

## Corporate Governance and Audit Process

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**Abstract:** Based on agency theory, the importance of Corporate Governance (CG) is to reduce agency conflicts between those who control and those who own the residual claims in a firm. Auditors can be also considered as a part of CG structure because they monitor the quality of the financial reporting process to reduce the information asymmetry between managers and stakeholders. The interaction between CG and external audit services often suggest that they are complementary. In fact, auditors must work with other factors in the CG structure to ensure that stakeholders receive the highest quality financial reports and help to protect their interests. Therefore, the objective of this study is to explore the perceptions of experts on the CG consideration in outlining and directing an audit engagement. A semi-structured interview is conducted with two certified public accountants (CPA) to obtain a consensus on the opinion of experts. Analyzing of interviewees' response suggests that auditors consider CG as a monitoring device in their audit engagement. Among different aspects of CG the board of directors is more considered by auditors. CG has more influence when auditors are planning an audit process.

**Key words:** corporate governance, auditors, audit process, board of director

### 1. Introduction

Corporate Governance (CG) is a way in which stakeholders assure themselves of getting a return on their investment (Shleifer & Vishny 1997). 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. This 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 & Meckling 1976). Hence, agency theory suggests that 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 important aspect 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). 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).

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). Therefore, an auditor can lessen the agency problems resulting from the separation of ownership and control. It should be noted that auditors could be successful only if their audit opinion represent the true findings of the audit engagement. Simultaneously, from an agency perspective, auditors can be considered as part of the CG structure because they monitor the quality of the financial reporting process (Beasley & Salterio 2001). Therefore, the interaction between CG and external audit services often suggests that they are complementary and the purpose of both is to protect stakeholders' interest. Hence, auditors must work with other factors in the 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. Therefore, the objective of this study is to obtain the opinion of auditors 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.

## **2. Literature Review**

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). 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. 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. 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 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 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 & 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 could 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 affect the evidence obtained and, thus, the quality of audit decisions.

### **3. 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 seven questions, was conducted in English, 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.

### **4. Analysis of Findings**

This section presents the research findings based on the conducted interviews. Respondents were requested to answer seven questions to give their opinion on the CG consideration in audit process.

#### **4.1. How do auditors define CG?**

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

*"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 two definitions of CG presented by Shleifer and Vishny (1997).

#### **4.2. Which approach in their view can better explain the CG importance?**

Cohen et al. (2000) indicate that prior researches in accounting, finance and management have shown different 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. In this study, both respondents frame their definition of CG on a system of regulations and mechanisms that control the managers' operation.

*"In effect, 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."*

It should be noted that this kind of definition of CG as a supervisory system to control the opportunistic behavior of managers, is consistent with the agency theory perspective.

#### **4.3. Do auditors concern the CG information in client acceptance?**

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.

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. 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.

#### **4.4. How and in which stages do the CG information is used by auditors in audit process?**

They 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 he uses 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."*

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.

#### **4.5. Which aspects of CG do auditors consider?**

One of the factors affecting the CG strength is the board of directors' composition and the best composition from 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. 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. Another issue is the CEO duality. Interviewee 2 asserts that:

*"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."*

He continues:

*"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. Furthermore, audit committee has an important proactive role relative to audit risk management and the related audit planning decisions."*

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.

#### **4.6. 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 with the audit committee as a formality stage in audit process.

#### **4.7. Are other mechanisms in CG important and effective?**

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.

### **5. Conclusion**

Based on the semi-structured interview approach to address the research question it can be concluded that auditors consider CG as a monitoring and controlling device in audit engagement. This perspective is consistent with agency theory that assumes an opportunistic behavior of agents. When the CG structures are strong and efficient, then the auditors will rely more on management reports because of the lower risk in auditing. In addition, they will reduce the efforts and reviews in audit engagement. Among the different factors in CG, the most important and powerful is the board of directors that can influence on other characteristics. In addition, accounting and auditing expertise of audit committee members has an important effect on auditors' decision in audit engagement.

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