
THE INFLUENCE OF FINANCIAL AUDITOR ON THE EARNINGS MANAGEMENT PROCESS: MANDATORY APPLICATION OF IFRS FOR THE FIRST TIME IN ROMANIA

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Abstract

The present research is focused on the amount of the discretionary accruals estimated under the Romanian Accounting Regulations, as well as under the International Financial Reporting Standards referential. The purpose of our research was to provide evidence about the importance granted by the auditor when the value of discretionary accruals is encountered and estimate the impact for first mandatory application of IFRS for the first time in Romania. We estimated the value of discretionary accruals using the value of residuals from two equations as regression models that compute and identify the value of total accruals, one of equations has been used by Larcker and Richardson (2004) model. Several composed variables regarded to the auditor and to the CEO/chair variable and the auditor and industry specification variable, were used in relation with the discretionary accruals. The auditor changed from a non-BIG 4 company to a BIG 4 one considering the switch between the two regulations was tested in relationship with the value of discretionary accruals.

Keywords

audit, discretionary accruals, IFRS, , CEO duality, , accounting, earnings management.

JEL Classification

M41, M42, M40.

Introduction

Since the 2012 we identify that 68 Romanian companies (71 at the end of 2013) had to adopt the International Financial Reporting Standards (IFRS) as their accounting referential. According to several accounting regulations, such as the adoption of this International Financial Reporting Standards is compulsory for the companies that are listed on Bucharest Stock of Exchange.

It is useful to mention that the accounting regulations are in accordance with a previous one from 2006 on the application of International Financial Reporting Standards, according to which listed companies had to present their consolidated financial statements using the IFRS.

Similar decisions have also been taken for the credit institutions. As a fact, according to National Bank of Romania, starting from 2012, the individual financial statements for credit institutions should be elaborate and present according IFRS

The IFRS implementation is based on the fact that the role of financial accounting and reporting is to present information, elaborated in due time and in a credible manner, with significant contribution to value added. We can consider that an improvement in the accounting financial reporting quality for the individual financial statements will be achieved as a result of the IFRS adoption.

The managers and internal users are interested in selecting the methods and in determining the company's performance in such a way that they could gain private benefits. Healy and Wahlen (1999) consider that one of the factors that encourage managers to declare unreliable financial information is to obtain private benefits. As a fact, the purpose of a reliable audit is to provide reasonable assurance that the financial statements are elaborated in such a way as they are in accordance with the reality.

In this paper we want to provide information about the relevance of financial auditors when the earnings management process is encountered. We plan to identify if the quality of financial auditor has any influence on the earnings management process.

Literature review

There is a large literature that presents a relationship between the processes of earnings management and the auditor's activity (managers misrepresent the external financial reports to gain private benefits- Healy and Wahlen -1999) -. The concern about the audit quality is a problem that has increased over time due to recently financial disclosures (DeAngelo, 1981).

A similar conclusion was obtained by Caramanis and Lennox (2008) as they presented that a low audit effort is related with the higher probability for managers to report higher values of earnings management. Considering that the BIG four companies perceive higher fees than the smaller ones, Gui et al. (2010) found a positive relationship between the discretionary accruals and audit fees, when the managers of the entities have high management ownership. On the other hand, Van Tendeloo and Vanstraelen (2005) discovered that having a Big 4 auditor do not influence the value of discretionary accruals either if the companies report under IFRS or not.

There are also other ways to determine the value of earnings management. Studies that focused on this element are conducted on the earnings smoothing process. As a fact, the value of earnings management is detected either by smaller and positive values of net profit, either by smaller or negative values of net profit (timely loss recognition technique). For example, Chen et al. (2010) found a negative correlation between the timely lost recognition process and the type of auditor (the correlation was statistically significant for audited companies that are part of BIG four).

These studies are focused on comparing the values obtained before and after the adoption of the IFRS referential.

In order to identify if the oscillating evolution of net income, of the ratio between net income and the cash flow from operations and the variability of and the value of accruals changed, the auditor variable is taken into consideration as an individual factor of influence. As a fact, we decided to conduct an analysis based on identifying how the reputation and the independence of the financial auditor affects the value of discretionary accruals. There is a study of Dobre et al. (2015) according to which there is no difference in the value of discretionary accruals if they are computed under both accounting frameworks .The idea of this research is to detect if the value of the discretionary accruals, if affected by the type of financial auditor and with other variables that can influence them, is a negative one.

Methodology of the research

In order to estimate the influence of audit activity on the values of discretionary accruals, financial data from all our 71 companies was taken from their financial statements. The first

stage of our research was based on collecting data for a three years period of time, from 2010 to 2012 as some indicators could be use one-year lag difference. The period chosen for analysis is composed of two sub-periods of time:

- The first one is between 2010 and 2011 as the financial accounting information was presented using the Romanian Accounting Standards or RAS;
- The second one is between 2011 and 2012 as the financial accounting information is measured using the International Financial Reporting Standards or IFRS.

For each entity, some financial information was collected such as the value of total assets (proxy for the size of the entity), the value of sales, the value of debts both on short and long term, the value of shareholders' equity and other types of variables were collected. From the initial sample, we eliminated firstly the companies that were in their insolvency procedure in 2010-2013, having to implement their business reorganization plan conducted by a judicial administrator. These entities are: CGC (CONTOR GROUP S.A. Arad), COFI (CONCEFA SA), SRT (SIRETUL PASCANI S.A), UZT (UZTEL S.A.), UCM (UCM RESITA S.A), Nowadays, the first three are delisted from the Bucharest Stock Exchange. We have also excluded the BVB entity as it wasn't totally complying with IFRS reporting regulation. We haven't also considered the entities that have a negative value of their shareholders' equity as they do not create financial performance both for their shareholders and for their stakeholders. Consequently, our sample size has 56 companies.

In order to estimate the value of discretionary accruals, we computed it by subtracting from the value of total accruals the value of the non-discretionary accruals (the process is similar with the method used by Callao and Jarne (2010), Zéghal et al. (2011), Houque et al. (2012), etc and it has the form presented in equation (1):

$$DA_i = TA_i - NonDA_i \quad (1)$$

Where:

DA_i - value of discretionary accruals component that entity i has;

TA_i - value of total accruals component that entity i has;

$NonDA$ - value of non-discretionary accruals component that entity i has.

The value of non-discretionary accruals $NonDA$ is calculated by using the estimation of total accruals according to the equation (2). The technique considers that the values of $NonDA$ are computed based on the adjusted values that result from the equation (2). This way of estimation was proposed by Larcker and Richardson (2004)

$$TA_i = \beta_0 + \beta_1 \times (\Delta REV_i - \Delta AR_i) + \beta_2 \times GPPE_i + \beta_3 \times BMV_i + \beta_4 \times CFO_i + \varepsilon_i \quad (2)$$

Where:

TA_i - value of total accruals for company i;

ΔREV_i - change in revenues from one year to another for company i;

ΔAR_i - change in accounts receivable for company i from one year to another;

$GPPE_i$ - gross property, plant, and equipment for company i;

BMV_i - book to market value for company i;

CFO_i - value of cash flow from operations scaled by total lagged assets for company i;

ε_i - error term of the equation (2)

It is considered that discretionary accruals is the most widely tool that can be used by managers in order to manipulate financial statements. The discretionary accruals component is actually computed using equation (3):

$$DA_i = TA_i - \hat{TA}_i \quad (3)$$

Where:

$$\hat{TA}_i = NonDA_i \quad (4)$$

In our sample, we had some entities such as CMCM (COMCM SA CONSTANTA), PEI (PETROLEXPORTIMPORT S.A.), TUFE (TURISM FELIX S.A.), VNC (VRANCART SA), SCD (ZENTIVA S.A.), CAOR (SIF HOTELURI SA), CMF (COMELF S.A.) that haven't provided the value of cash flow from operations either on their individual site, either in their individual financial reports. As there is lack of data regarding the value of cash flow from operations, we computed it, by using the approach found in Dumitrescu et al (2002, p. 42), which is presented in equation (5):

$$CFO_i = NetP_i + AMO_i - ASales_{result_i} - Financial_{result_i} - \Delta NFC_i \quad (5)$$

Where:

CFO_i - value of cash flow from operations for company i;

$NetP_i$ - value of net profit for company i;

AMO_i - value of amortization for company i;

$ASales_{result_i}$ - value of the result of assets sales which is the difference between revenues and the expenses of the assets transferred for company i;

$Financial_{result_i}$ - financial result which is the difference between financial revenues and financial expenses;

ΔNFC - difference between the need of floating capital register in two consecutive years.

The ΔNFC is computed using information found in in equation (6)

$$\Delta NFC = \Delta Inventories + \Delta AccrV - \Delta operLib \text{ (without cash liabilities)} \quad (6)$$

Where $AccrV$ is the accounts receivables and $operLib$ is operating liabilities.

The value of total accruals was computed by using the approach proposed by Leuz et al. (2003). They consider that the value of total accruals can be computed based on the formula found in equation (7):

$$TA_i = \Delta CA_i - \Delta Cash_i - (\Delta CL_i - \Delta STD - \Delta IT_i) - Dep \quad (7)$$

Where:

TA_i - total accruals for company i;

CA_i - change in current assets for company i;

$\Delta Cash_i$ - change in cash components for company i;

ΔCL_i - change in current liabilities for company i;

ΔSTD_i - change current debt for company i;

ΔIT_i - change in income tax payable for company i;

Dep_i - current value of depreciation and amortization for company i in the year of reporting.

The idea of research is to reveal the factors that influence the value of discretionary accruals considering effect that the financial auditor has on them. The research was constructed using composed variables. This is for providing information if the financial auditor, together with other components has an influence on the value of discretionary accruals. In other words, the auditor variable was composed with other specific elements that can influence the value of

discretionary accruals. The methodology based on using combined variables is similar to the methodology presented by Van Tendeloo and Vanstraelen (2005).

The discretionary model component was regressed against the variables that are found in equation, considering their individual and cumulated effect (8):

$$DA_i = \beta_0 + \beta_1 \times INDP_i + \beta_2 \times AUD_i \times INDP_i + \beta_3 \times Size_i + \beta_4 \times L + \beta_6 \times Firm_{indicator_i} \times AUD_i + \varepsilon_i \quad (8)$$

Where:

- DA_i - value of discretionary accruals for company i;
- $INDP_i$ - variable that reveals the independent characteristics of the entity such as the CEO/chair duality or the industry where the entity belongs to, mainly the manufacturing industry;
- $AUD_i \times INDP_i$ - compute variable that reveals the type of influence the financial auditor has on the industry and on the duality of CEO/chair for company i;
- $Size_i$ - value of firm express by natural logarithm of total assets for company i;
- LEV_i - value of debts divided by own capital for company i;
- $Sales_i$ - value of sales for company i for year;
- $Firm_{indicator_i}$ - firm characteristic such as size, levier (indebtedness ratio) or sales;
- ε_i - error term of the equation.

The selection of the independent variables from equation (8) is based on the fact that these elements were also used in the literature in order to observe the impact on financial measures. They are used as financial proxy for measuring the financial performance. The indebtedness ratio can also influence the financial performance. The Sales indicator can also influence the financial performance and it can be easily manipulated by the financial manager (Huselid, 1995). Regarding the influence of other independent variables, such as the CEO/chair duality the literature reports that the difference between CEO and Chair influence positively the financial performance. Regarding the industry component, Brad et al. (2013) provide evidence that Romanian shareholders focus on obtaining short term financial performance (especially in food and service area), while foreign investor expect to obtain a long term financial performance (for example in construction and industry field). Considering the auditor dummy variables (which has the value 1 if the financial auditor is a company that is part from BIG 4), Zeghal et al. (2011) detect a positive influence of the financial auditor (that is from BIG 4) on financial performance. We use these variables as financial performance can be easily manipulated by financial manager in order to gain private benefit.

We also conducted additionally analysis in order to detect if the financial auditor has or not an impact on the value of discretionary accruals. Krishnan (2003) and Zhao (2010) points out that discretionary accruals are positively related with the size of the auditor, or in other words that Big-4 auditors encourage the presence of discretionary accruals. Opposite opinion is found by Tennander & Olsson (2010) who reveal that Big 4 auditor are negatively related with discretionary accruals, while non-Big 4 are positively related with them. As a fact, both the type of financial auditor identified under RAS and IFRS approach was tested. In the equation was also included the switch of financial auditor from a non-Big 4 company to a BIG 4 one. The additional analysis was conducted using the formula presented in equation (9).

$$DA_i = \beta_0 + \beta_1 \times Size_i + \beta_2 \times LEV_i + \beta_3 \times Sales_i + \beta_4 \times AUD_{RAS_i} + \beta_5 \times AUD_{IFRS_i} + \beta_6 \times CHAUD_i + \varepsilon_i \quad (9)$$

Where:

AUD_{RAS} - dummy variable that measures if the financial auditor was an entity from BIG 4 when the RAS approach is used. In this case, the variable takes value 1;

AUD_{IFRS} - dummy variable that measures if the financial auditor was an entity from BIG 4 when the IFRS approach is used. In this case, the variable takes value 1;

$CHAUD$ - dummy variable that takes 1 if the auditor switch from a non- BIG 4 company to a BIG 4 company once the IFRS accounting measures have been implemented.

Results and discussions

The purpose of this research is to provide evidence about the influence of the auditor type on the value of discretionary accruals deflated by the lagged value of total assets. In order to achieve this objective, firstly, the value of discretionary accruals was computed. The value of discretionary accruals was calculated by subtracting the value of non-discretionary accruals from the value of total accruals. The discretionary accruals component was found by using the Larcker and Richardson (2004) model.

The results of the regression model are presented in Table no. 1 and are also consistent with equation (8)

Table no. 1. The influence of the CEO/chair duality and of the auditor's type on the value of discretionary accruals

ELEMENT	RAS APPROACH		
	Model 1	Model 2	Model 3
Constant	0.4948*	0.4398*	0.4776*
Size	-0.0264**	-0.0225	-0.0247*
LEV	-0.00006	-0.0005	-0.00005
Sales	-0.04819	-0.0616	-0.0536
CEO	0.0194		
$CEO \times AUD$		-0.371	
$CEO \times MNF_{IND} \times AUD$			-0.0222
R squared	9.08%	9.61%	8.85%
F stat	1.274 (p=0.2922)	1.355 (p=0.2622)	1.239 (p=0.3061)
DW	2.07	2.05	2.04
ELEMENT	IFRS APPROACH		
Constant	-0.3103	-0.0043	-0.2639
Size	0.0162		0.0136
LEV	-0.0025	-0.0024	-0.0026
Sales	-0.0138	-0.0003	-0.0131
CEO	0.0048		
$CEO \times AUD$		0.0228	
$CEO \times MNF_{IND} \times AUD$			0.0483
R squared	5.42%	2.01%	6.75%
F stat	0.731 (p=0.5749)	0.357 (p=0.7842)	0.923 (p=0.457)
DW	1.68	1.61	1,69

Note ** and * denotes statistically significance at 5% and 10%

Source: Authors' calculations

From Table no. 1, there is no statistically significant influence either of the variable that reveals the effect of auditor type (if the financial auditor is a Big 4 entity or not) combine with the CEO/chair duality or with the CEO/chair duality and the manufacturing industry,

either of the chair/CEO duality influence. The idea was to emphasize the influence that the financial auditor has in case the entity that was audited by a BIG 4 company is having two different persons as CEO and as a board of directors. The models that we computed are not valid significant statistically. Moreover, the coefficients that were estimated are not statistically significantly different from zero. On the other hand, if we considered the presence of BIG 4 auditor, we can observe that the entities that have a financial auditor from BIG4 and a CEO different by the board of directors have lower discretionary accruals under RAS and higher discretionary accruals under IFRS. Similar interpretation is found for the entities that belong to the manufacturing industry that had a Big 4 auditor and that where CEO is different from the general director.

The results are presented in Table no. 2 and are based on equation (9).

Table no. 2. The influence of the auditor's type and of the change of auditor's type on the value of discretionary accruals

ELEMENT	MODEL 1	MODEL 2	MODEL 3	MODEL 4	MODEL 5
Constant	0.465*	0.0006	-0.3822*	0.0003	0.0005
Size	-0.024*		0.0203*		
LEV	-0.0005	-0.0022	-0.0033	-0.0023	-0.0022
Sales	-0.0543	0.0013	-0.020	0.0017	0.0001
AUD_{RAS}	-0.015				
AUD_{IFRS}		-0.0033			-0.0001
$CHAUD$			-0.0588		
$AUD_{IFRS} \times CHAUD$				-0.0167	-0.0158
R squared	8.81%	1.44%	6.82%	1.5%	1.5%
F stat	1.233 (p=0.308)	0.253 (p=0.853)	0.933 (p=0.452)	0.264 (p=0.8508)	0.194 (p=0.94)
DW	2.05	1.62	1.66	1.61	1.62

Source: Authors' calculations, Note * denotes statistically significance at 10%

As it can be seen in Table no. 2 there is no influence of the type of financial auditor on the value of discretionary accruals either considering RAs or IFRS as the accounting. Moreover, a switch between being audited by a non-BIG 4 company and a BIG 4 company has no influence on the values of discretionary accruals considering the statistical relevance. On the other hand, a change of the auditor from a non-BIG4 entity to a BIG 4 entity would determine smaller discretionary accruals found in IFRS approach. Overall, the auditing activity seems to decrease the value of discretionary accruals either considering RAs or IFRS as the accounting approaches.

Conclusions

The present research proposed to identify if the financial auditor had an influence on the value of discretionary accruals considering the both the RAs or IFRS as the accounting approaches. The hypothesis on which the analysis was conducted is based on the assumption that if the auditor is part of BIG four entities, the value of discretionary accruals would be mitigated or in other words, smaller discretionary accruals would be registered for the listed entities. To emphasize if there is any influence of the financial auditor on the value of discretionary accruals, the dependent variable, the value of discretionary accruals was computed by subtracting from the value of total accruals the values of non-discretionary accruals.

The results are in accordance with the results found by Van Tendeloo and Vanstraelen (2005) due to the fact that the auditor's type does not statistically influence the value of

discretionary accruals either if they are estimated using the IFRS accounting approach or the Romanian accounting approach. , if we don't take into account the statistical significance of the coefficients, the auditor from BIG 4 mitigates the value of discretionary accruals.

Moreover, no influence of the combined effect of the auditor type and of the manufacturing industry was revealed, but it seems that entities that belong to manufacturing industry with a BIG 4 financial auditor have smaller discretionary accruals. No relevance of the combined effect of auditor type with the CEO/chair duality was found, but it seems that the combination of BIG 4 auditor and the CEO different from the board of directors increase discretionary accruals after IFRS adoption.

The lack of this research is based on the fact that variables that were included into the analysis were manually collected, the dimension of the sample is quite small (only 56 entities) and the estimation of the regression model are not statistically significant and did not provide reliable information about the importance of the auditor type on the value of discretionary accruals.

Further research is going to be conducted on the value of discretionary accruals by using other techniques of estimations or by using a panel model to identify specific elements for each entity.

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