events (**Table no. 5**).

Table no. 5. Regressions results for Model 1

Regression Statistics	
Multiple R	0.6318
R Square	0.3992
Adjusted R Square	0.3911
Standard Error	0.5503
Observations	124

ANOVA					
	df	SS	MS	F	Significance F
Regression	1	24.50	24.75	81.724	2.933
Residual	123	37.25	0.302		
Total	124	62			

	Coefficients	Standard Error	t Stat	P-value
Intercept	0	#N/A	#N/A	#N/A
Categ auditor	0.75	0.0830	9.0402	0.0000

Source: Own projection, 2018

After testing the model with all the independent variables (Model 2) was observed that the model was validated in the case of the variable auditor's category, but with an important significance also of

the variable auditor's opinion, according to the **Table no. 6**. Modifying the independent variables influences in a proportion of 52 % the change of the dependent variable.

Table no. 6. Regressions results for Model 2

Regression Statistics					
Multiple R	0.7217				
R Square	0.5208				
Adjusted R Square	0.5005				
Standard Error	0.4976				
Observation	124				
ANOVA					
	df	SS	MS	F	Significance F
Regression	4	32.2885	8.0721	32.6021	0.0000
Residual	120	29.7115	0.2476		
Total	124	62			
	Coefficients	Standard Error	t Stat	P-value	
Intercept	0	#N/A	#N/A	#N/A	
Ca	0.4348	0.0978	4.4480	0.0000	
Oa	0.2789	0.1091	2.5565	0.0118	
Rf	-0.007	0.1176	0.0595	0.95264	
Sc	0.1271	0.0962	1.3213	0.18890	

Source: Own projection, 2018

Next, the model was been tested with only these two variables (Model 3) for which the model was validated, the change of the two variables influence

in proportion of 51% the change of the dependent variable, and Multiple R shows a very strong link between them (**Table no. 7**).

Table no. 7. Regressions results for Model 3

Regression Statistics					
Multiple R	0.7166				
R Square	0.5134				
Adjusted R Square	0.5013				
Standard Error	0.4973				
Observations	124				
ANOVA					
	df	SS	MS	F	Significance F
Regression	2	31.834	15.916	64.372	9.120
Residual	122	30.166	0.2472		
Total	124	62			
	Coefficients	Standard Error	t Stat	P-value	
Intercept	0	#N/A	#N/A	#N/A	
Auditor category	0.7822	0.0901	5.3515	0.0000	
Auditor opinion	0.3183	0.0594	5.3524	0.0000	

Source: Own projection, 2018

For revision, the model has been tested only with the auditor's opinion variable (Model 4) turning out that dependent variable *Subsequent events* can be

influenced to some extent (39%) also by the variable Oa, but the link is not as strong (Table no. 8).

Table no. 8. Regressions results for Model 4

Regression Statistics	
Multiple R	0.6318
R Square	0.3992
Adjusted R Square	0.3911
Standard Error	0.5503
Observations	124

ANOVA					
	df	SS	MS	F	Significance F
Regression	1	24.752	24.7524	81.7384	2.9215
Residual	123	37.248	0.3028		
Total	124	62			

	Coefficients	Standard Error	t Stat	P-value
Intercept	0	#N/A	#N/A	#N/A
Opinion auditor	0.4951	0.0547	9.0409	0.0000

Source: Own projection, 2018

Therefore, the independent variables that influence the reporting of subsequent events which were identified are

the auditor's category and the opinion issued by the auditors, as shown in Table no. 9.

Table no. 9. Synthesis of regression results

	Model 1	Model 2	Model 3	Model 4
Observations	124	124	124	124
Multiple R	0.721	0.631	0.631	0.716
R-squared	0.520	0.399	0.399	0.513
F	36.60	81.72	81.73	64.37
Ca	0.434 (4.448)***	0.75 (9.040)***		0.482 (5.351)***
Oa	0.278 (2.556)***		0.495 (9.041)***	0.318 (5.352)***
Rf	-0.007 (-0.059)			
Sc	0.127 (1.321)			

Source: Own projection, 2018

Conclusions

Throughout this article were presented the theoretical and practical aspects regarding the accounting and

auditing subsequent events, necessary for the good performance of the economic activity of an entity. The topic of subsequent events remains an important subject to be followed by users of financial statements when

they take investment decisions or other strategic decisions.

The subsequent events are and will continue to be a key area in audit processes and it is essential that everyone involved in this process knows what audit evidence are required for the auditor to confirm that the accounting policies and disclosures have been correctly applied in the annual financial statements.

An important conclusion that comes after this work is that subsequent events can provide important information, sometimes even essential to ensure the observance of the principle of continuity activity, both for the management of the entity and for the auditor of the financial statements, similar to Lessambo's (2018) research.

In accounting terms, post-balance sheet events are reflected in the financial statements, when events require an adjustment, or explanatory notes, when events are not so significant that they need to reflect the values in the financial statements.

From the point of view of the implications in audit it is very important the time when auditors discover these events, because, depending on the period in which they occurred, these events may influence the auditor's opinion and, in some cases, even amending the initial

audit report issued by the financial statements. Practice can focus on complex events, but by rigorously applying the rules of accounting and auditing standards, and using professional judgment, the most effective views on an audit mission can be built.

The article can be a bibliographic source for researches in the field of accounting and financial audit, for enterprise's management, to understand the necessity and the importance of reporting subsequent events, as well as for the practitioners of the accounting profession who find in the paper indications of the types of subsequent events which can be reported, as well as the fact that they can influence the assessment of how the enterprise respect or not the principle of continuity activity.

The limits of the research were the fact that it is not a certified database, the data were collected manually, being retrieved from information published by the companies, their confidence being provided by the independent financial auditor's reports.

Future research directions can be materialized into expanding the number of companies and the period of study, as well as a comparative analysis of the reporting of subsequent events of the companies from different countries.

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Does IFRSs adoption contribute to the protection of minority investors?

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Abstract

The purpose of the present article is to analyse the connection between the protection of minority shareholders and International Financial Reporting Standards' (IFRSs') adoption. Thus, the authors estimate the status of IFRSs' adoption for 109 countries and involve the Protecting Minority Investors' ranking (as a component of Ease of Doing Business Index provided by World Bank). In order to deal with the reverse causality issues, a GMM methodological framework was adopted. The results reveal that the impact of IFRSs' adoption on a country's rank (in respect to the status of minority investors' protection) is reverse U-shaped and statistically significant. These findings are robust, even if we consider different control variables (legal system features, conditions of borrowed financial resources' markets and insolvency resolution procedures) and estimation methodologies. In addition, the authors compare OECD versus non-OECD countries and find that the strongest impact of IFRSs' adoption is in the case of the latter group.

Keywords: minority shareholders, IFRSs, legal system, insolvency, OECD & non-OECD countries

JEL Classification: C10, C13, C14, D01, D22, G39, M49

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1. Introduction

In the last decades, as the financial markets developed at a faster pace, new institutions emerged in order to ensure the stability of the market and to enable investors to trust the application of comparable global financial reporting standards. As a key group of financial information users, investors prefer to invest when the legal environment guarantees them enough protection (Leuz et al, 2009). Moreover, as Bishara (2011) notes, the existence of corruption, the lack of investors' protection and of minority shareholders' rights can de-motivate potential investors from taking the risk of investing in companies operating on a certain market. Pagano (1993) shows that weak investors' protection discourages financial markets' development and, so, in order to avoid the reduction of financial inflows, protection must be provided by the market. Some authors consider that financial markets' development level is frequently generated by the level of investors' protection and that the financial crisis was just a proof of market regulators and supervisors' "incapacity of adapting to the market reality and to ensure an adequate investors' protection" (Barna & Nachescu, 2014).

Still, no matter how hard regulators try to ensure the same conditions to all market participants, the protection of minority investors is one of the major issues perceived on both noseological and empirical levels. Financial markets where minority investors' rights are properly protected are less sensitive to financial constraints, allowing an increase in investments' performance. Stultz (2005:26) argues that "when the state ruler agency problem is significant, controlling shareholders can exploit it to their advantage. For instance, by bribing state rulers, they can get away with expropriation of minority shareholders that would not be possible if the state strictly adhered to its laws and regulations. Further, corporate insiders who earn rents through control of corporations do not have incentives to take steps that would reduce the discretion of state rulers when that discretion helps them protect their rents."

On the other hand, the level of investments in internal governance is associated with the country-level investor protection. La Porta et al. (1997, 1998, 2000) shows that a strong investor protection is the most

important factor associated with promoting good corporate governance. Strong investor protection creates an environment that deters managers from opportunistic behaviour, reduces the risk of mismanagement, and increases shareholders' confidence and their willingness to participate on financial markets (DeFond & Hung, 2004).

Houqe et al. (2012) use in their analysis six country-level measures of investor protection: board independence, enforcement of securities laws, protection of minority shareholder rights, enforcement of accounting and auditing standards, judicial independence, and freedom of the press. They conclude that International Financial Reporting Standards' (IFRSs') adoption does not lead to higher earnings quality, except when a country's investor protection regime is well-established. These results are consistent with the findings of Leuz et al. (2003), La Porta et al. (1998, 2000, 2002), and Ball et al. (2003), which conclude that adopting high quality standards is a necessary but not a sufficient condition in acquiring high quality information, and that strong investor protection is a must in promoting earnings quality, even given high quality reporting standards are implemented.

La Porta et al. (1998) argue that country-level strong investor protection improves the rights of outside (minority) investors and reduces agency problems between insiders/controlling shareholders and outsiders/minority shareholders.

Several authors (La Porta et al., 1997, 1998, 2000; Djankov et al., 2003; Beck et al., 2003a, 2003b; Claessens & Laeven, 2003) show that the investment flows and the capacity of companies to find financing increase when shareholders and creditors are better protected by law.

Modigliani & al. (2000) find supporting evidence for the correlation between investor protection and financial markets' development, by using measures of investor protection and corruption, plus a price measure (the premium on voting stock). When the minority rights are not well protected, the companies' capacity to raise equity capital is affected, leading to less funding resources for new risky ventures. The consequences may include low capitalization and a preference for internal equity and bank lending over traded securities.

One key element influencing the availability of credit, especially for small firms, is the severity of the bankruptcy law's treatment of debtors. A forgiving bankruptcy law offers entrepreneurs partial insurance against the consequences of failure (Jackson, 1985; Lee et al., 2007).

Even if the literature has extensively studied the connections between equity rights protection and the development of financial markets, it also documents the impact of creditor rights' protection on financial markets (Bae & Goyal, 2003; Demircuc-Kunt & Maksimovic, 1998). Still, cross-country empirical evidences are highly limited to the use of a general index equal to the number of rights given to creditors. Such an index was developed by La Porta et al. (1998) and it uses 4 dummy variables: restrictive reorganization, mandatory management turnover, no automatic stay on assets, secured creditors priority. By using this general index, the empirical evidences suggest that the aggregate strength of creditor rights has limited effects on financial development (probably due to the very different aspects taken into account).

Moreover, the adopted legal system has a significant impact on the different aspects concerning the corporate governance principles used. There are quite a few studies analyzing the relationship between law and finance. Most attempt to determine the level of protection provided by law to investors, the differences between the legal systems adopted by different countries or to establish the impact of firm-level corporate governance on firm's performance. A country's legal system is significantly related to the quality of accounting information (La Porta et al., 1998; Ball et al., 2000; Hung, 2000; Burgstahler et al., 2007). La Porta et al. (1997, 1998) show that common law systems (like UK or USA systems), promote strong minority investors' protection, while it is weak or almost inexistent in civil law systems. Weak legal protection for minority shareholders creates opportunities for managerial abuses and, so, the level of protection offered by law to investors (through the rule of law) becomes a basic determinant of how corporate governance evolves in that country.

Nonetheless, the existence of legal regulations is not sufficient if these are not respected by market participants (Berkowitz & al., 2003). Institutional characteristics, such as the rule of law and the

efficiency of a country's judicial system, affect the quality of accounting information and the functioning of financial markets, in general (Leuz et al., 2003; Morck et al., 2000).

Bhattacharya and Daouk (2002) show that share prices do not fluctuate with the adoption of new protection measures, but significantly vary when the first infringement of those regulations is penalised. Ben Naceur et al. (2007) proves that a legislation that ensures better protection of shareholders' rights decreases agency costs and offers a better supervision of managers' actions.

When discussing the determinants of the differences in economic development among countries, one of the factors taken into account is the legal environment (Beck et al., 2000). The study shows that a low level on investors' protection, measured through the legal stipulations and the level to which these are imposed, is reflected by the small size of the financial markets.

The level of investors' protection, by means of the existing legal regulations, differs according to the origins of the legal system and, thus, economic growth patterns differ from one country to another (La Porta et al., 2000). The database compiled by La Porta et al. (1997, 1998) when considering investor protection, was disputed by different authors (Djankov et al., 2008; Spamann, 2010), who had concerns about the construction of the classic investor protection measures' index, *The Antidirector Right Index* (ADRI) developed by La Porta et al. (1998). It ranges from zero to six and measures the ease with which shareholders exercise their voting rights and other legal rights – such as suing directors and calling special shareholder meetings. Spamann (2010) has shown that there are significant differences between common law and code law countries, with respect to this index. On the other hand, Djankov et al. (2008) developed an anti-self-dealing index, measuring the protection of minority shareholders from expropriation by controlling shareholders, through self-dealing transactions. This index is a better measure for the minority shareholders' protection, in the case of countries in which ownership is very concentrated, as it includes measures of approval, disclosure and public enforcement of self-dealing transactions.

One major problem that investors face and which affects their capacity of taking adequate decisions is

the quality of the financial information available on the market. Penman (2002) considers that financial information quality should be discussed in terms of the usefulness of the information provided for the shareholders' interest but also taking into account the public interest.

In this context, IFRSs have become, during the last two decades, the principal global financial reporting framework, being accepted for the issuers' admittance on the main stock exchanges in the world (Mueller et al., 1997). IFRSs' adoption by several jurisdictions may be seen as a key event in the history of financial reporting and in the convergence of national accounting systems (Larson and Street, 2004; Whittington, 2005), leading to an increase in the understandability and relevance of financial information for users.

Barth et al. (2008) and Bartov et al. (2004) show that by adopting the IASB standards (clearly influenced by common-law countries, like the United States of America and the United Kingdom), the accounting quality has improved. Barth et al. (2008) shows that, after IASs adoption, firms' evidence less earnings management, more timely loss recognition and more value relevance of accounting data than firms that do not adopt. Aharony et al. (2010) investigate the national impact of IFRSs adoption, by comparing the price and return-based value-relevance models to assess how switching from domestic standards affects the informativeness of accounting figures to investors.

However, the adoption of such a global financial reporting framework puts a lot of pressure on management and auditors, leaving scope to exercise discretion and reducing earnings management activities (Sunder, 1997; Ewert & Wagenhofer, 2005).

Investor protection laws encourage more accurate financial reporting (Leuz et al, 2003) and more arbitrage, both of which should result in stock prices more accurately reflecting fundamental values.

Bushman & Smith (2001) consider that strong protection of investors' rights, at country level, stimulates companies to offer better quality accounting information, and, so, the economy has the premises to grow faster. There were other authors (Bhattacharya et al., 2003; Bushman et al., 2004) that believe that one factor that influences financial transparency is the level

of protection ensured by one country to its investors. Therefore, several authors (Ball et al., 2000; Daske et al., 2008; Hung, 2000; La Porta et al., 1998, 2000, 2002) argue that the adoption of higher quality standards in financial reporting becomes a necessary condition for high quality information. Still, they do not consider that such a measure is sufficient for a better country-level investors' protection. Francis et al (2001) observe that, in countries with well set in place laws for investors' protection, the accounting standards become more transparent.

Leuz et al. (2003) show that, since strong protection limits insiders' ability to mask the performance of the company, as the investors' protection increases, the quality of the disclosed financial information increases as well.

In addition, Ding et al. (2007) investigate how a country's legal systems, economic development, financial markets, and ownership concentration influence its accounting standards, and, consequently, the quality of its financial reporting.

Since many countries have legal stipulations that allow firms to either opt out certain provisions in investors' protection laws or to choose to adopt additional ones (Black & Gilson, 1998; Easterbrook & Fischel, 1991; Klapper & Love, 2004), the degree of corporate governance applied by firms in the same country can significantly differ from one company to another. Such legal stipulations allow managers acting in environments characterized by weak corporate governance to compensate the negative perception of investors towards that environment, by incorporating stronger measures of investors' protection and making them known to the capital owners. In this context, Klapper & Love (2004) note that although firm-level efforts do not fully substitute the absence of a good legal infrastructure, it can, to a certain degree, independently improve investors' protection and minority shareholders' rights, contradicting the theory of Shleifer & Wolfenzon (2002) that consider that the absence of an efficient legal system at country level makes it impossible for firms to ensure a positive perception of the environment in the eyes of the investors. Even though such studies (Klapper & Love, 2004; Shleifer & Wolfenzon, 2002) have shed some light over the relation between governance and performance, they

only refer to the US market, without clarifying such connection for developing countries.

Faccio and Lang (2002) find differences regarding the ownership structure, showing that, in common-law countries (with strong regulation), companies are more likely to be widely held, while in code-law countries (with weak regulation) they are usually family controlled. Also, the state holdings are more significant in code-law countries. They point out that in a widely-dispersed share ownership, managers and shareholders' interests may diverge in important ways, raising the problem of asymmetric information. This generates the need for high quality financial reporting and other forms of timely public disclosure.

Wenjie & Wayne (2014) investigate the impact of accounting standards and legal environments on the information content of stock prices. They consider that there is a negative correlation between the adoption of IFRSs or US GAAP and the stock price synchronicity, at the univariate level, correlation that disappears in a multivariate setting, when measures of legal environments such as the level of shareholder protection or legal origin are included. This shows that the simple adoption of a set of accounting standards is not sufficient for increasing financial market efficiency. They prove that the relationship between stock price synchronicity and accounting standards is significantly negative only in countries with a common-law origin, better shareholder protection, and proper legal enforcements in general. Their conclusions are in line with those of other researchers (Burgstahler et al. 2007; Daske et al., 2008; Doidge et al, 2007; and Leuz et al., 2009), agreeing that high-quality accounting standards make stock prices more informative, only in countries with strong legal environments.

Thus, by reviewing the literature we found that, so far the implications of IFRSs' adoption on the protection of minority investors lack empirical and theoretical support. Our study intends to cover this gap, by addressing this reverse connection too.

Consequently, based on the previous arguments we adopt the following research hypotheses:

H1: *The adoption of IFRSs contributes to the protection of minority investors.*

H2: *The best results are achieved for the full adoption of IFRSs, while the mix of these with national GAAPs leads to a less clear effect.*

H3: *A legal system based on common law does not automatically warranty the best protection of minority investors and a mix of common and civil / Muslim laws performs better in respect to the protection of minority rights.*

The paper is structured as follows: in the next section we present data and research methodology; section 3 reports the results and robustness checks. Several conclusions are drawn and some further policy implications are suggested in section 4.

2. International data

The website of IFRS Foundation and International Accounting Standards Board (IASB) posts profiles about the use of IFRSs in individual jurisdictions. These profiles were developed on the basis of very different sources, the most important one being the set of responses provided by standard-setters and other relevant bodies to a survey conducted by IFRS Foundation. The profiles were reviewed by regulators, international audit firms and the respondents to the survey and their comments are reflected in the posted materials.

We decided to use 109 such profiles as provided by IFRS Foundation at <http://www.ifrs.org/Use-around-the-world/Pages/Jurisdiction-profiles.aspx>, at November 16, 2014 (Table no. 1).

We have constructed a dummy variable that takes value 2 for countries in which IFRSs (as adopted by European Union or published by IASB) are fully adopted, value 1 for countries that have partially adopted IFRSs and 0 for those that decided not to adopt IFRSs. The dataset includes a wide spectrum of situations: out of the sample, 21 countries have not adopted IFRSs, 13 are cases of partial adoption and 75 have fully adopted the standards.

Table no. 1. Countries used in the sample and the state of IFRS adoption and protection of minority investors

Country	IFRS adoption	Protecting minority investors	Country	IFRS adoption	Protecting minority investors	Country	IFRS adoption	Protecting minority investors
Singapore	2	3	Israel	2	11	Philippines	1	154
New Zealand	2	1	Chile	2	56	Ukraine	2	109
Hong Kong SAR, China	2	2	Belgium	2	40	Bahamas, The	2	141
Denmark	2	17	South Africa	1	17	Dominica	2	87
Korea, Rep.	2	21	Czech Republic	2	83	Sri Lanka	2	51
Norway	2	12	Armenia	2	49	St. Lucia	2	141
United States	1	25	Rwanda	2	117	Brunei		
United Kingdom	2	4	Romania	2	40	Darussalam	0	110
Finland	2	76	Saudi Arabia	0	62	Barbados	1	177
Australia	2	71	Slovenia	2	14	El Salvador	2	154
Sweden	2	32	Panama	2	76	Zambia	2	83
Iceland	2	28	Hungary	2	110	Egypt, Arab Rep.	0	135
Ireland	2	6	Turkey	2	13	Indonesia	0	43
Germany	2	51	Italy	2	21	Ecuador	2	117
Georgia	2	43	Belarus	0	94	Jordan	2	154
Canada	2	7	Jamaica	2	71	Belize	0	169
Estonia	2	56	Luxembourg	2	117	Nicaragua	1	172
Malaysia	2	5	Greece	2	62	Brazil	2	35
Switzerland	1	78	Russian Federation	2	100	St. Kitts and Nevis	2	87
Austria	2	32	Moldova	2	56	Guyana	2	135
United Arab Emirates	1	43	Cyprus	2	14	Argentina	2	62
Latvia	2	49	Croatia	2	62	Pakistan	1	21
Lithuania	2	78	Oman	2	122	Tanzania	2	141
Portugal	2	51	Albania	0	7	Kenya	2	122
Thailand	0	25	Ghana	2	56	Sierra Leone	2	62
Netherlands	2	94	Mongolia	2	17	Uzbekistan	0	100
Mauritius	1	28	Guatemala	1	174	India	0	7
Japan	0	35	Vietnam	0	117	Bolivia	0	160
Macedonia, FYR	2	21	Trinidad and Tobago	2	62	Madagascar	0	87
France	2	17	Azerbaijan	2	51	Niger	0	146
Poland	2	35	Fiji	2	110	Nigeria	0	62
Spain	2	30	Uruguay	1	110	Zimbabwe	2	87
Colombia	0	10	Costa Rica	2	181	Bangladesh	2	43
Peru	2	40	Dominican Republic	0	83	Guinea-Bissau	0	122
Slovak Republic	2	100	Antigua and Barbuda	2	35	Angola	0	94
Bulgaria	2	14	Paraguay	0	166	Venezuela, RB	1	178
Mexico	1	62	Malta	2	51			

Source: Data processed by the authors

In addition, we use data provided by Doing Business (www.doingbusiness.org). This database provides information regarding the protection of minority

investors. The data come from a questionnaire administered to corporate and securities lawyers and are based on securities regulations, company laws,

civil procedure codes and court rules of evidence. The ranking is according to the distance to frontier scores for protecting minority investors.

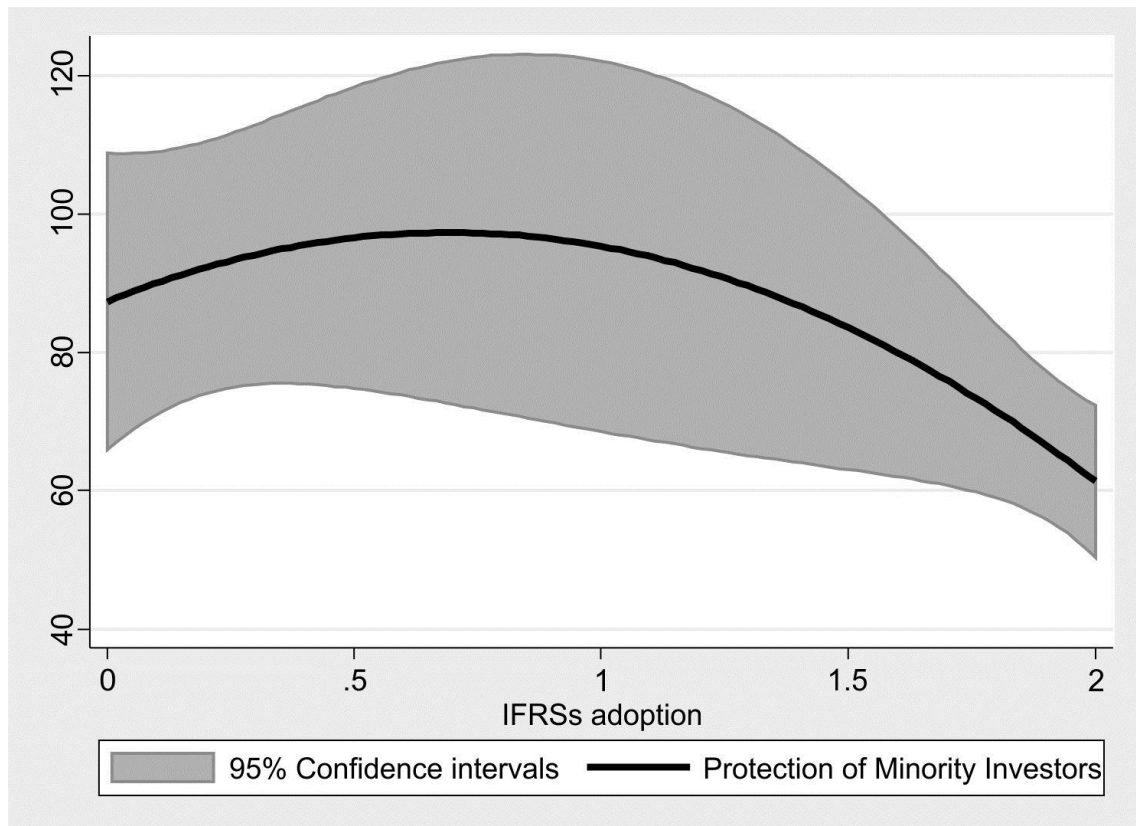
With the IFRSs adoption dummy as the main explanatory variable, we control for ease of getting credit and for resolving insolvency mechanisms. Doing Business measures the legal rights of the borrowers with respect to secured transactions, through one set of indicators, and the sharing of credit information, through another.

The ranking of economies on the ease of getting credit is determined by sorting their distance to frontier scores for getting credit. These scores are the distance to frontier score for the sum of the strength of legal rights index and the depth of credit information index.

The ranking of economies on the ease of resolving insolvency is determined by sorting their distance to frontier scores for resolving insolvency. These scores are the simple average of the distance to frontier scores for the recovery rate and the strength of insolvency framework index.

We also control for the specific features of the legal system. Data for each country are provided by University of Ottawa, JuriGlobe-World Legal Systems (<http://www.juriglobe.ca/eng/syst-onu/index-alpha.php>). The dummy variable takes value 2 for countries with a common law system, 1 for countries with mixed systems and 0 for those having a civil law system.

Figure no. 1. Kernel (Epanechnikov) fit for protection of minority investors and IFRSs' adoption



Source: Data processed by the authors

Preliminary *kernel fit* for protection of minority investors and IFRSs' adoption suggests that there might be a reverse U-shaped connection between these two variables (Figure no. 1). However, a more detailed analysis is required.

3. Results and comments

3.1. OLS and Stochastic Frontier estimates

We initially run a preliminary an OLS regression. The results are reported in Column 1 of Table no. 2.

Table no. 2. Protection of Minority investors and IFRSs' adoption

A) Full sample: 109 countries

	(1)	(2)	(3)
	OLS	Stochastic Frontier Analysis (SFA)	Instrumental Generalized Method of Moments (GMM)
IFRSs adoption dummy	90.261*** (28.687)	90.263*** (23.675)	227.942*** (75.836)
IFRSs adoption dummy squares	-41.614*** (14.295)	-41.614*** (11.699)	-109.133*** (37.790)
Common Law dummy	-52.837*** (18.706)	-52.837*** (18.735)	-70.199*** (23.622)
Common Law dummy squares	26.145** (10.742)	26.145*** (9.978)	32.585*** (12.483)
Getting Credit variable	0.356*** (0.094)	0.356*** (0.088)	0.323*** (0.094)
Resolving Insolvency variable	0.465*** (0.086)	0.465*** (0.082)	0.442*** (0.078)
Number of observations	109	109	109
R-squared	0.784		
Wald χ^2		396.12 (Probability=0.000)	
Likelihood-ratio test of null that is no <i>technical inefficiency</i> component		$\chi^2=0$ (Probability=1.00)	
GMM C statistic χ^2			5.765 (Probability=0.056)
Hansen's J χ^2			2.181 (Probability=0.536)

B) OECD countries: 35 countries

	(1)	(2)	(3)
	OLS	Stochastic Frontier Analysis (SFA)	Instrumental Generalized Method of Moments (GMM)
IFRSs adoption dummy	98.168*** (21.658)	98.168*** (35.612)	100.394** (46.291)
IFRSs adoption dummy squares	-38.304*** (8.877)	-38.304** (17.305)	-33.657 (22.115)
Common Law dummy	-54.731*** (16.231)	-54.731 (35.040)	-64.098*** (17.722)
Common Law dummy squares	20.666** (9.175)	20.666 (17.991)	21.605** (9.762)
Getting Credit variable	0.048 (0.234)	0.048 (0.151)	-0.368 (0.228)

Resolving Insolvency variable	0.126 (0.334)	0.126 (0.223)	0.015 (0.251)
Number of observations	35	35	35
R-squared	0.718		
Wald χ^2		88.96 (Probability=0.000)	
Likelihood-ratio test of null that is no <i>technical inefficiency</i> component		$\chi^2=0$ (Probability=1.00)	
GMM C statistic χ^2			1.179 (Probability=0.555)
Hansen's J χ^2			2.131 (Probability=0.345)

C) Non-OECD countries: 74 countries

	(1) OLS	(2) Stochastic Frontier Analysis (SFA)	(3) Instrumental Generalized Method of Moments (GMM)
IFRSs adoption dummy	95.750** (37.733)	95.747*** (29.584)	300.574*** (98.120)
IFRSs adoption dummy squares	-44.770** (18.629)	-44.770** (14.568)	-147.844*** (48.545)
Common Law dummy	-59.602*** (22.592)	-59.602*** (22.600)	-82.991** (35.547)
Common Law dummy squares	29.525** (13.667)	29.525** (12.052)	40.369** (17.888)
Getting Credit variable	0.405*** (0.117)	0.405*** (0.112)	0.382*** (0.122)
Resolving Insolvency variable	0.452*** (0.107)	0.451*** (0.105)	0.431*** (0.110)
Number of observations	74	74	74
R-squared	0.805		
Wald χ^2		305.12 (Probability=0.000)	
Likelihood-ratio test of null that is no <i>technical inefficiency</i> component		$\chi^2=0$ (Probability=1.00)	
GMM C statistic χ^2			6.326 (Probability=0.042)
Hansen's J χ^2			1.787 (Probability=0.618)

Notes: Dependent variable: *Protecting Minority Investors* ranks from *Doing Business* index. A greater value reflects a worst situation of minority protection. Robust estimates for OLS. C-statistics (Hayashi, 2000) tests the endogeneity of IFRS adoption dummy. It is robust to heteroskedasticity, autocorrelation, and clustering. The null is that IFRSs' adoption is exogenous. According to the values of the test, such null can be rejected. For SFA estimates: a production frontier model. The non-negative distribution component (a measurement of inefficiency) is assumed to be from a half-normal distribution Kumbhakar and Lovell (2000). For GMM estimates, the considered instruments are: Foreign Direct Investments (net inflows, % GDP; averages of all available data between 2000 and 2013), three regions dummies and a dummy for European Union membership. Hansen's (1982) J statistic test whether the instruments are uncorrelated with the error term. It also tests if the equation is misspecified and that one or more of the excluded exogenous variables should actually be included in the structural equation. According to this test, the null hypothesis that our instruments are valid cannot be rejected.

Source: Data processed by the authors

As these results highlight, the impact exercised by the status of IFRSs adoption on the protection of minority investors is statistically significant at 1%. Such impact appears to be a reverse U-shaped one: as the status of IFRSs adoption moves from “non-adoption” to “partial adoption”, the minority investors’ protection seems to be worsening in relative terms. The mix of IFRSs and national GAAP makes less transparent the information flow and does not seem to support a better assessment of minority investors’ situation. With the shift to “full adoption” of IFRSs, the situation clearly seems to improve. ‘Full adoption’ contributes to the ‘extent of disclosure’ and ‘ease of shareholder suits’ (access to documents and other evidences in case of trials). However, one can notice that such effect displays a certain degree of asymmetry, as reflected by the levels and squares coefficients. In other words, the beneficial effect of IFRSs’ adoption can be better evidenced for high ranks of minority shareholders’ strength of protection. Still, the ‘net’ effect of IFRSs’ adoption on minority rights is largely positive.

From the control variables, the distinctive features of common law-based legal systems provide a strong support for minority shareholders’ protection. This effect is U-shaped: countries with mixed legal systems benefit from better minority shareholders’ protection. Particularly, the favourable impact of the legal system’s architecture and practices seems to be stronger in countries combining elements of common law with civil or Muslim law.

The overall conditions of the borrowed financial resources’ markets, as are these captured by the strength of credit reporting systems and the effectiveness of collateral and bankruptcy laws in facilitating lending, contributes to a significant improvement in the ranking of a country, in terms of minority investors’ protection. The same type of effect is exercised by the way in which a country deals with the weaknesses in the existing bankruptcy law and the main procedural and administrative bottlenecks in the insolvency process.

Furthermore, we investigate the possibility of several frictionary mechanisms leading to a relative inefficiency of the associated transmission channels for the considered explanatory variables. Such factors can be, for instance, related to the severity of asymmetric information issues between majority and minority investors, imperfections of

financial markets’ institutions and mechanisms or to social and cultural practices and norms. Also, they can be related to regional trends or international organizations and institutions’ membership. For testing, we involve a *Stochastic Frontier Analysis* (SFA) framework.

In the respective framework, a perturbation to the structural model is assumed to incorporate two components (see Kumbhakar & Lovell, 2000). The first component is assumed to have a strictly non-negative distribution and it is labelled as the *inefficiency term*, while the second component (*the idiosyncratic error* displaying a normal distribution) is assumed to have a symmetric distribution. The existence of the first term lowers the outcome of the ‘production factors’ or, alternatively, raises the costs associated to a given outcome level. We involve a ‘production function’ for minority protection and a time-invariant parameterization of the *inefficiency term*. A one-sided generalized likelihood-ratio test (see Gutierrez et al., 2001) is applied and such test tends to accept the null of no inefficiency component: there is no shortfall of the observed protection of minority shareholders as output from maximum feasible output that can be obtained by taking into account the ‘production factors’ represented by the considered explanatory variables. In this case, the stochastic frontier model tends to generate results close to an OLS model with normal errors. Indeed, the SFA preserves all the results of the OLS with close values of the corresponding parameters (Column 2 of **Table no. 2**).

3.2. Reverse causality check

One might argue that there is a potential reverse causality issue in the specification of our model: the implied causality can run both ways between IFRSs’ adoption and minority investors’ protection. A strong pro-business economic and social environment can support the adoption of IFRSs, for a further enhancement of transparency and an improvement in financial information quality. In such case, ordinary linear regression generally produces biased and inconsistent estimates (Greene, 2012; Wooldridge, 2010). In order to deal with such problem, we use an instrumental-variables regression with *Generalized Method of Moments* (GMM) method (Hall, 2005). It involves some moment or *orthogonality* conditions and allows for heteroskedasticity in errors.

We instrument for the potential endogeneity of IFRSs' adoption by considering several variables. We use, as instruments, *Foreign Direct Investments* (FDI): net inflows, % GDP, averages for the time span between 2000 and 2013, as provided by World Bank, 2014. There are evidences in the literature of dual connections between the status of IFRSs' adoption and the existing and expecting FDI (see, for instance, Márquez-Ramos, 2008; Ramanna & Sletten, 2009): a country is more likely to adopt IFRSs, if it's trading partners or geographically neighbouring countries are IFRSs' adopters. Based on similar arguments, we consider as instruments three regions' dummies (for America, Asia, Africa). In order to reflect the consequences of IAS Regulation, adopted by the European Union in 2002, a dummy for European Union's membership is used. The results are reported in Column 3 of **Table no. 2**.

First, we test to see if the endogenous regressors are in fact exogenous. For such, the OLS estimator is more efficient. Depending on the strength of the instruments, the loose in efficiency, by using an instrumental-variables estimator, can be significant. However, the *C statistic* (also called 'difference-in-Sargan statistic'; robust to heteroskedasticity, autocorrelation and clustering; Hayashi, 2000) shows that this is not the case. The null that IFRSs' adoption is exogenous, in respect to the considered instruments, can be rejected. These instruments appear to be correspondingly correlated with the included endogenous regressors, but uncorrelated with the error term. Second, since our model is an over-identified one (implying that the number of additional instruments exceeds the number of endogenous regressors), we can test whether the instruments are uncorrelated with the error term. Also, we test if the model is misspecified and that one or more of the excluded exogenous variables should actually be included in the structural equation. According to the Hansen (1982) test, the null hypothesis that our instruments are valid cannot be rejected. Overall, we accept that IFRSs' adoption can be seen as at least partially endogenous in respect to minority shareholders' protection and we consequently correct for this in the GMM framework

Here, the key results are maintained: the *reverse U-shaped* effect exercised by IFRSs' adoption is present at a statistical significance of 1%. Still, as a result of the corrections for OLS estimators' biases and due to that the instrumental-variables' estimators exhibit lower biases – since the instruments are strongly correlated

with the endogenous variable – the occurring amplitude of the corresponding parameters is higher in comparison with OLS and SFA estimates.

The same applies for the *U-shaped* associated with the common law dummy, while, in this case, the increases in parameters in comparison with OLS and SFA estimates are less substantial. For *Getting Credit* and, respectively, *Resolving Insolvency* the results are comparable with the ones previously obtained.

All together, these findings indicate that, in the full sample of 109 countries, the positive effect of IFRSs' adoption on minority investors' protection is robust across estimation methods and its amplitudes exceeds those associated with the characteristics of the legal systems, conditions of borrowed financial resources' markets and insolvency resolution procedures.

3.3. Robustness check: OECD versus non-OECD countries

One question that can be raised in relation to our results is: how robust remain our results if the overall development status for the considered countries is taken into account? In order to provide an assessment, we split our full data sample in two sub-samples: for OECD and, respectively, non-OECD countries. The results are show in Panel "B" and Panel "C" of Table no. 2.

For OECD countries, OLS and SFA estimates for the effects of IFRSs' adoption show the same profile as for the full sample. Still, in GMM framework, the non-linear effects are no longer statistically significant, while the significance for levels' coefficients is 5% and the corresponding amplitude is half that of the full sample (and around one third compared to the non-OECD countries).

The characteristics of the legal systems maintain the *U-shaped* effect for OECD countries. Still, if these are statistically significant in OLS, their significance is lost in SFA. For the GMM estimates, the non-linear component is significant only at 5%, with lower breadth/span of the induced effects in relation to the full sample. Interestingly, the significance of conditions of borrowed financial resources' markets and insolvency resolution procedures is completely vanished in OECD data sample. For these countries, the two control variables play virtually no role in explaining the protection of minority investors' rights.

For non-OECD countries, the impact of IFRSs' adoption is significant at 1% across all estimation methods and the corresponding amplitude is somehow larger compared to the full sample. With the exception of non-linear components of legal systems' distinctive features, which are significant at 5%, all the control variables display a statistical significance of 1% and induce similar effects as in full sample, with a relatively higher dimension.

4. Conclusions

Overall, there are some clear structural differences in the nature, efficiency and consequences of the involved transmission channels between OECD and, respectively, non-OECD countries. So, it can be argued that the global development level modulates the impact of the considered variables on the minority shareholders' protection. One can advance the argument that a higher level of economic development is usually associated with a strong supportive business environment (including a well-articulated and effectiveness protection of minority investors). However, this argument should be nuanced, since the influence of IFRSs' adoption is preserved with different ranges and significance in both samples. In other words, even if a consistent system of minority

protection is already in place, the IFRSs' adoption can still contribute to its further enhancement.

Probably the most important policy implication of our findings consists in the idea that the adoption of IFRSs strongly supports the protection of minority investors' rights. Also, our results draw attention to the fact that best results are achieved for the full adoption of international standards, while the mix of these with national standards leads to a less clear effect.

Furthermore, a design of the legal system based on common law does not automatically guarantee the best protection of minority investors. Rather, a mix of common and civil / Muslim laws performs better in respect to such outcome.

Finally, an improvement in lending market conditions as well as efficient mechanisms for insolvency resolution can support the protection of minority investors especially in developing countries.

The existence of the bi-univocal relationship between IFRSs' adoption and the distinctive features of the business environment suggests that even if IFRSs' adoption is an exogenous policy measure, the ex-ante existence of a corresponding architecture of the business environment can contribute to the *de facto* implementation of IFRSs. This last connection requires further analysis.

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Auditor Selection in Borsa Istanbul

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Abstract

The objective of this study is to examine the effect of firms' characteristics and audit quality in Turkey. This study provides additional insights for audit quality literature by examining how firms characteristic effect on clients' incentives and abilities to demand high audit quality in Turkey. Turkey is one of the less developed and most under-researched capital markets in the world. This study used the data of 146 firms listed in Borsa Istanbul (BIST) over the period from 2011 to 2015. Using logistic regression, the findings explained that clients' incentives and abilities to demand high audit quality weaken because of control-ownership wedge, which an unfavourable outcome for minority shareholders. Thus, this study proposes that regulators, particularly the Capital Market Board of Turkey (CMBT), should increase law enforcement to enhance good corporate governance in Turkey to accommodate the unique features of wedge firms and provide a protected environment for minority shareholders.

Keywords: statutory audit, audit quality, listed firms, Turkey

JEL Classification: M42, G15

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1. Introduction

Recently, audit market competition leads to increase the need to acknowledge the issues that affect client's decision in term of auditor selection. Previous literature addressed auditor selection decision extensively. DeFond & Zhang (2014) argue that auditor selection is encouraged from three potential bases are client characteristics, firms' characteristics and audit environment. Previous studies addressed auditor choice came from developed countries and particularly US and some in other developed markets for instance New Zealand (Firth & Smith, 1992a), Australia (Craswell, 1988) and the UK (Beattie & Fearnley, 1995). This study going to be among few exceptions for instance, auditor selection study conducted in the context of Turkey by Onder, Aksu, & Balci (n.d.) that addresses auditor choice process in Borsa Istanbul (BIST). It is the first study to focus on the auditor choice process in Turkey after the communique on independent Auditing Standards in Capital market (Serial: X, No: 22). Client's demand for external auditor have been changed as a result of new communique from CMB in 2006 which defines the legal requirements and auditor independency, regulates audit quality services by determining audit scope, identify the audit tenure and introduces local auditing standard in line with the audit international standards (Karaibrahimoglu, 2013; Mustafa, Che-Ahmad, & Chandren, 2018). Based on the Communiqué, firms listed in BIST are required to engage with independent auditor in order to audit the financial statements. Consequently, the Turkish commercial code has been delivered from 2012 in order to enhance the effectiveness of corporate governance, audit service and financial reporting quality.

This study aims is to examine the empirical relationship between auditor choice and auditees characteristics for the Turkish listed in BIST for 2011 to 2015. The basis of this research is derived upon the different levels of client's demand for audit quality. This study concentrates on determining the strength of the relationship between auditor selection and clients' characteristics. Furthermore, this study examines the credibility of audit firms measured by Big4 and Non-Big4 in the perspective of firms listed in BIST. The process of auditor choice is a worldwide issue because of different levels of client's demand for high audit quality. This would encourage audit firms to make better markets targeting decisions. Similarly, firms might select high quality auditor or a

particular kind of auditor as a sign of the quality of the firms.

2. Demand for audit quality

The elements influencing the demand for financial statement audits have been addressed in auditing literature for many years. The demand for different levels of audit quality rely upon different levels of conflicts between managers and owners (Jensen & Meckling, 1976). Agency conflicts levels illustrates the quality of audit services required to enhance management credibility. Previous studies argued that agency conflicts might be decreased by increasing managerial ownership of the firms (Jensen & Meckling, 1976). This indicates that the preference for audit quality decrease since managerial ownership increase. As *managerial ownership* increases in a firm, the need for higher quality audits decrease since the self-interest of the management would not diverge from that of outside stockholders. Using management share ownership as a proxy for agency costs, Simunic and Stein (1987) study the relationship between the percentage of non-management ownership of the firm and the choice of auditor quality as proxies by brand-name reputation in firms making an initial public offering. They observe a significant positive relationship between the percentage of non-management ownership and the choice of Big-Eight auditor. DeFond (1992) also finds that changes in managerial ownership are associated with changes in audit quality. Moreover, clients demand for high audit quality differ depend on the degree of conflict between owners–managers and owners–debt-holders (Jensen & Meckling, 1976). Thus, *client firm leverage* represents as another driver of agency conflicts. Managers might expropriate debt holders' wealth since they favor the interests of stockholders (Jensen & Meckling, 1976). Therefore, independent external auditor and restricted debt contracts are required as a monitoring mechanism. This is because audit function increases the credibility of accounting and financial information utilized to verify compliance with debt agreements.

The strength of the agency conflict determines extend to which the quality of audit is required to enhance management credibility. Demand for the external monitoring increases as a result of increase in the percentage of debt in the capital structure of the firm (Mustafa, Che Ahmad, & Chandren, 2017). Palmrose

(1984) suggest that the existence of long-term debt agreements enhance client demand for audit quality. Defond (1992) report a significant positive relationship between the existence of debt in the capital structure and clients tendency to demand high audit quality and this view is align with that provided by Firth and Smith (1992a). On the contrary, many studies such as Francis and Wilson (1988) and Simunic and Stein (1987) document a negative relationship between the existence of long-term debt in the capital structure and the selection of high audit quality proxies by Big4 auditor. This is because that Big4 auditor is more likely to deal with audit inherent risk with high present of leverage in the capital structure.

A review literature of audit quality and agency conflict is provided by Defond (1992) who review literature in order to understand inherent problem in the literature and what is required to be learned going forward. The finding of study by Mohammed (2018) indicates that larger firms and companies issuing new securities are more likely to engage with high audit quality proxies by Big-4 firms.

The aforementioned study conducted in US and many others in the UK and Australia. Very view studies conducted in the other countries. For instance, a study by Manalis and Citron (2000) addressed Greek audit market. The study examined the relationship between client characteristics and clients demand for high audit quality in term of Big4, second tier and local audit firms after the radical regulatory changes in Greek audit market in 1992. The client characteristics examined are control-ownership wedge, leverage, size and profitability for years 2011 to 2015. The study findings indicate that clients issue dual class shares are less likely to hire Big4 auditor than Non-Big4 auditor and it is significant at 1% level of significant. Furthermore, the average percent of return on assets, firm size and leverage is greater for clients hire Big4 auditor than clients hire Non-Big4 auditor.

3. The variables and the hypotheses

Previous literature found a relationship between clients' demand for strong external monitoring mechanism and clients' characteristics. This study concentrates on client characteristics for instance, control-ownership wedge, firm size, leverage and return on assets, as a degree of agency conflict.

3.1. Dependent Variable: Big4 versus other types of audit firms

Big4 uses as a proxy in this study to measure audit quality. This study propose dichotomies variable to measure audit quality, it coded 1 if the client hire Big4 auditor, otherwise 0 (DeAngelo, 1981a, 1981b). There are many reasons which promote this study to use Big4 auditor to measure audit quality. First, Big4 audit firms provide more quality audit than non- Big4 and this is the public perception regarding Big4 and nonBig-4. This comes from the idea that Big4 audit firms have more access to the knowledge and resource than non-Big4. Secondly, Big4 audit firms are more conservative to protect their reputational capital through adapting higher quality standards than non-Big4 audit firms (Balsam, Krishnan, & Yang, 2003; Caramanis & Lennox, 2008; Francis, 2004).

3.2. Independent variables: Client firm characteristics

3.2.1. Control-Ownership Wedge

Ownership structure (e.g. dispersed and concentrated ownership) has a substitution or complementary influence with board composition to monitor management activities via engagement with external monitoring mechanisms such as audit quality (Desender et al., 2013). This study combines agency theory and resource dependency theory to illustrate the board's incentive and ability to oversee management actions and reduce agency conflicts between majority shareholders and minority shareholders. Clients' incentive and the ability to monitor management activities in terms of hiring high audit quality is two-fold, namely, the alignments of interest and entrenchment effects.

According to alignment interests the board of directors and audit committee have a strong incentive to hire high audit quality on the grounds that controlling shareholders have strong incentives to enhance the contracting terms with other parties. Whereas, based on negative entrenchment effects the board of directors possess weak incentive to demand high audit quality in order to avoid realising any material misstatement in the financial reports and decrease the inherent litigation risk. This is because controlling shareholders tend to jeopardise minority shareholders' wealth. A review of the literature for audit quality by DeFond and Zhang (2014) proposes

that agency conflicts are the most important driver for clients' to demand high audit quality. This indicates that firms suffering severe agency conflicts possess strong incentives to demand high audit quality (Mohammed & Saeed, 2018).

Previous evidence documents that clients' selection of the external auditor derives from clients' preferences for auditor characteristics, whether that be auditor size or industry specialist auditor. There are few studies that support this argument, because most studies document that agency conflicts are considered as a better explanation for clients' incentives demand for high audit quality (DeFond & Zhang, 2014). It is of interest to extend the agency cost scope to carry out further investigation into the factors enhancing the clients' demand for high audit quality such as ownership structure. This indicates that the demand for strong external monitoring via high audit quality is contingent on the ownership structure; for example, the control-ownership structure (wedge) in Turkey. Thus, there is a need to examine the effect of control-ownership wedge on audit quality. For that reason, this study hypothesised that there is a relationship between control-ownership wedge and audit quality. Therefore, based on the aforementioned, this study's hypotheses are:

H1: There is a relationship between wedge and audit quality.

3.2.2. Firms size

Previous studies hypothesize a positive relationship between firms' size and auditor choice in term of high audit quality. This is because previous studies perceive that firm size is an indicator for the extent of agency conflicts (Abbott & Parker, 2000, Firth & Smith, 1992b, Francis & Wilson, 1988, Simunic & Stein, 1987, Healy & Lys, 1986). A study by Manalis and Citron (2000) examining Greece context find that firm size is positively impacts on the client demand for high audit quality in term of Big4 auditor at 10 percent significant level. On the other hand, larger firms might receive more attention from Big4 audit firms (Berton, 1995). Additionally, larger firms might have received better services from a myriad of specialized and professional advisors; hence, the might not receive the same quality services when they engage with Non-big4 audit firms. Moreover, the big firms might ask additional professional services for

instance, legal services, consultation and tax services. Etc. and Big4 firms possess more capabilities to supply this kind of services. Based on above discussion, it could be suggested that there is a positive relationship between clients' size and clients demand for high audit quality in term of auditor selection. This study will use natural log of total assets as proxy to measure clients' firm size.

H2: There is a positive relationship between client firm size and high audit quality.

3.2.3 Leverage

In an agency frame, scholars' report agency cost exacerbates as a result of high debt percentage capital structure. This leads to increase clients demand for high external monitoring mechanism (DeFond & Zhang, 2014). The same view is provides by Li, Cho, and Wu (2014) that's high agency cost proxy by leverage increase the demand for high audit quality in terms of brand name auditor. Previous literature hypothesized and tested the relationship between clients tendency to hire high quality auditor and agency cost peroxided by leverage ratio to capital (Watts & Zimmerman, 1986). Ashbaugh and Warfield (2003); Craswell, Francis, and Taylor, (1995); Francis and Wilson (1988); Fan and Wong (2005) report a positive relationship between clients demand for high quality audit and leverage. This is because high reputational auditor have sufficient abilities to diversify away the risk related to high leverage ratio (Johnson & Lys, 1990). An addition, DeAngelo (1981) report that reputational auditor are more likely to provide high quality audit services. That's large auditor with high number of clients is more exposure to lose their clients in case of any failing to discover the breach and report the breach in clients accounting system. Nevertheless, Francis and Wilson (1988a) report a negative relationship between reputational auditor and leverage. This is support by both of Healy and Lys (1986b) and Johnson and Lys (1990) that there is a negative relationship between high debt level and audit quality. This is because firms structure their capital with high leverage ratios are more likely to switch to a lower quality audit services. Hence, there is inconsistent of previous studies results about the

relationship between leverage and clients demand for high quality auditor. Therefore, based on the aforementioned, the hypothesis is:

H3: There is a relationship between leverage and high-quality audit

3.2.4. Return on Assets (ROA)

Our profitability measure return on assets is measured as the ratio of net income to total assets and provides an idea of the overall return on investment earned by the firm. In other words, it measures how effectively management uses the assets under its control to generate income, regardless of how these assets are financed. Mustafa et al. (2017) identify ROA as a variable that may be related to auditor choice. Consistent with this argument, Abbott and Parker (2000) hypothesize that ROA is positively related to engagement of an industry specialist auditor, since a more profitable firm is more likely to pay the fee premium demanded by a specialist. They indeed find a positive, but not significant, correlation between ROA and industry specialist auditors. Manalis and Citron (2000) however, did not observe a significant difference between the ROA levels of two clients of the two groups of auditors- the Big-Six vs. the non-Big-Six- in the Greek market. They also find that the Big- Six clients are indeed more profitable compared to those of second tier audit firms, but surprisingly, the clients of local audit firms have higher (but insignificant) ROA than those of second tier audit firms. Accordingly, the hypothesis is:

H4: There is a relationship between leverage and high-quality audit

4. Methodology

All Turkish listed firms are used as the population for this study. The sample used in this study covers five years 2011 to 2015 period. The data are included by sectors, with nine main sectors. The sample consists of non-financial Turkish listed firms. There are several reasons to choose public Turkish listed firms, namely, the annual reports are publicly available and can be easily accessed via the BIST website. The second reason is that the data published via annual reports are suitably presented based on the firms' commercial code and

GAAP. The initial sample comprises of 411 firms, including banks and financial institutions (Mustafa, Che-Ahmad & Chandren, 2017). These kinds of industries are excluded from the sample because they are governed by different regulations and corporate governance codes (Zulkarnain, 2009). There is one reason behind the selection of this study period, this is because of new Turkish commercial code has been issued, effective from July, 1, 2012.

This study dependent variable is measured by categorical variable (Big4), thus logistic regression is utilized to examine the influence of a set of independent variables on dependent variable. Pallant (2011) propose three assumptions applied in logistic regression for instance, sample size, multicollinearity and outliers. Sample size classified as a logistic regression assumption (Julie Pallant, 2013). The sample size of this study is 146 firms with an average of 36 firms for each independent variable. The proper percentage required is about 10 observations for each explanatory variable as proposed by (Pallant, 2007).

It is very necessary to confirm that the data is free from multicollinearity problem before starting with the findings of regression analysis. The multicollinearity problem present when one or more independent variable/s are highly correlated with each other that might influence negatively on the findings of the regression analysis (Hair, Anderson, Babin, & Black, 2010). Generally, Variance Inflation Factor (VIF) is represents as the most utilized tool to evaluate multicollinearity for each independent variables (Pallant, 2011). Currently, the literature does not addressed any cut-off point to use as a sign for the existence of collinear repressor/s (Alsaeed, 2006). Nevertheless, some scholars proposed that the researchers could be aware of the value of VIF of more than 10, that is reflects high multicollinearity problem. On the other hand, the researcher might depend on the level of tolerance factor (1/VIF) to make a decision on multicollinearity. Theoretically, the tolerance factor illustrates the level of corresponding of independent variable's variability that is not illustrated by other explanatory variable in the regression model. According to tolerance factor the collinearity problem present when the value of 1/VIF is less than 0.10 (Pallant, 2011). **Table no. 1** shows the results of VIF and it shows that there is no indicator of multicollinearity problems. The VIF results of all independent variables and control variables are not greater than 5, and far

below the threshold value of 10, as proposed by (Hair et al., 2010), as a result this assert to the absence of multicollinearity problem.

Table no. 1. Variance Inflation Factor (VIF) and Tolerance Factor (1/VIF) Tests

Variable	VIF	1/VIF
WEDGE	1.18	0.848761
FSIZE	1.40	0.716455
LEVE	1.14	0.879643
FAGE	1.14	0.873398
Mean VIF	1.68	

Notes: WEDGE = Control-ownership wedge. FSIZE = Natural log of firm size. LEVE = leverage. FAGE = Natural log of firm age.

Source: Own projection

Nevertheless, the data are not affected by any multicollinearity problem, panel data method has the capability to overcome such problem, if it is present, as it is an effective method to generate many more degree of freedom that might assist to reduce any collinearity problem (Baltagi, 1998; Hsiao, 2003). The third assumption of logistic regression is the outliers. Outliers represent a unique combination of values across number of variables or observations that are unusually low and high value on a variable that will distort statistics (Hair et al., 2006). Standardized residual cases less than -3.3 and more than 3.3 represents as outliers (Pallant, 2007). In this study, the minimum standard residual is -2.38 and the maximum standard residual is -2.40 and this indicates that this study doesn't have any outliers. **Table no. 2** displays the standard residuals for Big4 audit firms as a dependent variable in this study.

Table no. 2. Residual Statistics-Test of Outliers

	Minimum	Maximum	Mean	Std. Deviation	N
Residual	-0.968	0.964	0.008	0.404	724
Std. Residual	-2.408	2.383	0.000	1.000	724

Source: Own projection

Based on Hosmer Jr, Lemeshow, and Sturdivant (2013) linearity is not an assumption in term of logistic regression. Nevertheless, the odd ratio must be linear with the logit value. As such linearity tests on continuous variables are preceded to check for linearity violations. A particular procedure under STATA, the lincheck procedure¹ displays that continuous variables in this study possess add ratios that are linear with the logit value. Therefore, the linearity is not obvious.

4.1. Model specification

To address the research objective of this study, this study model investigates the relationship between firms'

¹ Lincheck procedure provides a quick-and-dirty check of whether a continuous covariate in a general linearized model (GLM) in linear in the link function. Lincheck makes a new categorical variable that breaks the continuous covariate into quartiles, then re-estimates the GLM using dummy variables for the quartiles, and finally provides a graph of estimated coefficients plotted against the midpoints of the quartiles. A linear graph supports the assumption of linearity of the continuous covariate. Lincheck works with most GLM commands such as logit/logistic and probit model.

features (control-ownership wedge, firm size, leverage and firm age) and audit quality. This study's hypotheses outlines are examined using the following model.

$$AUD_{it} = \beta_0 + \beta_1 WEDGE_{it} + \beta_2 FSIZE_{it} + \beta_3 LEVE_{it} + \beta_4 FAGE_{it} + \epsilon_{it}$$

Where:

For each firm (i) and each year (t)

AUD_{it} = Audit quality. A dichotomous variable is used to examine the hypotheses variables.

FSIZE= Firm size

LEVE= Leverage

FAGE= Firm age

ϵ_{it} = Error term supposed to be normally scattered with constant differences.

5. Results and discussions

This study investigates empirically the effects of clients' characteristics on audit quality of firms listed in BIST.

This section shows the descriptive statistic, correlation matrix and multiple regressions of independent variables and dependent variable. Descriptive statistics and univariate test results for binary variables (e.g. WEDGE) the divergence in proportion is identified in **Table no. 3**. *Chi-square* test¹ explains the divergence in proportions of the binary variables between the both groups of firms. The *Chi-square* test is used for categorical having a number of categories and there is no agreed method to order those from the lowest to highest (Idre, 2017). The result of the *Chi-square* test for the distribution differences between WEDGE and non-WEDGE firms exposes that Big4 and non-Big4 selection is a statistically significant at 1% ($\chi^2 = 56.9964$; $p = 0.000$). The results explain that the auditor selection in the environment of Turkey is driven by the presence of WEDGE (divergence between control rights and cash flow rights). The number of clients hire non-Big4 auditor and Big4 auditor is about 94 and 211 respectively, for non-WEDGE firms. While firms practice WEDGE and hire non-Big4 auditor are about 248 firms and WEDGE firms hire Big4 auditor are about 171 firms.

Table no. 3. Descriptive Statistics (Frequency) and Univariate Test Results for Dummy Variables for WEDGE and Audit Quality

	Non-WEDGE	WEDGE	Total
Non-Big4	94	248	342
Big4	211	171	382
Total	305	418	724

Pearson $\chi^2(1) = 56.9964$ Pr = 0.000

Note: for categorical variables (i.e. WEDGE) (tabulate Big4 non-WEDGE, χ^2) has been employed to report the χ^2 and P-value.

Source: Own projection

Then it is evident that WEDGE firms display higher frequency in regards to engage with non-big4 audit firms. The *Chi-square* test show that WEDGE is significant determinant of client's demand of high audit quality. Controlling shareholders might get strong incentive to expropriate minority shareholders wealth as a consequence of their negative entrenchment effect (Desender et al., 2013). Controlling shareholders possess adequate incentive and ability to monitor management directly instead of depending on external monitoring and hold them accountable for activities not aligned with their interests (Bohinc & Bainbridge, 2001). This means that there is significant relationship between WEDGE and audit quality. The result is consistent with that of (Chien et al., 2008; Fan & Wong, 2002) in the context of Taiwan and East Asia respectively. Also, this study finding in align with the Turkey environment (Ararat, Aksu, and Tansel Cetin, 2015b).

Table no. 4 shows the number of observations, mean, standard deviation, min and max for of firm size, leverage, and firm age. The average firm size (FSIZE) measured by total assets of the firms in this study sample is (1,904) Turkey Lira (TL) (\$5,277 at \$1= 3.608) with a standard deviation of 2.608 and a minimum value of 1.433 and a maximum value of 2.608.

The mean ratio of total debt to total assets (LEVE) of the firms in the sample is 0.481 (0.279 percentage the standard deviation) with a minimum of 0 and a maximum of 1.707. The mean level of firms age (FAGE) is 33.825 with a minimum and maximum value (1 & 80) respectively. This range is very close to study conducted by Gacar (2016) in the context of Turkey that reported a mean value of 39.910 and standard variation of 15.211 and a minimum of 0.60 and a maximum of 81.00.

Table no. 4. Descriptive Statistics of Continuous Variables

Variable	Obs	Mean	Std. Dev.	Min	Max
FSIZE	724	1.904	1.781	1.433	2.608
LEVE	724	0.481	0.279	0	1.707
FAGE	724	33.825	15.856	1	80

Source: Own projection

¹ *Chi-square* test is used in order to compare the average ranks of WEDGE firms and Big4 audit firms. This test is fit for non-parametric tests for categorical variables instead of *t*-test. A normal distribution of the mean variances is the assumption of the *t*-test. Categorical variable is one that has two or more

categories and there is no intrinsic ordering to the categories. For instance, hair colour is a categorical having a number of categories (e.g. brown, blonde, red ... etc.) and there is no agreed method to order those from lowest to highest.

Table no. 5 displays the correlation between this study variable. The general overview indicates that the correlation between variable is less than 0.80 (the

threshold value). This infers that the multicollinearity between variables is at low level.

	Big4	DUSH	FSIZE	LEVE	FAGE
Big4	1.00				
DUSH	-0.28	1.00			
FSIZE	0.39	-0.22	1.00		
LEVE	0.16	-0.13	0.24	1.00	
FAGE	0.25	-0.15	0.10	-0.06	1.00

Source: Own projection

Table no. 5 shows that WEDGE has negative correlation with audit quality. While FSIZE, LEVE and FAGE positively correlated with audit quality in term of brand name auditor.

(control-ownership wedge, firm size, leverage and firm age). The relationship between control-ownership wedge and the Big4 is very highly significant at 1% level of significance $p = 0.000$ ($t = -4.82$); with a very strong impact (Table no. 6). This influence is effective at 83.7%.

Table no. 6 shows that about 18% of the differences in the audit quality are explained by firms' characteristics

Variable	Coeff	T-Value	Probability
DUSH	-0.837	-4.82	0.000
FSIZE	0.471	8.42	0.000
LEVE	0.692	2.13	0.033
FAGE	0.656	4.54	0.000
R ²	0.18		
Prob>chi ²	0.000		

Source: Own projection

The implication is that wedge can influence the appointment or non-appointment of Big4 auditors by some 83.7%. A critical evaluation of the coefficients also shows that the type of the relationship that exists between the two is negative. This shows that the influence of wedge strongly discourages the appointment of Big4 auditors; because this relationship is highly significant and very strong it should be considered very reliable by management. The evidences align with this study results was documented by previous empirical studies (Jong-hag Choi, 2008; Kim & Yi, 2006). The result supports Hypothesis 1. As anticipated, FSIZE proxies by natural log of total assets positively influence on clients demand for high quality auditors. The level of significant of FSIZE is at 1% level of significance ($t = 8.42$). Besides, the degree of influence on Big4 is

47.1%. This result is inferred to mean that big sized firms are more likely to engage with high quality auditor in terms of Big4 audit firms. Consistently, Karaibrahimoglu (2013) reports that large firms issue high quality financial reports in order to obtain additional resource of money (capital) and attracts more investors, that's in turn, require strong external auditors. The result supports Hypothesis 2.

Table no. 6 displays that LEVE has significant positive influence on clients incentive to hire Big4 ($t = 2.13$; $p = 0.033$). The level of significant is at 5% level of significance. The result reflects that firms have high ratio of debt to total assets are more likely to acquire strong external monitoring mechanism. Previous literature by Abbott and Parker

(2000); Adeyemi and Fagbemi (2010) and Hope, Kang, Thomas, and Yoo (2008) report that firms with high ratio of leverage are more likely to hire strong monitoring mechanism. They infer that there is a positive relationship between leverage and high-quality audit services. Financial risk and agency conflicts between agent (managers) and principle (shareholders and debt holders) is high for firms with high proportion of debt to capital structure. Thus, high audit quality is required in order to protect debt holders' rights from managers' expropriation (Ashbaugh & Warfield, 2003; Francis & Wilson, 1988). Thus, the result supports Hypothesis 3. **Table no. 6** also displays that FAGE has high significant positive relationship with clients' incentive to demand Big4 audit firms. The significant level is at 1% level of significance ($t = 4.54$). This is because old firms have got enough experience to enhance the quality of their financial reports (Shan, 2014). Furthermore, older firms are more likely to be controlled by family founders and this could enhance their entrenchment effects (Liu, Ahlstrom, & Yeh, 2006; Wong, Chang, & Chen, 2010). Therefore, in order to create protected environment for investors particularly minority shareholders, older firms are more likely to hire Big4 audit firms. This argument aligns with previous studies by (Arosa, Iturralde, &

Maseda, 2010; Anderson, Mansi, & Reeb, 2003). The result supports Hypothesis 4.

6. Conclusion

The discussion addressed above has revealed that control-ownership wedge possesses negative influence on clients' ability to demand high audit quality of Turkish listed firms. FSIZE, LEVE and FAGE have positive influence on clients' ability to demand high quality audit services. This is because control-ownership influence not only on director's incentive to monitor, but also their abilities to do so. Thus, the study infers that control-ownership wedge has significant impacts on clients' incentive and ability to demand high audit quality. The research therefore, recommends policy makers to introduce unique definition and measurements of corporate governance to accommodate the unique feature of control-ownership wedge firms listed in BIST. The study also recommends further studies that could include more data, inclusion of other variables of corporate governance at before and after regulatory changes in 2012 for comparison of clients' demand before and the aftermath.

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Internal auditing quality in the banking sector of Kosovo

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Abstract

Among the factors affecting the quality of internal auditing in banks are the auditors' competence, objectivity and performance. In order to verify this assertion, the authors have reviewed the relationship between the internal auditor's competence, objectivity and performance and the quality of internal audit in the commercial banks of Kosovo. To reach the research objectives and test the hypotheses, a questionnaire was compiled, which was sent to internal auditors of all Commercial Banks of Kosovo. The results of this research provide evidence that the internal auditors in Kosovo's commercial banks consider the objectivity, competence and performance as major factors that affect the quality of the internal audit (IA) function. Based on these papers results the authors recommend that Kosovo's commercial banks should ensure the availability of main resources to achieve a better functioning of the internal audit department and its function.

Keywords: internal auditing, characteristics of the auditor, internal audit quality, internal control system, Kosovo

JEL Classification: M41, M42

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1. Introduction

The *Internal Audit Department (IAD)* is an important part of the corporate governance structure within the bank. The Corporate Governance includes those supervisory activities performed by the Board of Directors and the Audit Committee to ensure the integrity of the financial reporting process and the achievement of the objectives set out by the management.

The corporate governance body of knowledge has set out four monitoring layers which exist in every corporate entity: External Audit, Internal Audit, Board of Directors, as well as the Audit Committee¹. The functioning of *internal audit* can be seen as *the first line of defence* for preventing bad corporate governance and inadequate financial reporting in the banking sector. With the right support from the Board of Directors and the Audit Committee, *the internal audit staff* may be in a better position to gather information on inappropriate accounting practices, inadequate internal control and inadequate corporate governance². Therefore, it can be argued that the more objective, competent and efficient in performing its duties, the internal audit staff is, the better it serves its defensive role within the bank.

The research studies of *internal audit quality and factors affecting its effectiveness*, especially in banking sector, are not much investigated in the Western Balkan countries. This research, aims to review the major factors that have an impact on the quality of internal audit in the banking sector in Kosovo. Factors such as: objectivity, competence of internal audit staff and their performance have been put into test, in order to find out if there is any relationship between these major factors and the quality of internal audit function in the banking sector in Kosovo.

2. Literature review

This part deals with the literature review in the area of internal audit function related to the topic of this research.

The research paper of Gramling et al. (2004)³ examined the literature on the role of internal audit in corporate

governance. The findings from this review are that the analysis of the role of internal audit function in corporate governance uses the quality assessment by the external auditors, and the factors of this support decision, the scope and nature of its work are supported by the external auditors.

Through his research paper, Hermanson (2006)⁴ explained the importance of focusing on the proper functioning of the internal audit for fraud detection and risk management. As a requirement, internal auditors should consider four key areas: assessing modern business trends, information technology, risk management, and contributing to the growth of the company. The findings from this research are that the internal audit function has expanded from its traditional role as a financial audit to a new role as a management audit focusing on adding value to the company, reflected in the risk management and the implementation of the risk-based approach to auditing; and the quality of the internal audit function plays an important role in the realization of this new role. Eisa's research paper⁵ determined the factors that affected the quality of internal audit functionality to improve the quality of corporate governance. The author revealed that enhancing the appropriateness of internal auditors through increasing the level of education, increasing the level of professional experience, and increasing the level of training would **lead to increased internal audit quality**. Also, increasing the objectivity of internal auditors through increasing the level of independence leads to increased internal audit quality.

In addition, the authors Ahlawat and Lowe (2004)⁶ through their research paper came to the conclusion that the functioning of internal audit was changed from the traditional oversight function into a function that consisted of a large number of activities that added value to the entity organization.

Author AbdulAziz Alzeban (2013)⁷, through his study of 239 internal auditors, investigated the factors affecting

¹ The IIA (2003a) "Simply, Good Business" – High Tone, August 2003.

² R. I. (Bob) Tricker, Robert Ian Tricker, "Corporate governance: Principles, policies, and practices", 2015, UK.

³ Gramling, A.A, Maletta, M. J, Schneider, A. and Church, B. K. (2004). 'The Role of Internal Audit in Corporate Governance', *Journal of Accounting Literature* – Volume 23: Page. 194-244.

⁴ Robert D. Allen, Dana R. Hermanson, Thomas M. Kozloski, and Robert J. Ramsav (2006). Auditor Risk Assessment: Insights from the Academic Literature, *Accounting Horizons*: June 2006, Vol. 20, No. 2, pp. 157-177.

⁵ Eisa, S.K (2008). 'Determinants of Internal Audit Quality to Improve Corporate Governance Empirical Study', *Journal of the Faculty of Commerce for Science Research*, Publication 45, no. 1. gif.1-57.

⁶ Ahlawat, S.S. and Lowe, J (2004). 'An Examination of Internal Auditors' Objectivity' *Auditing: A Journal of Practice & Theory*, Vol.23 Nr. 2, p.147-160.

⁷ AbdulAziz Alzeban, (2013). "Factors affecting the internal audit effectiveness: A survey of the Saudi public sector", *Journal of International Accounting, Auditing and Taxation*, Volume 23.

mostly the quality and effectiveness of internal auditing. The study suggests that the management support for internal audit quality drives the effectiveness of internal audit function. The study also suggest that competence is a major factor affecting the quality of internal auditing.

Another study conducted by Drogalas George (2015)¹ on the internal audit quality and the factors affecting it, finds out that the main factors affecting internal audit effectiveness are: (1) quality of internal audit, (2) competence of internal audit team, (3) independence of internal audit and (4) management support. The results of his research also reveal that the independence of internal audit is the foundation of the internal audit effectiveness, as it is the most crucial factor in their model.

3. Conceptual framework

3.1. Concepts

Internal audit is defined as the independent, objective and advisory security, designed to add value and improve the organization's operations. Internal Audit helps an organization meet its objectives by bringing a systematic, disciplined approach to assessing and enhancing the effectiveness of risk management, control and governance processes (IIA, 2011)².

The internal audit, as a process, is influenced by the Board of Directors, Management and other staff, which are designed to provide reasonable assurance on achieving the organization's objectives in different categories and also, the internal audit is a key element of the financial reporting reliability, effective and efficient organization operations, and compliance with applicable laws and regulations (COSO-Internal Control³).

It can be argued that the review of the quality of internal audit in a bank requires internal audit activities. Therefore, although internal audit and internal control

should be assessed separately, they should also be evaluated on a complementary basis. The function of internal audit can assess and review the appropriateness and efficient internal controls in the banking environment. Hence, the internal auditors are primarily responsible to offer the audit committee and board of directors of the bank with the information about the efficiency and effectiveness of internal control within the bank operations. The internal audit activities can be considered as a first line of defence and an important internal control activity with its role in detecting fraud and error, which reflect the loss of revenue and assets.

Among the most important factors that determine the effectiveness of internal audit function in a bank are: the current "position/placement" of the internal audit function within the bank; the purpose of its operation; the authorized access to each type of information, documentation, notes and records; independence and objectivity; competence; oversight and monitoring of internal audit professionals; and the compliance of internal auditors with the international standards on internal audit as issued by the Institute of the Internal Auditors (The IIA). In the recent years, the Internal audit function has changed its 'idea' as not being an only internal control tool, but a 'wider' and more comprehensive one. Based on the findings of the very well-known authors Staciokas & Rupsys⁴, the internal auditors' role has been enhanced to include also assessing the future risks the bank may face, by consulting senior management in this regard. The authors also found out that all the internal parties within the bank (top management, board of directors and audit committee) must have adequate knowledge about the internal audit function.

3.2. Internal Audit Quality (IAQ)

The International Standards for Auditing (ISA) and the International Standards for Internal Audit (ISIA), for both internal and external auditing, have identified the factors needed to ensure the quality of internal audit functionality. Based on the AICPA standard nr. 65, the quality factors of internal audit functionality include (AICPA, 1991)⁵:

¹ Drogalas George, (2015) "Factors associated with Internal Audit Effectiveness: Evidence from Greece", *Journal of Accounting and Taxation*, Volume 5. 2015, Article Number: 9A5352054234.

² Institute of Internal Auditors (IIA), (2011). 'International Standards on Professional Practice of Internal Auditing', obtained from the URL: <http://www.theiia.org/guidance/standards-and-guidance>.

³ Committee of Sponsoring Organizations of the Treadway Commission (COSO), Internal Control— Integrated Framework: Volume I, Executive Summary, pp 500 – 501.

⁴ Staciokas, R, and Rupsys, R. (2005). 'Internal Audit and Its Role and Its Role in Organizational Governance'

⁵ American Institute of Certified Auditors (AICPA) – 'Internal 'Internal Auditors' Auditing of Financial Statements' Standard no. 65, New York, 1991.

- (i) Competence; measured by the level of education and professional designations the auditor has achieved during his career.
- (ii) Objectivity; measured by the parties to whom the internal audit department is accountable to and to whom they report on a regular basis;
- (iii) The quality of performance of duties; which is measured by the accuracy and appropriateness of the audit programs, and the scope of the audit.

Similarly, based on the Standards of the Institute of Internal Auditors (IIA, 2003b¹) there are identified the factors of the quality of internal audit functionality, which are:

- (i) Capacity,
- (ii) Independence and
- (iii) Objectivity

The audit committee and the external auditor (based on the International Standards of Auditing) should evaluate the quality of internal control including the assessment of the quality of the internal audit function within the entity. It should be added that the Standards of the Institute of Internal Auditors (the IIA) require that the head of internal audit department improve the quality of internal audit functionality, which includes the periodic assessment of the quality of internal audit functionality².

4. Research

4.1. Research methodology

This scientific research is conducted according to the statistical analysis methods, content analysis, and to achieve its research objectives it is based on primary data and secondary data. The secondary data for this research is provided through references, similar research published by other universities and international internal auditing standards issued by the IAASB and the IIA. The primary data are provided through the questionnaire, which is designed and compiled in order to fit all the elements described in the previous sections.

To achieve the objectives of this paper, we applied the descriptive statistics technique along with the content

¹ IIA (2003b), "Survey results: Impact of Sarbanes-Oxley Act on Internal Audit," February 25, 2003

² International Standard of Internal Auditing No. 1300 – Quality Assurance and Improvement Program, including sections 1310 and 1311.

analysis. The questionnaire consists of two parts, the first part includes demographic characteristics, while the second part includes the attitudes of respondents regarding each element examined in this research, and it was adapted from the author Ghassan. F. Al Matameh (2011)³. We applied the five-degree LIKERT system, which represented the most used and appropriate method for statistical analysis of data obtained through the questionnaire. Each answer was allocated a weight starting from (5) for the answer to 'fully agree', (4) 'agree', (3) 'neutral', (2) 'disagree', and (1) completely disagree'. This questionnaire was sent to all internal auditors of the commercial banks in Kosovo, including the Central Bank of Kosovo (CBK). During the part of statistical data analysis, the arithmetic mean, standard deviation and percentages were used.

4.2. Research Hypotheses

Therefore, based on the conceptual framework and the theory regarding the internal auditing quality (IAQ) discussed in section 3.2, we developed the following hypotheses:

H1: *There is a correlation between the competence and the quality of internal audit.*

H2: *There is a correlation between the objectivity and the quality of internal audit.*

H3: *There is correlation between the quality of internal audit performance and the audit quality.*

4.3. The sample of Internal Auditors and the regression model

The comprehensive population of this research includes all internal auditors in the commercial banks in Kosovo, including the Central Bank of Kosovo (CBK). The questionnaire was sent electronically and out of a total of 23 auditors (100% of the population), the number of valid questionnaires for analysis is 17. Therefore, the total percentage of the population involved in this research is 74%, which is enough to extrapolate the findings for the entire population for the Kosovo banking sector. The small number of internal auditors can be considered as a limitation of this study and the findings should not be generalized to other Western Balkan countries.

³ Ghassan. F. Al Matameh, Factors Determining the Internal Audit Quality in Banks: Empirical Evidence from Jordan, 2011.

To analyse the factors affecting the internal audit quality we applied this statistical model known as the multiple regression model, which was used by multiple authors (i.e. Eisa 2008¹; Suwaidan and Qasim 2010²)

$$QIA = \beta_0 + \beta_1KO + \beta_2OB + \beta_3PE + e$$

Where:

QIA – Quality of Internal Audit;

β_i – Regression coefficient, $i = 0, 1, 2, 3$;

KO – Competency;

OB – Objectivity;

PE – Performance;

e – error;

Independent Variables:

- Competence: measured with the attributes set out in Table no. 2.
- Objectivity: measured with the attributes set out in Table no. 3.
- Performance: measured with the attributes set out in Table no. 4.

Dependent Variables:

- Quality of internal Audit: measured with the attributes set out in Table no. 5.

5. Research results

5.1. Research methodology

Based on the data obtained from the first part of the questionnaire we noticed (Table no. 1) that 6 or 33% of respondents had completed the bachelor level, while 11 or 64.7% had completed the master level. Regarding the field of study, the vast majority of respondents have specialization in accounting (8 or 47.1%), while 6 or 35.3% of them have specialization in finance, and the rest of 17.6% has other specializations such as Banking, Retail and Technology Management. From the table it can be seen that the vast majority of respondents, 52.9%, have had an audit experience for more than five years. This fact *adds credibility to findings* of this research. So, we conclude that based on this information or these features, respondents were qualified to respond to the research questions and we could rely on the answers received from them to reach our conclusions on the research objectives.

Table no. 1. Qualification, Specialization and Experience of IA

Variable	Categories of the variable	Frequency in number	Frequency in percent (%)
Qualification	High School	0	0.0%
	Bachelor level	6	35.3%
	Master level	11	64.7%
Specialization	Accounting	8	47.1%
	Finance	6	35.3%
	Other	3	17.6%
Experience in internal audit	Less than 5 years	5	29.4%
	From 5 to 10 years	9	52.9%
	From 10 to 15 years	4	17.6%
	From 15 to 20 years	0	0.0%

Source: Own projection

¹ Eisa, S.K (2008). 'Determinants of Internal Audit Quality to Improve Corporate Governance – Empirical Study', *Journal of the Faculty of Commerce for Science Research*, Publication 45, no. 1 .gif.1-57.

² Suwaidan, M.S., and Qasim, A (2010), 'Supporting external auditors in internal audits and their impact on audit fees – Empirical Case', *Managerial Auditing Journal*, Publication. 25, Nr. 6, page. 509-525.

5.2. Descriptive statistics

The internal auditor's competence (Table no. 2):

Five factors were used regarding the qualification and education of the auditors. Based on the results of the study, most of the internal auditors emphasized the following important elements: the level of education, the

practical work and the knowledge of the internal policies and procedures of the bank, the level of professional designation, the level of technical expertise and continuous professional education (CPE). The simple mean of respondents' responses in this category is high, reaching 4.5122, while the standard deviation is 0.3215.

Table no. 2. Competence of internal audit staff

Paragraph	Mean	Standard deviation
– The internal auditor education	4.7160	0.4891
– Professional experience in internal audit and knowledge of processes, procedures they operate	4.8111	0.3616
– Level of professional certification (eg, Certified Auditor, Certified Internal Auditor, and similar)	4.4215	0.7312
– The internal auditor's preparation and technical training	4.2516	0.6126
– Updating and ongoing training	4.3612	0.4145
Total	4.5122	0.3215

Source: Own projection

Objectivity of the internal auditor (Table no. 3):

Six factors were used regarding the objectivity of the auditors. Based on the results of the study, most of the internal auditors emphasized the following important elements: direct linkage with top management; assignment, promotion, remuneration and dismissal of internal auditors from the audit committee; the freedom of auditors to have access to

all departments of the bank; the independence of the internal audit department; the freedom of internal auditors to carry out all necessary internal audit procedures; the existence and accessibility of the audit committee without interference. The simple mean of respondents' responses in this category is high, reaching 4.1778, while the standard deviation is 0.4812.

Table no. 3. Determining factors of objectivity in internal audit

Paragraph	Mean	Standard deviation
– The IA communicates directly with top management of the bank.	4.7870	0.4940
– Assignment, promotion, remuneration and termination of internal auditors from the Audit Committee or management.	3.9120	1.2210
– The freedom to have access to all departments of the bank.	4.1550	0.8616
– The independence of IA staff from other departments of the bank.	3.7220	1.1051
– The freedom provided to IA to carry out all necessary internal audit procedures.	4.2110	0.5622
– -The existence of the audit committee and access to it without interference.	4.2800	0.7291
Total	4.1778	0.4812

Source: Own projection

Performance of the internal auditor (Table no. 4):

Six factors were used regarding the performance of the auditors. Based on the results of the study, most of the

internal auditors emphasized the following important elements: the completeness and appropriateness of the internal audit working papers; the completeness and appropriateness of the scope of the internal audit work;

the level of internal auditors' care in carrying out audit procedures; support of auditors by management; assessing the performance of quality by outsiders from those who have practical experience in this field. The

simple mean of respondents' responses in this category is high, reaching 4.5969, while the standard deviation is 0.3215.

Table no. 4. Determining factors of performance in internal audit		
Paragraph	Mean	Standard deviation
– The completeness and appropriateness of internal audit programs.	4.5911	0.5121
– The completeness and appropriateness of scope of internal audit work.	4.8812	0.4451
– The level of internal auditor's care when carrying out audit procedures.	4.5517	0.6912
– Support of auditors from management.	4.7712	0.4312
– Evaluating the performance of quality by outsiders from those who have practical experience in this field.	4.2155	0.7791
– Ensure asset protection from errors, irregularities, and ensure accurate, inclusive and timely annual reports.	4.5712	0.7812
Total	4.5969	0.3215

Source: Own projection

Quality of internal audit (Table no. 5):

Six factors were used which reflected the quality of an internal auditor. Based on the results of the study, most of the internal auditors emphasized the following important elements: ensuring the protection of assets from misappropriation and misuse; providing accurate, inclusive and timely annual reports; providing the

necessary information to external auditors, management and related committees; the application of international accounting standards (IAS) and international financial reporting standards (IFRS). The simple mean of respondents' responses in this category is high, reaching 4.5501, while the standard deviation is 0.2891.

Table no. 5. Quality factors of IA		
Paragraph	Mean	Standard deviation
– Providing asset protection from errors and irregularities.	4.5591	0.5151
– Ensure accurate, inclusive and timely annual reporting.	4.8124	0.4102
– Provide the necessary information to external auditors, management and related committees.	4.6122	0.6851
– Focus on completing the audit and implementation of audit approach according to risk principle.	4.3157	0.6216
– Application of IAS and IFRS.	4.5891	0.5155
– Assessing the administrative performance and its plans to achieve the objectives of the organization.	4.4124	0.5712
Total	4.5501	0.2891

Source: Own projection

5.3. Testing the hypotheses

In this part of the research, the results of testing the hypotheses are reported using the statistical model explained in section 4. We also tested the correlation between all the elements specified in the previous section and the quality of internal audit in the commercial banks in Kosovo. Based on the results

presented in Table no. 6, with regard to "Competence", the calculated value of "B" is 0.455 at the level of significance of 0.00, while the calculated value "T" is 4.251, which is higher than the indexed value of 1.96, which implies the viability of the model. The value of the standard "Beta" regression coefficient is 0.521, indicating that the change of a single independent

variable value leads to the change of the dependent variables to 0.521. Based on the beta coefficient, we

accept as scientifically proven the first hypothesis.

Table no. 6. Statistical analysis results

Independent variables	"T"	"B"	"Beta"	"Significance"
Competence	4.251	0.455	0.521	0.000
Objectivity	4.663	0.315	0.550	0.000
Performance	7.315	0.661	0.739	0.000

Source: Own projection

In addition, with regard to "Objectivity", the calculated value "B" is 0.315 at the level of significance of 0.00, whereas the accrued value "T" is 4.663, which is higher than the indexed value of 1.91, which means the model's eligibility. The value of the standard "Beta" regression coefficient is 0.550, which indicates that the change from one point of the value of Objectivity leads to the change of the dependent variable in the value of 0.550. Based on the beta coefficient, we accept as scientifically proven the second hypothesis.

In addition, with regard to "Performance" variable, the calculated value "B" is 0.661 at the significance level of 0.00, while the calculated value "T" is 7.315, which is higher than the indexed value of 1.96, which implies the viability of the model. The value of the standard "Beta" regression coefficient is 0.739, indicating that the change of a single independent variable scale leads to a

change in the dependent variable in the value of 0.739. Based on the beta coefficient, we accept as scientifically proven the third hypothesis.

Table no. 7 – "Regression results" – presents the research outcome following the application of independent regression variables in the dependent variables. The results are highly significant (Value F = 20.314, P = 0.000) with a corrected R² of 0.538, which means that 53.8% of the changes in the internal audit quality can be explained through three independent variables included in this model that we researched. The coefficient of the variables is positive, thus highlighting a *positive relationship between the quality of the internal audit and the independent variables*. Based on the information analysed above we can summarize that there is a straight-line correlation between the competence, objectivity, performance and the quality of the internal audit.

Table no. 7. Regression results

	"R"	"R ² "	"R ² corrected"	"F"	"Significance"
IAQ	0.742	0.550	0.538	20.314	0.000

Source: Own projection

Conclusions

The results of the research suggest that the internal auditors of the banks in Kosovo consider the *competence, objectivity and performance* of internal auditors as important factors that affect the *quality of internal audit*. It was identified that "Performance" had the highest average value of 4.5969, followed by "Competence" with an average value of 4.5122 and "Objectivity" with an average value of 4.1778. The regression results point out that the internal audit performance is the crucial variable which affects the dependent variable quality of the internal audit of 68.4%

(adjusted R²), competence is the second variable with 45.1% (adjusted R²) and objectivity is the lowest factor which determines the quality of internal audit with 33.7% (adjusted R²).

The small number of internal auditor responses can be considered as a limitation of this study and the findings should not be generalized to other Western Balkan countries. The sample size, even though it covers 74% of all internal auditors working in the banking sector of Kosovo, is considered low from the statistical point of view.

Based on the research we recommend to the commercial banks of Kosovo to work on a continuous basis to ensure the availability of resources in order to

achieve the quality of the internal audit function. In addition, we propose them to perform external and internal assessments of the internal audit function as foreseen by the International Standard of Internal Auditing No. 1300 – Quality Assurance and Improvement Program, including sections 1310 and

1311, as issued by the Institute of Internal Auditors (the IIA).

Future research can be aimed at investigating a much higher number of internal auditors working in the banking sector from all the Western Balkan countries, and to compare the results.

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