

audit

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The Use of Audit Opinion in Estimating the Financial Reporting Transparency Level

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ABSTRACT

Information presented to stakeholders through a system of standardized indicators and transparency in financial reporting are the basis in the decision-making process for a sustainable development of the companies. The purpose of this study is to analyze and assess the transparency in financial reporting, assessed based on the audit opinion, and the influence of determinant factors on transparency, using logistic regression. The determinant factors are expressed by principal dimensions of financial statements identified through the Principal Component Analysis applied on the indicators of position and performance. The observed sample consists of 62 companies listed on Bucharest Stock Exchange during the period 2011-2016. The main results reveal the existence of three principal components of the financial statements, Cash flow component, Return component and Current assets structure component; among these dimensions, only the return component has significant influence on transparency in financial reporting assessed through the audit opinion.

Keywords: sustainable development, transparency, financial reporting, audit opinion, principal component analysis, logistic regression

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1. Introduction

During the last decade, companies were encouraged by United Nations (UN) members' governments to adopt the principles of sustainable development in their corporate governance act (Labuschagne, Brent, and van Erck, 2005). The use of these principles leads companies to achieve some objectives regarding the environment protection, social equity and economic prosperity (Bansal, 2005). The result of achieving these objectives by the companies is reflected through transparency in the reporting the sustainable development (Heemskerk *et al.*, 2002). Under the stakeholders' pressure, the analysis of this type of information allows the evaluation of the sustainable performance (Heemskerk *et al.*, 2002).

Transparency in the environmental reporting of company aims to present the activities related to prevention and control of the environment pollution (Heemskerk *et al.*, 2002). As for the social equity, the transparency in companies' reporting must ensure the disclosure of the company's activity in the field of social responsibility (Heemskerk *et al.*, 2002). For the third dimension, the economic prosperity, the transparency considers the disclosure, in a standardized form, the faithful representation of the financial position and performance, according to a reporting framework (Patel *et al.*, 2002).

By ensuring compliance with an applicable reporting framework, transparency in financial reporting leads to a reduction in information asymmetry (Hayes *et al.*, 2005). The compliance with the reporting framework is confirmed by a third part, an independent and objective professional, namely a (financial) auditor. Within his engagement, the scope of the financial auditor is to provide an opinion on the quality of the information from the financial statements of the audited company, regarding the financial position and performance, according to the applicable accounting standards (IAASB, 2016).

The purpose of this study is to analyze and evaluate the influence of the financial statements' dimensions on the transparency in financial reporting. In this study, we propose assessing transparency of the financial statements using the auditors' opinions, assuming that financial statements are transparent if an unqualified opinion or an unqualified opinion but with insignificant observations are provide by the auditors.

A first objective of this study is to determine the information content, by estimating the dimensions of the financial statements. A second objective involves the analysis and assessment of the financial statements dimensions' effect on ensuring transparency in financial reporting.

The study was carried on a sample of 62 Romanian companies, listed on the Bucharest Stock Exchange (BSE), between 2011 and 2016. The study results revealed the existence of three dimensions of financial statements, identified by principal component analysis and the estimation of each dimension's influence on the transparency in financial reporting, using logistic regression analysis, based on audit opinion.

Further, the study is structured as follows: section 2 – Literature review and hypotheses development, section 3 – Research methodology, section 4 – Results and discussions, section 5 – Conclusions.

2. Literature review and hypothesis development

Sustainability reporting at the corporate level requires a transparent disclosure of the companies' activity, having as reference the reporting requirements included in the Global Reporting Initiative (GRI) (Ortas, Alvarez, Garayar, 2015). Sustainability and integrated reporting represent important global trends that cannot be achieved without the support of accountants, in their position as producers of financial information, but also as auditors (James, 2014). An analysis of this type of information allows the assessment of sustainable performance (Labuschagne, Brent, and van Erck, 2005; Visser, 2002), and the degree to which social and environmental elements reported by the listed companies are useful to all stakeholders in decision making.

2.1. Sustainable development reporting

Implementation of sustainable development principles to all business levels has allowed companies to obtain competitive advantages compared to companies that do not apply such principles (Lopez, Garcia, Rodriguez, 2007). Therefore, optimal decisions in a business can only be made by considering all economic, social and environmental consequences (Labuschagne, Brent, van Erck, 2005; Hockerts, 1999). However, assigning

resources to investments taking into account sustainability objectives implies a cost or reallocation of resources that may negatively affect the firm's performance (Lopez, Garcia, and Rodriguez, 2007; Orlitzky, Schmidt, and Reynes, 2003).

Evaluation of entities contribution to sustainable development can be achieved based on information reported by the company on Corporate Social Responsibility (CSR) (Lungu et al., 2011; Farcaș, 2015). CSR involves organizing business by applying the principles of corporate social responsibility, ensuring a balance between the firm's activities, environment and society (Fauzi, Svensson, Rahman, 2015).

Through Directive 2014/95/EU on disclosure of non-financial information and diversity Undertakings by Certain large companies and groups companies are recommended to present, in the reports of those in charged with governance, information about policies, risks and achievements in terms of the environment, employees and other social elements, human rights, fighting corruption, diversity management structure. The stated purpose of this kind of complementary financial reporting is to provide stakeholders a clearer picture of overall performance of companies.

Sustainability information is published often in a voluntary manner and without enough control from independent institutions (Lackmann et al., 2012). But the credibility of sustainability reporting and performance ensure the usefulness and relevance of information to investors and help to establish the market value of a firm (Lackmann et al., 2012). To ensure credibility, by Directive 2014/95/EU it is recommended the need to audit these reports in order to express an opinion by the auditor on such non-financial information published by eligible companies.

In the case of sustainability reporting, indicators that are used should provide the necessary information on the manner in which the company contributes to sustainable development (Krajnc & Glavic, 2005a; Azapagic & Perdan, 2000; Azapagic, 2004). However, only some of the sustainability indicators used to assess corporate sustainable development have an integrated approach taking into account environmental, economic and social aspects (Singh, Murty, Gupta, & Dikshit, 2009).

The relationship between indicators of performance and those of sustainability has been studied by many authors

(Bansal, 2005; McWilliams & Siegel, 2000; Preston & O'Bannon, 1997; Stanwick & Stanwick, 1998; McGuire, Sundgren & Scheneweiss, 1988). For measuring the progress and the performance of companies towards sustainable development systems specific methodologies of core and supplemental indicators are necessary (Krajnc & Glavic, 2005b). The sustainability indicators that are used to assess corporate sustainable development are based on composite index (Singh, Murty, Gupta & Dikshit, 2009).

2.2. Financial disclosure and the usefulness of financial information

Financial reporting must ensure to all the users a faithful representation of the financial position and performance of the companies during a financial year. The financial position and performance, as well as the information regarding the cash flows of companies are reflected in the standardized parts of the companies' financial statements (IAS 1, IASB, 2015). These financial statements include information that can reduce the uncertainty regarding the evolution of the companies and are useful to stakeholders in decision making process (Arrow, 1984, p. 138, quoted in Shapiro & Varian, 1983).

Financial statements can meet the information exigencies of the shareholders and ease the communication of the financial information, with significant impact on planning and coordinating the activities within the company (Palttala & Vos, 2012). By knowing certain elements regarding the profitability, the cost of the used capital, the indebtedness or solvability degree of a listed company, investors can decide on buying or selling the shares of that company for a certain price. The result of the meeting of the offer and the demand for certain shares, the price can be also influenced by the yield they offer (Modigliani & Miller, 1958).

The standardization efforts of financial reporting are also determined by the need of ensuring qualitative CSR. For better information of stakeholders, the implementation of the IFRS (International Financial Reporting Standards) intend to lead to an improvement of financial information quality (Barth et al., 2008) and also of the non-financial one, with direct impact on the CSR. But informational the need is different for each category of stakeholders, and this diversity could represent a barrier for the

materialization of the CSR development efforts (Tschopp&Nastanski, 2014).

Improving the information quality through IFRS led to an implicit increase on its relevance for investors (Barth, 2008). But according to the types and dimensions to which they disclosed, financial information has a different relevance for investors, with a variation of the influence on the share price or market capitalization (Ohlson, 1995; Sloan, 1996; Brown *et al.*, 1999; Barth *et al.*, 2008).

In Romania, the transition to the IFRS in the individual financial statements of listed companies was made in a very short period of time (the norm was published in June 2012 for a mandatory application starting with the 2012 financial year). In fact, the application of IFRS in Romania was stimulated by the recommendations of the international financial organizations (the World Bank and the International Monetary Fund), as well as the affiliation of some Romanian companies to multinational groups whose reporting referential is represented by the IFRS (Bunget *et al.*, 2009). Initially, the transition to IFRS has had a significant impact especially in the individual accounts of Romanian listed companies (Ionașcu *et al.*, 2014). Subsequent studies revealed that the transition to IFRS led the Romanian listed companies to a slight increase in total equities, to a significant decrease in net income and operating income, which affected the values of profitability indicators (Săcărin, 2014; Istrate, 2014).

Although, by introducing IFRS, it was expected that in Romania to get a major increase of financial information quality, in the case of BSE listed companies there is a persistence of IFRS accounting policies versus RAS - *Romanian Accounting Standards* (Istrate, 2015). Based on these records it can be further considered that accounting result has a high relevance for investors, unlike other elements of financial statements (Filip & Raffournier, 2010).

2.3. Transparency in sustainability reporting and in financial disclosure

CSR reports are useful to stakeholders when they provide information regarding the whole activity of the company, in a transparent manner, not only with declarative objectives, or as a marketing and public relations tool (Boerner, 2011).

For measuring the transparency at the corporate level, it can be analyzed information from the annual reports,

grouped into three sub-categories: ownership structure and investors' relations, financial transparency and information disclosure, board and management structure and process (Patel *et al.*, 2002). From approximate 40 attributes retained for financial transparency and information disclosure, the most important are related to: the presentation of the applicable accounting rules, the analysis by business segments, the name of the audit firm, the audit report, the audit and non-audit fees, the efficiency indicators - ROA (return on assets), ROE (return on equities), NM (net margin) (Adiloglu și Vuran, 2012). Although transparency and disclosure do not necessarily lead to an increase in operational performance of companies, they improve the investors' perception on the company's governance, with direct implications on their market value (Stiglbauer, 2010).

Transparency in multidimensional reporting (financial, environmental, social etc.) also causes new problems to the auditors, who must express an opinion on the way in which such information are relevant to investors (Abeysekera, 2013). As for the financial information, transparency represents an important part of corporate governance, leading to the reduction of the informational asymmetry and to the increase of trust on financial markets, which contributes to the reduction of the cost of capital (Patel *et al.*, 2002; Stiglbauer, 2010).

Financial reporting obligations of listed companies are established by complex and precise set of rules regarding transparency of information to provide for stakeholders. Both American standards (US GAAP - Generally Accepted Accounting Standards United States) and international (IFRS) are becoming more comprehensive as dimensions and include more stringent reporting rules complementary to the financial ones. In addition, the annual financial statements are often, part of an annual report that includes non-financial issues related items disclosed voluntarily.

The conformity of financial information with the applicable accounting reporting framework is ensured by the independent, objective and competent opinion expressed by a financial auditor (Hayes *et al.*, 2005). The audit opinion is the most important section within the audit report, issued in accordance with ISA - International Standards on Auditing. The report issued by an auditor contributes to the improvement of transparency and the growth of the relevance of the information from financial statements, by including some elements related to the reporting quality, the going

concern assumption, the presence of the fraud risk and even to sustainable development (Jerry L. Turner, Theodore J. Mock, Paul J. Coram, and Glen L. Gray, 2010).

2.4. Hypothesis development

The purpose of financial reporting is to reduce the information asymmetry as the basis of faithful representation, to determine the business value and to facilitate the managers monitoring (Pinnuk, 2012). Applying a certain reporting framework may influence the reporting dimensions, with a direct impact on transparency and particularly on the profitability of companies shares (stock returns) (Morris *et al.*, 2011). Among the principles that are used in preparation and presentation of financial statements and the principles of sustainable development there is strong correlation (Dobre *et al.*, 2015). In this regard, assuring transparency in financial reporting should lead to transparency of sustainable development reporting at the corporate level.

Given the results presented in the literature, the main research hypothesis proposed for testing consider the following:

Research hypothesis: *the dimensions of the financial statements have a significant influence on the transparency in financial reporting, with direct impact on sustainable development.*

In a first step, the research objective is to identify the principal dimensions of the financial statements of companies that apply principles of sustainable development. Once identified dimensions of financial statements, in the second step there will be estimated their influence on transparency in financial reporting, to assess the impact on sustainable development.

3. Research methodology

To reach the research objectives, in this study we propose a statistical demarche to estimate the influence of the principal dimensions of the financial statements on transparency in financial reporting, with direct impact on the sustainable development. In this study, transparency in the financial reporting is evaluated based on the auditing opinion, expressed by the auditor in his issued report.

3.1. Research population an sample

Formulated research hypothesis will be tested on the population represented by Romanian companies listed on the Bucharest Stock Exchange (BSE). BSE listed companies should report, in all cases, annual financial statements for a period that covers the annual year. Financial statements of the BSE listed companies were to be made until 2012 according to the Romanian accounting standards (harmonized with the European directives), but, starting from 2012, companies were mandated to use the IFRS for their individual accounting. These financial statements of the Romanian BSE listed companies make the subject of mandatory auditing carried out by an independent auditor, member of the Financial Auditors Chamber in Romania, then making the subject of approval by the Shareholders' General Assembly (SGA). Romanian law stipulates, in principle, a limit term of 4 months from the end of the financial year, in order to publish the audited and approved annual financial statements.

At the end of the 2017 financial year (was considered this year because it represents the year of adoption of Law 162/2017), 84 companies were listed on the BSE section (24 in the *Premium* class and 60 in the *Standard* class). In our study we retained only 62 companies, after elimination of those whose activities are predominantly of financial (financial and monetary intermediates, mutual and investment funds) and those for which we have not found enough information. The period studied covers 2011 (the latest year of reporting under RAS), plus the period between 2012 and 2016, when the Romanian listed companies apply IFRS for individual financial statements. The analysis is performed on the individual financial statements because there are few BSE listed companies that consolidate their accounts. To ensure comparability of data collected, for a number of 372 observations (firms / year) in this study we used a balanced sample.

3.2. Variables and data source

Based on the structure of financial statements recognized under accounting standards (including IAS 1 - *Presentation of Financial Statements*) in **Table no. 1** we propose the analyzed variables.

Table no. 1. Independent variables used for the identification of the principal financial reporting components

Symbol	Formula
Eq/TA	Total equities/Total assets
TO/TA	Turnover/ Total assets
OI/TA	Operating Income/ Total assets
OI/TO	Operating Income/ Turnover
OI/Pay	Operating Income/Payroll expenses
NI/Eq	Net Income/ Total equities
NI/TA	Net Income /Total assets
NI/TO	Net Income/ Turnover
CFO/OI	Operating cash flows/ Operating Income
CFT/TO	Total cash flows/ Turnover
CFT/GP	Total cash flows / Gross profit
CFT/TA	Total cash flows / Total assets
FA/TA	Fixed assets/ Total assets
CA/TA	Current assets / Total assets
Cash/TA	Cash and cash equivalents/ Total assets
INV/CA	Inventories/Current assets
REC/CA	Receivables/ Current assets
Cash/CA	Cash and equivalents/ Current assets
LTD/TA	Long-term debts/ Total assets
FL	Total liabilities /Total equities

Source: Own projection

Variables from the **Table no. 1** are indicators, with informational content, that describe financial position and performance of the company and the cash flows statement. These variables are used to identify the principal dimensions of financial reporting.

To assess transparency in financial reporting, with direct impact on sustainable development, in this study we used the audit opinion. An unqualified opinion or an unqualified opinion but with no significant observations reveal transparency in financial reporting and compliance with applicable financial reporting framework (ISA 700 - IAASB). In other cases, when the audit reports contain modified opinions (a qualified opinion, an adverse opinion or the disclaimer of opinion) it is considered that transparency in financial reporting is affected.

For indicators calculated data were collected from the financial statements reported by companies on BSE website (bvb.ro) and on their websites.

3.3. Methods for data analysis

To identify the dimensions of financial reporting in the case of Romanian BSE listed companies, the study uses

the principal component analysis (PCA). The principal component analysis is a multivariate descriptive method (Lebart *et al.*, 2006) whose scope is to reduce the analyzed data, based on their common nature and to identify latent variables (Jaba & Robu, 2011). Through this method, starting from the initial X_i ($i = 1, \dots, n; n = 20$) set of variables, displayed in *Table 1*, we eliminate the existing collinearities and we determined a set of new variables. These m new components, C_j ($j = 1, \dots, m$), replace the original variables associated to financial reporting and have the following form:

$$C_j = \beta_{j1}X_1 + \beta_{j2}X_2 + \dots + \beta_{ji}X_i + \dots + \beta_{jn}X_n \quad (1)$$

and $m \leq n$.

Based on the *equation (1)* it can be seen that the new components (C_j) correspond to m dimensions of financial reporting and are determined as a linear combination of initial variables X_i . The C_j components comply with the assumption of independence that can be validated using statistical test χ^2 or using KMO statistics (Kaiser-Meyer-Olkin) which determines the intensity of the relationship between X_i variables (Jaba & Robu, 2011).

The KMO statistics has values in the [0,1] interval, where 0 shows the absence of a correlation between the initial variables, and value 1 signals the existence of a significant correlation [49]. The PCA estimates the (β_{ji}) parameters, which represent the contribution of each initial variable to the development of principal component (Jaba & Robu, 2011).

Once there were identified the principal dimensions of the financial statements, in the second part of the study the influence of these dimensions on transparency in financial reporting will be analyzed using logistic regression analysis. This type of analysis uses regression models with alternative variables (Dodge, 2007), in this case the existence or absence of transparency in financial reporting.

The logistic regression model proposed in the analysis is defined by the relation (Bourbonnais, 2011):

$$\ln[p_i/(1-p_i)] = \delta_0 + \delta_1 C_{1i} + \dots + \delta_j C_{ji} + \dots + \delta_m C_{mi} + \varepsilon_i \quad (2)$$

where p_i shows the probability of transparency existence in financial reporting, defined based on an unqualified opinion or unqualified opinion but with insignificant observations. $C_j (j = 1, \dots, m)$ are the components identified through the PCA, $\delta_j (j = 0, \dots, m)$ represent the coefficients of the logistic regression model and ε is the error component.

Logistic regression model parameters are estimated using maximum likelihood method (Dodge, 2007), and

their testing was made using the likelihood ratio, a Pearson χ^2 statistical test (Agresti, 2007).

To obtain research results, in this study the data analysis was performed using SPSS 20.0 statistical software.

4. Results and discussion

Starting from the research objectives proposed in the study, the main reached results consider the identification of the principal components of the Romanian BSE listed companies' financial statements, as well as the estimation of these components' influence on the transparency in financial reporting.

4.1. Identification of the principal components of financial statements

As a result of considering the 20 variables proposed in Table no. 1 in PCA, we identified the principal components of financial statements which explain 84.574% in the variation of the financial information reported by the Romanian BSE listed companies. A high value of the KMO test statistics (0.744) indicate the existence of a significant relation between the variables that remained in the analysis as a result of PCA use (Table no. 2).

Table no. 2. Identification criteria of the principal components of the BSE listed companies' financial statements

KMO = 0.744 Sig = 0.000	Total variance explained (rotated)			
	Component	Total	% of Variance	Cumulative
	C ₁	5.054	50.540	50.540
	C ₂	1.901	19.013	69.553
	C ₃	1.502	15.021	84.574

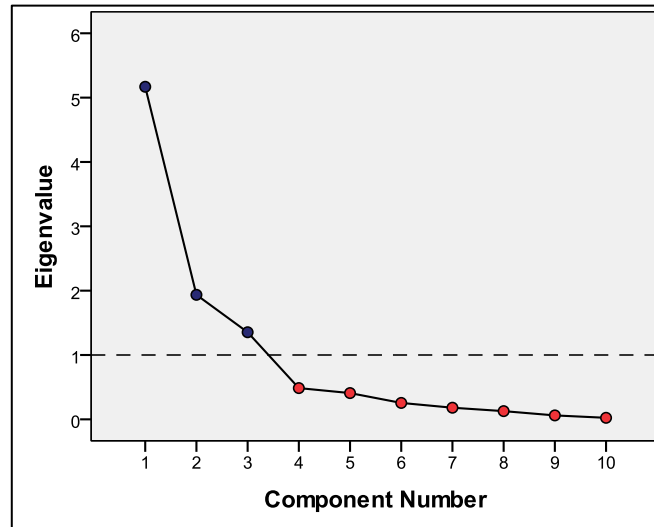
Source: Own processing in SPSS 22.0

To determine the number of principal components corresponding to the financial statements, the study uses Bénécri's criterion (Jaba & Robu, 2011). Thus, we identified 3 principal components that have eigenvalues higher than one.

Using the above-mentioned criteria, in this study there were identified 3 principal components that

are specific for the financial statements of the Romanian BSE listed companies (see Table no. 3 and Figure no. 1). The three (C_j) identified components meet the independence hypothesis, fact that is emphasized as a result of removing 10 variables which displayed collinearity from the 20 initial variables (X_i).

Figure no. 1. The number of principal components (Cj) identified through PCA



Source: Own processing in SPSS 22.0

Descriptive statistics corresponding to the variables considered in the PCA are displayed in **Table no. 3**. Variables retained in the analysis are used to define the

principal components of the Romanian BSE listed companies' financial statements.

Table no. 3. Descriptive statistics for the variables considered in PCA

Variable		Mean	Std. Deviation	Minimum	Maximum
Retained in the analysis	OI/TA	0.0122	0.0762	-0.1801	0.1359
	OI/TO	0.0122	0.1462	-0.3513	0.2347
	OI/Pay	0.1525	0.8250	-1.8123	1.6214
	NI/Eq	-0.0586	0.2513	-0.8241	0.1650
	NI/TA	-0.0019	0.0774	-0.1950	0.1217
	NI/TO	-0.0197	0.1705	-0.4447	0.2187
	CFT/TO	0.0132	0.0776	-0.1337	0.2065
	CFT/TA	0.0041	0.0365	-0.0774	0.0936
	INV/CA	0.2990	0.1955	0.0346	0.7187
	REC/CA	0.4652	0.2201	0.1065	0.7987
Excluded from the analysis	Eq/TA	0.5622	0.2905	-0.0288	0.9299
	TO/TA	0.6434	0.4097	0.1112	1.6036
	CFO/OI	1.0172	1.8956	-2.2776	5.9730
	CFT/GP	0.0540	1.2407	-3.0527	2.7842
	FA/TA	0.5801	0.2061	0.1932	0.9218
	CA/TA	0.4197	0.2056	0.0782	0.8016
	Cash/TA	0.0582	0.0737	0.0012	0.2606
	Cash/CA	0.1430	0.1531	0.0035	0.5034
	LTD/TA	0.1196	0.1231	0.0000	0.4097
	FL	-0.9121	6.5189	-25.7687	3.8113

Source: Own processing in SPSS 22.0

Using the *Correlation Matrix* (Table no. 4) in which the correlations between the variables retained in the ACP are presented, the components resulting from the

analysis can be identified. Each component is defined based on the links between the variables that display strong correlations between each other.

Table no. 4. The correlation matrix between the variables retained in PCA

	OI/TA	OI/TO	OI/Pay	NI/Eq	NI/TA	NI/TO	CFT/TO	CFT/TA	INV/CA	REC/CA
OI/TA	1.000	0.878	0.843	0.734	0.944	0.821	0.075	0.156	-0.204	0.051
OI/TO	0.878	1.000	0.844	0.677	0.844	0.920	0.072	0.143	-0.232	0.065
OI/Pay	0.843	0.844	1.000	0.641	0.791	0.755	0.064	0.123	-0.275	0.106
NI/Eq	0.734	0.677	0.641	1.000	0.827	0.737	0.052	0.081	-0.186	0.011
NI/TA	0.944	0.844	0.791	0.827	1.000	0.865	0.061	0.128	-0.250	0.028
NI/TO	0.821	0.920	0.755	0.737	0.865	1.000	0.009	0.108	-0.249	0.031
CFT/TO	0.075	0.072	0.064	0.052	0.061	0.009	1.000	0.865	-0.023	-0.203
CFT/TA	0.156	0.143	0.123	0.081	0.128	0.108	0.865	1.000	-0.041	-0.155
INV/CA	-0.204	-0.232	-0.275	-0.186	-0.250	-0.249	-0.023	-0.041	1.000	-0.480
REC/CA	0.051	0.065	0.106	0.011	0.028	0.031	-0.203	-0.155	-0.480	1.000

Source: Own processing in SPSS 22.0

Based on the correlations identified at the level of the variables proposed in the analysis and retained in PCA, in this study we identified the following the three principal components of the financial statements: the *Return component* (CR), the *Cash flow component* (CF) and the *Current assets structure component* (CS).

The *Return component* is defined based on the **OI/TA, OI/TO, OI/Pay, NI/Eq, NI/TA, NI/TO** variables, between which significant correlations exist. These financial ratios describe the profitableness of the operating activity depending on the existing assets, the registered turnover of the company, the workforce expenditures and the shareholders' equity.

The *Cash flow component* is defined by the **CFT/TO, CFT/TA** financial ratios and describes the value of the cash flows reported by the company, reported to the turnover or to the total assets.

The *Current assets structure component* is defined by the **INV/CA, REC/CA** financial ratios and includes the structure of the current assets, minus the cash and cash equivalents.

The influence of the X_i variables, retained in the analysis on each of the 3 components of financial statements is emphasized through the results regarding the structure matrix in Table no. 5.

Table no. 5. The structure matrix of the identified components

	Component		
	CR	CF	CS
OI/TA	0.946		
OI/TO	0.934		
OI/Pay	0.874		0.151
NI/Eq	0.838		
NI/TA	0.957		
NI/TO	0.927		
CFT/TO		0.964	
CFT/TA		0.958	
INV/CA	-0.194		-0.845
REC/CA		-0.178	0.862

Source: Own processing in SPSS 22.0

Based on the data displayed in **Table no. 5**, we can notice that the variation of the *Return component* is significantly and positively influenced by 94.60% of the **OI/TA** variation, 93.40% of the **OI/TO** variation, 87.40% of the **OI/Pay** variation, by 83.80% of the **NI/Eq** variation, by 95.70% of the **NI/TA** variation and by 92.70% of the **NI/TO** variation. The *Cash flow component* is significantly and positively influenced by 96.40% of the **CFI/TO** variation and by 95.80% in the **CFT/CA** variation. The *Current assets structure*

component is negatively influenced by 84.50% of the **INV/CA** variation and by 86.20% of the **REC/CA** variation. A decrease in the inventories (especially of goods sold) caused by their sale leads to an increase of the receivables value.

To estimate the scores of each company, corresponding to each dimension of financial reporting, **Table no. 6** displays the estimations of the parameters of the functions associated to the three C_j components.

Table no. 6. Parameters estimates for the functions associated to the components of financial statements identified through PCA

	Component		
	CR	CF	CS
OI/TA	0.191	-0.003	-0.032
OI/TO	0.186	-0.004	-0.010
OI/Pay	0.169	0.001	0.040
NI/Eq	0.174	-0.029	-0.059
NI/TA	0.194	-0.015	-0.032
NI/TO	0.189	-0.033	-0.027
CFT/TO	-0.036	0.515	0.020
CFT/TA	-0.023	0.511	0.037
INV/CA	0.030	-0.096	-0.582
REC/CA	-0.063	-0.039	0.592

Source: Own processing in SPSS 22.0

From the data presented in **Table no. 6**, the score functions of each of the three components are calculated with the following formulas:

$$CR = 0.191OI/TA + 0.186OI/TO + 0.169OI/Pay + 0.174NI/Eq + 0.194NI/TA + 0.189NI/TO - 0.036CFT/TO - 0.023CFT/TA + 0.030INV/CA - 0.063REC/CA \quad (3)$$

$$CF = -0.003OI/TA - 0.004OI/TO + 0.001OI/Pay - 0.029NI/Eq - 0.015NI/TA - 0.033NI/TO + 0.515CFT/TO + 0.511CFT/TA - 0.096INV/CA - 0.039REC/CA \quad (4)$$

$$CS = -0.032OI/TA - 0.010OI/TO + 0.040OI/Pay - 0.059NI/Eq - 0.032NI/TA - 0.027NI/TO + 0.020CFT/TO + 0.037CFT/TA - 0.582INV/CA + 0.592REC/CA \quad (5)$$

Using equations (3), (4) and (5) associated to the score functions corresponding to each component of financial statements, we determine the *reporting scores* for each company in the sample. Descriptive statistics regarding the calculated scores for each dimension are displayed in **Table no. 7**.

Table no. 7. Descriptive statistics for the estimated scores corresponding to the components identified in the PCA

Component	Mean	Std. Deviation	Minimum	Maximum
CR	0.000	1.000	-2.939	1.644
CF	0.000	1.000	-2.184	2.671
CS	0.000	1.000	-2.328	1.875

Source: Own processing in SPSS 22.0

For the *Return component*, a positive score value shows the existence of profitability within a company, while negative values indicate losses. For the *Cash flow component*, a positive score value indicates the fact that the used assets generate future economic benefits, while negative values indicate decreases in the benefits or debt payments that lead to cash outflows. For the *Current assets structure component*, a positive score value indicate the fact that inventories are predominant in the structure of the current assets, while negative values indicate the fact that in the structure of the assets, receivables are predominant, with direct influence on the company's liquidity and solvency.

Once the scores were estimated for each company, in each of the 2011-2016 financial years, we test the influence of the financial statements' component on the financial reporting transparency.

4.2. The influence of the financial statements' components on the financial reporting transparency

Using the logistic regression analysis, we estimated and tested the influence of the previously identified components of the financial statements, on the financial reporting transparency. The transparency existence was determined based on the unqualified opinions or unqualified opinions with insignificant observations that were expressed by the financial auditor. If other types of audit opinions were expressed in the audit reports, than we consider there is no (or not enough) transparency in financial reporting.

The parameters estimates of the regression models proposed in the analysis, equation (2), in which the estimated scores of the three previously identified components are included are displayed in **Table no. 8**.

Table no. 8. Parameters estimates for the proposed logistic regression model

Variables	B	S.E.	Wald	Sig.	Exp(B)
CR	0.575	0.145	15.760	0.000	1.777
CF	-0.016	0.154	0.011	0.916	0.984
CS	-0.147	0.153	0.917	0.338	0.864
Constant	1.150	0.155	55.128	0.000	3.159
χ^2 – Omnibus test of model coefficient:			17.318	0.001	
-2 Log likelihood:			263.776		
Cox & Shell R Square:			0.067		
Nagelkerke R Square:			0.099		
Observations:			372		

*. significant values for a risk level of 0.05.

Source: Own processing in SPSS 22.0

From the data in **Table no. 8**, we can notice that within the analyzed sample, the *Return component* has the most significant influence on the financial reporting transparency. An increase in the companies' profitability (with a unit at the level of the estimated score of the PCA-identified component) leads to a 77% increase of the probability that the company reports this information in a transparent manner. In this case, the auditor's opinion will be an unqualified one or unqualified but with insignificant observations. The influence of profitability on transparency can be explained by the fact that, alongside with the improvement of financial

performances, the company becomes more and more attractive to investors, which, in turn, are willing to receive more information regarding the reported results of the company.

We can see that the other components of financial statements, identified by the PCA, do not have a significant influence on transparency in financial reporting. This can be explained by the fact that the information regarding the cash flows (collected and paid), as well as the ones regarding the structure of the assets are not that important to investors, as they do not describe the future generated benefits.

5. Conclusions

The results obtained in the study have led to the achievement of the research objectives and the validation of the research hypothesis proposed for testing and validation.

Thus, in this study there were estimated three principal components of the financial statements that synthesize the informational content useful to investors. The *Return component* is defined by the financial ratios describing the profitability of the operating activity taking into consideration the total assets, the reported turnover of the company, the workforce expenditures and the shareholders' equity. The *Cash flow component* is defined by the variables describing the value of the cash flows of the company (as effective economic benefits), reported to the turnover or to the total assets. The *Current assets structure component* is defined by the indicators displaying the structure of current assets, without the cash and cash equivalents assets.

As the principal components were identified, we tested their influence on the transparency in financial reporting, assessed based on the audit opinion. The research results show that, of the three identified components, only the *Return component* has a significant influence on financial reporting transparency. The other two components have insignificant influence. The significant influence of the *Return component* on the transparency can be explained by the fact that investors are mainly interested in decision making by the information

regarding the future profits/benefits to be gained as a result of placing invested capitals in the company. Such a situation can though lead to accounting manipulation or earnings management, within the company, of the information regarding the profitability (performance), just to influence the investors' decisions. To this regard, an increase in the financial performance, given the conditions of the eventual investors' reward, also mandates an increase of the financial reporting transparency just to display such information as transparent as possible.

Ensuring the financial reporting transparency supports the faithful representation of the financial position and performance of the company, allowing it to allocate resources better and a better, and also an improvement in management of the registered benefits. These benefits could be used to start social projects or which are to lead to environmental protection, thus ensuring a sustainable development of the company.

The main limits of this research are represented by the low size of the analyzed sample, just 62 companies. This is due to the low number of BSE listed companies, but in the future research we are to enlarge the size of the sample by including other capital markets too, at least in Eastern Europe.

As for the sustainable development, another research limit consists of the inclusion in the analysis of the financial dimension only, but future directions also consider the evaluation of the social and environmental dimensions influence on the sustainable development.

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Audit Quality and Several of Its Determinants

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ABSTRACT

The objective of this article is to identify the relationship between the quality of services provided by the financial auditors and its determinants, among which the initial and continuing training of auditors occupies an important place as long as their authorization depends on achieving an adequate level of education and professional training. It has been taken into account the fact that the purpose of public interest entities has become global, and the ethical and professional challenges to which auditors are exposed are becoming more and more difficult to manage.

To this end, it has set out from the initial and continuous education and training requirements recommended by the International Education Standards Board and there have been corroborated the obtained information with the results of other studies addressing the current challenges faced by the financial auditors (more and more regulations, changes in the financial and non-financial reporting, technology development and increase of business complexity), while trying to answer the question regarding the effect of these challenges on the audit quality. The analysis was a qualitative one that pursued the researchers' concerns about the audit quality in order to identify the best ways to improve it.

The article has a direct practical use both for the financial auditor organizations and the statutory audit oversight authorities to guide the continuing professional training, as well as for the financial auditors and audit firms which can better manage their work in order to increase the quality of the services they offer.

Keywords: audit quality, education, professional development, the International Education Standards

JEL Classification: M42, M49

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Introduction

The quality of the services provided by the financial auditors has become a growing issue over the last few years, especially due to the financial scandals, where the role of auditors has sometimes been direct (see the Enron case). The effect of the audit quality on the client firm is mainly due to the credibility of the audited financial statements if the stakeholders consider the audit to be at an appropriate quality level.

In the last decades, the role of financial auditors has become more complex, the regulation of the professional activity increasingly difficult to perform, yet more and more necessary, education, initial and continuing training in the field of financial auditing have diversified, and the quality of the financial auditors' work has been getting harder to appreciate despite the increasingly clear rules governing the quality control and supervision in the field of the assurance services.

As a result of the continuous concerns for the quality of services provided by the financial auditors, in 2016 the International Accounting Standards Board revised the International Education Standard 8 - *IES 8 - Professional Competence for Engagement Partners Responsible for Audits of Financial Statements*. Also, as a result of the quality concerns in the field of the financial audit, there has been developed at European level the Common Content project, which aims to "bring professional qualifications closer together" (CCP, 2018).

In the context of continuous concern for the quality of services provided by the financial auditors, we consider that an analysis of the main studies of recent years on the determinants that significantly influence the quality of the financial auditors' engagements is relevant. Thus, our findings allow at least two observations to be made: (1) the multitude of determinants influencing the audit quality always complicate the analysis in the sense that an overall analysis of these determinants is not possible; (2) the results are sometimes contradictory, also due to the effects of the determinants which are hard to detect. However, the purpose of our research was to identify as many determinants of audit quality as possible so

that to be possible to find punctual and realistic solutions to improve it.

Education and professional training in financial audit

The series of scandals around the year 2000 brought into question the issue of audit quality as all the reforms in the audit field had as their start-up point the need to increase confidence in the financial market. This can also be done through a quality audit with multiple determinants, including factors controllable by auditors, but also others totally independent of them. In the first category undoubtedly enter the auditors' initial and continuing education and professional training.

It has always been considered that there is a direct link between a quality audit and the level of general and specific education of the auditor. Thus, the International Accounting Education Standards Board (IAESB) was set up as a regulatory body serving the public interest by issuing regulations in the field of the professional accounting education. They describe the technical competence, professional competence, values, ethical aspects and attitudes required in this field. In addition, the Public Interest Oversight Board (PIOB) (IAESB, 2018) was created to ensure transparency in the process of developing these regulations.

The International Education Standards (IESs) issued by the IAESB start from the definition of the entry requirements to professional accounting education programs (IES 1), then they describe the technical competence (IES 2), the professional skills (IES 3), the professional values, ethics, and attitudes (IES 4) and respectively, the practical experience (IES 5) required to be acquired within an initial professional development program. IES 6 sets out the manners of assessing professional competence, and IES 7 presents the content of the continuing professional development. IES 8 has a specific addressability in that it deals with issues related to the professional competence for engagement partners responsible for audits of financial statements (see Table no.1) (IAESB, 2017).

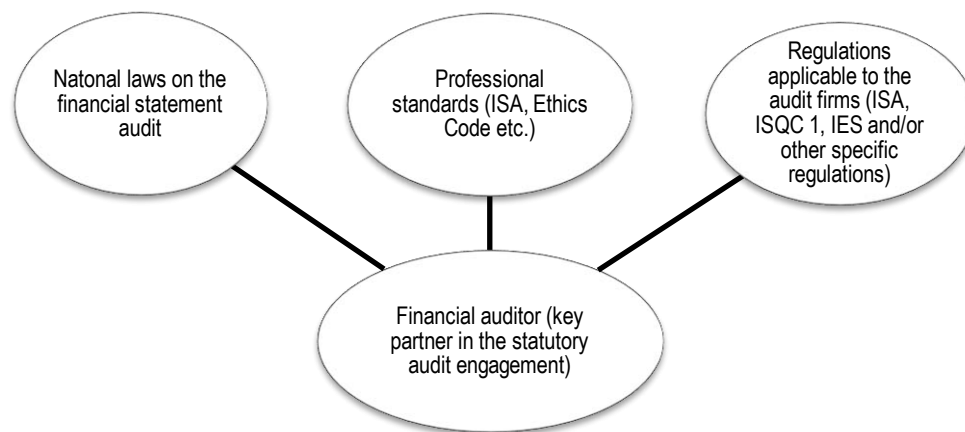
Table no. 1. The Guiding Principles Defined by the International Education Standards for the Professional Accountants and Professional Aspirants	
The International Education Standard	The Guiding Principles
IES 1 – Entry Requirements to Professional Accounting Education Programs	5. Prescription of certain principles to be used when there are set up and communicated the educational requirements for the access to a professional accounting education program; 6. Assuring a reasonable chance to graduate such a program; 7. Appropriate requirements for access; 8. Different forms of the enrolling requirements.
IES 2 – Initial Professional Development – Technical Competence	3. Definition of the areas of competence and learning outcomes relevant to these areas; 4. Description of the professional competence required to the aspirants in the accounting profession at the end of the initial professional development program (IPD).
IES 3 – Initial Professional Development – Professional Skills	2. Definition of the learning outcomes at the end of the IPD program, for the professional (intellectual, interpersonal and communication, personal and organizational) skills required to those people aspiring to the accounting profession.
IES 4 – Initial Professional Development – Professional Values, Ethics and Attitudes	2. Definition of the learning outcomes at the end of the IPD program, for the professional values, ethics and attitudes required to those people aspiring to the accounting profession.
IES 5 – Initial Professional Development – Practical Experience	4. Definition of the expertise that people aspiring to the accounting profession should have acquired at the end of the IPD program. 5. The required expertise may also concern: - the role of statutory auditor; - other forms of specialization; - regulated activities. 3. Expertise is part of lifelong learning and should be maintained and developed through continuing professional development programs (CPDs).
IES 6 – Initial Professional Development – Assessment of Professional Competence	3. It recommends the requirements for the professional competence assessment that people aspiring to the accounting profession need to demonstrate at the end of the IPD program. 4. Evaluation must be characterized by trust, validity, equity, transparency and sufficiency.
IES 7 – Continuing Professional Development	3. It recommends the CPD requirements for the professional accountants to develop and maintain the professional competence required to provide high quality services to clients, employers and other stakeholders and thereby, to ensure high public trust in the accounting profession. 4. It recommends to the professional organizations: - to promote among the professional accountants the idea of lifelong learning; - to enable the access of professional accountants to the opportunities and resources of the CPD program; - to adopt the prescribed requirements for the development and implementation of the assessment, monitoring and compliance procedures to help the professional accountants develop and maintain the necessary professional competence to protect the public interest.
IES 8 – Professional Competence for Engagement Partners Responsible for Audits of Financial Statements	3. It recommends the level of professional competence that the professional accountants need to develop and maintain when they act as the engagement partner responsible for audits of financial statements. 4. The IES 8 requirements should be applied taking into account the Statement of Membership Obligations (SMO) 1 – Quality Assurance, International Standard on Auditing (ISA) 220 – Quality Control for an Audit of Financial Statements and the International Standard on Quality Control (ISQC) 1 – Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and other Assurance and Related Services Engagements

Source: Own processing, 2018, after IAESB (2017), *Handbook of International Education Pronouncements*, pp. 25 – 111

We note that the first six standards refer to the acquirement of professional competence through the IPD program, while the next standards particularly aim to develop and maintain it through the CPD program. The last standard - IES 8 - exclusively addresses the engagement partner's competence in the audits of financial statements, which means that the auditor's high level of professional training is presumed, but it must be

maintained and developed. If we take into account the financial auditor not just as an engagement partner, we notice that there are several categories of constraints upon the financial auditor, all imposed by the legal or professional regulations. Thus, **Figure no. 1** allows the understanding of the auditor's relationship with the parties involved in the regulatory process of its field of activity.

Figure no. 1. Regulatory constraints applicable to the financial auditor



Source: Own processing, 2018

Therefore, the relationships between the financial auditors or audit firms are numerous and they require compliance with many rules imposed by the regulations issued by various authorities and bodies. These concern not only the contractual relationships with the clients, but also the relationships with the regulators and/or oversight authorities, as well as with the professional organizations. All these rules, established by the legal regulations and professional standards, aim to ensure a high quality level of the financial auditors' engagements. Therefore, we can say that the first conditions for a quality audit are the acquirement, maintenance and development of the professional competence, as well as the compliance with the legislation and professional regulations applicable to the financial auditors. Thus, there can be explained the differences in respect of the audit quality in different jurisdictions, taking into account the manner of acquiring the regulations recommended

by the international bodies (IFAC – International Federation of Accountants), as well as the rigor in terms of compliance with the regulations, given that this is also dependent on cultural considerations.

What does quality mean in audit?

DeAngelo (1981) defined the quality of audit services as the dual probability of the auditor's discovery of significant misstatements and their reporting. Thus, there were identified as the primary factors of audit quality: the auditor's capacity to identify misstatements, the used procedures, and the size of the samples, all of which depending significantly on the auditor's competence and endowment with the appropriate technologies.

In the 1980s, there could be seen at international level the concern of the professional organizations to

ensure quality in auditing through regulations and to develop methods to verify the manner in which the audit firms are aware about and ensure quality. In recent years, but especially after the big financial scandals (where the role of the auditors has not always been neutral), there is an increasing concern for studying the factors which influence audit quality, perhaps as a consequence of the social utility of audit.

Audit quality is not ensured only by regulations, but there are also a lot of factors which can influence the manner in which audit is performed by the auditors from different firms and even from the same firm. Also, audit quality is difficult and costly to evaluate both by the professional organizations and the beneficiaries of the audit. We take into account that auditors or audit firms may offer different services to their clients in terms of quality, but also that an auditor or an audit firm can offer different quality services from one period to another to the same clients.

The audit quality has been judged over time both from the institutional point of view, respectively, the verification by professional organizations or oversight authorities of the financial auditors' work in terms of the manner they comply with the applicable legal and professional regulations and from other stakeholders' point of view, the criteria being usually different. If in terms of quality assessment at the professional level there is also the possibility of applying corrective or sanctioning measures whose application is verifiable, in the case of quality assessment by other stakeholders (investors, competitors, partners), there is only the option of adjusting the auditors or audit firms' behaviour to potential reactions of current and potential clients.

Appropriate professional judgments are also considered as essential elements in assessing the quality of an audit engagement. Wedemeyer (2010) estimates that auditors use the professional reasoning to make decisions about:

- assessing the risks of material misstatement of financial statements, including the potential effects of fraud, bias and business risk;

- identifying, performing and evaluating the audit procedures in response to the assessed risks;
- assessing the audit evidence in order to specify their quality and adequacy to determine the need for additional evidence;
- formation of an opinion on the financial statements and making the decision whether or not to express an opinion.

Moreover, sometimes it is also discussed what the reduction of the audit quality means or, more specific, what behaviour involves the diminution of the audit quality (Coram et al., 2008).

Although we have not identified many studies to indicate the existence of any direct relationship between the sanctions applied to financial auditors or audit firms and the audit market reaction to them, there are articles which show the effect of sanctioning the financial auditors upon their relationship with the prospective clients (Davis and Simon, 1992), in the sense of the client pressure on auditors to lower the required audit fees.

Research method

The research method was a qualitative one, aiming at reviewing the most relevant research on audit quality, respectively those studies that had the effect of determining the audit quality. In this respect we conducted a descriptive-explanatory study of several articles considered relevant to the intended purpose. Thus, we selected the studies from the Clarivate Analytics (Web of Science Core Collection) database, for the period 1975 - present, using as the search criterion the phrase "audit quality" for the "Articles" category, the publication language "English" of the following five categories Web of Science: Business Finance, Management, Economics, Business, Social Sciences Interdisciplinary and Ethics. Out of the total of 43 resulted articles, there were included within the analysis only the ones with the title "audit quality", resulting in a total of 16 articles, available in full format in the "Open Access" system, as it can be seen from **Table no. 2**.

Table no. 2. Studies on audit quality

Authors	Year	Article	Journal	Research method
Khasharmeh, H., and Desoky, A.M.	2018	Does the provision of non-audit services affect auditor independence and audit quality? Evidence from Bahrain	Asian Academy of Management Journal of Accounting and Finance	Questionnaire
Abid, A., Shaique, M., and Haq, M.A.	2018	Do Big Four Auditors Always Provide Higher Audit Quality? Evidence from Pakistan	International Journal of Financial Studies	Descriptive statistics and regression
Febrianto, R., Dini, F., Audina, D., Yuskar, Y., and Juita, V.	2017	The Influence of Pseudo Auditor Rotation on Audit Quality: New Evidence	Australasian Accounting, Business and Finance Journal	Descriptive statistics and regression
Choi, J.-S., Lim, H.-J., & Mali, D.	2017	Mandatory audit firm rotation and Big4 effect on audit quality: Evidence from South Korea	Asian Academy of Management Journal of Accounting and Finance	Descriptive statistics and multivariate analysis
Broberg, P., Tagesson, T., Argento, D., Gyllengahm, N., Martensson, O.	2017	Explaining the influence of time budget pressure on audit quality in Sweden	Journal of Management and Governance	Questionnaire, descriptive statistics and regression
Lobo, G.J., Paugam, L., Casta, J.F.	2017	The Effect of Joint Auditor Pair Composition on Audit Quality: Evidence from Impairment Tests	Contemporary Accounting Research	Descriptive statistics and regression
Yan, H., Xie, S.	2016	How does auditors' work stress affect audit quality? Empirical evidence from the Chinese stock market	China Journal of Accounting Research	Descriptive statistics and regression
Brown, V.L., Gissel, J.L., Neely, D.G.	2016	Audit quality indicators: perceptions of junior-level auditors	Managerial Auditing Journal	Questionnaire
Löhlein, L.	2016	From peer review to PCAOB inspections: regulating for audit quality in the U.S.	Journal of Accounting Literature	Review
De Fuentes, C., Illueca, M., Consuelo Pucheta-Martinez, M.	2015	External investigations and disciplinary sanctions against auditors: the impact on audit quality	Series-Journal of the Spanish Economic Association	Descriptive statistics and regression
Gonzalez-Diaz, B., Garcia-Fernandez, R., Lopez-Diaz, A.	2015	Auditor tenure and audit quality in Spanish state-owned foundations	Spanish Accounting Review	Descriptive statistics and regression
Wang, C., Dou, H.	2015	Does the transformation of accounting firms' organizational form improve audit quality? Evidence from China	China Journal of Accounting Research	Descriptive statistics and regression
Beisland, L., Mersland, R., Strom, R.	2015	Audit Quality and Corporate Governance: Evidence from the Microfinance Industry	International Journal of Auditing	Descriptive statistics and regression
Bills, K.L., and Cunningham, L.M.	2015	How Small Audit Firm Membership in Associations, Networks, and Alliances Can Impact Audit Quality and Audit Fees	Current Issues in Auditing	Descriptive statistics and regression
Bell, T.B., Causholli, M., Knechel, W.R.	2015	Audit Firm Tenure, Non-Audit Services, and Internal Assessments of Audit Quality	Journal of Accounting Research	Descriptive statistics and regression
Francis, J.R., Michas, P.N.	2013	The Contagion Effect of Low-Quality Audits	Accounting Review	Descriptive statistics and regression

Source: Own processing, 2018

As research methods used into the selected articles, there can be mentioned the descriptive statistics and regression, very few studies being of a qualitative type, using as a research method the review (an article) or the questionnaire (two articles).

A descriptive analysis

From the analysis of the selected articles, it appeared that the determinants of the audit quality are: providing non-audit services to the audit clients (Khasharmeh and Desoky, 2018); the audit firm category, respectively Big 4 or non-Big 4 (Abid et al., 2018); the manner of auditors' rotation and switch to another category of audit firm (Febrianto et al., 2017); the manner of auditors' rotation (voluntary or mandatory), the membership of the audit firm to Big 4 and the auditor tenure (Choi et al., 2017). Other factors were also identified, such as: time to complete the engagement, the auditors' gender, position within the firm and experience, number of

clients, size of the local office and audit firm (Broberg et al., 2017); the category of firms in the case of joint audit (Lobo et al., 2017); the audit team members' response to stress (Yan and Xie, 2016); the level of knowledge of the auditing standards and the degree of auditors' loading (Brown et al., 2016); the quality control of the audit supervision (Löhlein, 2016); the disciplinary sanctions imposed by the professional organizations (De Fuentes et al., 2015); the auditor tenure (Gonzalez-Diaz et al., 2015); the change of the organization form of the audit firm (Wang and Dou, 2015); the client firm's governance (Beisland et al., 2015); the membership in an association of small audit firms (Bills and Cunningham, 2015); the auditor tenure and fees for non-audit services (Bell et al., 2015) and the previous audit failure (Francis and Michas, 2013).

For the selected articles, we presented in **Table no. 3** the results obtained by the researchers who had analyzed the influence of the identified factors on the audit quality.

Authors	Factors	Influence on audit quality
Khasharmeh, H., and Desoky, A.M.	Provision of non-audit services to the audit clients	Audit quality is improved if the auditor renders non-audit services.
Abid, A., Shaique, M., and Haq, M.A.	The audit firm belongs to Big4 or non-Big4	All Big 4 and non-Big 4 auditors will offer the same level of audit quality across different time periods.
Febrianto, R., Dini, F., Audina, D., Yuskar, Y., and Juita, V.	(1) Manner of the auditors' rotation (2) Shift to another category of audit firm	(1) Companies that rotate their auditors mandatorily have higher audit quality than that of companies voluntarily rotating auditors. (2) Switching among bigger accounting firms have the highest audit quality rather than switching between smaller audit firms which have lower audit quality.
Choi, J.-S., Lim, H.-J., & Mali, D.	(1) Manner of the auditors' rotation (2) Membership of the audit firm to Big4 (3) The auditor tenure	(1) Audit quality of the mandatory rotation firm sample is lower compared to firms that voluntarily adopted the rotation rules. (2) Audit quality of Big4 accounting firms is superior to Non-Big4 firms. (3) Longer audit tenure and switches to Big4 audit firms generally have a positive effect upon audit quality.
Broberg, P., Tagesson, T., Argento, D., Gyllengahm, N., Martensson, O.	(1) Time to complete the engagement (2) Auditors' gender, position within the firm and experience, number of clients, size of the local office and audit firm	(1) Time budget pressure lowers the quality of audits performed by Swedish auditors, but it is not the only explanation. (2) Audit quality is also related to other factors such as gender, position, experience, number of clients, local office size and audit firm.
Lobo, G.J, Paugam, L, Casta, J.F.	Business category in the case of joint audit	(1) Using two Big 4 auditors (in joint audit) may not necessarily result in the highest audit quality. (2) Audit quality is better for the Big 4–non-Big 4 auditor pair than the Big 4–Big 4 auditor pair.

Authors	Factors	Influence on audit quality
Yan, H., Xie, S.	The audit team members' response to stress	In general, there is no pervasive deterioration in audit quality resulting from auditors' work stress that is under control. There is a significant negative association between work stress and audit quality in the initial audits of new clients after setting apart different stages of audit tenure, due to the lack of comprehensive understanding of client and industry information.
Brown, V.L., Gissel, J.L., Neely, D.G.	(1) Level of knowledge of the international audit standards (2) Number of work tasks (3) Degree of auditors' load (4) Degree of involvement of audit firms in other activities	(1) Lack of knowledge in the ISAs could impede audit quality for the participants' future audits. (2) Multi-tasking in general has been found to be associated with reduced audit quality. (3) Overworked auditors are at a higher risk of job burnout which can lead to poor audit performance. (4) Some audit firms' activities may be hindering the production of high-quality audits.
Löhlein, L.	Quality control of the audit oversight authority	The initial introduction of external quality controls through peer reviews enhanced the quality of services provided by audit firms. PCAOB (Public Company Accounting Oversight Board) inspections have a positive effect on audit quality.
De Fuentes, C., Illueca, M., Consuelo Pucheta-Martinez, M.	The disciplinary sanctions applied by the professional organizations	Disciplinary actions imposed by the Institute of Accounting and Auditing from Spain prompt changes in audit quality only when the auditors were penalized with lower sanctions.
Gonzalez-Diaz, B., Garcia-Fernandez, R., Lopez-Diaz, A.	The auditor tenure	Audit quality, measured as the likelihood that an auditor will submit a qualified opinion, increases over the first five years of the relationship and then decreases.
Wang, C., Dou, H.	The change of the organization form of the audit firm	Accounting firm size and listed company ownership not significantly affect the relationship between transformations and audit quality. Accounting firm transformations improve audit quality.
Beisland, L., Mersland, R., Strom, R.	The audit client's governance	For situations in which a significant relationship between audit quality and governance does exist, the sign of this relationship is always positive.
Bills, K.L., and Cunningham, L.M.	Membership in an association of small audit firms	Small audit firm association members provide higher-quality audits and charge higher fees than small audit firms that are not members of an association.
Bell, T.B., Causholli, M., Knechel, W.R.	(1) The auditor tenure (2) The fees for the non-audit services	(1) First-year audits receive lower assessments of audit quality, but quality improves significantly after the first year and it sustained over very long tenure for the listed companies. Long tenure is associated with lower audit quality for the sub-sample of privately-held firms. (2) The total non-audit services fees are positively associated with quality for listed companies and negatively associated with quality for privately-held clients.
Francis, J.R., Michas, P.N.	Audit failure	Certain auditor offices have systematic audit-quality problems and that these problems persist over time. Offices with an audit failure are more likely to have additional (new) audit failures in the subsequent five years, suggesting a longitudinal contagion of audit failures over time.

Source: Own processing based on the reviewed articles, 2018

Although sometimes it may be easy to identify the factors that affect the audit quality, in practice there can be noticed that their influence may be different

depending on the characteristics of the client company, the audit firm, or the behavioural features of those carrying out the audit on behalf of the audit firm.

Results and discussion

The analysis of the impact of the identified factors on the audit quality made possible to identify certain results, which on the one hand, were predictable, but on the other hand, were apparently contradictory.

Thus, although Khasharmeh and Desoky (2018) and Bell et al. (2015) state that the provision of non-audit services to audit clients is associated with an improvement in the audit quality, in recent years the legislative changes have been made in respect of restricting in different ways or even prohibiting the provision of non-audit services to audit clients (SOX, 2002, EU Regulation No. 537/2014). However, in the case of the study carried out by Bell et al. (2015), the previous finding is valid only for the listed companies, the result being the opposite in the case of non-listed companies. Also, although for a long time it has been considered that Big-N firms offer high quality services than that provided by non-Big-N auditing firms, we find that the results of the analysed studies provide information contradicting this perception to a certain extent. Thus, Abid et al. (2018) come to the conclusion that all auditors, either from Big 4 or not from Big 4, will provide audit services at the same level of quality over different periods of time. Lobo et al. (2017) studied a particular aspect of audit, i.e. the joint audit, and they concluded that the association of two firms from different groups (Big4 and non-Big4) was capable of providing a higher quality audit than that offered by the association of two Big4 firms. The only consistent result with the general perception that Big4 firms provide the highest quality audit services was that obtained by Choi et al. (2017).

Febrianto et al. (2017) and Choi et al. (2017) obtained different results regarding the influence of the causes of the rotation of auditors on the audit quality (done on a voluntary basis or as a requirement imposed by the law). However, they also achieved similar results in terms of the positive influence which the size of the audit firm had on the audit quality.

The positive effect of the audit contract duration on the audit quality was demonstrated by Choi et al. (2017), Gonzalez-Diaz et al. (2015) and Bell et al. (2015), with the observation that in the last case this finding was only valid for the listed companies, in the case of non-listed companies, the result having been opposite. The results obtained by Broberg et al. (2017) are interesting

because there can be observed the negative effect of time pressure on the audit quality, but there are also taken into account the behaviour elements determined by the auditor's gender, training and experience, as well as those of the size of the auditor (number of clients, the size of office and/or audit firm).

A low level of professional knowledge is negatively associated with the level of the audit quality, in the study performed by Brown et al. (2016), the same effect having the multiple tasks assigned to auditors (overloading), and the involvement of audit firms in (too many) other activities.

Löhlein's (2016) research highlighted the positive effect of the inspections carried out by the professional bodies and/or supervisors on the audit quality, and the one carried out by De Fuentes et al. (2015) pointed out such an effect even in the case of the disciplinary measures, but only if the sanctions applied to the auditors were small.

Yan and Xie (2016) found the negative impact of the professional stress on the audit quality, especially in the initial audit engagements. At the same time, they observed that there were perceptions of the professional stress and responses to it which vary from one person to another depending on the individual characteristics of the auditors. Thus, the results of the study suggest that the auditors within the international audit firms and key audit partners respond better to professional stress than the experienced auditors within the field of activity of the client firm. On the other hand, there was no evidence of any relationship between the auditor's gender or age and the auditor's response to stress.

However, it was found that auditors tend to be more sensitive and to react more strongly to state-owned client firms. Beisland et al. (2015) highlighted the positive effect of the client firm's governance mechanism on the audit quality. A research performed by Francis and Michas (2013) highlighted the effect of longitudinal contagion of failures in audit over time.

Therefore, as other authors state defining and evaluating the quality of an audit is sometimes a difficult process (Colbert and Murray, 1999).

Conclusions

It is believed both among practitioners and at the level of the regulatory bodies that, in order for auditors to

perform a quality audit, it is essential for them to maintain their professional skepticism and to make appropriate professional judgments.

The professional judgment and the factors influencing it have been object of the practitioners and researchers' concerns. For example, Mansouri et al. (2009) believe that the public can rely on the representations of an auditor when the public trusts that the auditor has acted as an impartial judge, who has drawn the conclusions based on objective evidence. This happens because up against the financial reporting, which is influenced by factors such as the accounting standards, the economic factors, responsibilities and professional ethics, the audit also involves a critical professional judgment. In audit, professional judgement refers to the use of audit knowledge and experience, gained through the in-depth study of the accounting and auditing standards and of the ethical code of the profession, in order to make the right decisions.

There are many research analysing how knowledge can affect the professional judgment within audit and how to support auditors in making the best decisions (Mala and Chand, 2015). At the same time, other authors point out that the acquirement of knowledge by auditors is achieved through education, training and experience (Bhattacharjee and Moreno, 2002).

Although there are many quality determinants, it is observed that the effect of their action often depends on the response that auditors can provide in situations where there is a risk of diminishing the quality of audits. In this respect, it is essential to determine how auditors perform their tasks and what kind of education and training could support them in making the best decisions.

In this respect, in order to assess what can be done to ensure a high quality level of the services provided by the financial auditors, we consider to be significant the strategic objectives that the US PCAOB - Public Company Accounting Oversight Board established for the period 2018-2022: (1) improve the audit quality through a combination of prevention, detection, deterrence and remediation of deficiencies; (2) anticipate and respond to the changing environment, including emerging technologies and related risks and opportunities.

Taking into account these concerns and also our own findings, we consider that a first way to improve the audit

quality is to ensure an initial and continuing quality training for the financial auditors by linking the content of the curricula and the professionals' required training courses to the current economic realities. Starting from the finding that the size of the audit firm (membership in Big4) is not always a determinant of the audit quality, it becomes increasingly clear that the individual level of the financial auditors' training is a determinant of quality and that, for this reason, the financial auditors and audit firms should be concerned with the assurance of their own professional development and their employees' development beyond the training requirements imposed by the professional organizations.

We also consider the fact that, at the level of the audit firms, there may be more flexibility in organizing specific training programs for the needs of the employees, taking into account the more accurate knowledge of their needs, as well as the obligations imposed by the International Standard on Quality Control (ISQC) 1 - Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and other Assurance and Related Services Engagements, the International Standard on Auditing (ISA) 220 - Quality Control for an Audit of Financial Statements and the Statement of Membership Obligations) 1 - Quality Assurance.

Therefore, improving the audit quality is not and should not remain just a concern of the oversight authorities and professional organizations, but it must also be a constant concern of the managers from the audit firms which need to emphasize the importance of their training programs of employees for their companies. There can be assumed that a very good professional training will enable the financial auditors to carry out professional quality judgments at all stages of the audit.

On the other hand, we find that many determinants of audit quality are beyond auditors' control. There are rules imposed by legislation on the rotation of auditors and on the provision of non-audit services so that auditors can only respect them regardless of what researchers find out about the effect of these obligations of the auditors on the audit quality. Thus, Gonzalez-Diaz et al. (2015) assumed that a manner to measure the audit quality was the probability that an auditor would issue a qualified opinion, concluding that the probability increased in the first five years of the contract and then decreased. In this context, it can be said that along with the passage of time, the client firm's motivation to change the auditor disappears, because a quality audit,

in this respect, is unflattering to it. Therefore, the introduction of the rules on the auditors' rotation and those to reduce or eliminate the threat of familiarity can be considered a way to ensure the audit quality.

Also, the engagements performed by the financial auditors are subject to the market rigors, so that the decisions of the client firms in terms of the selection of auditors are often influenced by psychological factors (motivation, persuasion, attitudes), whose accurate quantification is not always possible, which often makes impossible to act on them. Similarly, the financial resources available to client firms are an important restriction in selecting an auditor who, even if it provides high quality services, it can also practice high fees, which cannot be paid by some categories of client firms.

In respect of the quality control on the auditors' work and the possible sanctions applied to them, it is obvious that their purpose is actually to identify and sanction the prospect impairments found in the audit performance so that the planning and effective implementation of such controls and the provision of recommendations in terms of their removal are the direct methods for improving the audit quality. This also prevents the longitudinal contagion effect of audit failure.

Regardless of the factors acting on the audit quality, the correct judgement and ethical actions of the auditor are those that can lead to a quality audit. For this, an auditor must have a high level of professional knowledge and competence and must have assimilated the ethical conduct required by the professional and social regulations.

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Hedge Accounting: An Auditor's Perspective

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ABSTRACT

Radical changes have been introduced in the hedge accounting framework by the new IFRS accounting standards. In particular, the hedge effectiveness regime has been completely overhauled and replaced by a strong principles-based charter. The relevance of qualitative assessment procedures has, accordingly, increased making the audit of such assignments immensely challenging. Pronouncements from regulatory bodies providing professional guidance on audit issues of hedge accounting and effectiveness testing have failed to keep pace with this rapid transition, enhancing the complexity of such audit exercises. In the present article, after providing a brief analysis of the contemporary hedge accounting and effectiveness testing provisions, we dwell upon the salient issues connected with the auditor's predicament and highlight the way forward in the changed environment.

Keywords: IFRS 9, audit, hedge accounting, risk management

JEL Classification: G32, M41, M42

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1. Introduction

Hedge accounting is an accounting procedure whereby the changes in the values of hedged items and hedging instruments (that would, under normal accounting, find their way into the income statements of different accounting periods) are presented in the income statement of the same accounting period. This enables the risk management strategies of hedging entities to be reported in tandem with the economic effects of the said strategies. If hedge accounting is not adopted, the hedged item and the hedging instrument are considered as unrelated objects and, therefore, accounted for on an item-by-item basis. Hedging instruments, usually being financial derivatives, are considered at fair value through profit or loss (FVTPL hereinafter) and the hedged item is classified on the basis of its intrinsic nature and measured and valued accordingly. This possible difference in the basis of measurement and valuation could result in distortion in the reporting of impacts of changes in the values of the hedged item and the hedging instrument in the income statement. The corresponding financials could transmit an impression of enhanced earnings volatility among user groups that is not warranted by economic reality. The provisions of hedge accounting are enacted to obviate this anomaly by enabling the entity, which takes recourse to hedge accounting, to match the measurement bases or value changes of the constituents of the hedging relationship. This is necessary to ensure the correct reporting of income volatility in the financials.

Hedge accounting is, however, allowed only on the precondition that the hedge is effective. It, thus, becomes necessary for auditors to take a call on hedge effectiveness in auditing the accounts of entities adopting hedge accounting.

A radically upgraded hedge accounting framework has been introduced by International Financial Reporting Standard (IFRS hereinafter) 9 (IASB, 2008, 2012). The new pronouncements are aimed at rationalizing the accounting and reporting for financial hedges in order to provide an accurate and synchronized portrayal of the risk management strategies of the entity in its reported financials (IFRS Foundation, 2013; Kablan, 2014; McCarroll and Khatri, 2014; Panaretou et. al 2013). A closer correlation between the economic implications of such strategies and the accounting and reporting thereof is intended (Chang et al, 2016).

In view of the nascent status of the new pronouncements, there exists little authoritative professional guidance for auditors in context of assessing effectiveness of derivative hedges. This issue assumes significance because of the huge variety of hedging situations encountered in practice, precipitated by the multifarious risk components desired to be hedged against by entities together with diversity of hedging instruments accessible for the purpose. As a corollary, a variety of procedures could be adopted by the auditor for effectiveness testing and a consensus regarding the hedge effectiveness assessment criteria among the fraternity is unlikely. In the absence of standardized pronouncements, individual perceptions could have a significant say in the overall audit assessments. For instance, whether a correlation measure is fully appropriate to be the ultimate determinant of effectiveness and, if so, the degree of correlation that can be construed to be adequate evidence therefor may be an issue of debate.

The paucity of structured pronouncements in this field result in personal experience and professional judgement constituting the cornerstones of audit decisions. In the pre-IFRS 9 realm, the overwhelming perception among users and auditors was that quantitative tests were both necessary and sufficient for establishing hedge effectiveness. Such tests could take the form of Dollar Offsetting, Correlation & Regression analysis or variants thereof (Althoff & Finnerty, 2001; Canabarro, 1999; Ederington, 1979; Finnerty & Dwight, 2002; Franckle, 1980; Kalotay and Abreo 2001; Kawaller & Koch, 2000; Royall, 2001).

However, the new pronouncements on hedge accounting have introduced sweeping and far-reaching changes. The well-entrenched "80/125" bright line quantitative requirement has been done away with and replaced by a set of principle-based criteria. No numerical range of effectiveness is prescribed. The revised standard requires the presence of an economic relationship between the hedging instrument and the hedged item, with credit risk not dominating this relationship and an opposite hedge ratio designating the hedge for establishing hedge effectiveness. Nevertheless, if ineffectiveness is persistently reflected in a hedge, the continuance / sustenance of the economic relationship and the veracity of the hedge ratio needs to be unequivocally established by the entity.

It is pertinent to mention that the IAS 39 (that preceded IFRS 9) did not contain any explicit provision regarding prescribing a numerical bright line for high hedge effectiveness of hedging relationships. The “80/125” bright line benchmark owed its origin to the perceived link between “high effectiveness” and “high correlation” with the latter being generally interpreted as the 80/125 rule in the social sciences (Swad, 1995; Lipe, 1996).

2. The new hedge effectiveness framework: a summary

Several fundamental amendments have been introduced by the new standards in the hedge accounting framework, in general and effectiveness testing, in particular. The cardinal features of these standards in the present context include (Althoff et. al, 2014; BDO, 2014; Deloitte, 2013; Du Plooy et. al, 2014; KPMG, 2013; PwC, 2013):

- (a) the adoption of a principle-based hedge effectiveness assessment in lieu of the 80/125 percent “bright line” offset prescription;
- (b) replacement of the requirement of prospective and retrospective assessment of effectiveness by assessment on a prospective basis at the commencement of each hedge period; and
- (c) greater autonomy to the entity in demonstrating hedge effectiveness.

The following three-pronged hedge effectiveness assessment criteria is pronounced in context of a hedging relationship:

- (i) the constituents of the hedging relationship should have an underlying economic relationship that may be asserted either through qualitative or quantitative testing or both;
- (ii) the value changes emanating from the economic relationship among the hedge constituents should not be dominated by the effects of credit risk (Zoltan, 2016);
- (iii) the hedge ratio that is used for designating and describing the hedging relationship in context of hedge accounting shall be the same as the ratio based on the physical volume actually adopted by the reporting entity of the constituents of the hedge.

3. Hedge effectiveness assessment: some salient features

The opposite directional movements of the price processes of the constituents of the hedging relationship as a response to a causal economic impact of the underlying risk stimulus would be strong testimony of the existence of an economic relationship. Existence of a statistical relationship may, unilaterally, not be conclusive of the existence of such causal relationship. However, strong inverse correlation would categorically substantiate such a causal connection.

The regulators have retained the earlier paradigm of not prescribing any specific methodology for establishing a causal economic association, making the auditors' role especially precarious. The auditors', in exercise of their judgement and skill, need to ensure that the method captures the essence of the hedging relationship. Appropriate quantitative outcomes would invariably corroborate qualitative inferences in borderline cases (Deloitte, 2012; Ernst & Young, 2011, 2014 a, b, c).

If the critical terms of the constituents of the hedging relationship are matched and the derivative has a zero nil fair value at the point of hedge creation, a prime facie inference of an economic relationship would seem vindicated with a hedge ratio of 1:1. Nevertheless, a review of the factors contributing to hedge ineffectiveness, if any, needs to be conducted. It would be sufficient, in general, to perform a qualitative assessment. On the other hand, if the critical terms are not entirely matched but nearly so, it may be appropriate to corroborate the qualitative results by numerical or statistical tests. In such situations, professional judgement would dictate the need for and extent of quantitative validation actually required. In particular, quantitative outputs may be valuable in demonstrating that an adequate underlying economic relationship subsists despite the critical terms mismatch. Numerical and/or statistical test results may also provide evidence of the appropriateness of the hedge ratio adopted in the hedging relationship.

If there is considerable incongruity between the critical terms of the components of the hedging relationship but the derivative has the same or related underlying, it may be necessary to substantiate qualitative justification of an underlying economic relationship and the hedge ratio

by a thorough numerical and/or statistical testimony. The auditor's professional skill, astuteness and judgement are called into scrutiny in such situations.

Nevertheless, the "80/125" offset bright line adherence is no longer mandated. With sufficient underlying rationale, a smaller offset may be accepted as conclusive evidence of high effectiveness. It is cardinal to analyze actual and potential hedge ineffectiveness and identify factors contributing thereto e.g. credit risk, basis risk with complete and proper documentation.

The second condition for hedge effectiveness is that the value changes in the constituents of the hedge causally emanating from the underlying economic relationship must not be dominated by the price changes that are a consequence of the impact of credit risk. The credit risk for this purpose would include the credit risk of (i) either of the hedge components or both and (ii) of the hedging entity as well as the counterparty.

In context of this provision, the auditor needs to exercise discretion on two counts. Firstly, he is required to identify and authenticate the changes in value of the hedge constituents due to market factors (hedged risks) and those due to the impact of credit risk. Thereafter, he must gauge whether or not the value changes due to the influence of credit risk "dominate" the value changes due to the hedged risk.

The assessment of the effect of credit risk, generally, takes the form of a qualitative appraisal. Entities usually have risk management policies in place that elaborately describe the risk limits for counterparties, together with procedures to be implemented for the periodic monitoring of the creditworthiness of these parties. If the credit standing of a party declines significantly, provision would be made for the initiation of appropriate corrective measures. Recourse is, sometimes, had to numerical simulation and/or statistical approaches e.g. for isolating factors contributing to low offset in certain hedges and assessing their degree of influence.

The ratio of the physical quantities of the hedge constituents is termed as *the hedge ratio*. The optimal hedge ratio corresponds to the minima of the variance of the portfolio comprising of the hedge components i.e. the hedged item and the hedging instrument. The ratio takes the value 1:1 in the event of the hedged risk and the underlying of the hedging instrument being perfectly correlated. In general, the

hedge ratio depends on the covariance of the price processes of the hedge constituents.

The third prescription for hedge effectiveness mandates that the hedge ratio implicit in hedge accounting construct adopted by the entity must be the same as that actually applied for construction of the hedge. However, it is emphasized that the standard insists on the equality of the "hedge ratio" only, but does not require that:

- (a) the "extent of hedging" be identical in both contexts;
- (b) the hedge ratio be so chosen as to minimize effectiveness; and
- (c) any prescribed methodology or template be used for hedge ratio computation.

It follows that the standard recognizes that there may subsist no 'right' answer and, as such, the regulators feel that the entity's management and auditors are best placed in the matter.

The standard does not envision a "perfect hedge". If imbalances in hedging are likely to arise due to the standardized contract sizes of the derivative used for hedging, the hedging would very much qualify this mandate in the absence of other evidence precipitating a contrary inference.

Retrospective testing of hedge effectiveness has been dispensed with. The assessment of hedge effectiveness needs to be performed at the inception of the hedge and, thereafter for each immediately following reporting period at the beginning of such period.

However, measurement and recognition of hedge ineffectiveness by entities adopting hedge accounting is required as earlier. In this context, the measurement of hedge effectiveness is different from hedge effectiveness testing. Whilst the effectiveness assessment pertains to the determining the admissibility for hedge accounting of the hedging relationship, the latter relates to its subsequent accounting. That is, in the event of the hedging relationship being eligible for and the reporting entity choosing to adopt hedge accounting, the entity must measure and recognize hedge ineffectiveness to the income statement forthwith (except for a cash flow under-hedge). The provisions in relation to eligibility criteria have undergone radical changes while those on subsequent measurement and recognition of hedge ineffectiveness are substantively unchanged.

Similarly, there is the additional accounting requirement to recognize and measure the ineffectiveness arising out of the influence of credit risk to determine the amount of hedge ineffectiveness to be recognized in the income statement. Again, this ineffectiveness measurement is in addition and subsequent to the determination of the impact of credit risk changes for purposes of vetting the “dominance” test of hedge effectiveness, which is necessary for meeting the criteria for entitlement to use hedge accounting, in the first place.

4. Hedge effectiveness assessment: the auditors’ perspective

It needs to be emphasized here that auditing in hedge accounting environment is immensely intricate as such accounting procedures allow entities to defer recognition of gains and losses relating to the hedging relationship, thereby calling for enhanced due diligence. This is so because if, in subsequent years, it is found that the client had inappropriately deferred gains/losses under the guise of hedge accounting, material write-offs will result.

At the very outset, the classification of a set of transactions as constituting a hedging relationship involves exercise of prudence and judgement. It needs to be based on an objective assessment of several factors that would include, but not be limited to, (i) the motivation for and the intent underlying the transaction at the time of initiation; (ii) the uncertainty, if any, embedded in the exposure purported to be hedged; and (iii) the correlation between the hedge and the underlying exposure.

In the context of assessing hedge effectiveness, a seminal distinction in perspective must not be overlooked. While the entity’s management may be inclined to assign some weightage to the possibility of positive returns emerging as by-products of risk management strategies, the auditor’s analysis would be focused entirely on the risk mitigation effects thereof. Consequently, it may be appropriate in many instances for the auditor to undertake a hedge assessment independent of the management’s view thereon.

While high “hedge effectiveness” remains the cardinal pre-requisite for entities to avail hedge accounting, pronouncements on the auditing thereof are few leaving profound scope for exercise of professional judgement

and discretion by the auditor. While several quantitative tests of hedge effectiveness are available, the underlying philosophy of most of them is the negative relationship between the changes in value of the constituents of the hedge. However, to what extent these methods serve as reliable auditing procedures remains unclear in view of the differing vantage points. Besides, the standards remain silent on the choice of methods as well as the desired test results for inferring high effectiveness.

The auditor’s assessment exercise would invariably commence with review the client’s calculations, models and documentation. The outcome of such “review” exercises would enable him to formulate the future course of action towards taking a call on the effectiveness of the entity’s hedging strategies. It would be imperative for the auditor to thoroughly examine the relevant information and reporting systems in vogue in the client organization, experience and expertise of client’s staff in financial markets and in understanding and dealing with the various hedging instruments being employed.

A valuable strategy that is not only gradually finding acceptance among audit firms but also becoming advisable in view of the escalating complexity of business operations and the variety of hedging relationships is the hiring of specialists in specific areas of audit. The engagement of these specialists and judicious use of their expertise will, undoubtedly, enhance the quality of audits. Furthermore, auditors could take recourse to the US PCAOB pronouncements and practices of US audit firms for guidance, they being the most sensitized outfits in the profession.

While the paramount factor in assessing the eligibility for hedge accounting is, unquestionably, the effectiveness of the hedge, several factors would facilitate such an inference by the auditor e.g. the unambiguous identification of the position or item being hedged, the designation of hedge components as a hedge and also of the management’s intent in the hedge documentation, the expected continuance of the hedge to be effective etc.

As mentioned earlier, the standards do not envision a perfect hedge. As such, a specific one-to-one identification of the hedging instrument with the hedged item or position is neither envisaged nor to be insisted upon by the auditors. Furthermore, the existence of a high degree of inverse correlation would be strong

evidence, although there could be situations where qualitative assessments suffice. The situation, essentially, needs to be handled on a case to case basis with professional due diligence, particularly with the new subjective effectiveness criteria coming into play.

To start with, it would be appropriate for the auditors to look at the qualitative aspects of the hedging relationship, in particular, the characteristics of the products used for hedging against underlying exposures. The subsequent steps would largely be determined by the nature of the hedging relationship, the client's internal controls environment as well as the auditor's own professional skill set and experience. Valuable inputs can be obtained from the entity's technical experts on salient and complex operational aspects, although reliance thereon should be with extreme restraint, comprehensive corroboration and thorough due diligence.

Nevertheless, if the auditor does decide to accept the entity's use of a correlation based quantitative measure, two vital issues need to be assessed:

- (i) The appropriateness of the acceptable range of correlation adopted by the entity's management in context of the nature of hedged items. It is emphasized that acceptable range would depend on whether the hedged item is a portfolio of assets or liabilities or a specific transaction or interest rates or foreign exchange transactions.
- (ii) The suitability of the time periods that were considered when assessing correlation. Possible alternatives would be to cover future periods up until the expiry of the hedged contracts, the current financial year or somewhere in-between. It is for the auditor to assess that the time frame selected by the entity's management is in line with the envisaged objective of the hedging relationship.

The depth of the audit exercise shall, as usual, be dictated by issues of materiality/ significance of the hedging relationship in context of the overall business dimensions of the entity, the past relationship and experience of the auditor with the client and, perhaps most importantly, the internal controls that the client has in place.

The audit assignment would be essentially incomplete without a comprehensive review of the hedge documentation. This is absolutely necessary as complete, precise and comprehensive documentation is

a cardinal pre-requisite for availing hedge accounting. The auditor must ensure that this mandate is faithfully met.

Another issue of significance that calls for auditor's decision making is whether the (risk offsetting) influence of other instruments or positions taken within the entity needs to be assessed as part of the hedge effectiveness assessment. The level at which the reduction or mitigation of client risk is to be assessed by the auditor is also relevant to the audit exercise. In general, the risk considered would be at the entity level with emphasis on the specific transaction in context of which the hedging relationship is under review.

Conclusion

It is unquestionable that the audit of hedge accounting relationships exposes the auditor to a greater audit risk relative to audit of situations wherein the hedge components are accurately recorded under mark-to-market accounting. The situation is further aggravated by the paucity of professional pronouncements on this issue, particularly, in context of the completely renovated hedge accounting framework. Under the circumstances, the auditor, really, has little choice but to rely upon his own professional skills, judgement and experience. Needless to say, the role of a meticulous due diligence can hardly be overemphasized in this situation. It is pertinent to underscore at this point that the new hedge effectiveness assessment framework enables a powerful principles based testing formulation which is significantly more amenable to qualitative assessment than its predecessor that had literally encapsulated to the "80/125" bright line test.

The audit exercise in context of hedge effectiveness testing would invariably proceed with a review of the qualitative aspects of the hedging relationship, the nature of the products used for hedging against underlying exposures and the client's internal controls environment. A comprehensive review of hedging documentation is imperative and indispensable. In case quantitative evidence is presented to the auditor to vindicate the hedge effectiveness, the underlying models, the input parameter values and periodicities and the calculations may need to be examined. There may also be situations in which the auditor may, *suo moto*, decide to adopt quantitative assessment procedures.

Most importantly, in course of the audit exercise, the auditor must never overlook that perspectives of hedging may vary across the client and the auditor. For the client, the hedging strategy may translate to a risk-return tradeoff, whereas the auditor will simply view it in context of mitigation or management of risk. Another caveat is that there may exist a number of hedging strategies like

portfolio hedging, dynamic hedging etc. that are not amenable to hedge accounting intrinsically. To conclude, it justifies reiterating that the auditor needs to be abundantly vigilant in discharging audit functions wherein a deferral of recognition of gains & losses have been affected through hedge accounting in view of the several added audit risk factors elaborated above.

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Prudence vs. Credibility. A Formal Comparative Analysis between Romanian Accounting Regulations and IFRS

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ABSTRACT

Starting from the controversial influence that prudence may have on the credibility of accounting information and from the fact that there are different views of the global accounting systems on this concept, the present research aims to analyze the level of formal convergence between the Romanian accounting regulations and the International Financial Reporting Standards (IFRS) on the application of prudence. In this regard, the requirements for provisions, property, plant and equipment, inventories and receivables were considered, with a focus on asset depreciation and impairment losses, elements that were considered in this case as being representative for prudence in accounting. Using the Jaccard coefficients, the paper compares the requirements of the Romanian accounting regulations, represented by OMFP no. 1802/2014 with the ones presented in IAS 16 „Property, plant and equipment”, IAS 36 „Impairment of Assets”, IAS 38 „Intangible Assets”, IAS 37 „Provisions, Contingent Liabilities and Contingent Assets”, IAS 32 „Financial Instruments: presentation” and IFRS 9 „Financial Instruments”. The results show that the highest degree of convergence is identified for the provisions, and the lowest for financial assets. Also, the requirements on depreciation and impairment losses presented in OMFP no. 1802/2014 differ significantly from those presented in IFRSs.

Keywords: *Romanian accounting regulations, IFRS, similarity, convergence, accounting policies*

JEL Classification: *M41, M48*

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Introduction

Globalization has intensified unprecedentedly in the recent years, being considered, perhaps, the most important economic process that marked the end of the millennium. After nearly 50 years in which „three different worlds” co-existed: countries with developed economies, with developing economies and those with a hyper-centralized economic system, these worlds have come closer, barriers between them being reduced. Their national economies have become more and more interconnected within the international economic system and have gradually come to a global economic system where economic interdependence between countries is considered to be an essential element (Olaru and Olaru, 2009). In terms of accounting, the two dominant accounting systems (the Anglo-Saxon and the Continental one) exerted a strong influence on national accounting systems that showed significant differences. These differences generated many concerns regarding an unique reporting framework. Under these conditions, international accounting harmonization has become necessary, with the aim of eliminating differences in financial reporting between countries, being increasingly demanded by investors, especially foreign ones who needed to compare, by equivalent criteria, the opportunities for capital placement. The start of the international accounting convergence process took place in October 2002 when the FASB and the IASB announced the signing of a Memorandum of Understanding called Norwalk Agreement, an act that will remain in the history of international accounting as a compromise made for the adoption of some compatible solutions for problems related to accounting treatments (Dima Cristea and Șărămăt, 2011, p. 3).

In the context of the current economy, the decision making process is dependent on the quality and the quantity of information provided by companies. At the same time, accounting information results from primary accounting data, processed by accountants. Given the mere fact that human resources are implicated it is subjected to a high degree of subjectivity. When referring to subjectivity in accounting, we must consider the prudence principle. It requires accounting information to be pessimistic, to ignore unrealized gains and asset gains, and to consider losses and the rise of real or potential debts. This concept is found in every country's accounting regulations and pursues the same idea everywhere: to provide a safety margin for society

and users of financial information (Toma 2001). It induces the idea of legal protection, meaning that it protects tomorrow's owner from an expense that belongs to today's owner and avoids decapitalization of the firm, which may occur in response to the distribution of unrealistic benefits (Horomnea 2013). It also prohibits the overstatement of a company's assets and income and the understatement of its liabilities, expenses and equity, and implies taking into account potential losses, risks and impairments, without leading to the creation of hidden reserves or oversized provisions.

In IASB's view, the Conceptual Framework for the Preparation and Presentation of Financial Statements, issued in 1989, presented prudence between the qualitative characteristics of the financial statements, more precisely as a component of credibility. Its review in the years that followed, with an emphasis on the 2010 version, has produced a number of major changes, including the exclusion of prudence on the grounds that it disagrees with neutrality and that it is not an universal characteristic, which applies to all the standards. In order to eliminate this inconvenience and to meet the demands of those that opposed to the exclusion of prudence from the Conceptual Framework, in the March 2018 version of the Framework, the Council reintroduced prudence in close correlation with neutrality. Thus, in the current version, it is specified that: „neutrality is supported by the exercise of prudence” (point 2.16 IASB, 2018) and that its exercise does not imply an informational asymmetry, the latter not being a feature of useful financial information. Mihalache (2016) emphasizes that prudence is reflected in UK accounting regulations, as in the 1989 version of the IASB's Conceptual Framework, among the requirements needed to ensure the credibility of financial information.

In FASB's (Financial Accounting Standards Board) view, unlike IASB, prudence was not seen as a component of credibility but it was considered necessary, being a reaction to the uncertainty that exists in the economic system.

The Continental accounting system, closely related to the Romanian accounting system for a long time, is oriented towards taxation and the use of the banking sector as the main user, the financial markets being still in an early stage. In these circumstances, the accounting was over-directed towards prudence (Bebeșelea, 2016), this principle being considered of vital importance and also a precaution for creditors.

Starting from the importance of the International Financial Reporting Standards proposed by the IASB in the process of harmonization at international and national level, we considered necessary to analyze how prudence is addressed in the international accounting referential and in Romanian accounting regulations, prior to conducting an analysis of material convergence (*de facto*) on this subject. Jaccard coefficients will be used for this purpose, this method being the most used and recommended in the international literature as it provides a much more credible basis for evaluation compared to other existing methods for analyzing the degree of formal convergence (*de jure*) between certain sets of regulations (Fontes, Rodrigues, & Craig, 2005, p. 417).

Referring to International Financial Reporting Standards, it can be argued that they address the issue of prudence in terms of the effects of its application, exercised over the various elements included in the financial statements. As seen from the perspective of the national regulations, Ionașcu and Feleagă (1997, p.372) identify the place of prudence from an operational point of view in the valuation process, namely in the valuation of elements at the end of the financial year and their presentation on the balance sheet, as presented in the current national regulations (MFP 2014).

We propose, in the following, to present: the current state of the field regarding the analysis of convergence between different sets of regulations (first section), the methodology applied in the undertaken analysis (second section), the analysis of the results and the identification of the main factors that have led to the appearance of differences between regulations (third section), as well as the conclusions and the limits of the study (last section).

1. Literature review

The accounting literature on the formal convergence between different sets of regulations is based mostly on the work of Rahman, Perera and Ganeshanandam (1996) and that of Fontes et al (2005). This section aims to create an image of the research on formal convergence both at the international literature level, referring to the most cited papers, as well as at the level of the Romanian academic environment.

A first paper belonging to Rahman, Perera and Ganeshanandam (1996) introduced a methodology for

measuring formal harmonization between countries, targeting the case of Australia and New Zealand. The study involved a comparison of the requirements applicable to listed companies by focusing on presentation, disclosure and measurement. For this analysis the requirements of the standards were divided into four types: type 1 (required for all listed companies), type 2 (recommended or suggested), type 3 (permitted), or type 4 (not allowed). The method used by the authors was Multiple Discrimination Analysis (MDA), the purpose of which was to measure the level of formal harmonization between the two countries' accounting regulations. The results of the study highlighted the usefulness of the method and served as a model for many other researchers. Garrido et al. (2002) developed a methodology for measuring formal harmonization that could be used to analyze the degree of comparability between different sets of regulations at different times or even between different countries. The authors provided a method for measuring the progress of IASC on formal harmonization, based on three historical stages in the development of the standards: 1973-1988 (Stage A), 1989-1995 (Stage B), 1995-present (stage C). The analyzed sample contained the accounting treatments included in the International Accounting Standards (IAS) which have been modified over the existence of the IASC. The authors divided them into four categories in a similar manner to the methodology applied by Rahman, Perera and Ganeshanandam (1996), as follows: „requested”, „reference”, „allowed”, and „forbidden”. The results were obtained using the Euclidean Distance Method and indicate that the IASC has made significant progress regarding the comparability of financial information.

Fontes et al (2005) studied the comparison between a set of national accounting standards (for the case of Portugal) and IAS / IFRS. The author proposed three methods for measuring formal harmonization, namely Euclidean distance, Jaccard coefficients and Spearman coefficients. The analyzed sample included a number of IAS / IFRS accounting requirements, and the results indicated a high level of convergence between Portuguese and International Financial Reporting Standards. After applying all three methods the authors' recommendation was to use Jaccard's coefficients because this method provides a much stronger basis evaluation compared to the other proposed methods.

The study of Ding et al. (2005) investigated the degree of convergence between national accounting standards for a sample of 30 countries and the IAS, using two indices: the absence index (to quantify the extent to which certain accounting rules are not found in the National Accounting Standards, but they are covered by IAS) and the divergence index (which covers rules related to the same accounting item, but differ in the two sets of standards). Additionally, through a regression, the determinants of absence and divergence for the analyzed sample were identified.

Strouhal (2009) focused on the degree of convergence between Czech accounting standards and IFRSs through Jaccard's similarity coefficients. The results of the study indicate a high degree of convergence between the two analyzed sets.

Qu and Zhang (2008) studied the convergence between Chinese accounting standards and IFRS, using fuzzy clustering method. The results of the study showed a high degree of convergence between the two sets of standards. Another study that focused on the convergence of Chinese standards with IAS / IFRS, this time using a longitudinal analysis for the 1992-2006 period of time, belongs to Peng and van der Laan Smith (2010). For the analysis, the Chinese accounting standards were compared with IFRS and a convergence score for each item analyzed was established using three categories: „total convergence”, „substantial convergence” or „non-convergence” with IFRS.

Baltariu and Cârstea (2012) analyze the degree of formal accounting harmonization within the European Union regarding EC Regulation no. 1606/2002 adopted by the European Parliament and the European Council on 19 July 2002, which regulates the IFRS application for the financial reporting of listed European companies. For this purpose, Rogers and Tanimoto coefficients, Lance and Williams coefficients, the Euclidean distance coefficient and Jaccard's coefficients were used. The results confirmed the hypothesis according to which: the degree of similarity is higher between the Romanian accounting system and the accounting systems of the countries that belong to the continental accounting system and is smaller between the Romanian accounting system and the accounting systems of the countries that belong to the Anglo-Saxon system.

Gîrbină et al (2012) presented a comparative study between Romanian national regulations and IFRS for SMEs in order to determine the differences and similarities between the two sets of regulations, using four indices: the modified Jaccard coefficient, the

absence index, the divergence index and the average distance.

Albu and Pălărie (2016) analyzed the level of convergence between Romanian accounting regulations and IFRS (IAS 16, IAS 17, IAS 41 and SIC 15) over a period of ten years. The authors assigned scores such as: „1 for full convergence” and „0 for complete difference”, in order to measure the level of convergence between the requirements of both standards. The results showed that in 2005 there was a high level of convergence for property, plant and equipment, medium level of convergence for leasing and divergences for agriculture. The analysis also revealed that the level of convergence has improved over time, but there is still room for more.

2. Research methodology

In order to determine the degree of formal convergence between Romanian accounting regulations and IFRS (with emphasis on IAS 16, „Property, plant and equipment”, IAS 36 „Impairment of Assets”, IAS 38 „Intangible Assets”, IAS 37 „Provisions, Contingent Liabilities and Contingent Assets”, IAS 32 „Financial Instruments: Presentation” and IFRS 9 „Financial Instruments”) with respect to prudence, we used a methodology based on Jaccard coefficients, calculated using the following formulas:

$$S_{ij} = \frac{a}{(a+b+c)}$$

$$D_{ij} = \frac{(b+c)}{(a+b+c)} \text{ where,}$$

S_{ij} - Jaccard's similarity coefficient, which is the extent to which the sets of regulations i and j are similar;

D_{ij} - Jaccard's distance coefficient, which is the extent to which the sets of regulations i and j are different;

a - the number of elements found in both sets of regulations;

b - the number of elements that are found in the set of regulations j , but are not found in the set of regulations i ;

c - the number of elements found in the set of regulations i , but not found in the set of regulations j .

The Jaccard's similarity and distance coefficients values are complementary, their sum being always equal to 1. The closest the coefficient of similarity is to 1, the higher the degree of convergence between the two sets of regulations.

To begin with, in order to establish the degree of formal convergence between national accounting regulations and IFRS, we analyzed the assets that require the use of impairment losses and depreciation, and the provisions, which are consistent with the prudence principle. Thus, we analyzed the requirements for recognition, valuation moments, types of values and other items attributable for the following: provisions, property, plant and equipment, intangible assets, inventories, accounts receivables and short-term investments.

In OMFP 1802/2014, the valuation of assets and liabilities is presented on several levels: first, in a separate section, the general valuation rules are established, after which, for assets and liabilities, details are presented in the sections reserved for each category (Istrate, 2018). Three aspects of the assessment are taken into account in the Romanian

accounting: the valuation at entry, the valuation at inventory and the presentation in the balance sheet and at the retirement or disposal moment. In IFRS we do not find a distinct section that presents the general valuation rules and there is no delimitation of the moments presented in OMFP 1802/2014. This is why, for the selection of the elements analyzed to determine the degree of convergence, we took into account both the national accounting regulations and IFRS regulations.

3. Results and discussions

The comparative analysis undertaken in order to establish the degree of convergence between the two sets of regulations for the selected categories is presented in **Table no. 1**.

Table no. 1. Formal accounting convergence - analyzed categories		
Category / Element	OMFP 1802 vs. IAS / IFRS	
	OMFP 1802/2014	IAS/ IFRS
Intangible assets		
Recognition	1	0
Entry	1	1
Amortization	0	1
Impairment	0	1
Presentation and disclosure	0	1
Property, plant and equipment		
Recognition	1	1
Entry	1	1
Amortization	0	1
Impairment	0	1
Presentation and disclosure	0	1
Inventories		
Recognition	1	1
Entry	1	0
Impairment	1	1
Presentation and disclosure	0	1
Retirement or disposals	1	0
Provisions		
Recognition	1	0
Changes in provisions - creation	1	1
Changes in provisions - increase	0	1
Changes in provisions - decrease	1	1
Use of provision	1	1
Reimbursement	1	1
Presentation and disclosure	0	1

Category / Element	OMFP 1802 vs. IAS / IFRS	
	OMFP 1802/2014	IAS/ IFRS
Financial assets		
Recognition	0	1
Entry	0	1
Impairment loss	0	1
Financial assets classification	0	1

Source: Authors' compilation

The values of the Jaccard coefficients for the analyzed categories can be found in **Table no. 2**.

Table no. 2. Jaccard coefficients for the analyzed categories		
Category	Jaccard coefficients OMFP 1802 – IAS / IFRS	
	Sij	Dij
Property, Plant and Equipment	0,20	0,80
Intangible assets	0,40	0,60
Inventories	0,40	0,60
Provisions	0,58	0,42
Financial Assets	0	1

Source: Authors' compilation

For the first two analyzed categories, **property, plant and equipment** and **intangible assets**, a first difference that can be identified follows the recognition of these assets (as can be seen in Table no. 1). Thus, analyzing the requirements presented in OMFP 1802/2014, it is observed that the scope for *property, plant and equipment* is more extensive than IAS 16, the Romanian regulations including, in this category, a series of assets for which are applied the accounting treatments that fall within the scope of other standards (for example, the IFRS 5 „Non-current assets held for sale and discontinued operations” or investment property covered by IAS 40 „Investment property”).

For the second category, **inventories**, accounting policies presented in OMFP 1802/2014 are applied to assets that fall within the scope of other international standards (as it is the case for a set of assets that fall under IAS 41 „Agriculture”). Although the requirements of IAS 2 „Inventories” have been mostly taken over in national regulations, some differences remain, particularly in the valuation chapter, which have not been totally converged. Thus, it was noted that IAS 2 does not distinguish between different types of discounts, all of them reducing the acquisition cost. In

both sets of regulations, end-of-year inventory valuation is made at the minimum between the cost and the net realizable value. The net realizable value results from the estimated selling price that could be obtained during the normal course of a business less estimated costs for completion of the asset, where applicable, and the estimated sales costs. If the book value is greater than the inventory value, the inventory value decreases to the net realizable value by creating an impairment adjustment. The last difference is attributed to the methods that can be applied when removing fungible stocks from the inventory. In this respect OMFP 1802/2014 allows the LIFO method (last in first out), a method that is forbidden by IAS / IFRS.

For **provisions**, it can be seen that between OMFP 1802/2014 and IFRS (focusing on the IAS 37) there is a high degree of convergence (58%). A first difference between the two sets of regulations can be attributed to the details provided by OMFP 1802/2014 regarding the types of provisions that may be created and their description. With regard to their increase, IAS 37 provides that provisions are measured before taxation because its effects are regulated by IAS 12. In Romania,

the taxation part is not reflected in the OMFP 1802/2014, but in the Fiscal Code (Law no 227/2015).

As far as the **financial assets** are concerned, they are not found in OMFP 1802/2014 under this name. According to paragraphs 11 and AG3-AG4 of IAS 32, a financial asset is any asset that is cash; an equity instrument of another entity; a contractual right (to receive cash or another financial asset from another entity, or to change financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity); a contract that will or may be settled in the entity's own equity instruments.

In this case, in order to determine the characteristics for the financial assets category, we considered the elements: accounts receivables, green certificates (environment certificates), cash, short-term investments stipulated in OMFP 1802/2014 and we compared the requirements with those included in IAS 32 „Financial Instruments: Presentation” and those presented in IFRS

9 „Financial Instruments”. Thus, in international standards, regarding recognition, financial assets are measured at fair value or at cost, directly attributable to the transaction. Subsequently, they can be measured, based on the entity's business model, at amortized cost, fair value through profit or loss or fair value through other comprehensive income, which differentiates national accounting from international accounting. Upon their entry, according to OMFP 1802/2014, the financial assets are valued at the acquisition cost or the value stipulated in the contracts, and their value at inventory and their presentation in the balance sheet are subject to impairment loss.

Considering that prudence manifests by provisioning, but also in order to determine the degree of depreciation due to permanent physical usage or to determine the size of adjustments corresponding to reversible impairments, for the analyzed categories, we shall present a separate section with the Jaccard coefficients for depreciation and impairment adjustments (**Table no. 3**).

Table no. 3. Formal accounting convergence – amortization and impairment loss		
Analyzed element / Details	OMFP 1802/2014	IAS / IFRS
Amortization of intangible assets		
Amortized value	0	1
Useful life	0	1
Methods of amortization	1	0
Changing amortization methods	0	1
Bookkeeping	1	0
Treatment of amortization at retirements and disposals	1	1
Depreciation of Property, Plant and Equipment		
Depreciable cost	0	1
Useful life	0	1
Methods of depreciation	1	0
Changing depreciation methods	0	1
Bookkeeping	1	0
Treatment of depreciation at retirements and disposals	1	1
Impairment of assets		
Identifying an asset that is impaired	0	1
Moment for determining an impairment loss	0	1
Reversing an impairment loss	0	1

Source: Authors' compilation

The values of the Jaccard coefficients for amortization/depreciation and impairment loss, for the

categories in which differences were observed, can be found in **Table no. 4**.

Table no. 4. Jaccard coefficients for amortization and impairment loss

Category	Jaccard coefficients OMFP 1802 – IAS / IFRS	
	Sij	Dij
Amortization of intangible assets	0,17	0,83
Depreciation of Property, Plant and Equipment	0,17	0,83
Impairment loss for assets	0	1
Impairment loss for financial assets	0	1

Source: Author's compilation

The first case, analyzed in a detailed manner, concerns the **depreciation of Property, Plant and Equipment and the amortization of intangible assets** and we observe, in Table no. 4, that the degree of convergence between the two analyzed sets is low (17%). In Table no. 3 it can be seen that the differences refer to the amortized value, the methods of determining the useful life, the allowed depreciation and amortization methods, the regulation for their change and the rules that apply to bookkeeping of the *Property, Plant and Equipment and of the intangible assets*.

First, unlike OMFP 1802/2014, IAS 16 „Property, Plant and Equipment” requires the residual value be taken into account for the calculation of the depreciation, within OMFP 1802/2014 the residual value being null. IAS 16 requires depreciation to be calculated using the method that best reflects the rate at which the economic benefits of the asset are being consumed, while OMFP 1802/2014 presents four accepted methods (linear, degressive, accelerated and calculated per unit of product or service), of which the accelerated depreciation method is not permitted by IAS 16. Under international regulations, companies have to analyze whether the useful life, the rate at which the economic benefits of the asset are being consumed and residual values are in line with economic reality. Otherwise, a reassessment of them is carried out. In OMFP 1802/2014, however, it is considered that the reassessment of the useful life may occur extremely rare, and the change in the depreciation method can only occur when it is determined by an error in estimating the mode of consumption of the benefits associated with that asset. In accordance with IAS 16, depreciation begins from the date of putting into service of the asset, while the OMFP provides that the depreciation is recorded from the first of the month following the entrance of the asset in the entity.

Regarding the amortization of intangible assets, IAS 38 „Intangible assets” specifies two cases: intangible assets that are not amortized, but tested for impairment at least once during the year (for assets with indefinite life) and intangible assets which amortize (for those with defined life).

The second case, analyzed in a detailed manner, concerns the impairment loss that affects *Property, Plant and Equipment and intangible assets*. In Table no. 4 we observe that the degree of convergence is 0, which means that no significant similarities between national accounting regulations and IAS / IFRS have been identified. First of all, even though many notions regarding the depreciation provided by IAS 36 „Impairment of Assets” have been taken over in OMFP 1802/2014, the notion of recoverable amount (with all that it implies for its calculation) and the specifications related to cash-generating units (CGUs) are not presented in the Romanian regulations.

Under IAS 36, an asset is depreciated when its carrying amount is greater than recoverable amount. In this respect, IAS 36 states that recoverable amount is the maximum of the fair value less estimated expense with the sale of the asset and its useful value (the present value of future cash flows arising from the continuing use and disposal of the asset).

OMFP 1802/2014 requires that the valuation of *Property, Plant and Equipment and intangible assets* for the purposes of determining impairment loss shall be made at the inventory and shall be made at the inventory value (determined by the inventory commission or the authorized valuers). The correction of the value is made, depending on the type of depreciation, either by recognizing additional amortization if irreversible depreciation is found or by impairment loss, if there is a reversible depreciation. IAS 36 also requires that, at the

end of each reporting period, an entity should measure the existence of indications that would justify reducing or canceling an impairment loss recognized in prior periods for an asset other than goodwill. If there are any indications in this respect, the entity must estimate the recoverable amount of the asset.

As for the financial assets impairment, IFRS 9 introduces a new model based on expected losses that require early recognition of losses that are expected to arise from impairment of accounts receivables. The Standard requires entities to recognize the expected impairment losses on the accounts receivables from the initial recognition of financial instruments and to recognize the expected impairment losses over the life of the financial instruments.

There is a three-step approach, which is based on the change in the quality of the financial asset from the initial recognition. Doba (2018) explains that, in practice, these new requirements mean that entities will have to record an estimated loss related to a period of 12 months from the initial recognition of the financial assets that are not impaired (or a loss over the expected lifetime for trade receivables).

A final difference globally observed concerns presentation and disclosure. IFRS has in each case a detailed list of information to be included in the financial statements in order to provide a complete, transparent and fair view about the entity's financial position and

performance. These lists are not explicitly found in OMFP 1802/2014, for any of the analyzed items.

4. Conclusions

The undertaken analysis aims to highlight accounting practices that regard the perception of prudence at a theoretical level so that, in future research, we would be able to analyze the convergence through a material analysis (*de facto*). Regarding the results of the formal convergence analysis (*de jure*), Jaccard's coefficients revealed that the highest degree of convergence is recorded for the provisions. On the opposite side, the lowest degree is recorded for financial assets (cash, accounts receivables, temporary investments etc.). Also, accounting treatments for depreciation and impairment of assets, presented in OMFP 1802/2014, significantly differ from those presented in IFRSs. Establishing the extent to which Romanian accounting regulations are converging with International Financial Reporting Standards is a necessary pre-requisite for the purpose of conducting a material convergence analysis (*de facto*), which is why we can emphasize the relevance of this type of study.

The limits of the study refer to the fact that the analysis of the degree of convergence only focused on the issue of prudence, leaving aside the other requirements contained in the two sets of regulations under consideration.

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Adoption of International Financial Reporting Standards (IFRSs)

**and their Impact on Loan Terms:
Kosovo Case**

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ABSTRACT

As part of the major international developments on financial reporting and auditing, the International Financial Reporting Standards (IFRS), which are now applied in many countries around the world, are creating an international harmonization and a common language for financial reporting and accounting between firms that apply and report in accordance to these standards. This paper empirically tests whether adoption of IFRS in developing and transitional Kosovo, has impact on bank's loan terms and conditions for companies that are mandatory adopters of IFRSs. To test the hypothesis, the authors analyzed the opinions of the banking sector and of companies that are mandatory adopters of IFRSs in Kosovo. The research results suggest that the adoption of IFRSs in Kosovo has impact on interest rates offered by banks to mandatory adopters, as well as on non-financial loan terms such as: loan time limits, mortgage requirements, lower administrative costs and renegotiating loan terms. Mandatory IFRS adopters have a better loan rating compared to other companies in Kosovo and the percentage of non-performing loans is lower for mandatory IFRS adopters in Kosovo. Based on this research, the aim is to demonstrate to policy makers and other stakeholders that only the mere implementation of high quality financial reporting standards, such as IFRSs, is not sufficient to improve the quality of accounting and financial reporting in Kosovo, especially since there are no institutional mechanisms to empower the implementation of IFRSs. For companies in Kosovo receiving better loan terms from banks can be an incentive to improve their financial reporting systems, but the focus is also on other benefits that should be considered as well.

Keywords: IFRS, financial statements, cost of borrowings, loan terms, disclosures, transparency, accountability

JEL Classification: M41, M42

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Introduction

The adoption of International Financial Reporting Standards (IFRSs) in many countries of the world is a momentum in the development of the accounting and auditing profession worldwide and it can be seen as one of the most important regulatory changes in accounting and financial reporting history. Over 100 countries have moved towards reporting in accordance with IFRSs and regulators expect an increase of the comparability of financial statements, an increase of transparency and an improvement of the quality of financial reporting. In this regard, broad literature is focused on the effects of the IFRSs in different **aspects of the business** environment and the economy as a whole.

Strengthening the financial reporting regime, as a result of financial crises, has led to a stronger oversight of the accounting and auditing profession as well. As such, in the future, this would prevent a similar crisis by distributing and eliminating the risks. Consequently, the adoption of IFRSs is well supported by many countries because it can improve the quality, timeliness and international comparability of financial reporting systems by creating a common financial reporting language.

Moreover, these objectives cannot be achieved without a proper monitoring and supervision from the regulators, who seek to promote the rigorous and consistent use of IFRSs.

Another issue that seems to come into view is that, based on research, the adoption of IFRSs improves the information environment and reduces the information asymmetry, thus affecting the capital market and resulting in a reduction of cost of capital.

In general, the literature review suggests that the application of IFRSs leads to an increase in the quantity and / or quality of specific financial information of companies and more disclosures in the financial information for public use. This leads to the fact that the adoption of IFRSs is associated with lower flexibility in accounting and lower analyst forecast errors (Ashbaugh and Pincus, 2001), lower costs of capital and loan interest rates (Leas and Verrechia, 2000), higher performance coefficients (Bartov et al., 2005), higher performance ratios (Daske et al., 2007; Kim and Shi, 2009a), higher market liquidity and higher trading volume, better accounting quality and financial reporting (Barth et al., 2008), increased investment as a result of attracting more foreign funds and greater efficiency in

contracting private debt (Covrig et al, 2007; Kim et al., 2010).

In our study we have chosen to analyze *the impact of IFRS adoption on loan terms for companies in Kosovo, since there is no capital market in Kosovo, and financing of the companies, even mandatory IFRS adopters, relies mostly on bank loans.*

Therefore, the aim of this study is to give an empiric answer to the research question of **whether adoption of IFRSs in a developing economy of Kosovo has had a significant impact on loan terms and cost of borrowing capital or not.**

Although Kosovo has adopted IFRSs since 2012, no such research has been done in this area, neither on other benefits or costs of implementing these standards.

In fact, some previous studies have documented the differential effects of IFRSs on capital markets and the information environment across different countries. For example, Daske et al. (2008) found that capital markets that benefit from IFRSs exist only in countries with **strong enforcement**; Byard et al. (2011) noted that the adoption of IFRSs only improves the information environment of analysts in countries with both **robust enforcement regimes** and accounting standards that differ significantly from the IFRS; Landsman et al. (2012) commented that the improvement in the content of financial information after the adoption of IFRSs is greater in countries with **strong legal enforcement**. DeFond et al. (2011) and Yu (2012) indicated that the adoption of IFRS hampers greater **cross-border investments**.

Overall, the literature shows that the adoption of IFRSs has significant implications on markets, information asymmetry, cost of capital, on increasing the reliance and trust on financial statements information, transparency and accountability and in developing the economy as a whole.

We find that most of the research argues that companies in countries that apply IFRSs and IASs have higher quality of accounting and financial reporting, evidenced and documented by stronger recognition and measurement policies for transactions and accounts in financial statements, such as a "fair value" concept in accounting, as a major feature of IFRSs.

Compared to local accounting standards, IFRSs have broader disclosure requirements and accounting rules, which will impact on better serving the needs of

“interested” parties such as investors, creditors, oversight authorities, etc. in decisions’ process, with timely and relevant information. In this regard, we noted that in most of the literature this comparison between local and international standards comes as a result of IFRSs having detailed rule basis for measuring and recognizing assets and liabilities, expenses and revenues, equity elements, employee benefits, as well as extensive disclosure requirements for transactions with related parties, information about subsidiaries, cash flow statement, etc. In fact, in local accounting and financial reporting standards the above mentioned requirements may often be simplified or lack at all.

Some studies show that the economic consequences of IFRSs are also explained and justified by changes in the financial reporting and auditing environment, the level of enforcement of laws and regulations, the level of capacity building for the implementation of IFRSs, adoption and implementation of audit standards etc. (Hail et al., 2010).

Further on, previous studies generally document a positive effect of adoption of IFRS in the environment of financial analysts and capital markets (e.g. Landsman et al., 2011; Byard, Li, and Yu, 2011; Tan, Wang, and Welker, 2011). However, findings show that the effects of adoption of IFRS in capital markets are partly attributable to improved **voluntary disclosures**, as this has a positive impact also on the information environment and liquidity (e.g. Welker, 1995; Leuz and Schrand, 2009; Balakrishnan et al., 2012). Specifically, the liquidity benefits from IFRSs are greater for firms that increase their level of voluntary disclosures and this suggests the existence of an **indirect mechanism** by which IFRSs affect the liquidity of companies.

On the other hand, Nobes and Parker (2006) point out that although the harmonization of accounting and financial reporting standards will raise many benefits, there are many elements to be considered in the harmonization of these standards such as **culture, economic and political systems** that are different not only between developed and developing countries, but also between countries that may have similar characteristics. These elements can be considered as **barriers to adoption** and harmonization process.

Haller and Walton (2003) show that **standardization** is the way of using single accounting rules, while **harmonization** is the way of reducing the differences between accounting systems that will help improve the

comparability of financial results in different countries (Radebaugh et al., 2006). Harmonization of accounting and financial reporting standards is motivated by many factors such as the growth of foreign direct investment (FDI), the growth of financial markets and the development of multinational organizations (Gray, 1988).

1. Literature review

When analyzing the literature on “pros and cons” of the IFRS adoption, we find that while mandatory IFRS implementation is a part of the countries’ reporting framework and financial reporting regime, with the aim to increase the quality of financial statements in benefit of transparency, accountability and comparability for all the stakeholders in order to protect the public interest, **voluntary adoption of IFRSs** can be incentivized by a strategic commitment of a firm to provide better financial reporting strategies and higher level of disclosure of financial information (Leuz and Verrecchia, 2000; Covrig et al., 2007).

Largely, firms usually make decisions to switch their financial reporting standards as in some of the three cases below:

- **First**, when adopting a new set of standards, a voluntary change gives firms the opportunity to choose between two possibilities: one is based on management expectations to get a lower capital cost, resulting from high quality information and a lower information asymmetry, and the other one resulting in a higher market evaluation of a firm (Leuz and Verrecchia, 2000). In this regard, for voluntary adopters usually the benefits outweigh the convergence and transition costs for the fast-growing internationally owned companies (Harris and Muller, 1999).
- **Secondly**, flexible mandatory transition to IFRS gives opportunities to firms to decide over the time of change. Balsam et al. (1995) find that companies in these cases attempt to postpone the time for transition to IFRSs, so “reported earnings increase and corporate debt constraints decrease.”
- **Finally**, mandatory changes dictate both the new standards and the transition time to IFRSs.

The effectiveness of the regulation in achieving such benefits as a reduction in the cost of capital is likely to depend on the degree to which the institutional

environment (e.g., the quality of legal enforcement) motivate the financial statements preparers (e.g., Ball et al., 2003).

Therefore, it is still unclear how the cost of capital is affected by the adoption of IFRSs and this remains an empirical question.

In fact, the empirical results in academic literature so far **are mixed**. Mostly based on the significances for capital markets, existing literature highlights a considerable **heterogeneity** in the economic consequences of the adoption of IFRSs.

Extending disclosures through the voluntary adoption of IFRSs may affect market participants' incentives for gathering, processing and disseminating specific information of the company. However, the above-mentioned studies in general do not provide a clear answer to the question of whether additional disclosures under IFRSs encourage or discourage the involvement of specific company information, reflecting not only the cost of capital but also stock prices.

On the other hand, increasing the quantity and quality of public information in compliance with IFRSs **may reduce the cost and increase effectiveness of obtaining specific information** about the company and thus discourage market participants from collecting and disseminating private information, as more comprehensive information is made publicly available (Kim and Verrecchia, 2001). In such a case, stock prices and cost of capital move along with public information (Dasgupta et al., 2010). Given the lack of evidence on which of these effects dominate, the objective of these studies is to test **whether and how the voluntary adoption** of IFRSs improves the impact of specific company information on stock prices, thus reducing the cost of capital.

Easley and O'Hara (2004) as well as Leuz and Verrecchia (2004) predict that firms with higher risk of information will have higher cost of capital. The risk of information is related to the uncertainty or impreciseness of information used or needed and desired by investors, and the latter necessarily relates to the price of securities. In addition to creating a common reporting language, adoption and implementation of the IFRS is assumed that will also eliminate the above-mentioned risk.

Previous research also suggests an indirect link between **disclosures and cost of capital of firms**,

based on market liquidity and adverse selection in secondary markets (e.g., Diamond and Verrecchia, 1991; Baiman and Verrecchia, 1996; Easley and O'Hara, 2004).

However, these studies, analyze the parameters with a single company (or parameters where the cash flows in all firms are unrelated). Thus, it is unclear whether the effects shown in these studies are persistent to the diversification and expand into more general parameters. Piotroski (2005) finds that the increase of the disclosure is positively correlated with analysts' forecasts and profit capitalization rates, but this study does not document significant changes in the liquidity of the companies which have been part of this study.

Although some studies (e.g., Ball, 2001; Ball et al, 2003) have an uncertainty on the effect of adopting international financial reporting standards at the local level without institutional support, recent studies argue that the decision of a company to voluntarily apply IFRSs leads to preferred economic consequences and the evidence shows that IFRS disclosures are, on average, of higher quality than those that are in compliance with local accounting and financial reporting standards in the majority of financial reporting regimes.

These studies are consistent with Aboody et al. (2004) and Easley and O'Hara (2004), which provide evidence that the **risk of information is costly** and thus it's perceived that a cost reduction can result in a market reaction. Investors may also react positively to adoption of IFRSs if they expect the implementation to have positive effects on the cash flow. The improvement of future liquidity for firms is as a result of a greater disclosure and this lowers the firm's cost of capital.

2. Scientific research

2.1. Methodology

In this research, we have scientifically analyzed the results to test our hypothesis based on the statistical methods such as: descriptive statistics, ANOVA variances analysis, the standard deviation and the statistical F test.

The research data consist in **primary** and **secondary** data, where primary data are collected from questionnaire responses and interviews with banks and companies that are mandatory adopters of IFRSs and

secondary data are collected from other similar studies, guides and IFRSs, as issued by the International Accounting Standards Board (IASB). The questionnaire for primary data was designed for banks and the other one for secondary data was designed for companies, consisting of 2 parts. The first part included questions for determining the characteristics of respondents and the second part included questions regarding respondents' opinion on each of the loan terms that can be impacted by the adoption of IFRSs.

Respondents were asked if the companies that prepared their financial statements in accordance with IFRSs benefit from lower interest rates on loans, which were measured using Likert scale from 1 to 5 (1-Strongly disagree, 2-Disagree, 3-Neutral, 4-Agree and 5-Fully agree).

Respondents were further asked to calculate the level of compliance with the various assertions in the questionnaire. Each response's rank (1 to 5) was multiplied by the weight (1 to 5), where the highest level of compliance gets the most weight.

Respondents were also required to assess if companies that prepare IFRS financial statements benefit from other loan terms such as time limits, mortgages, lower administrative costs, and so on. Moreover, respondents were asked if banks make possible renegotiations on loan terms and whether the percentage of bad loans for companies reporting under IFRSs is lower compared to other firms.

2.2. Hypotheses

Based on both prior research and the literature review, we have developed our hypotheses as presented below:

- H1: Adoption of IFRSs in Kosovo has **impact on interest rates** offered by banks to mandatory adopters;
- H2: Adoption of IFRSs in Kosovo has **impact on non-financial loan terms** such as: time limits, mortgages, lower administrative costs and renegotiating loan terms;
- H3: Mandatory IFRS adopters **have a better loan rating** compared to other companies in Kosovo;
- H4: The **percentage of bad loans / debts** (non-performing loans) is lower for mandatory IFRS adopters in Kosovo.

2.3. Sample

The population of this research is comprised of all the banks in Kosovo and the mandatory IFRS adopters in Kosovo.

The total number of banks in Kosovo is **10**; we have collected responses from 56 loan analysts in 9 banks (90% of the population), those that analyze financial statements prepared under IFRSs and have an impact on loan decision making.

In the private sector in Kosovo there are **252** mandatory adopters; we have collected responses from 182 companies (a sample of 72% of the population). Referring to the complexity and constraints encountered in the sample selection from such a large population of companies adopting IFRSs in Kosovo, **random sample selection** was used in our research.

3. Research results

3.1. Demographic characteristics of respondents

As mentioned above, first part of the questionnaire was designed to get an overview of **respondent's characteristics**. Based on the results (as shown in **Table no. 1**) from the banking sector, a vast majority have master degree (55.88%, representing a number of 31 respondents), 44.12% of the respondents (25 respondents) have a bachelor degree and none of them has a Ph.D. degree. Regarding their professional qualification, 64.52% of the respondents (a number of 36 respondents) are Accounting Technicians, 29.03% of the respondents (a number of 16 respondents) are Certified Accountants, 6.45% of them (a number of 4 respondents) are Certified Auditors, and none of them is a Statutory Auditor (practicing auditor). Since the law in Kosovo for statutory auditors requires candidates to be working in practice as auditors, and the respondents from banks were not working as auditors, this is the reason why this is zero. With regard to their experience in the banking sector, 50% (28 respondents) had 5-10 years of experience, 23.53% (13 respondents) had 10-15 years of experience and 5.88% (3 of respondents) had more than 15 years of experience.

Table no. 1. Education, professional background and experience of respondents from banking sector

Variable	Categories of variable	Frequency	Percentage
Academic degree	Bachelor	25	44.12%
	Master	31	55.88%
	Ph.D.	0	0%
Professional degree	Certified accounting technician	36	64.52%
	Certified Accountant	16	29.03%
	Certified Auditor	4	6.45%
	Statutory Auditor	0	0%
Experience in banking sector	Less than 5 yrs.	12	20.59%
	5-10 yrs.	28	50.00%
	10-15 yrs.	13	23.53%
	More than 15 yrs.	3	5.88%

Source: Authors' projection

Since in our study we have also taken into consideration opinions from private sector, respectively those companies that are mandatory adopters of IFRS in Kosovo, we have shown the characteristics of respondents from this sector as well (as disclosed in Table no. 2). In this regard, from the private sector 63.54% or 116 have academic degree as Master, 31.25% or 57 have Bachelor Degree and 5.21% or 9 have Ph.D. degree. For professional qualification 37.5%

or 68 of respondents are Certified Accountants, 28.13% or 51 are Certified Accounting Technicians, 27.08% or 49 are Certified Auditors and 7.29% or 14 are Statutory Auditors. Regarding their experience, 31.95% or 58 respondents have 5-10 years of practical experience, 28.86% or 53 have 10-15 years, 21.67% or 39 have more than 15 years of experience and 17.52% or 32 have less than 5 years of experience.

Table no. 2. Education, professional background and experience of respondents from private sector

Variable	Categories of variable	Frequency	Percentage
Academic degree	Bachelor	57	31.25%
	Master	116	63.54%
	Ph. D.	9	5.21%
Professional degree	Certified accounting technician	51	28.13%
	Certified Accountant	68	37.50%
	Certified Auditor	49	27.08%
	Statutory Auditor	14	7.29%
Experience in company	Less than 5 yrs.	32	17.52%
	5-10 yrs.	58	31.95%
	10-15 yrs.	53	28.86%
	More than 15 yrs.	39	21.67%

Source: Authors' projection

Based on these results, it is seen that the respondent's level of understanding of these international reporting standards is quite satisfactory, given their academic, professional qualifications, as well as the work experience in accounting, finance or auditing. As such, the received answers can be considered very relevant and important to test the research hypotheses.

3.2. Testing the hypothesis and research results

The variance analysis results (ANOVA) show that there was a significant variation in the impact of the IFRS on borrowing terms for companies applying IFRSs from the perspective of a banking sector, with a variance

F = 7,004 and significance $p < 0.01$. Apart from analyzing whether the interest rates will be lower or not for these companies, we have also empirically proved that there is a significant impact on the other non-financial terms of the loans, as well as those presented in **Table no. 3**.

The analysis shows that the impact of adopting IFRSs is greater in the *credit rating* (average value 4.34, standard deviation 0.63), which indicates that the companies whose statements are prepared under IFRS have the best credit ratings for banks in Kosovo, compared to those that do not prepare the financial statements in accordance with these standards. Based on the results in **Table no. 3**, the second component influenced by the use of IFRSs

is the *loan time limits* (average value 4.11, standard deviation 0.94), third component is *mortgage requirements* (average value 4.08, standard deviation 0.91), fourth component is *interest rates* (average value 4.02, standard deviation 0.82), consisting in the adoption of IFRSs at lower interest rates. The fifth component shows that companies using IFRSs have the *low percentage of non-performing loans* (average value 3.94, standard deviation 0.89), the other component affected by IFRSs is the *renegotiation of loan terms* (the average value 3.83, standard deviation 0.97) and the last component rated by respondents are the *administrative costs* (average value 3.52, standard deviation 0.92).

Table no. 3. Results of ANOVA analysis on the impact of adoption of IFRSs on loan terms from the perspective of the banking sector

Variables	Average	Standard deviation	F	Pr > F*
Interest rate	4.02	0.82	7.004	0.008
Loan time limits	4.11	0.94		
Mortgage requirements	4.08	0.91		
Lower administrative cost	3.52	0.92		
Renegotiation of loan terms	3.83	0.97		
Better credit rating	4.34	0.63		
Lower percentage of non-performing loans	3.94	0.89		

*significant $p < 0.05$

Source: Authors calculations from the questionnaire data

To test the hypothesis of our study and since the questionnaire was sent to companies that adopt IFRSs in order to have a full view of the situation on both sides, we have also presented the data analysis from the questionnaire sent to companies (shown in Table 4). According to the data from the analysis in Table 4, we see that the results from the ANOVA analysis are the variance ratio F = 25.348 and significance $p < 0.01$.

According to these results, the private sector, therefore, companies surveyed for the impact of IFRSs on credit terms, have estimated that the term which is influenced the most by the adoption of IFRSs in Kosovo is the *credit rating*, which is also in line with responses received from the

banking sector (average value 4.20, standard deviation 0.98). The second component influenced by the use of IFRSs is represented by the *mortgage requirements* (average value 4.03, standard deviation 0.86), followed by *loan time limits* (average value 3.83, standard deviation 1.13), the other component affected by IFRSs is the *renegotiation of loan terms* (average value 3.81, standard deviation 1.12), then *interest rates* (average value 3.80, standard deviation 1.13), *lower administrative costs* (average value 3.64, standard deviation 0.85) and the latest component rated by companies is considered the *lowest percentage of non-performing loans* (average value 3.60, standard deviation 1.04).

Table no. 4. Results of ANOVA analysis on the impact of adoption of IFRSs on loan terms from a perspective of private sector

Variables	Average	Standard deviation	F	Pr > F*
Interest rate	3.80	1.13	25.348	<0.0001
Loan time limits	3.83	1.13		
Mortgage requirements	4.03	0.86		
Lower administrative cost	3.81	1.12		
Renegotiation of loan terms	3.64	0.85		
Better credit rating	4.20	0.98		
Lower percentage of non-performing loans	3.60	1.04		

*significant $p < 0.05$

Source: Authors calculations from the questionnaire data

Based on the results presented above, we see that there was a significant variation in the impact of the IFRS on loan terms for companies applying IFRSs in Kosovo from both the perspective of a banking sector and private sector, therefore we accept as scientifically proven all the above-mentioned hypothesis.

4. Conclusion

In our study having significant results from ANOVA analysis from both banking and private sector, we have concluded that the adoption of IFRSs in Kosovo had an impact on interest rates, offered by banks to mandatory adopters and as well on non-financial loan terms such as: time limits, mortgages, lower administrative costs, and renegotiating loan terms. Mandatory IFRS adopters have a better loan rating compared to other companies in Kosovo and the percentage of non-performing loans is lower for mandatory IFRS adopters in Kosovo.

Literature review brings to our attention that in order to have a more reliable, comprehensive and transparent information available for all stakeholders including banks, only adopting IFRSs as a reporting framework of a country is not enough. If IFRSs are not applied consistently and if firms have no incentives to improve their financial reporting systems, the benefits of adoption will not be visible.

Therefore, based on the above research, our suggestion to policy makers, especially those in developing and transitional countries, is that only the implementation of high quality financial reporting standards, such as IFRSs, is not sufficient to improve the quality of accounting and financial reporting, while there are no institutional mechanisms that empower the implementation of IFRSs and while companies do not have the benefits and incentives that exceed the costs, to provide high-quality information to stakeholders.

Future area of research can consist in a larger number of companies in Kosovo, analyzing the benefits of IFRS adoption not only from one dimension – respectively from the perspective of loan terms – but also focused on analyzing costs and benefits of the adoption of IFRSs in Kosovo. Given the fact that Kosovo is in a development process and has lately adopted IFRSs, there are no research studies that have been conducted in this area until now.

Other future research recommendation can refer to including a comparison with other Eastern European countries, especially those that have similarities with Kosovo’s economy, and to analyze the differences and similarities, the challenges and opportunities on the adoption of IFRSs, in a comparative manner with these countries.

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Theoretical Approach between the Soft and Hard Law in the Context of Corporate Governance

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ABSTRACT

The proposed study analyzes developments and perspectives of soft and hard law in the context of corporate governance. Thus, at the level of the specialized literature, a series of studies were conducted on the role of effective corporate governance as well as on the evolution and prospects of soft and hard law on information transparency. For the purpose of the analysis, the authors conducted a qualitative study on the evolution and prospect of soft and hard law in the context of corporate governance. The results show that corporate governance has evolved more and more in the post-economic crisis and a greater emphasis is placed on the transparency of the information provided in conjunction with the revival legislation.

Keywords: corporate governance, law, capital market, financial crisis

JEL Classification: M40, M42

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Introduction

First of all, we consider that it is necessary to state the importance of this subject. It is a proven fact that history has the tendency of repeating itself, regardless of the domain or area of interest. That is the reason why we think that it is of incontestable relevance to analyze the past, the present and, based on these elements, the future of corporate governance. Is there any potential future of interest for this analysis? Clearly, not. It would be useful to identify and regulate the specific measure that would have the potential to prevent economic failures, even extended to global financial crisis, from happening. This is the desired result, but it is far from the reachable and even a partial improvement could serve as a real success.

Why is now the proper moment for such an analysis? Because some of the panic and turbulence caused by the relatively recent global financial crisis have started to fade, leaving a better view upon the major factors that triggered the financial crisis and the mechanism that allowed it to expand. This is the perfect example that history tends to repeat itself. One of the major factors was, the same as for the financial crisis that occurred at the beginning of the precedent century, either the failure of corporate governance regulation, or improper appliance of such regulations. Analyzing how corporate governance failed to play its role and stop or at least help at damage control is of crucial importance to be able to correct the flaws as soon as possible. Prompt action must be taken not only to develop regulations that could prevent future crisis from emerging, but also to be able to recover faster from the current crisis, which we consider not to be fully over.

This paper has the scope of analyzing some of the regulations that are connected with the stated status quo, the way they were influence by the latest crisis and how they reacted to change depending on the domain they were implemented in.

1. Research methodology

Currently, the speciality literature defines the methods of scientific incursion and text construction of a paper as being a „way” to be followed in the research activity for fulfilling the objectives, namely for informing and training. The procedures, techniques and instruments used in the scientific incursion are components of the method,

viewed as support elements or concrete ways for its capitalisation (Gray et al., 2007, Dunbar and Weber, 2014, Kiss et al. 2015)

The research endeavour represents a logical incursion for approaching the evolutions and perspectives of soft and hard law on corporate governance, which is based on a positive research, by trying to explain and predict the actual reporting practices in audit, but in the same time a normative research as well. For reaching the objectives of this research, we rely on a qualitative approach for summarising the aspects which will be discussed in every section. By using an approach from general to particular (Gray et al., 2007), we begin any analysis by presenting the concepts, taking into consideration the discoveries offered by the academic research and professional bodies. In what the human and social sciences concerns, this research is based on the non-participative observation (Lesage and Wechtler, 2012), on the inductive research method, on the document analysis and comparison techniques. The reforms in the corporate governance domain were punctuated by the cross-section method, which is mostly applied to the theoretical aspects, where we presented a historical incursion of the most important reforms in the domain of corporate governance.

2. Conceptual approaches regarding corporate governance

After seeing that legal framework for better corporate governance is being elaborated, we consider to be of crucial importance to have a better monitoring of how the legal framework is being implemented in practice. Apparently, there seems not to be a very efficient monitoring of the corporate governance statements that the companies publish. "In most Member States, responsibility for enforcing the obligation to publish is left to investors who, depending on the culture and traditions in their Member State, often take little action. Financial market authorities or stock exchanges and other monitoring bodies work within different legislative frameworks and have developed different practices" (Green Paper, p.19). The main issue is that in most of the Member States they only play a formal role in verifying whether the corporate governance statement has been published. Meanwhile, there are few Member

States that check if the information provided by the companies is complete or not by the means of either public or specialized authorities.

A more practical and efficient method according to European Commission's Green Paper would be to have the information published by the companies checked whether it is sufficiently comprehensive by so called monitoring bodies such as stock exchanges or securities regulators. This solution arises a problem of objectivity on behalf of the monitoring bodies. The specified bodies or authorities should not have a say on the content of the information disclosed or make business judgments regarding the solutions chosen by the company for that matter. On the other hand, to enhance the desired effect, authorities could rely on publishing the result obtained out of the monitoring activity, indirectly forcing the companies towards more complete transparency. As any legal framework, for this to be effective enough, the use of formal sanctions in case of serious non-compliance could and should be enforced, as it is currently done in Spain for example (Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States, page 63).

The European Commission believes that "one way to improve monitoring could be to define the corporate governance statement as regulated information within the meaning of Article 2(1)(k) of Directive 2004/109/EC and thus make it subject to the powers of competent national authorities laid down in Article 24(4) of the Directive." (Green Paper, p.19). There is one good part in the fact that monitoring bodies in Member States developed different practices in having a great potential for improving the exchange of best practice.

3. Transposition and application of soft and hard law on corporate governance

Domains of appliance for corporate governance regulations

It can be stated that corporate governance "has become a multilevel regulatory laboratory, in which 'hard' law overlaps and intersects with 'soft' law in numerous, fast-evolving ways, a traditional approach to the study of corporate or company law as a relatively confined

doctrinal area soon reaches its limits" (Sun, W. et al., 2011). Therefore, it is compulsory to analyze some of the main areas of interest in which corporate governance has interactions and notice how those interaction have been influenced by the recent financial crisis. It is known that financial systems around the world can be mainly delimited as being either capital market - based systems or bank-based systems.

a) Capital market

Since the 60's, corporations have suffered a financialization process that has led to significant changes in the corporate regulatory framework. There is no doubt that some form of regulation in the financial sector is justified, and no regulatory system functions well unless it is accompanied by proper regulation and enforcement thereof, but the value of regulation must be determined by both its benefits and its costs.

Compared to other types of markets such as product markets, capital market are well-developed markets and operate in highly regulated environments. A need for further development of existing regulations emerges from the fact that the capital market is an area with numerous opportunities for fraudulent activities such as insider trading or manipulation and incentives to defraud public investors. Therefore, "capital markets are relatively difficult to regulate because, unlike in the bank system, there is no single focal point on which regulators can focus. Regulators must regulate the market entirely, and due to the nature of the capital market, regulatory failure would lead to disaster" (Kieff & Paredes, 2010).

The next natural question is how to regulate capital markets. Empirical studies have not managed yet to fully identify the benefits of capital market regulation, but United States experience is a good starting point considering the fact that in the U.S. one can find the most advanced capital markets. Suggestions based on U.S. experience clearly show that for capital markets to work properly there is need for three sets of regulation:

- "strong investor protection;
- a strong watchdog or enforcement agency, like the U.S. Securities and Exchange Commission;
- strong regulation of intermediary institutions." (Kieff & Paredes, 2010).

What needs to be done can be sketched out from the U.S. model, but the complexity of enforcement of capital

market regulation should not be underestimated. Starting from disclosure regulation cannot work without proper accounting and auditing rules and leading to antifraud rules that can work only sustained by a strong watchdog such as SEC, there are a multitude of factors to be taken into account along with private enforcement and a well-functioning judicial system.

"The Transparency Directive is a minimum harmonisation measure requiring listed companies to disclose acquisitions and disposals of substantial shareholdings, and prescribing minimum content for management reports" (Johnston A., 2009). According to provisions in the mentioned Directive, Member States must require shareholders to notify companies in case the amount of the voting rights "reaches, exceeds or falls below" (Directive 2004/109/EC) various thresholds (set at the lower level, 5%, by most of the states). In case of shareholders agreements of acting in a coordinated manner, either by transferring voting rights or concluding a range of agreements that have implications for corporate control, similar obligations apply. The Directive specifies the information that must be included in the notification given to the company. There must be made a statement about:

- "the resulting situation in terms of voting rights;
- the chain of controlled undertakings through voting rights are effectively held;
- the date the threshold was crossed or reached;
- the identity of the shareholder and any person entitled to exercise voting rights on the shareholders' behalf" (Directive 2004/109/EC).

The notification does not have implications only regarding the relationship between the shareholders that have this obligation and the company, but also to third persons, the company being obliged to make this information public within three days from receipt.

There are also specific obligations that occur in case of a public listed company, that are enforced by the mentioned Directive and have the purpose to raise the degree of transparency, which was a considerable important factor that caused major problems during the last financial crisis that occurred in 2008-2009. The problem of transparency has tried to be solved following the fact that listed companies are required to:

- "ensure equal treatment for all holders of shares who are in the same position" (Directive

2004/109/EC) as regarded to the supply of information;

- "produce an annual financial report which consists of audited accounts and management report" (Directive 2004/109/EC);
- produce a "half-yearly financial reports, which include condensed financial statements and an interim management report" (Directive 2004/109/EC).

The direct implications of the application of these provisions considering the fact that the report must be certified by the ones responsible is to offer a correct perspective upon the performance of the company's business and position, a realistic view over the main risks and uncertainties that the company faces and last but not least, to comply with the requirements of the Fourth Company Law Directive by producing qualitative as well as quantitative reporting.

"By assisting shareholders to gain a better understanding of the way in which resources are developed, enhanced and allocated within companies, this reflexive solution aims to ensure that corporate management have sufficient autonomy to pursue project which have a longer-time horizon, whilst leaving the existing legal mechanisms of accountability to shareholders intact" (Johnston A., 2009). The important note that has to be made is that the use of quantitative disclosure as a part of reflexive regulatory strategy is at an experimental stage and has to be kept under review, whether it works or not, to ensure that the costs of the exercise can be justified.

There is more to capital market regulations, obligations that occurred after the financial crisis and have to do with the disclosure of corporate governance regime. It is required by law for the listed companies to "include a corporate report governance statement in their annual financial report" (Directive 2006/46/EC). The statement should contain, according to the Directive, relevant information such as the national corporate governance code that the company is subject to, any codes the company voluntarily decided to apply, all important information regarding corporate governance practices applied beyond the requirements under national law and explanations concerning departures from the codes to which it is subject (comply or explain principle). "These far-reaching disclosure obligations, particularly those prescribed by the Takeover Directive, will enable the

market better to evaluate the possibility of a transfer of corporate control, and to price the company's shares accordingly" (Johnston A., 2009).

In conclusion, numerous regulations regarding capital market and listed companies have been elaborated with high cost and it is time to measure whether the impact was made in the right direction and of the proper amplitude. "Taken together, these regulatory interventions signal an attempt to harness market forces to encourage companies to comply with shareholder preferences as to governance structure, within the existing constraints and possibilities of national company law. Institutional investors might build on this regulatory framework and use their market power to drive convergence on a norm of one share, one vote, without positive harmonisation being required at the supranational level" (Johnston A., 2009). In the end, all these measures aim to encourage shareholders and institutional investors to play a more active role in the governance of the companies they invest in.

b) Credit institutions / Banks

In this case, the main question is "why?". Why is there need for regulation in the bank system considering the straight forward way it works? Basically, banks fund themselves from the deposits of those who have liquid capital and then loan the money to those who need this kind of capital. The answer finds its sustainability in two main ideas. "One is that it is impractical for dispersed depositors to monitor the bank effectively in an organized fashion because of the collective action problem. Thus, regulators monitor banks on behalf of dispersed depositors" (Dewatripont & Tirole, 1995). Second, "banks often participate in (and sometimes operate) payment systems that inevitably accompany systemic risk, thus producing a negative externality. Failure of one payment transaction may lead to disaster, so participants call for some form of regulation to deal with this systemic risk" (Goodhart et al., 1998).

Moreover, there is need to analyze what kind of problem could the regulations prevent. Firstly, there the tendency for the banks to either loan more than they can afford or give loans that are not profitable. Partially, this problem has some safe measures in most jurisdictions such as deposit insurance in case of bank failure, rescue measures from the central bank or the government. On the other hand, the banking system faces a lot of various risks because of the different financial assets or failures caused by technological failure.

Bank regulation is designed to respond the risks that affect the banks as centralized risk takers by ensuring proper risk management by the banks. Of the changes brought by these regulations is that banks are obliged to make proper and strict assessments of each loan in the bank's asset portfolio. "These strong and active interventions by regulators are understood to be necessary in the bank system today. While enhancing the transparency of banks is considered important, market discipline is often not practicable, even though academics often argue that it should be" (Kieff & Paredes, 2010).

The banking environment has today shifted from only facing credit risk to also facing market risk, from economies of scope to economies of scale which tend to create large banking institutions that are hard to monitor properly and from traditional banking business activities to other new business activities. Nowadays, regulatory measures have been altered by the needs and are rather indirect than direct as they used to be in the past. For example, past regulations were developed in such manner that they tried to manage risk by prohibiting risky investments. On the other hand, regulations developed in present have an indirect approach towards risk and analyses only capital, counting on the fact that capital regulation has other pillars to rely on, such as internal control and accounting systems of the banks.

In the end, it also comes to the cost of bank regulation which indicates the effectiveness of the measures compared to the prevented risks. "First, there is the cost of providing proper deposit insurance. Second, regulation tries to prevent bank failure by requiring soundness of banks. Third, bank failure results in an enormous cost, as post insolvency treatments often carry very high costs" (Kieff & Paredes, 2010). The main idea is that this comes to confirm once again that it is better to prevent than to treat.

Lessons from the financial crisis and the way forward

"The speed and intensity of the panic in 2008 gave financial globalization a bad name in many countries, thereby undermining the credibility and political leverage of institutional investors and hedge funds to press for governance improvements via public ordering" (Sun W. et al., 2011). The Great Recession had a major impact on asset repricing, mainly regarding substantial losses incurred by pension funds in countries all over the world,

fact which triggered a strong public support for corporate governance reforms, support which is probably directly correlated with the equity exposure of the pension assets in each country. Another effect of asset repricing and also of higher international market correlation have led to an increased incentive for outside investors to put pressure on the firm included in their portfolio for increased alpha performance. "At the same time, the conservative funding strategy adopted by many non-financial firms, at least in developed markets, may have attenuated this private ordering leverage." (Sun W. et al., 2011).

The recent financial crisis has its roots in fraudulent behaviour of board members, excessive remuneration levels topped with failure to monitor and oversee. These are the factors that have managed to turn this financial crisis in one of the worst and dangerous financial collapses since the early part of the twentieth century. "Improved decision-making is thus called for in moving corporations to better performance levels" (Useem, 2006). "However, boards are trying to balance their function as compliance officers with their function as shapers of the corporation's future" (Lorsch & Clark, 2008).

At the same time, another problem occurred - society has begun to reconsider deviant behaviour and as a result the lower levels of conduct are now considered to be acceptable whereas in the past same levels were totally unacceptable. "Thus, even though researchers and commentators have usually linked corporate governance to control are seeing new approaches that call for behavioural and leadership change and the development of a holistic paradigm that is more suitable for the complexities of the twenty-first century" (van Ees et al., 2009).

Basically, the impact of the latest financial crisis and the foregoing analysis and arguments point to the fact that there is obvious need for effective and enforceable regulation, a strengthening of governance codes, a greater focus on ethics and leadership, the enhancement of shareholder voice and last but not least the strengthening of disclosure and transparency. "Other drivers of governance are originating from corporate responsibility and socially responsible investment themes" (Brennan & Solomon, 2008). There is opportunity for learning from relationship-based systems and this could provide a whole new path, the one where key-stakeholders have greater influence and decision-

making rights, this leading as a natural conclusion to a higher level of input into the companies' strategies.

"The importance of incorporating a multidisciplinary perspective in governance appears to be the key to understanding governance failures. Governance research has often been left to accounting and legal academics and it is increasingly evident that this approach is far too narrow. Drawing on a more holistic approach to governance will provide a wider lens through which to view the antecedents and impact of the global financial crisis. In addition, it will provide executives and directors with a range of variables that influence good governance and highlight where the focus should be in introducing good governance practices." (Sun W. et al., 2011).

The conducted analysis clearly leads to the conclusion that there is need for a holistic, even a multidisciplinary approach by integrating multiple lenses and perspectives in understanding corporate governance. This is necessary because corporate governance has gone further that its borders being connected with several other domains and therefore, in order to be able to correctly assess the current status of corporate governance. Why? The answer is simple and mainly relies in the fact that only by this method the correct and adequate future path for corporate governance could be regulated. "This would enable corporations and the economy to mitigate and to better manage a crisis. In this way, a balance between compliance and behavioural approaches is important - regulation to ensure timely and valid disclosure and good structures, alongside focus on ethics, culture, leadership, power and human resource practices to ensure organizational objectives are met in an ethical manner" (Sun W. et al., 2011).

This being said it is obvious that a purely structural approach does not offer the necessary wide view upon the matter, leading to the need of inclusion of other several processes which would ensure a balance between shareholder and stakeholder needs, internal and external environment. The finally of this change, along with the proper organizational purpose, would clearly bring a more effective governance. It is necessary to understand what makes corporate governance tick. We consider that a better understanding of its major pillars - decision-making process, the boardroom culture or the networks and structures of the decision-makers and elites - would

contribute to a deeper and richer model of corporate governance.

Conclusions

After an overview on the past and current situation, there is proof beyond any doubt that more has to be invested in developing stronger, wider and more effective corporate governance regulations. There comes the question of cost, but no matter what the cost may be it is certainly lower than the losses caused by the repeated systemic failures. Although, it is difficult to estimate correctly the cost of regulation and enforcement, at first sight, the cost of regulation in the capital market seems higher (it has to reach a wider range of matters) than in the banking system.

Investing in better regulations for one of these systems, may depend as a choice, on how developed a country's economy is. In smaller economies with not such a developed capital market, investing in regulations for banking system seems more rational as it comes with lower costs as well. On the other hand, in a larger economy, where the capital market is a source for providing capital at cheaper cost, focusing on the

development of capital market regulation is wiser considering the fact that the benefits provided by the capital market could outweigh the cost of regulation. Compared to the theoretical analysis, in the real world, the cost of the two systems have to be considered in an aggregate manner as they coexist as globalization of the financial markets allow investors to borrow or fund themselves from foreign markets, this making the situation far more complex.

As a final statement, it could be said that clearly one system does not fit all economies. Although it is the era of globalization, it should not be forgotten the fact that economies still have the tendency of preserving the specifications given by the geographic and legal environment. Therefore, in order to prevent the unfortunate past events from happening once again, when developing new regulation, even it is made in such a manner that it should work worldwide, adjusting it to the specific of each economic system should be of great concern.

Corporate governance is a system that acts and reacts. It is up to the regulating institutions to provide such an input, that the reaction will better suit our purposes.

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Mission, Vision, and Values of Organizations, the Catalysts of Corporate Social Responsibility

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ABSTRACT

The present research explores the strategic orientation of listed companies, with a focus on their mission, vision, and values, that defines the aspirations and the goals that govern that organization. The data were collected from the official websites. Based on the literature review there were identified the main missions, values, and visions, that were grouped, after analyzing all the financial and non-financial reports, within categories, such as emphatic values/people oriented, cultural values, workplace values. Because one of the most important stakeholder within any organization is represented by the employee, the authors also grouped them within identity reflected (relational, organization, workplace, competence/professional).

Results are mixed and show that only 62% of companies disclose information regarding their vision, 85% of them disclose information regarding their mission, while 54% of companies disclose their values. The main objective of the classification is to establish a framework for a future template of corporate social responsibility.

The relevance of the research is given by the topicality of the research. The originality of the research derived from the modality of approaching the theme, from the objective of the research and also from the fact that there is an increasing interest in society, in general, for promoting accountability, respect for human rights, environment, health and security.

The objective of the present research is to highlight the important role of vision, mission and values of a company. These represents the pillars for a successful organization and may be disclosed in separated statements or may be integrated in a single statement. Their purpose is to communicate to both internal and external stakeholders the main goal of the organization.

Keywords: mission, vision, values, corporate social responsibility

JEL Classification: G30, G39, M40, M49

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Introduction

Nowadays there is an increasing need for socially responsible organization, due to the lack of efficiency in both public and private sector and to the inconsistency of the many reforms in time.

We can imagine an ideal organization which is the accountable, the social responsible and autonomous one and whose behavior is managed by good values and visions in order to achieve the performance on long run.

Within the present study we highlight the missions, the values and the visions of organizations as they are available on the websites of the companies from our sample. By analysing the vision, the mission and the values of organizations we try to reflect the identities of companies. The most used values are also important in interpersonal relationships, such as respect, integrity etc.

The Romanian context is chosen for the present study, because we want to explore and create a radiography of the entities from our country and of the way they use to implement the concepts of social responsibility and sustainability.

The importance of the research is given by the fact that it represents a contribution to the field of corporate social responsibility, by exploring the concept, in connection with other factors, with impact on different stakeholders.

The main objective of the paper is to establish a framework for a future template of corporate social responsibility. The relevance of the research is given by the topicality of the research. The originality of the research derived from the modality of approaching the theme, from the objective of the research and also from the fact that there is an increasing interest in society, in general, for promoting accountability, respect for human rights, environment, health, and security. The objective of the present research is to highlight the important role of vision, mission, and values of a company. These represent the pillars for a successful organization and may be disclosed in separated statements or may be integrated into a single statement. Their purpose is to communicate to both internal and external stakeholders the main goal of the organization.

The estimated results will be obtained under a qualitative and a quantitative research methodology, based on the study conducted. Findings revealed that

Corporate Social Responsibility Reporting is important not only for the good reputation of the company, but also for the quality of the products or of the information delivered, for the winning of the confidence of stakeholders and also for increasing the profitability. The conclusions derived from this research are useful for both students and professionals.

Within the research process, a study was realized regarding the conceptual items. The analysis included concepts such as the degree of implementation of social responsibility, the link between social responsibility and corporate governance, as well as the categories of stakeholders involved, and the importance of social responsibility.

The main research question is **what are the aspirations and the goals that govern the organization?** This will be addressed both by exploring the relevant literature and through the research conducted, that investigates this issue in the context of a sample, in Romania. There were analyzed the mission, vision and values statements of organizations that contribute to sustainability creation. The mission represents the statement regarding the core purpose and must be written in the present tense. The vision represents the statement about where the organization wants to arrive and is better to be written in future tense. Values can be inspired by mission and vision and represent the way in which our employees behave or interact.

There were included in the sample the most liquid companies, those that are part of BET Index, considering that they are the ones that can represent an example of all organizations. It was selected the interpretative methodology by analyzing the financial and the non-financial reports of the companies that are parts of the sample, such as the annual reports, the CSR reports, the corporate governance reports, the sustainability reports and the vision, mission and values statements and the other information disclosed on their websites. Data were collected from the annual reports, from the corporate social responsibility reports, from the official websites of the companies and from other sources. We used the listed companies because we considered them the most representative ones.

The paper consists of an introduction, followed by the study of the literature review in the field of social responsibility, regulations and new trends in social responsibility field, the methodology of the research, the aspirations and the goals that govern the organization,

such as mission, vision, values. Regarding the practical implications, this study can serve as a basis for future research on this topic and also may be useful to investors and to other actors of the economic life.

1. Literature review on social responsibility

Companies have as main objective the profit, that is usually connected with efficiency, productivity, innovation, value added to the company (MacGregor and Fontrodona 2008: 1).

Researchers found different factors that affect social responsibility within organizations, such as different groups, social awareness, education, competitive advantage, international standards, reputation, ethical issues (Jothi, 2016), transparency, customer loyalty (Kim & Kim, 2016).

Besides other factors, a company has a socially responsible behavior to improve its image, to better manage human resources (Maloni and Brown, 2006).

There were developed studies in order to find out the factors that affect the corporate social responsibility implementation process (Dagilene et al, 2014, Dagilene, 2010, Habek and Wolniak, 2013), other mentioned industry and stakeholders' pressure (Fifka, 2013) and

Governments issues (Matten and Moon, 2005).

Other authors discovered factors such as promotional initiative, educational initiative, meeting the needs of stakeholders, better focus on long-term goals, improving risk management (Habek and Wolniak, 2015).

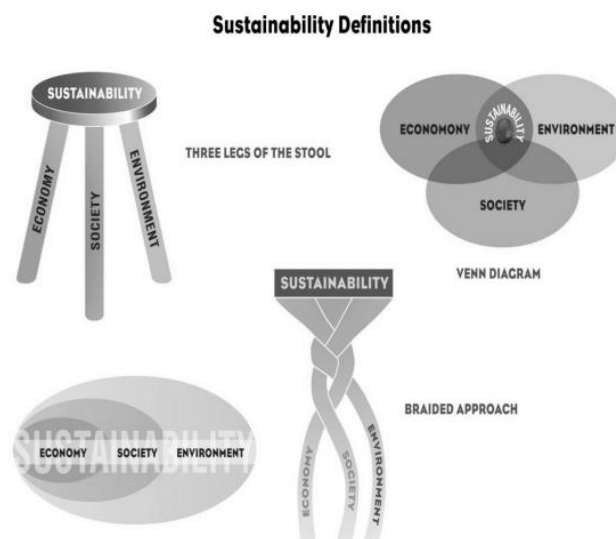
Social responsibility, accountability, and sustainability have been always the objective of many sectors of activity, and from this point of view, we focused on different sectors of activity, that have many negative impacts.

Nowadays a company involved in corporate social responsibility has a competitive advantage, contributes to sustainability, consolidates its relationship with investors, customers, suppliers, and other stakeholders. As such, it is important to observe that social responsibility can have both a negative and a positive impact.

Social responsibility has received an increased attention. Researchers have, thus, developed indices, as well as correlations and assessments. It is important to observe the link between organizational culture, the object of activity, strategies, and planning.

In practice, corporate social responsibility is interconnected with sustainability (Figure no. 1), mission, vision and values of the organization, reporting statements and relationships with stakeholders.

Figure no. 1. Sustainability



Source: <https://www.ccu.a.com>

Organizations disclose sustainability and social responsibility reports on their websites. Companies' main objective is to present the environmental, economic and social impact. All these reports include their developed actions and activities, the progress and efforts involved. In this regard, there are guidelines, issued in order to provide organizations a framework for the preparation of social responsibility and sustainability reports. There is no specific template for these reports.

Regarding the other aspects of accounting, such as corporate governance, we observe that in Romania there were made few steps in terms of regulations and new trends in social responsibility field (Feleagă, 2011). The reason could be the changes within the legislative system: Corporate Governance Code (August 2001); OECD Report regarding the implementation of Corporate Governance in Romania (December 2001); Corporate Governance Institute (July 2003); Principles of Implementation of Corporate Governance (July 2005); Code of Corporate Governance (2008); Emergency Government Ordinance No. 109/2011 (December 2011); Corporate Governance Index (2013); Law of Corporate Governance for State-Owned Entities No. 111/2016 (May 27, 2016).

2. Methodology and results

Sustainability creation is provided through the mission, values and vision statement. An effective management instrument in order to draw up the strategy of an organization is the mission, values and vision statement. In order to achieve the sustainability any company needs to find its equilibrium between the financial and the non-financial performance. The study highlights the sustainability creation through mission, values, and vision.

Why we are doing what we are doing is represented by the mission of the organization.

Where we are trying to go in the near future is representing our vision.

How we are going to do about it are our values.

Even if mission, vision, and values seem to be esoteric or abstract, they are very important for any organization. The mission represents the statement regarding the core purpose and must be written in the present tense. The vision represents the statement about where the organization wants to arrive and is better to be written in future tense. The values can be inspired by mission and vision and represent the way in which company's employees behave or interact.

The study included in the sample the most liquid companies, those that are part of BET Index, considering that they are the ones that can represent an example of all organizations (Table no. 1).

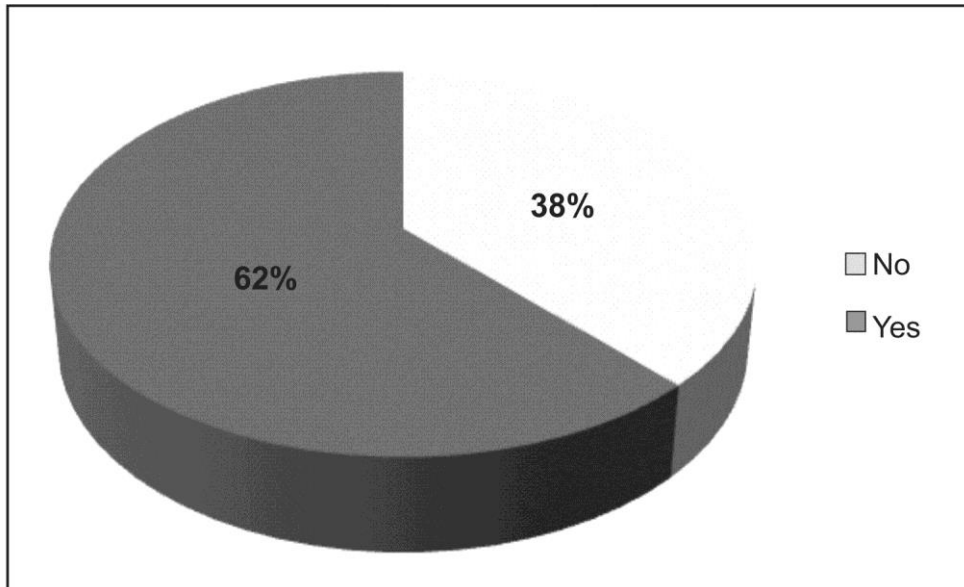
Table no. 1. The sample

No.	COMPANY
1	BANCA TRANSILVANIA SA
2	FONDUL PROPRIETATEA
3	OMV PETROM SA
4	SNGN ROMGAZ SA
5	BRD SA
6	SNTGN TRANSGAZ SA
7	SOCIETATEA ENERGETICA ELECTRICA SA
8	DIGI COMMUNICATIONS NV
9	CNTEE TRANSELECTRICA
10	SN NUCLEARELECTRICA SA
11	CONPET SA
12	MEDLIFE SA
13	BVB SA

Source: <http://www.bvb.ro/financialinstruments/indices/indicesprofiles>

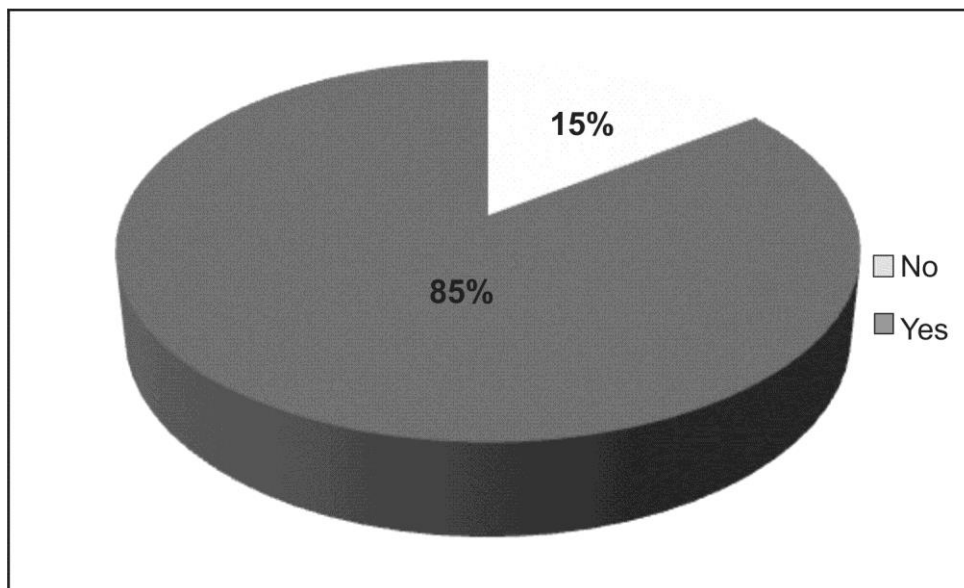
By analysing the financial and the non-financial reports of the companies that are part of the sample, such as the annual reports, the CSR reports, the corporate governance reports, the sustainability reports, the vision, mission and values statements and the other information disclosed on their websites the study discovered that only 62% of companies disclose information related to their vision (Figure no. 2), 85% regarding their mission (Figure no. 3), and only 54% disclose information related to their values (Figure no. 4).

Figure no. 2. Information disclosed by companies regarding their vision



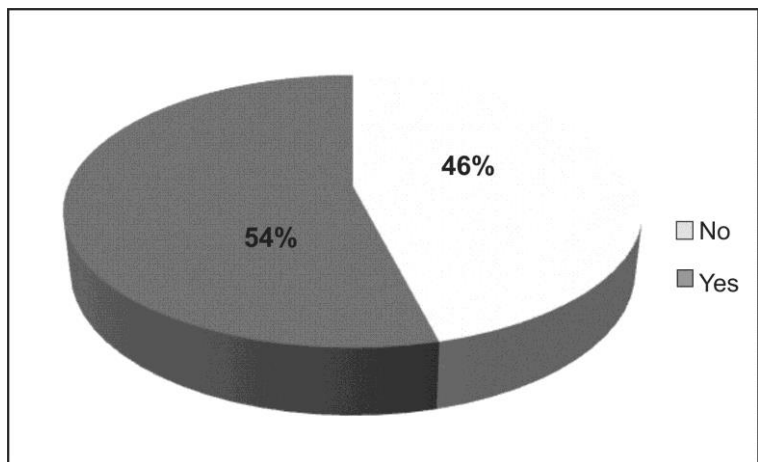
Source: Author's own projection

Figure no. 3. Information disclosed by companies regarding their mission



Source: Author's own projection

Figure no. 4. Information disclosed by companies regarding their value



Source: Author's own projection

After analyzing all the financial and non-financial reports the values were grouped within categories in order to establish a framework for a future template of corporate social responsibility. Thus, we split within categories of values, that were grouped within:

- emphatic values/people oriented: integrity, respect, transparency, openness, compassion, customer service, responsiveness, involvement, responsibility, respect for people and environment, sustainability, transparency, dynamism, flexibility, care
- cultural values: innovation
- workplace values: teamwork, long life learning, security/safety, professionalism, competitiveness, communication, cooperation, stability.

Because one of the most important stakeholder within any organization is represented by the employee, we also grouped them within:

- relational: implication, care, respect openness
- organization: excellence, accountability, responsibility, effectiveness, leadership, performance, sustainability, assuming social responsibility, professionalism, transparency, dynamism, flexibility, competitiveness, communication, cooperation, stability
- workplace: teamwork, innovation, quality, diversity, collaboration, motivated employees
- competence/professional: knowledge, competences, innovation, long life learning, safety.

3. Conclusions

We live in a changing world and from this point of view we are challenged to be competitive in order to be productive and to obtain performance (Autor, 2014; Autor, 2015). Socially responsible practices nowadays must come into spotlights, being one of the basic values. The reason is that we must understand and prioritize the factors that are within the DNA of the organization. People are responsible in their day by day activity, with the family, with the environment, with their friends, they learn about social responsibility at home, at school, at workplace, through socially responsible examples. People consider a socially responsible organization when it has a responsible attitude for its customers, for community, employees, suppliers and when it respects the rules.

Socially responsible business practices are initiatives through which a company is increasing the way of action for the wellbeing of the community and of the environment.

A company can make changes regarding:

- increasing the access to products for people with disabilities (access within shops)
- socially responsible marketing for children (no more selling dangerous products within schools)
- development of programs for the wellbeing of the employees (medical assistance,

- psychological counselling, sport and wellness activities)
- delivering fair information regarding the products (the packages contain information regarding side effects, the volume of physical activities needed in order to burn the calories or the fats of the products)
- choosing the raw materials and the packages that are eco-friendly (in order to reduce the waste, to increase the recycling process, to eliminate the toxic emissions)

- withdrawal of the products that are dangerous or illegal (for example there are companies that decided to withdraw the unhealthy food or to combine with the healthy one)

Aspects such as corporate governance, social responsibility and sustainability of organizations are interconnected and represent modern concepts and hot issues of developed countries, with impact on all stakeholders.

A future research direction could be the perception of decision makers (Parliament, Government) in the implementation of social responsibility, by implementing and creating an appropriate legislative framework.

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