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The influence of post crisis corporate governance practices upon financial audit

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Abstract

The correlation between financial audit and corporate governance increased significantly after the release of financial crisis. This study aims to identify the corporate governance factors that influence the audit quality. The audit quality is measured in terms of BIG 4 companies and the research is conducted upon Romanian Market. The individual factors include audit fees, the existence of audit committee, the number of executive directors and other individual financial indicators. The results provide evidence that the existence of corporate governance elements do positively influence the audit quality of the entity, especially when it comes to the number of members that the executive board has. Considering the other variables, mixt results were detected.

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1. Introduction

The release of recent financial crisis revealed important shortcomings in corporate governance practices even though important improvements have been done at international level. In 1999, the OECD endorsed the Principles of Corporate Governance where guidelines both for regulatory and legislative framework were provided. The guideline was offered for OECD members and non-OECD members. It is considered that good corporate governance can positively influence the financial markets, the economic growth and the investment level (OECD, 2004). Recently, in 2014, the process of reviewing the principles of corporate governance started, with the aim to confer a conclusion of them within one year. The purpose of this review is to give advice on corporate governance practices for shareholders, investors or other national or international bodies that set specific standards.

On the other hand, it has to be considered that the existence of corporate governance is not enough in order to ensure financial credibility. According to the agent theory, developed by Jensen and Meckling, 1976 managers and shareholders have different interests, as managers are more inclined to report the results on which they can gain private benefits. The literature is focusing on the fact that the agency cost can be mitigated by the existence of a financial auditor, as he is independent and can reduce the mistrust that exists among shareholders regarding manager's way of reporting. Eccles et al, 2012 consider that firms that have a higher level of sustainability provide additional information to their shareholders, information that is checked during a financial audit process. Moreover, if the auditor is a company from BIG 4 then higher transparency to the audit process is considered to be provided (Michaely and Shaw, 1995, Rahman,1998).

Based on these assumptions, this research tries to detect the corporate governance factors that can influence the decision of a company to have a BIG 4 company as financial auditor. The analysis is conducted on Romanian market, on the entities that are listed on Bucharest Stock of Exchange.

The remain of the paper is structured in several sections: section 1 presents the some background of the correlation between financial audit and corporate governance, section 2 reveals the methodology of research, section 3 focuses on results and discussions, while section 4 provides conclusions, limits of the research and future perspective.

2. Literature review

Several reports have been issued over time with the purpose of improving the corporate governance practices. For example, in UK, the Cadbury Report, 1992 focused mainly on division of top responsibilities such as independence of non-executive directors and the lack of power of decision at individual level, while the Greenbury Report, 1995 relies more on directors' remuneration and the Hampel Report, 1998 summarizes the board principals. The financial scandals (Enron case), were followed by other reports such as Higgs Report, 2003 that focuses on the role that the audit committee has. Other regulations were established though Smith Report, 2003 that is concerned with the problems regarding the independence of audit and on the fact that the auditor should also check for the reality of corporate governance indicators.

The OECD principals of corporate governance also mention the correlation between financial auditor and corporate governance indicators. For example, shareholders can ask questions about external audit process when they have any misunderstandings. The independence of financial auditor is also a particular aspect upon which the principals are focusing on. Moreover, the external auditor should be recommended by an independent audit committee and it should also analyze the value of non-audit elements.

It can be said that the existence of corporate governance is related with increasing the quality of audit that the company has, but on the other side, it is considered that the role of financial auditor should be increased in order to enhance reliable corporate governance practices (Baker et Owsen, 2002).

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