AUDIT FUNCTION ROLE IN ACHIEVING AN EFFICIENT CORPORATE GOVERNANCE – CONCEPTUAL MODEL PROPOSAL

Melinda Timea Fülöp
Babeş–Bolyai University of Cluj-Napoca,
Faculty of Economic Sciences and Business Administration
Str. Teodor Mihali, Nr. 58-60 400591, Cluj Napoca, Romania
Tel: +40.264 41 86 52/3/4/5 Fax: +40.264 41 25 70, email: fulop_melinda@yahoo.de

Abstract
Nowadays corporate governance plays an important role in decisions making processes, which represents a relatively new approach for both Romanian scientific studies and practice. As a consequence we consider the increased attention given to corporate governance to be crucial, especially addressing the role of the audit function and the importance of the corporate governance code. Audit function is of particular practical importance in corporate governance, therefore we decided meticulously to consider it, and especially to develop a conceptual framework for its role in support of an effective corporate governance. We consider that there are two levels and seven key elements utilized in order to achieve an effective corporate governance. In conclusion, audit function as a whole, with an active role in improving corporate governance, should perform correlated in terms of its components: internal audit, external audit and audit committees.
Keywords: internal audit, external audit, audit committee, corporate governance, financial information

1. Introduction / basic theories of corporate governance

We started our research from a basic definition of enounced by Méndez-Picazo MT et.al. (2012) who considered corporate governance as simply the modality to manage an entity. We also relied on another extremely relevant assertions from Aras & Crowther's (2008), who believed that corporate governance could be considered as an environment of trust, ethics, moral values and confidence, and at the same time a synergic effort of all the constituents of society.
Economic theories are the basis for both adequate leadership and control. The so-called "economic imperialism" after developing theories and their use emerged, and is largely attributed to the Chicago School. Tricker (1996:31) believed that administration theory, stakeholder theory and agency theory are all essentially ethnocentric.
In 1996, Hawley & Williams research included a review on the corporate governance literature published in the U.S. as a research background for the The Organisation for Economic Co-operation and Development (OECD). They identified four theoretical sources underlying corporate governance: 1) Agency

theory, 2) Theory of transaction costs, 3) Administration theory, and 4) Stakeholder theory.

According to the ***Agency theory*** founded by American economic literature in the early 70's, the owners of a company and its directors enter into a representation agreement when the first designate the last as agent mates to represent them in a specific decisional domain. Agency theory developed by Berle & Means (1932) leads to dissociation between administration and control. Management is involved in the entity development for its reputation and not for a better return on shareholders' interest (Jud G., 1996).. Jensen and Meckling (1976) affirmed that the manager who did not accept the property followed his personal interests and not the interests of shareholders. The base model of the Principal-Agent-Theory regards agents as acting in the interests of owners but also inevitably turning towards their own benefits. On that reason there is an unilateral orientation, which can be seen or noticed in reality, although this trend is not generally valid for all actors (Küpper H. & J. Weber, 1995 LL & Heracleous L. Lan, 2010). The second premise is based on the fact that agents have fundamental knowledge of their future decisions at the expense of the owner. The agents are able to estimate the results of the company while also knowing their own aspirations.

Transaction cost theory Transaction cost theory was initiated in 1985 by Williamson's study "The Economic Institutions of Capitalism: Firms Markets Relational Contracting", which provided a detailed description. Transaction costs approach was defined as an integrated part of organizational economics, by trying to explain the rationale of the entity existence and its internal organization. Transaction costs paradigm is no exception, being utilized in economic, political sciences and in many other fields thus producing interdisciplinary approaches usually exceeding the economic reductionalism.

Administration theory (Stewardship Theory) was prepared subsequent to the criticism of agency theory (Davis, HJ et al., 1997). Its basis are represented by exchange relations, namely between a Principal (owner) and a Steward (administrator). Administration theory states that managers are skilled administrators who make quality work for the owners 's benefit. The desire for promotion, affiliation, achievement and accountability motivates managers to move towards long-term collective responsibility, therefore managers will not pursue their own benefits (Fischer, F. 2003).

The starting premise for the administration theory is that managers are essentially reliable, in terms of corporate governance. It is very important that managers do not automatically adopt behavior focused on their own interests but concentrate on the owners' interest (Salomon J., 2007).

Conceptual basis of the theory is related to the development of Y Theory developed by McGregor (1960) which assumes that managers are rational beings, therefore there is no need for an excessive monitoring of their behavior as in the Agency Theory (G. Nicholson and G. Kiel, 2007).

Stakeholder theory gained momentum in 1970. Freeman (1984) initiated the first publications in the management of stakeholder theory. He proposed a general

theory of all entities, thus the entities administration is required to provide some information to its shareholders. Since then the applicability of the theory has grown in different disciplines (T. Donaldson & Preston L., 1995). Freeman believed that management decisions must be made considering the impact they had on factors possibly affected by the decisions, which include shareholders and entrepreneurs, managers, employees, suppliers, customers and the community (T. Beauchamp & N. Bowie, 2004). There is a general agreement that the public sector is complex and engages a mixture of stakeholders and that this intrinsic complexity is translated into the e-government arena (Rowley, J., 2011).
From the perspective of corporate governance, stakeholder theory lays the responsibility and accountability foundations for both stakeholders and the entire society.
Knapp et al. (2011) argued that two of the leading theories on corporate governance (e.g. agency theory or Stewardship theory) offered a rather simplistic approach, and their perspective was quite rigid in human nature.
In order to underline the importance of the audit function for an effective corporate governance we offer a solution through a conceptual model which can best reflect the reality of the modeled item using a set of concepts and rules for combining them.

2. Methodological aspects on the development of the conceptual model

In developing the conceptual model we took into consideration three aspects in the analysis of the modeled, namely: 1st stage - structural static analysis that allowed us to study the subject object modeling components and links established between them; 2nd stage - behavioral (temporal) dynamic analysis where we studied the object components and connections' states in response to the occurrence of certain external events and their effects during the transition from one state to another; 3rd phase - functional analysis where we studied components and connections' transformations for fulfilling the needs generated by the system functionality.

Table 1. Conceptual model stage

Stage	Description
1st stage	Identify the components of each audit functions and the links between them
2nd stage	Identify common elements of the three audit functions Establish common elements on two levels: internal / external
3rd stage	Represent the conceptual model regarding the role of the audit function in achieving an effective corporate governance

The audit function as a whole and its components within corporate governance have been analyzed in three successive periods: before the current economic crisis, during the crisis and the postcrisis period.

We consider as essential in our approach a first classification based on two levels of audit role for an efficient corporate governance: internal level and external level (Fülöp, 2012). In the internal matter, as can be seen in the next figure, we focused on the factors that lead to an effective corporate governance within an entity. As for the external level, we centered on the elements that positively influence the effectiveness of corporate governance.

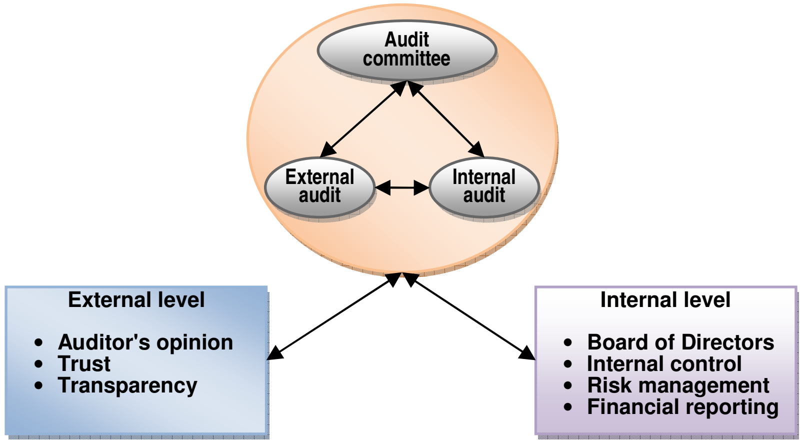

Fig. 1. Audit role for an efficient corporate governance

3. Synergies between the components of the audit function

In the next section, we summarize the characteristics of the audit function and the elements that define its role in achieving an effective corporate governance.

3.1. External auditor's opinion

The external auditor, after checking and analyzing the financial statements of an entity, issues a report on its compliance with the considered standards. The audit report should contain a clear expression, in writing, of opinion on the financial statements taken as a whole (ISA 700). The external auditor's favorable opinion certifies the accuracy of the information provided by the entity, thus increasing investors' confidence.

When transposing these elements in the context of an effective corporate governance, the expressed view is only supposed to be issued without any reservations by a competent and the independent auditor. Dye (1991) suggested in his research that when an audit fee was paid, auditor independence could be improved, because at that time there was no doubt about the possible influence on the auditor's opinion. Nevertheless, according to DeAngelo (1981a), the audit fee disclosure may be irrelevant to the issue of the audit opinion, because the possible costs caused by these influences would be much higher.

3.2. The confidence of investors

At the present time, audit function faces the independence compliance issue, which has an essential contribution in building trust. Independence means that management can completely rely on the findings and recommendations of the audit committee. A first aspect that characterizes the independence of the audit committee is objectivity, which represents a multitude of problems forming a complex maze. Furthermore, we believe that another factor contributing to the independence of the audit committee is impartiality. Also, there are other important factors, such as the validation of the auditor's opinion and professionalism in the performed activity. The Audit Committee has a central role in this matter by connecting the external and internal audit (Fülöp, 2012).

Lesage (2010) considered the independence and competence of the auditor particularly important in any auditing activity. Küppers and Sullivan (2010) also discussed the need for auditor independence and considered that independent auditors focused on improving performance, a specific feature for a quality audit. In many countries the auditor's independence is governed by definite rules and laws. In addition to respecting the independence, the auditor should first follow the Code of Ethics of the accounting profession. External audit, as an external monitoring function offers credibility to financial statements, but only to the extent in which users perceive this information in the correct way it was exposed by the auditor.

The external auditor through the audit report could bring additional confidence from investors. This topic is one of the utmost importance in the current postcrisis period especially for entities listed on stock exchanges. In order to monitor the conformity with the public interest by the audit firms, the International Federation of Accountants (IFAC) set up a Public Interest Oversight Board (PIOB), which was intended to restore public confidence in audit and the audit profession. At a European Union level it was also set up a similar organization. Baker et.al. (2010) supported the idea of double audits so as to improve audit quality, despite the fact that this idea is not approved in the Anglo-Saxon countries. On the other hand, in France, all listed or not listed companies that publish consolidated financial statements have the obligation of contracting two auditors..

3.3. Transparency of information

How exactly can an auditor contribute to the transparency principle? This is a question to which external auditors have been trying to find the answer. Barth and Schipper (2008) addressed the concept of transparency in financial reporting, which was defined as the extent to which an entity disclosed financial and nonfinancial information to stakeholders. The authors considered that the transparency of financial reporting can be achieved by setting global standards and consistency in the application of a single set of financial reporting standards. A new vision of transparency involves several important features such as inevitable trends toward greater transparency; more intensive checks from several groups; more complex requirements for the information collection, analysis and reporting;

more proactive attention from both observer and observed, and not least more debates on the characteristics of the information which is to be published.

3.4. The role of internal control

Internal control is one of the central elements of a good quality corporate governance and subject to evaluation from internal audit, audit committee and external audit. From the outset, it was recognized that internal control is a broad concept that extends beyond the accounting functions of a company. In 1985, a private sector initiative known as the Treadway Commission was formed to study the financial reporting system in the United States. In 1987, the Treadway Commission issued a report recommending its affiliated organizations to work together in order to integrate various concepts of internal control and to define and develop a common reference point.

In 1992, Committee of Sponsoring Organizations of the Treadway Commission (COSO.org) issued a first definition of internal control as a process influenced by the administration, management or other management bodies that ensure adequate security in relation to the objectives in the following categories: effectiveness and efficiency of operations, financial reporting reliability and compliance with laws and standards.

The concept of internal control has been defined in various corporate governance codes and regulations like Turnbull, Sarbanes Oxley (SOX) act and others. The most controversial aspect of SOX is Section 404, which requires that managers and external auditor to report on the adequacy of the company's internal control over financial reporting.

Hoitash et. al. (2009) examined the association between corporate governance and disclosure of financial reports by internal control. Based on their descriptive and statistical analysis the authors concluded that the features of the Audit Committee and of the managers were directly correlated with the quality of internal control. The internal auditor should be concerned about the control status within the organization.

3.5. Risk management

The entity is a group of people and cultures which interact, including their errors, and in addition it represents a constituent of risk management. The process of risk management is defined by the Standards of risk management as "the systematic application of management policies, procedures and practices to determine the context of identifying, analyzing, evaluating, treating, monitoring and communicating the risk".

In recent years, the concept of risk management has become an essential component in the context of corporate governance. Various corporate governance codes define risk management. For example, the Hampel report (1998), established links between risk management and corporate governance, knowing that investing in an entity is risky, therefore the ones entrusted with the task of defending the interests of shareholders should be required to identify, assess and control the possible risks. The corporate governance contributes to prosperity and financial reporting entity. A modification of the Hampel Report was published in the Combined Code which underlined the link between risk management and internal control.

Turnbull Report connects with the most popular control frameworks models like COSO or CoCo that describe risks as a part of the internal control system.

The international standard 1220.A3 of Internal Audit states that "the internal auditor should be alert to the significant risks that might affect objectives, operations or resources. However, assurance procedures alone, although conscientiously applied, do not guarantee that all significant risks will be identified". The Audit Committee has the role to monitor and evaluate the activities of internal control and risk management.

3.6. Financial / nonfinancial reporting

Financial but also nonfinancial reporting is central elements of an entity, without which the entity would not work. In order to ensure the smooth running of business within the entity, the Board of directors are directly responsible for financial and nonfinancial statements, and also conduct and activities in different compartments of the entity. Financial and nonfinancial reporting have currently become a business language that reflects the entity's position on the capital market.

Internal audit function received the role of examining, evaluating and monitoring the adequacy degree and the accounting efficiency. Subsequent to the preparation of financial statements that have been the subject to a review and evaluation by the internal audit department, these will be verified by the audit committee..

Management and audit functions are supposed to have distinct roles and responsibilities in financial and nonfinancial reporting. But still, we should not forget that management and audit functions share a common purpose, explicitly to ensure the quality of financial and nonfinancial reporting. In spite of the degree of autonomy, objectivity and independence the internal auditor and the audit committee cannot match the same degree of independence as external auditors. Therefore, in order to be endorsed, financial and nonfinancial reporting is subject to review and evaluation by the external auditor through the opinion stated in the audit report.

3.7. Board of Directors

In case the internal auditor understands the executive processes then it would be easier to work in partnership with the managers. This participatory approach brings closer the role of internal audit. The Board of Directors reviews and approves the internal audit plan after its approval by the Audit Committee. Internal audit missions will be conducted based on the Bord's mandate Board in compliance with internal regulations, audit techniques and the rules of conduct.

Following the detailed analysis of the seven elements of the developed conceptual model, we can affirm that both internal and external levels interact, and furthermore, each element interacts with the others regardless of level, while the interaction optimization can facilitate to streamline the position they hold.

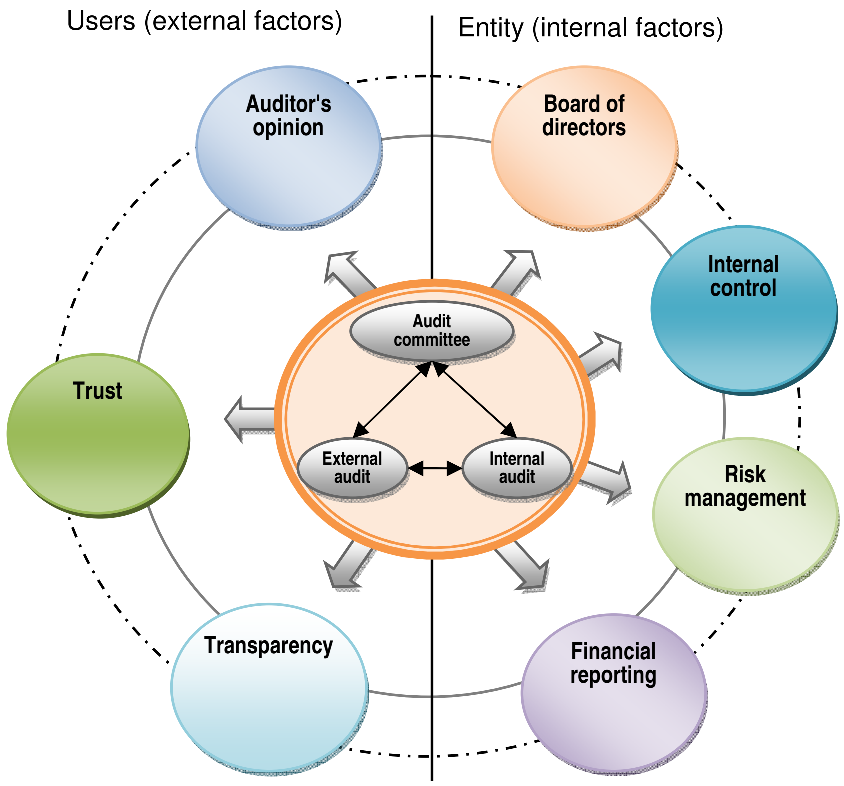

Fig.2. Decisive elements on the effectiveness of corporate governance in light of the audit function
Source: authors

We consider that the interaction between the seven elements in proposed the conceptual model genuinely enhances the effectiveness of corporate governance. Each element contributes to the efficiency of corporate governance, as the Table 2 shows.

Conclusion
Based on our research and practice we can affirm that achieving an effective corporate governance is founded on two levels and seven basic elements.
Audit function as a whole, in order to have an active role in improving corporate governance, should function correlated in terms of its components: internal audit, external audit and audit committees. In addition, we must also consider both the internal factors (relationship with the Board of directors, organization and supervision of internal control and risk management, as well of financial and

nonfinancial reporting) and external factors (auditor's opinion, the public interest and transparency of the supplied information).

Table 2. Element they contribut to the efficiency of corporate governance

Element	**Description**
Auditor's opinion	the external auditor certifies the information provided by the entity and increases investors' confidence, founded on a favorable opinion
Trust	the establishment of audit committees contributes significantly to trust enhancing and fraud reduction the external auditor, via the audit report, serves the public interest and helps to increase the confidence
Transparency	extent in which an entity discloses financial and nonfinancial information to stakeholders
Board of Directors	reviews and approves the internal audit plan after its approval by the Audit Committee is directly responsible for the preparation of financial and nonfinancial reporting
Internal control	is one of the central elements of a superior quality corporate governance is the subject for evaluations from both internal and external audit, being the whole time under the attention of the audit committee.
Risk management	is also subject to internal audit and for audit committees contributes to improve the efficiency of corporate governance
Financial / non-financial reporting	is a central element of the entity internal audit, external audit and the audit committees are concerned with the accuracy of data

REFERENCES

1. Actul (Legea) Sarbanes Oxley (2002), European Corporate governance institute (2009), http://www.ecgi.org/codes/all_codes.php;
2. Aras G. & Crowther D. (2008), Governance and sustainability An investigation into the relationship between corporate governance and corporate sustainability, *Management Decision*, Vol. 46 No. 3, pp. 433-448
3. Baker R.C. et. al (2010), One, two or more statutory auditors: a comparison of France, Italy and the United States Un ou plusieurs auditeurs pour la même entité: une comparaison entre la France, l'Italie et les Etats-Unis, Multiple Auditors, congrès AFC;
4. Barth M.E.& Schipper (2008), Financial Reporting Transparency, Journal of accounting,auditing& finance, p.173-190;
5. Beauchamp, T., & Bowie, N. (Eds.). (2004). *Ethical theory and business (7th ed.).* Upper Saddle River, NJ: Pearson Prentice Hall;
6. Berle, A. and Means, G. (1932) *The Modern Corporation and private property.* New York: Macmillan;

7. COSO (1992): Committee of Sponsoring Organizations of the Treadway Commission: Internal Control – Integrated Framework, New Jersey;
8. Davis, H. J., Schoorman, D. and Donaldson, L. (1997) 'Toward a stewardship Theory of Management' *Academy of Management Review,* 22(1): 20-47;
9. DeAngelo, L. (1981a.), Auditor Independence, _Low Balling_, and Disclosure Regulation.'' Journal of Accounting and Economics 3 (August): 113–127.
10. Donaldson, T. and Preston, L.E. (1995), 'The Stakeholder Theory of the Corporation: Concepts, Evidence and Implications', *Academy of Management Review*, 20(1): 65-91;
11. Dye, R. A. (1991), Informationally Motivated Auditor Replacement, Journal of Accounting and Economics 14 (December): 347–374;
12. Fischer F (2003) Reframing public policy: discursive politics and deliberative practices. Oxford University Press, Oxford;
13. Freeman, R.E. (1984), *Strategic Management: A stakeholder approach.* Boston: Pitman;
14. Fülöp, M.T. (2012), *Auditul în guvernanța corporativă*, Editura AlmaMater, Cluj-Napoca;
15. Hawley, J.P. and Williams A.T. (1996), *Corporate Governance in the United States: The Rise of Fiduciary Capitalism,* Working Paper, Saint Mary's College of California.
16. Hoitash U. et al. (2009), Corporate Governance and Internal Control over Financial Reporting: A Comparison of Regulatory Regimes, The accounting review, Vol.84(3), p.839-867;
17. ISA (2003): International Standards on Auditing (ISAs) – Internationale Prüfungsgrundsätze, Schäffer-Poeschel Verlag, Stuttgart;
18. Jensen, M.C., Meckling, H. W.(1976), „Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure", *Journal of Financial Economics*, vol. 3, nr. 41976;
19. Jud G.(1996), Die Überwachung der Unternehmen durch deren Organe, *Treuhand-Kammer*, Zürich
20. Küpper, H.U. & Weber, J.(1995), *Grundbegriffe des Controlling,Schäffer-Poetschel*, Stuttgart;
21. Küppers, R. J. & Sullivan, K. B. (2010), How and why an independent audit matters, International Journal of Disclosyre and Governance, Volume 7(4),p286-293;
22. Lan L. L. & Heracleous L., (2010), Rethinking agency theory: The view from law, *Academy of Management Review,* Vol. 35, No. 2, 294–314;
23. Méndez-Picazo M.T., Galindo-Martín M.A. & Ribeiro-Soriano D. (2012), Governance, entrepreneurship and economic growth, *Entrepreneurship & Regional Development: An International Journal*, 24:9-10, 865-877
24. Nicholson, G. J. and Kiel, G. C. (2007), Can Directors Impact Performance? A case-based test of three theories of corporate governance', *Journal Compilation, Blackwell publishing,* 15(4): 585-608.

25. Rowley J.(2011), e-Government stakeholders - Who are they and what do they want?, International Journal of Information Management, 31(1): 53-62;
26. Salomon J.(2007), *Corporate Governance and accountability*, Second Edition, JohnWiley&Sons, Ltd, England;
27. Tricker, R.I. (1996), *Pocket Director*, The Economist Books, London;
28. Williamson O.(1985), *The Economic Institutions of Capitalism: Firms Markets Relational Contracting,* Free Press, New York