CHALLENGES OF FINANCIAL AUDIT - THE IMPACT OF INTRODUCING UNIQUE REGULATION OF FINANCIAL MARKETS IN ROMANIA

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Abstract: *The theme of our research is related to the new type of relationship between financial audits (statutory) and unique regulation of financial markets in Romania.The Romanian authorities have decided as from 2013 regulation of financial markets, capital market, insurance market and private pensions market to achieve by a single entity, this situation will also lead to a number of challenges in the relationship between the auditor and the new regulatory regime. The main elements of our study are: the relationship between the audit committee and regulatory authority; quality of financial reporting for financial market entities. The auditor plays an important role in financial markets because it certifies the financial statements in accordance with European Union practice . It is also interesting to note potential interference that can occur in single regulation between compliance audit and financial stability and return on investment between performance audit and financial markets.In this case, financial regulation can coexist with compliance audit. EU legislation recommends that the auditor discuss with the audit committee the quality and acceptability of the financial reporting process.This recommendation is what should constitute a possible consensus to be highly unlikely between audit committees would align auditors in financial reporting disputes with management financial entities. In this regard, auditors should identify the factors we consider important in determining the quality of financial reporting. .We conducted this research in an effort to identify the possible divergence between the type of regulations that can emit single regulatory authority and the audit process. New regulator will operate on two levels, issue general regulations apply to all three categories of financial markets, capital market, insurance market and private pensions market, but in the same time and in greater extent will issue specific regulations of each market in part. We want to identify the extent to which audit the entities in these markets will be influenced by these changes. Interest is our largest to determine whether the audit can identify any changes in the new regulatory requirements on quality of financial statements.Our research results show the high importance of the audit committee in ensuring the high quality of financial reporting in the financial markets and seeks to identify potential points of conflict between audit conservatism and unique market regulation.*

Keywords: *auditing, capital markets, regulatory intervention, standards, GAAP, IFRS*

JEL: *M42, M48, N20*

Introduction

The achievement of this research is the result of the emergence of a regulatory entity for financial markets in the institutional landscape of Romania. This entity will regulate the capital market, insurance market and private pensions market, while money market will remain under the authority of the central bank. Under these conditions new elements occur that redefine the relationship between financial (statutory) audit and regulatory policies of public authorities in the field. Auditors play a crucial role in the functioning of capital markets by serving as independent agents that scrutinize firms' financial statements on behalf of shareholders, creditors and other accounting users. In the European Union, they attest that companies, in preparing their financial reports, conform to international financial reporting standards (IFRS) as specified by the International Accounting Standards Board (IASB).It is a well-accepted notion that auditing reduces the information risk in accounting reports, thereby improving investors' investment decision (Arens et al. 2006). Overall, the demand for and the supply of auditing determine the equilibrium auditor conservatism and audit quality. Companies with high business risk induce auditor conservatism, while companies with low business risk induce auditor aggressiveness. This finding contributes to the literature by linking auditor conservatism to client characteristics and therefore identifying the determinants of auditor conservatism in a capital market setting. We also provide a theoretical explanation for the positive relation between firm business risk and conservatism that has been documented. If auditor conservatism is in force, a greater client pressure on auditors improves audit quality, but if auditor aggressiveness is in force, a greater client pressure on auditors impairs audit quality. Client pressure on auditors can take the form of potential client businesses for the auditor, such as nonaudit services and repeat audit engagements (Kornish and Levine 2004). This result is contrary to the popular belief that client pressure on auditors is always bad. We find that client pressure is desirable when the auditor is conservative. The nature of investment efficiency depends on the auditor's attestation.

1.Literature review

Research has documented that there is a positive association between the effectiveness and knowledge of the audit committee and the quality of financial reporting (e.g., Stickney, C., Weil, R., Schipper, K., Francis, J., (2010). They found that more active and independent audit committees were associated with a decreased incidence of financial statement fraud while in a study evaluating a 10 year span of documented incidents of financial fraud. That the financial expertise of audit committee members had little association with the frequency of fraud, work by Watts, R., (2003) suggests that greater financial expertise of audit committee members may lead to a more effective relationship with external auditors. For example,Nocera, J., (2005) found that audit committee members with more knowledge in auditing were more likely to express support for external auditors in reporting disputes with management. This implies that audit committees with financially astute members will be more likely to help auditors in their struggle to maintain their independence from the pressures imposed by management. However, Gibbins et al. (2001) found audit partners' modal response to the importance of audit committees in resolving financial reporting disputes with the client management was "low." One possible rationale for this finding is outlined in a study by Cohen et al. (2000) who found that experienced external auditors believe that the lack of financial expertise of audit committee members negates the effectiveness of the committee. The effectiveness of audit committees and their ability to help auditors in their quest to maintain true independence may also be somewhat hampered by the strong influence of management. Our recommendations are to invoking new concepts and requirements that may be subject to uncertainty and ambiguity, potentially inhibiting their impact. If there is a lack of consensus on what constitutes financial reporting "quality" then it would be difficult for external auditors to evaluate this attribute and to enlist the support of audit committees in a reporting dispute with management. Although the Ramsay Report (2001) does not discuss the issue of financial reporting quality in the same manner as the BRC, it is imperative for companies in their ability to raise capital from external sources to have a similar understanding of the attributes that constitutes financial reporting quality as that found in primary global markets.

2.Financial regulators versus financial auditor independence

The tasks of the regulatory model shall include the following:

(1)undertaking measures aimed at ensuring regular operation of the financial market;(2) undertaking measures aimed at development of financial market and its competitiveness;(3)undertaking educational and information measures related to financial market operation;(4) participation in the drafting of legal acts related to financial market supervision;(5)creation the opportunities for amicable and conciliatory settlement of disputes which may arise between financial market actors, in particular disputes resulting from contractual relations between entities covered by FSA supervision and recipients of services provided by those entities;(6) carrying out other activities provided for by acts of law.The aim of financial market supervision is to ensure regular operation of this market, its stability, security and transparency, confidence in the financial market, as well as to ensure that the interests of market actors are protected.

Supervision of the financial market: A stable, competitive and financial system founded on integrity provides the basis for a functioning economy, sustainable employment and secure levels of affluence. The task of supervising the financial markets is therefore a crucially important one in all national economies.

Integrated supervision: As an integrated supervisory institution, the FSA, which was founded in 2012, brings together responsibility for supervising all significant providers and functions under one roof. The authority supervises, insurance undertakings, pension companies, corporate provision funds, investment firms and investment service providers, investment funds, financial conglomerates and exchange operating companies. It also monitors activities to ensure that trading in listed securities complies with legal requirements and the principles of fairness and transparency (supervision of the market and stock exchange

Tiered structure of supervision : Any efficient and effective supervisory system builds on the work of "upstream" supervisory instances. This is referred to as the tiered structure of supervision. The first tier of monitoring and control is provided by each financial institution's own internal auditing department. The institutions' supervisory boards and auditors form the second tier, which, while appointed by the individual companies, is composed of independent, third-party experts. The state system of supervision takes over at the third stage.

*Mission:*The primary mission of the institution is to assist through legal, administrative and informational means for the maintenance of stability and transparency on the non-banking financial sector, and to ensure the protection of the consumers of financial services and products.

*Regulatory activity:*The Commission's regulatory activity includes drafting and adoption of regulations and instructions provided for in the legislation, issuance of guidelines and instructions regarding the implementation and interpretation of the codes and laws. The Commission adopts secondary legislative acts concerning laws' implementation in relation to the carrying out of financial supervision. The regulation of the market participants' activity is in conformity with the European legislation, norms and practices.

*Licensing regime:*In its licensing activity the Commission is guided by the principle of impartiality and implementation of a unified approach and criteria with respect to all applicants. The Commission examines the documents that have been attached to the applications for permit issuance or amendment of one that has already been granted in view of their compliance with the regulatory requirements. It is being established whether all the required documents and data have been provided and whether the legal limitations to certain licensing proceedings have been complied with.

Sanctions: The relationship between the regulatory body of the capital market - and financial audit can be extended to the single regulatory authority, authority to possess a broad area of responsibility. In this sense, insurance companies and private pension funds can assimilate capital market entities, when acting as investment funds.In this case, financial regulation can coexist with compliance audit. For those synergies to be real we felt that our research must answer the questions on the link between financial auditor independence and audit committee role with financial reporting quality.

3.Research methodology

Thus, we are also interested in how external auditors interpret the recommendations of the BRC as it pertains to financial reporting "quality." To examine how external auditors perceive the effectiveness of the BRC to enhance the quality of the financial reporting process and help maintain auditor independence, we investigate the following research questions.We conducted our research in a study showing the effects of regulation on the single financial authority: functions and responsibilities of the audit committee; quality of financial reporting; communication with the audit committee.The study was conducted on a total of 34 respondents who expressed an opinion on the functions and responsibilities of the audit committee , the quality of financial reporting and the quality of communication with the audit committee .

Research Question 1: What do financial auditors consider as important functions and responsibilities of audit committees and what are the resulting implications of these issues for auditor independence?

Table1:Audit committee elements of influence(n=34)(Research question 1)

Panel I: Influence elements of audit committee	Mean	s.d.	Freq.	%
Influence elements of audit committee				
Ensuring quality of accounting policies and oversight of financial reporting			23	67%
The internal controls of ensuring quality			15	45%
The review of the relationship between the company and external auditors			15	45%
Anticipate financial risks			9	26%
Ensuring the selection/retention of quality, independent auditors			6	19%
The regularly review of the relationship between internal auditors and management			5	14%
High quality, and timely disclosure of financial and other material information to the board, unique markets regulatory, and shareholders			5	14%
Develop a direct, strong, and candid relationship with outside and internal auditors to encourage them to speak freely			4	12%
Other			5	14%
Will audit committee elements of influence change over the next 3 years? Yes No			20 14	60% 40%
Audit committees role in appointment/reappointment of financial auditor[1]	4.55	1.45		
Panel II : Audit committee Effectiveness				
Effectiveness of Audit committees in fulfilling financial reporting responsibilities[2]	4.22	0.91		
The administrative board role in influencing the effectiveness of an Audit committee[3]	4.76	1.68		
The management role in influencing the effectiveness of an audit committee[3]	4.52	1.48		

Reliance placed on audit committee to resolve financial reporting disputes with management [4]	2.81	1.31		
The corporate ownership role in determining the effectiveness of an audit committee[3]	4.89	1.72		
Audit committee influenced by financial analysts' expectations to accept aggressive accounting[1]	3.79	1.38		
Is it important to distinguish between "Form" and "Substance" of Audit committees? Yes No			 27 7	 80% 20%
Factors that constitute a "good" audit committee				
Independence			15	45%
The expertise in financial literacy			14	43%
Commitment			13	38%
Asks good questions			12	36%
Business knowledge			10	29%
Knowledge of auditing controls			8	24%
Experienced			4	12%
[1] 1=Not influenced at all: 7 = Significantly Influenced				
[2] 1=Not Very Effective; 7 = Very Effective				
[3] 1 =Insignificant Role: 7 = Highly Significant Role				
[4] 1=No Reliance; 7 = High Reliance				
[5] 1=Not Knowledgeable: 7=Highly Knowledgeable				

Research Question 2: What are the factors that financial auditors perceive determine financial reporting quality and what role does the audit committee play?

Table 2: Financial reporting quality (FRQ) (N=34) (Research question 2)

Panel I: Factors that determine Financial Reporting Quality	Mean	s.d.	Freq.	%
Clarity of company's financial disclosures[1]	5.57	1.29		
Degree of aggressiveness or conservatism with respect to accounting principles [2]	6.02	1.27		
Other significant management decisions in preparing financial disclosures[2]	5.38	1.21		
Determining factors in financial reporting quality (listed in rank order based on frequency of response)				
Clarity of financial disclosure			16	48%
Degree of aggressiveness and conservatism in accounting principles and estimates			15	43%
Other significant decisions by management in preparing the financial disclosure			5	14%
A comparison to current industry practices			2	5%
Quality of accounting staff			2	5%
Panel II: Audit Committee (AC) and Financial Reporting Quality				
Role ACs currently play in ensuring FRQ[2]	3.43	0.93		
Role ACs should play in ensuring FRQ[2]	5.58	1.15		
AC's effectiveness in reducing likelihood of financial reporting fraud[3]	3.32	1.18		
Do ACs have enough power to confront management? Yes No			 29 5	 85% 15%
Major challenges today in working with audit committees to ensure sound financial reporting? (listed in rank order based on frequency of response)				

Lack of sufficient financial sophistication on the part of audit committee members			16	48%
Audit committees lack the power or the will to work towards ensuring sound financial reporting			13	38%
Time Constraints			2	7%
Other (e.g. compensation, compensating liabilities)			2	7%
[1] 1=Little Importance; 7 = Extreme Importance				
[2] 1=Insignificant Role; 7 = Highly Significant Role				
[3] 1=Not Very Effective; 7 = Very Effective				

Research Question 3: What factors affect the level and quality of communications between the financial auditors and the audit committee?

Table3:Communications with audit committee (n=34) (Research question 3)

	Mean	s.d.	Freq.	%
The management influences on the nature, extent, and quality of communication between an outside auditor and the AC[a]	5.06	1.35		
AC factors (characteristics) that will encourage an open and frank communication between an outside auditor and the AC (listed in rank order based on frequency of response)				
Real competency			15	45%
Real independence			8	24%
Private meetings with the Audit Committee			6	19%
Receptive/questioning			6	19%
Frequent meetings/interest			3	10%
Involved in the selection of the auditor			3	10%
Real longevity			2	5%

Other			2	5%
Auditing firm (audithor) factors (characteristics) that will encourage an open and frank communication between an outside auditor and the AC (listed in rank order based on frequency of response)				
A strong relationship development (openness)			7	21%
Knowledge of client/industry/audit committee			6	17%
Frequent meetings			3	10%
Challenge the audit committee			3	10%
Alter the contract with the financial auditor (longer term, limit liability, rotation, hired by audit committee			3	10%
Willingness, if necessary, to lose client (with support from the firm)			3	10%
Other			3	10%
[a] 1=Not influenced at all; 7 = Significantly influenced				

Conclusions

Our research sought to identify the challenges and opportunities raised by a single financial supervisory authority to the independent financial auditor . We conducted on a total of 34 respondents who expressed an opinion on the functions and responsibilities of the audit committee , the quality of financial reporting and the quality of communication with the audit committee .The major functions of an audit committee are to oversee the financial function of the Company. They should have oversight responsibility for systems of internal controls, quality financial reporting and disclosure and financial risk management. Almost half of the respondents (45 percent) also indicated that ensuring quality internal controls and overseeing the audit process, including regularly reviewing the relationship between the company and its external auditors, are important responsibilities of an audit committee. This latter finding suggests that audit committees potentially may evaluate if there is too close of a relationship between management and the auditors that may call to attention a perceived lack of independence on the part of auditors. Surprisingly, despite the emphasis placed by the auditing profession on the potential importance of the interactions between the audit committees and the internal auditors, few auditors (14%) stressed the role of the audit committee in enhancing the effectiveness of the internal audit function.The legislation requires has called for the auditor to discuss with the audit committee the quality and not just the acceptability of the financial reporting process. This recommendation is consensus on what constitutes “quality,” it will be highly unlikely that audit committees would align with auditors in financial reporting disputes with management. However, the recommendation raises the issue of how “financial reporting quality” is to be defined. In this regard, auditors were asked an open-ended question regarding factors they consider important in determining financial reporting quality.Finally, we asked three questions regarding communications between the external auditor and the audit committee. First, in an open-ended question auditors identified audit committee factors or characteristics that encourage an open and frank communication. The most frequent factors cited were: competency (45 percent); independence (24 percent); private meetings with the audit committee (19 percent); and receptive to auditors questioning financial reporting positions (19 percent). In a second open-ended question we asked participants to identify auditor or audit firm factors that encourage strong communication. There were no overwhelming factors noted. However, those that were cited were: develop a strong relationship with the audit committee (21 percent); knowledge of client/industry/ audit committee (17 percent); frequent meetings (10 percent); challenge the audit committee on financial reporting issues (10 percent); alter the contract with the financial auditor (longer term, limit liability, rotation, hired by audit committee) (10 percent); and willingness to lose a client (10 percent). Therefore, it is possible that the mixed empirical evidence on the economic consequences of the directives of financial authority is due to the use of pooled samples in empirical studies that combine firms with the independence of auditors.

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