

PREFERENCE OF THE LISTED ENTITIES REGARDING THE SELECTION OF THE EXTERNAL AUDITOR

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The present research aims to highlight the importance of the external auditing in supporting corporate governance and the preference of the listed entities to be audited by the big audit companies. Given the proposed objectives of the research, our scientific method is based on a deductive approach from general to particular that combines quantitative and qualitative studies. The role of the external audit was analyzed by conducting a study of literature on two levels: a theoretical–conceptual level in terms of economic theories and an empirical-practical level based on literature from which we extracted through a content analysis the defining elements of the audit work quality. Falling within the scope of the study, we evaluated the preference of the listed entities to be audited by the Big Four. To this end we used the content analysis of the publicly posted audit reports for the period 2005-2009. Our research results show that although we are a country with an emerging capital market development, the entities in the I-st category on the Bucharest Stock Exchange tend to an audit conducted by one of the big audit companies. Another result arising from our study is that the entities of the I-st category on the Bucharest Stock Exchange become more transparent from a year to another. Whether for the year 2005 we find only 12 audit reports publicly posted, in 2007 we can find 21 audit reports publicly posted. The trend of the large entities audited shows that the preference of the entities to be audited by one of the Big Four is higher from a year to another. The preparation of the financial statements and their audit must be done according to regulations for the currently period. The presumption found in the literature according to which the large entities are audited by the big audit companies which provide higher audit quality is confirmed in the case of our national country as well.

*Keywords: external audit, audit report, opinion, listed companies, Big Four
M42, M48*

1. Introduction

One of the prevalent ideas in the literature supports the preference of the large entities to be audited by the big audit firms, and the most common argument to support this preference is the quality of their audit services (Moizer 1997, Francis 2004, and Barton 2005).

Starting from this hypothesis we wanted to study its validity on the Romanian capital market and we studied whether this preference also applies to the entities listed on the I-st category of the BSE, knowing the fact that Romania is an emerging country and its market capital is being developed. According to the analysis we can conclude that Romanian entities listed on the BSE follow the same preference as the companies listed on international markets.

In the Regulation no.1/2006 regarding the issuers and securities transactions the art.b227-(1) states that the companies admitted to trading on a regulated market will prepare, will make available to the public and send to CNVM and to the market operator their quarterly, biannual and annual financial reports accompanied by the full comments (Regulation no.1/2006, Title IV, Chapter III). The auditor's report deals with both the consolidated and individual financial statements. The annual report is made publicly available in writing, on request, and in electronic form on the website of the issuer. Annual reports remain available to the public at least for five years.

The paper is structured in three sections. In the first section is presented the actual stage of knowledge regarding the role of the external audit. This objective is achieved through a theoretical and conceptual approach on the role of audit, followed by a practical and empirical approach. In this approach we focused our attention on the quality of the services offered by the audit firms. In the second section we made a case study on the entities pertaining to the I-st category of BSE, through which we want to reflect the preference of the large entities to be audited by a big audit company. The third section of the paper contains the conclusions of our study.

2. Research methodology

Our study refers to the listed entities as they are prone to voluntarily apply the Code of Corporate Governance and thus the audit requirements regarding the transparency of the financial and non-financial statements. We analyzed only the audit reports of the individual financial statements as they can be found on the Bucharest Stock Exchange in greater numbers than those consolidated.

We analyzed the reports from 2005 to 2009, because only for this period we could find the complete information posted on the CNVM in order to compare it with data found on the websites of companies or on the BSE website.

In order to conduct the case study we used a deductive approach, through a content analysis of the audit reports publicly posted on the website of the Stock Exchange, National Securities Commission or on the entity's website. To reach that goal we followed the next steps: we analyzed the regulations concerning the preparation of the audit reports and the financial statements, we selected the necessary dates from the audit reports, and we selected the entities to be analyzed. Then we collected the information, we defined the analysis methodology, we made the proper analysis and, at the end, we interpreted the obtained results. The data analysis was made with the statistical program SPSS 16.

3. Actual stage of knowledge regarding the role of the external audit in corporate governance

Theoretical and conceptual approach

External audit has an undeniable role when stakeholders or interested third parties may trust the financial information provided by an entity. The auditor is the specialist that, through his opinion, confirms the fidelity/accuracy/reality of the financial statements, as they are legally able to verify such data. When the audit report contains an unqualified opinion, the users of the financial statements offer a deeply trust in the accuracy of the financial information.

Motivational theory

The motivational theory explains the audit process through a superior qualitative professional judgment of those who bear responsibility for the preparation and presentation of the financial statements to be audited (Dobroțeanu and Dobroțeanu 2002, Ball 2003, Woodbine and Gordon

2010). Moreover, the motivational theory considers that the audit process must be performed by the best prepared professionals which occupy the superior level position including the responsibility for expressing their opinions.

Agency theory

Agency theory developed by Berle and Means (1932) leads to the dissociation of the administration and control department. As stated Jensen and Meckling (1976) the principal which is not a shareholder is interested on his personal benefits and not on the interests of the shareholders. Thus, "the company is a legal fiction which serves as a focal point for a complex process in which conflicts between individuals are resolved by implementing a network of contractual relationship" (Jensen and Meckling, 1976).

Insurance theory

Insurance theory is based on two principles: the principle of ensuring according to which the audited information has a certain degree of assurance and the principle of information according to which the investors, managers have greater confidence in the audited information when making their decision. The importance of the financial audit explained by the theory of insurance, reduce the risk of presenting incorrect information. Information risk differs from the risk of business bankruptcy, although the information was properly presented. Business risk may occur as a result of events that cannot be anticipated.

Using financial statements may incur loss due to misstatements. The probability of recovery the loss becomes higher when the company has an auditor and is directly proportional to the size and reputation of the auditor. Important auditors, so-called "deep pockets" assure investors against the consequences of inaccurate financial statements (Simunic and Stein, 1995).

Theory of interested parties (stakeholders)

Individualistic approach of the economic, financial and political interdependences from nowadays when speaking of globalization, no longer finds relevance, so far the model becomes complex and the theory of stakeholders (theory) meets the information needs of all the stakeholders.

Stakeholder theory has gained momentum in 1970, but in 1984 was conducted the first research on stakeholder theory in management. Generally, the theory can be applied to all of the entities, while the management of the entities is required to provide information to all the stakeholders. The theory was also developed in other disciplines (Donaldson and Preston, 1995), given the role of the entities on the capital market which becomes increasingly important.

Practical and empirical approach

A number of researchers which examined the role of the external audit in corporate governance have focused on the study of the audit quality. From the 19th century, many countries have tried to improve the audit quality through regulation, laws or by creating rules regarding the auditor's independence, or regarding the public oversight. All such modifications and improvements have helped to improve the audit quality (Baker et. al., 2010). Some of them consider that audit quality can be measured by the risk reduction, by the reputation of the auditors (Brian et al., 2007, Lennox 1999) and others through the power and independence of auditors (Knechel 2000, Herrbach 2001, Lowensohn et al. 2007, Watkins et al., 2004).

Authors such as Moizer (1997), Francis (2004) and Barton (2005) analyzed the quality of the audit and concluded that the quality of the audit service is immeasurable. Thus it remains the duty of auditors to add credibility to the corporate financial reports through their examination and expressing of a true and correct opinion as required in IAPS 1004. The financial statements auditing provides confidence when the users are satisfied with the results of the process.

Francis (2004) supports the idea that audits conducted by one of the Big Four are of a higher quality than those made by an individual auditor. He made an empirical research analysis over

the past 25 years, especially in the United States, to assess the knowledge regarding the audit quality of the listed companies. His conclusions showed that the audit failure rate is low, much less of 1% per year, while the audit fees are quite small, less than 0.1% of the global sales of the customers. All these results show that the audit acceptable level of quality is achieved at low cost. Another finding of the mentioned study shows that the low quality audits in 1990 had a major contribution to the onset of the financial failures, and implicitly as a measure against them, the initiation of recent reforms, such as the elaboration of Sarbanes-Oxley Act 2002 in the U.S. Even though there have developed a series of laws and recommendations, the literature does not define an optimal level of audit quality, so it cannot be answered the question whether the level of audit quality is "too low" or "too high".

We can conclude that it is difficult to determine an optimal level of audit quality, but we also support the idea found in the literature that the audit conducted by one of the biggest firms is higher qualitatively than the audit performed by an individual auditor.

Lennox (1999) considers that the big audit firms are more stringent than the small firms. To demonstrate this statement he makes two assumptions: Hypothesis 1: reputation hypothesis according to which the big auditors have a greater interest in providing high quality services as they don't want to lose their reputation (DeAngelo, 1981) and Hypothesis 2: "deep pockets" hypothesis which mentions that big auditors should be more rigorous, because they have greater experience on the entities with litigation risk. The results show preference on the "deep pockets" hypothesis than on the reputation hypothesis as regards the size of the auditor and the litigation risk.

4. Study regarding the preference of the entities to be audited by one of the Big Four

Through this study we want to test if the hypothesis regarding the big entities' preference to be audited by the big audit companies is confirmed, taking into account that Romania is a country with an emerging capital market development.

The table below presents an overview of the number of companies audited by the Big Four and those audited by the other audit firms.

Tab.1. The number of companies audited by the audit companies

		2005		2006		2007		2008		2009	
		Frequency	Percent	Frequency	Percent	Frequency	Percent	Frequency	Percent	Frequency	Percent
Valid	DELOITTE	3	14.3	4	19.0	5	23.8	5	23.8	4	19.0
	KPMG			4	19.0	4	19.0	4	19.0	6	28.6
	ERNST & YOUNG	3	14.3	3	14.3	2	9.5	2	9.5	2	9.5
	PRICE WATERHOUSE COOPERS	0	0	1	4.8	2	9.5	2	9.5	2	9.5
	OTHER	6	28.6	7	33.3	8	31.8	8	38.1	7	33.3
	Total	12	57.1	19	90.5	21	100	21	100	21	100
	Missing System	9		2	9.5	0	0	0	0	0	0
Total		21	100	21	100	21	100	21	100	21	100

Source: projection made by the author

Analysis results

a. General trend of the publication of audit reports

As can be seen in the table above, from a year to another, the numbers of entities that publicly post their audit report increases. In 2005 from 21 entities considered in our analysis only 12 of them publicly posted their audit reports. Later, in 2009, there are 21 entities which made public their audit reports. We also note that in 2005 there were 20 entities listed on the stock market.

The constant increase of the entities that have publicly posted their audit reports and financial statements is a good thing. We consider that the publication of the audit reports and financial statements is a relevant indicator of effective corporate governance. Transparency of the financial

statements and audit reports due to their electronic publication and the unfettered public access represents the premises of effective corporate governance.

b. The number of entities audited by one of the Big Four

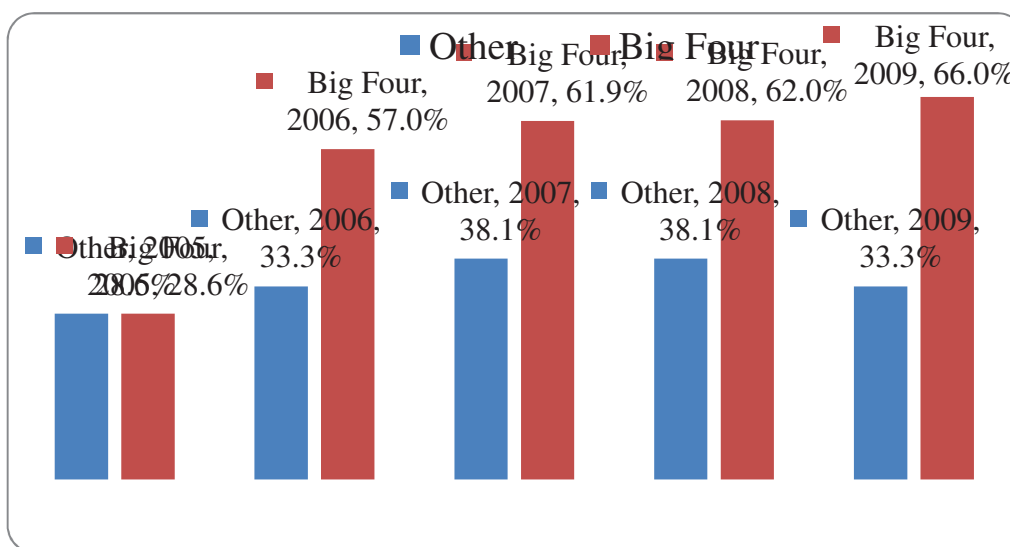
From the above analysis it can be seen the upward trend of the entities audited by one of the Big Four. The explanation of this trend refers to the fact that these companies perform high level of analysis when auditing the financial statements and their knowledge regarding the international accounting and auditing standards is superior.

In 2005 from the 12 entities that have publicly posted their audit report on the website of the BSE, CNVM or on its own website, six of the entities were audited by one of the Big Four audit company. One year later, in December 2006 there are already 12 entities audited by one of the Big Four of a total of 19 entities on the Bucharest Stock Exchange that had their financial statements audited.

c. The popularity of the big audit companies

In order to determine the popularity of the most important audit companies and their evolution over the last five years we have determined the annual total number of the audited entities, followed by the determination of the number of entities audited by one of the Big Four. In the figure below it can be observed the evolution of popularity of the audit firms during 2005-2009.

Fig.1. The popularity of the big audit companies from 2005 to 2009



Source: projection made by the authors

As can be seen in the figure above, even though we are a country with an emerging capital market development, the entities in the I-st category of the Bucharest Stock Exchange tend to an audit conducted by one of the big audit companies. In 2005 half of the entities were audited by one of the big audit companies and the other half by the other audit entities. Moreover, in 2009 the situation shows that from the 21 audit reports of the listed entities 66 % were audited by one of the Big Four.

A first conclusion arising from our study is that the I-st category entities from the Bucharest Stock Exchange become more transparent from a year to another. In 2005 we find only 12 audit reports which were publicly posted, while in 2007 all of the 21 entities electronically published their audit reports.

A second conclusion would be the ascending trend of the entities audited by one of the Big Four. Also the preparation of the financial statements and their auditing is done according to the specific regulations of the current period. Therefore, the evolution of the qualified or unqualified opinion is not constant and has no different upward or downward trend from a year to another. The modification in the auditor's opinion may be due to the fact that auditor changes from year to year, and most often when the auditor changes the opinion issued could be different. In conclusion, the presumption found in the literature, namely: the big entities are audited by the big audit companies because they provide higher audit quality is also confirmed in the case of the Romanian emerging countries with capital market development.

5. Conclusions

In this paper we approached the external audit role in achieving effective corporate governance from two perspectives: a theoretical-conceptual approach in terms of an economic theory and a practical-empirical approach in terms of specific literature. External audit has an undeniable role on the trust of the stakeholders in the financial information provided by an entity. The auditor is responsible in the issuance of an audit opinion in order to confirm to the interested parties the fidelity/accuracy/realty of the financial statements. The preparation and publication of the standard audit report provides greater confidence in the entity's financial statements and reports. One of the common ideas in the literature supports the preference of the big entities to be audited by the most important audit firms, as it is considered the superior quality of their audit services. Falling within the scope of our concerns and being strictly related to our research, we investigated whether this preference also applies to the I-st category entities listed on the BSE, knowing the fact that Romania is an emerging country and its capital market it is in a continuous development. At the end of the study we can conclude that Romanian entities listed on the BSE show the same preferences as those listed on the international markets. In addition, on the basis of the collected data we were able to draw several conclusions that define the audit market in Romania with examples on the entities listed on Bucharest Stock Exchange.

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