Auditor’s Consideration of Corporate Governance

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Abstract: In modern business world, companies need to attract a large number of shareholders because of the large amount of required capital. In these companies, shareholders hire managers to direct the firm and make decisions on behalf of them because they cannot have a full control over the firm’s activities. Therefore, managers have the competitive advantage of information within the firm rather than the shareholders which leads to asymmetry of information between managers and shareholders. In addition, agency theory assumes an opportunistic behavior that managers want to maximize their own expected interest disregard of shareholders right. In other words, managers may not necessarily make decisions in the best interests of shareholders because of conflict of interest and hence impose the agency costs on the firm. Agency theory suggests that corporate governance (CG) as an effective information system can monitor the management and align the interests of executives with those of shareholders to mitigate the agency costs. In addition, auditors must work with other factors in CG structure to ensure that stakeholders receive the highest quality of financial reports as well as help to protect the interests of stakeholders. Since CG and external audit services are complementary and the purpose of both is to protect stakeholders’ interest this study aims to explore the perceptions of professional auditors on the consideration of CG in an audit engagement. Applying a semi-structured interview with two certified public accountants (CPA), this study obtains the opinion of experts how to consider CG in their efforts. Analyzing of interviewees’ response suggests that auditors consider CG mechanism as a system of supervision to control the opportunistic behavior of individuals and monitor the financial reporting process. They use CG information in planning stage more than other stages to define the extent of efforts for audit process. Weaker CG mechanism increases the control risk and required auditors to make more efforts in their audits. Among different aspects of CG the board of directors is more considered by auditors. They believe that audit committee is an important mechanism in CG but board of directors affects it and hence board of directors has the most power to make decisions regarding financial reporting quality. Other characteristic of CG mechanism which can be considered by auditors is ownership structure and compensation committee.

Key words: corporate governance, board of directors, audit committee, audit, auditors.

INTRODUCTION

Audit is a systematic process of examination and verification of firms’ accounting records by a professional to make an opinion on reliability and validity of information reported by that firm (Fan and Wong 2005). The aim of audit services is to provide reasonable certainty about the accuracy and fairness of financial statements and assure that there is no important misstatement in financial reporting. In other words, auditors’ responsibility is to verify the consistency of financial statements with the GAAP and the accuracy of reflected financial condition and operating results in these statements (Lin and Hwang 2010). It is not only related to collect information about the financial records in a firm but also includes non-financial sections such as security and information system performance. It should be noted that auditors could be successful only if their audit opinions represent the true findings of the audit engagement. Generally accepted standards established by governing body provide all stakeholders with the confidence to rely on auditor’s report about the fairness and accuracy of financial statements.

In fact, the agency problems through the separation between those who control and those who own the residual claims and also information asymmetry between managers and shareholders necessitate an external audit service to assure all stakeholders about their investment (Lin and Hwang 2010). The separation of ownership from control implies that the stakeholders cannot exercise full control over managerial actions. Therefore, stakeholders hire managers to make decisions that are in the best interest of the stakeholders. Jensen and Meckling (1976) define this relationship as agency relationship in which shareholders engage managers to manage and direct their investment on their behalf. In addition, agency theory assumes an opportunistic behavior that is individuals want to maximize their own expected interests and are resourceful in doing so. Therefore, there will be a conflict of interest between managers and shareholders. Furthermore, there will be an information asymmetry between the shareholders and managements because the managers have the competitive advantage of information within the company over that of the owners (Zubaidah 2009).
This situation arises because of an ineffective information system to control the management behavior. Therefore, the agency problem will arise when the managers do not necessarily make decisions in the best interests of the shareholders and imposes agency costs on the shareholders (Jensen and Meckling 1976). Hence, researchers have suggested various governance mechanisms within the agency contract to align managerial motives with the interests of stockholders (Demsetz and Lehn 1985; Fama and Jensen 1983). Agency theory suggests that corporate governance (CG) helps to reduce agency conflicts by acting as a monitoring device to align management's goals with those of the stakeholders and lessen the agency costs. Based on agency theory, one of the important aspects of CG is financial information disclosure as a means to relieve the information asymmetry by providing reports from the managers to fund suppliers (Zubaidah et al., 2009). Eventually, CG plays a crucial role in improving the efficiency and quality of financial reporting (Rezaee 2004).

Simultaneously, from an agency perspective, auditors can be considered as a part of CG structure because they monitor the quality of the financial reporting process (Beasley and Salterio 2001). Auditors communicate and discuss with the audit committee about the quality of accounting principles exerted by clients. Therefore, their audit report can improve the credibility of financial statements reported by managers. Fan and Wong (2005) provide evidence to support the agency theory and suggests that auditors as a part of CG system have an important role to reduce the agency problems in emerging markets. In addition, the principles of CG formulated by the Organization for Economic Cooperation and Development (OECD) state that “An annual audit should be conducted by an independent and qualified auditor to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects,” (OECD 2004).

Therefore, CG and audit services are considered to have an important role in reducing information asymmetry as well as in mitigating agency problems between managers and stakeholders (Beatty 1989; Willenborg 1999). Since, CG and external audit services are complementary and the purpose of both is to protect stakeholders' interest, auditors must work with other factors in CG structure to ensure that stakeholders receive the highest quality financial reports as well as help to protect the interests of current and future stakeholders. Baker and Owsen (2002) believe that both auditing and CG aim to reduce the information asymmetry between managers and stakeholders. They assert that an appropriate CG system can lessen the audit risk and auditors adjust their audit effort in a company based on the quality of existing CG system. Therefore, the objective of this study is to obtain the opinion of respondents on CG consideration in outlining and directing an audit engagement by conducting a semi-structured interview with two professional auditors with more than 20 years experience in teaching and research on audit services.

This paper proceeds with following sections. The next section provides a background on CG and audit process and discusses the relevant literature. Section 3 describes the data collection and research method. In section 4, this study presents the analysis of findings through the interview. Finally, section 5 provides the conclusion of study.

Literature Review:

Zubaidah et al., (2009) argue that there is a fundamental information asymmetry between the directors who have direct access to information and fund suppliers who are external to the firm. Financial information is a means to relieve this asymmetry by providing reports from the managers to fund suppliers. Based on agency theory, information is referred as an object that can be purchased and organizations can invest in information systems such as board of directors in order to control agent's opportunism (Kathleen 1989). Financial reporting is an interactive supply chain process involving all CG factors to prepare and certificate the financial statements by corporate management under the supervision of the board of directors. In fact, CG mechanism has an important role to improve the credibility of corporate financial reporting and assure that financial statements are reported in accordance with generally accepted accounting principles (GAAP) (Lin and Hwang 2010). Rezaee (2004) in his article argues that the main purpose of CG is based on the accountability and responsibility rather than the image of who has the power and who is responsible. Management is accountable to the board of directors and the board of directors is accountable to the stakeholders to align the interests among managers, directors and stakeholders.

In addition, audit service can play an important role to reduce this information asymmetry and mitigate the agency problems between managers and stakeholders by verifying the financial statements provided by managers (Al-Ajmi 2009). In other words, audit quality can be considered as an important element of CG. Some professional guidelines and prior studies examine the effect of CG factors on the audit process and show that auditors consider CG mechanism in their audit planning (Cohen and Hanno 2000; Cohen et al., 2002). They document that weaknesses in CG structure are often resulted in lower financial reporting quality, earnings manipulation and even overt financial statement fraud. Further, Krishnan (2001) finds a relationship between the quality of the CG structure and the incidence of internal control problems. He argued that the strength of CG can influence the auditors' risk assessments and clients' acceptance decisions. Cohen and Hanno (2000) examine...
how auditors consider CG structure when they are planning an audit program. They found auditors believe that companies with independent board of directors and audit committees seem to have lower audit risk.

Gul and Tsui (2001) investigate the effect of free cash flow and management share ownership as two measures of agency risk on audit fees. They find that high free cash flow is associated with higher audit fees because auditors have to make more audit efforts but high management ownership is associated with lower audit fees or less audit efforts. While it is desirable that good CG structure seems to mitigate audit risk and that auditors are likely able to assess the quality of CG in a company and appropriately adjust their audit efforts, it should be noted that the main objective of both CG and auditing is to enhance the interests of shareholders. To recognize the CG characteristics affecting audit plans, auditors must first identify and properly assess the strength of CG and, second, appropriately weight and use this evidence to develop an audit plan (Cohen et al. 2002). If the CG structure is strong then auditors will potentially reduce sample size and thus reduce the extent of costly substantive testing. Finally, program plans influence the evidence obtained and, thus, the quality of audit decisions. Therefore, this study aims to get the perception of respondents about the CG consideration in an audit engagement.

**Research Method:**

Researchers in the social sciences most commonly use content analysis to analyze recorded transcripts of interviews with participants (Kimberly 2002). Content analysis is a methodology in the social sciences for studying the content of communication. The core questions of content analysis are: "Who says what, to whom, why, to what extent and with what effect?" In the present study, to gain a better understanding on perception of the effect of CG on audit process, it was deemed useful to seek viewpoints derived from experts who have studied in this area or have experienced this situation. Following Cohen et al. (2002), this study uses a semi-structured interview approach to address the research question and conducts an interview in 2011 with two certified public accountants with more than 20 years experience in teaching and research on audit services. We contacted the interviewees personally and invited them to participate in the research. For getting preliminary approval from them, an interview protocol explaining the nature and scope of the research was sent to interviewees. Each interview consumed one hour for eight questions, was tape-recorded and subsequently transcribed by the researcher. While the interview guide entails the purpose of leading discussions around the subject, semi-structured nature of interviews also provides the interviewer with the opportunity to decide on the sequence/wording of questions during the interview.

**Findings and Discussion:**

Interviewees were asked to answer eight questions to give their opinion about the consideration of CG in the audit process. Following section reports the research findings based on the conducted interviews. They define CG as a controlling mechanism which is important to reduce the agency problems and protect the shareholders interests. Auditors evaluate the strength of CG to make an audit planning and consider it in the extent of future efforts in audit process. Most important characteristics of CG based on respondents’ opinion are board independency and independent audit Committee. Board of directors has the most power and broader function to make decisions regarding financial reporting and audit committee focuses on monitoring the financial reporting quality.

**How Do Auditors Define CG?:**

With regards to the definition of CG, respondents define CG as both structure and process. According to interviewee 1:

"Although there is no generally accepted definition of CG, it may be defined as a system including all individuals, activities and processes to assure the appropriate supervision on the firms’ resources. As a structure it involves in board of directors, audit committee, internal and external auditors. As a process it is a controlling mechanism to ensure investors interests are being taken care."

Interviewee 2 Mentioned That:

"CG is a controlling mechanism in a company with the aim of ensuring that company will achieve the objective of the stakeholders. It is any rule, law and factor that controls the operation of the company or ensures that company operates in a proper manner in terms of using the money provided by investors."

Their definitions align with the definitions of CG presented by Shleifer and Vishny (1997). They define CG as a way in which stakeholders assure themselves of getting a return on their investment. Irrespective of the particular definition, the importance of CG arises in a firm because of the separation between those who control and those who own the residual claims.
Which Approach In Their View Can Better Explain The Cg Importance?:

In this study, both respondents frame their definition of CG on a system of regulations and mechanisms that control the managers' operation. They believe that managers want to maximize their own expected interests. In other words, because of their authority to direct the firm and weak control on their activities by shareholders, managers can easily pay less attention to maximize the shareholders' profitability and more to develop their own objectives. For this purpose, managers tend to misstate the financial position and future cash flow of a firm. Consequently, investors or stakeholders based on this misleading information will make decisions that indeed do not provide them with a desirable return. This type of definition by respondents considers CG mechanism as a system of supervision to control the opportunistic behavior of directors which is consistent with the perspective of agency theory.

Cohen et al., (2000) indicate that prior researches in accounting, finance and management have shown three views of CG. The first approach, which is widely held in accounting and finance, relies on agency theory (Core et al., 1999). The agency theory emphasis that those executing the monitoring function should be independent from those being monitored. Hence, the most desirable attributes for board members under the agency theory perspective are independence from management and expertise in monitoring and control. Under the second approach, resource dependence perspective, the main role of the board of directors is cooperating with managers to set policies and strategies and helping management to perform the strategic plans (Boyd 1990). Hence, the most valuable attributes of a board member under the resource dependence perspective are industry expertise, knowledge and the ability to provide access to external resources (Cohen et al., 2000). The third view is hegemonic perspective that CG mechanism is viewed as being ineffective at monitoring and largely symbolic in terms of oversight of management.

Does The Cg Affect The Financial Reporting Process?:

Regarding to the third question, interviewee 2 asserts that:

Due to the separation of ownership from control in the modern business world, a system of CG is required to supervise and monitor the management to reduce agency costs and align the interests of executives with those of stakeholders. An appropriate CG induces managers to exert the firms' resources in the best interest of shareholders and fairly report the operating performance and financial position of the firm."

Based on The Perspective of Interviewee 1:

A good CG mechanism can apply an effective monitoring system and influence the financial reporting process to provide investors with appropriate information to make decision about their investments in a firm."

Chen and Jaggi (2000) and Eng and Mak (2003) support the argument that CG widely can affect the process and also the extent of disclosure. Cohen et al., (2004) imply that one of the most important functions that CG can play is ensuring the quality of the financial reporting process. DeFond et al., (2005) and Carcello et al., (2008) apply the CG score including the board and audit committee characteristics and show that strong CG can improve the quality of financial reporting process.

Do Auditors Concern The Cg Information In Client Acceptance?:

Beasley et al., 2001 believe that an appropriate picture of CG in place can help auditors to assess different client risks in acceptance an audit contract and then outline a more effective and efficient audit program. In addition, Krishnan (2001) documents that the strength of CG could influence the assessment of risk in clients' acceptance decisions. In this study, interviewee 1 asserts that identifying and assessing the CG characteristics takes place much more at the beginning of the audit process before planning, even in client acceptance. In addition, interviewee 2 believes that in client acceptance, it is more likely that an auditor can truly assess the affiliated risk to its potential client and make decision about the audit process.

How and In Which Stages Do The Cg Information Is Used By Auditors In Audit Process?:

Regarding to the effect of CG on audit process, Beasley and Salterio (2001) believe that the board's success in discharging its fiduciary duties and, in working closely with the management, would be predicted to increase financial reporting quality and consequently auditors investigate the lower audit risk and less efforts in auditing. In addition, Krishnan (2005) finds a positive relationship between independency of audit committee and quality of internal control. Firms which do not have an effective audit committee are more likely to have an internal control weakness and need more efforts in audit process (Zhang et al., 2007). Felo et al., (2001) believe that CG information is important for allocating decisions of professional staff and efforts in an audit planning. Cohen and Hanno (2000) examine how auditors consider CG structure when they are planning an audit program.

In this interview, respondents indicate that the role of CG is important in all engagement but it is more considered in audit planning. Interviewee 2 explains that:

We assess CG in each firm by itself regardless of firm characteristics because in every audit engagement, recognizing the internal control system in organization is so important to assess the audit risk. The assessment of
control risk by auditors will be higher when the CG is weaker considering to its agency role in comparison with stronger CG. If we assess the CG structure as a good internal control system then we will reduce the future efforts and also the extent of review by managers and partners will be lessened."

Interviewee 1 recognizes and investigates the CG characteristics and then considers this information in the whole audit process including audit planning, field-testing stage and review stage. He mentioned that: "I use CG information in planning stage more than other stages because in this stage the extent of efforts for audit process is defined. Of course, the use of CG information varied based on the participant's position within the firm. Seniors collect information, then managers review this information and finally, partners review what managers have done but the assessment of CG is more important in the partners reviewing because the more strong CG reduces our efforts to review the managers operation."

**Which Aspects of CG Do Auditors Consider?:**

Based on respondents view, board of directors’ characteristics and its designated audit committees are common measures of CG effectiveness. Interviewee 2 asserts that:

- The more independent boards may decline the potential of misstatement and hence decrease the audit risk. Auditors may put less confidence on the board as a controlling mechanism in companies which the most of directors are not independent and cannot be effective in monitoring function. Another issue is the CEO duality. When the board chairman is also the CEO, the board intensity to monitor and oversee management is reduced as a result of lack of independence and a conflict of interest. In this position, CEO can dominant the board and weaken the board strength."

This result is consistent with Cohen et al., (2007) who report that when the board is stronger, control risk assessments will be lowest and auditors will decrease structured audit efforts and vice versa. One of the factors affecting the CG strength is the board of directors' composition and the best composition based on interviewee’s 1 perspective is a mixture of executive and independent non-executive members. The knowledge of firm, skills and expertise of executives will help them in better decision making aligning with the firm's goal. In addition, independent non-executive directors can control potential opportunistic behavior of executive members if they are really independent.

Another important aspect in CG who auditors should report to is audit committee. In effect, they are more responsible for auditors' work and they must review it. They also have more meeting with them to discuss about the issues in financial reporting system or internal control. Interviewee 1 believes that:

- Audit committee has an important proactive role relative to audit risk management and the related audit planning decisions. In other words, companies with more independent board have more tendencies to spend more on audits and improve the independency of their audit committees. More independent audit committees have more tendencies to interact with internal auditors and also protect the external auditors from client pressure. In addition, they decrease the occurrence of financial reporting problems and frauds."

In a balance sheet model of the firm, Gillan (2006) argues that the board of directors is the apex of internal governance system and is responsible to monitor and compensate management. Important characteristics for a good board of directors found in previous research include board independency, directors’ ownership and CEO duality (Zubaidah 2009; Abdullah 2004). In addition, an effective independent audit Committee is one of the factors that determine the audit quality (Dhaliwal et al., 2006). This committee recommends external auditors and directs the relationship between them and the company.

**How Important and Effective Is Audit Committee In Comparison With Board Of Directors?:**

Interviewee 2 believes that audit committee is an important mechanism in CG but board of directors affects it and hence board of directors has the most power to make decisions regarding financial reporting quality. Probably, the reason is that audit committee focuses only on monitoring the financial reporting but the board of director has a broader function in business strategies. Interviewee 1 says:

- The most important characteristic of audit committee members is the accounting and auditing expertise to perform their task effectively. Sometimes, the lack of experiences on financial issues makes the members of audit committee ineffective and not powerful enough to direct the quality of financial reporting process. When we are speaking to an audit committee throughout the year or throughout the audit engagement and understand that audit committee seems to be "rubber stamp for management", we will investigate a higher client risk."

The passivity of audit committees supports the arguments of Fogarty and Kalbers (1998), which use institutional theory to explain the symbolic nature of audit committees. Cohen et al., (2002) find that auditors explain that auditors organize their meeting whit the audit committee as a formality stage in audit process.

**Are Other Mechanisms In CG Important And Effective?:**

From the viewpoint of interviewee 1:

- Another characteristic of CG mechanism which can be considered by auditors in audit planning and audit process is ownership structure in a firm. Companies with more entrenchment problems and misalignment of
interests between controlling and minority shareholders need more audit efforts and hence pay higher price for auditing."

Fan and Wong (2005) report that Big 5 auditors consider the ownership structure of clients and firm’s agency conflicts between shareholders in making decisions about the audit efforts and audit fees. Finally interviewee 2 asserts:

We almost consider compensation committee because this committee set the salaries and bonuses. When we want to engage an audit, it will be an important factor to concern because we are usually curious about the motives for the remunerations."

As a final word, interviewee 1 asserts that the board of directors has the most important role in audit process and the effectiveness of other mechanisms is related to the board because board controls them. Therefore, it is inevitable to look at the board of directors at first and then go through the other mechanisms.

**Conclusion:**

Based on the semi-structured interview approach to address the research question it can be concluded that auditors consider CG mechanism as a supervisory system to control the opportunistic behavior of directors which is consistent with agency theory perspective. One of the most important functions of CG is to ensure the quality of financial reporting process to provide investors with appropriate information to make decision about their investments. Therefore, auditors use CG information for allocating decisions of professional staff and efforts in an audit engagement. When the CG structures are strong and efficient, the assessment of control risk will be lower. Then, auditors rely more on management reports and reduce the efforts and reviews in audit engagement. They use CG information in planning stage more than other stages because in this stage the extent of efforts for audit process is defined.

Among CG characteristics, board of directors and its designated audit committees are common measures of CG effectiveness which considered by auditors. However, when the board chairman is also the CEO, the board intensity to monitor and oversee management is reduced as a result of lack of independence and conflict of interest. Audit committee has an important proactive role relative to audit risk management and the related audit planning decisions. The most important characteristic of audit committee members is accounting and auditing expertise to perform their task effectively. Audit committee focuses only on monitoring the financial reporting but the board of director has a broader function in business strategies and the most power to make decisions regarding financial reporting quality. Other characteristics of CG mechanism which can be considered by auditors in audit planning and audit process are ownership structure and compensation committee.

**REFERENCES**


