EXPLORING THE RELATIONSHIP BETWEEN GOVERNANCE VERSUS AUDITING AND REPORTING STANDARDS

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Abstract: *The aim of this paper is to investigate the extent to which good governance has an impact on strength of auditing and reporting standards. Previous studies have shown there are some certain determinant factors for the strength of auditing and reporting standards such as legal framework, corporate governance, financial market and education. The goal of this cross-country investigation is to continue developing the idea of previous studies, trying to identify if there is any influence of the quality of governance on auditing and financial reporting standards. Using an approach from two perspectives such as the geographical regions and income group classification, the findings show the influence of the governance clusters on the strength of auditing and reporting standards is not quite uniform. Thus, while voice and accountability, political stability and government effectiveness are most significant for countries from Europe, Central and North America, the others governance indicators such as regulatory quality, rule of law and control of corruption are also significant for countries from South America and Asia. Countries from Africa seems to be least affected by all these six governance clusters. Speaking from the perspective of income group classification, the results show the influence of governance quality is particularly highlighted for countries included in upper middle income and high income OECD.*

Keywords: *Auditing standards, financial reporting standards, governance, rule of law, control of corruption.*

1. INTRODUCTION

As other academics [1] - [2] remarked, the international auditing standards (ISAs) and international financial reporting standards (IFRSs) continue to be implemented worldwide, but this process is far from being homogenous, due to various influencing factors such as political, legislative, cultural, economic and educational. According to some authors [1], there is a complex of relevant factors that influence in one way or another the accounting and auditing rules and practices of a country, and among them it could be mentioned legal framework, characteristics of accounting and audit regulatory process, financial market, education, policies for enhancing the shareholder protection and governance environment. In this context, for a country to have a good strength of auditing and reporting standards environment has to be able to ensure effective functioning of the capital market, an idea also emphasized by other scholarships ([3] and [4] cited by [1]).

Starting from the previous academic theoretical and empirical literature that underlines the idea of the relationship between the quality of governance and the strength of auditing and reporting standards, this paper aims to explore whether it is proved empirically that quality of governance

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measured through those six governance indicators developed by World Bank has a relevant impact on the strength of auditing and reporting standards, following to develop this empirical analyzis, from two perspectives, first is by using the geographical classification and second is by using the classification of economies of all countries divided on income groups. The premise of this empirical analyzis is that governance clusters positively influences the strength of auditing and reporting standards, even if this impact might be felt differently.

The remainder of this study is organized as follows. The next section includes a literature review of studies in the area of audit and accounting standards implementing process. Section 3 discusses the research design and data used for developing this empirical survey. The empirical results and findings are presented and analyzed in Section 4 and finally Section 5 contains the concluding section where there are presented the main conclusions and offers perspectives for further research hoping that this study will provide, the necessary context for developing constructive debates about the real impact of the governance environment on the strength of auditing and reporting standards.

2. THE INFLUENCE OF GOVERNANCE' DIMENSIONS ON ACCOUNTING AND AUDITING STANDARD-SETTING - BACKGROUND LITERATURE

How important is the effective governance for economic environment, including for accounting and auditing standards-setting process? This is one of the questions that this paper is trying to find some reliable answers.

Previous academic theoretical and empirical literature stressed the idea of positive relations between country-level governance and different business and economic development indicators. The study of [5] argued that the role of governance for the business environment is proved by starting from the idea that an economy with a moderate level of bureaucracy, a high concern for law compliance and controlling the corruption is expected to create and develop a business environment favorable to economic performance, same idea being also shared by other authors such as [6] - [7]. Even more, the effectiveness of government materialized in one of its outputs – efficiency of public administration might be considered as one of the determining factors for economic recession, in the vision of other specialists like [8] - [11]. But a major research question still needs well-argued answers: which is the impact of governance on the accounting and auditing implementation process?

The difficulties generated by the implementation processes of both financial reporting standards and auditing standards had been widely explored in the previous scholarship literature, but few are addressing the effect of country-level governance's quality on the strength of auditing and reporting standards. One general consensus in the international academic literature seems to be that the rise and the implementation of both ISAs and IFRSs vary from one country to another, being influenced by various factors that determined researchers from various interdisciplinary accounting fields to look for potential explanations of this problematic process [12] - [21]. Even more, as some author [12] admits the research interest for determining factors that influence the accounting harmonization go beyond the accounting literature to the wider areas of social and political sciences in order to understand how country-level governance could have an impact on the accounting and auditing standards-setting processes [12], [18], [22] - [26].
A review of main findings of various research studies focused on the relationship between global economic governance and accounting and auditing standards-setting process are disclosed within the Table 1.

Table 1: A synthesis of main findings related to the impact of governance on auditing and accounting standards-setting process

Source	Findings
[12]	This study uses the approach of analyzing the influence of political and economical dimensions on the relationship between the rise of international accounting standards and the dynamics generated by *"late 20th century capitalism"* in the context of East Asia Crisis. The study's conclusions support the idea that the rise of international accounting and auditing standards should also be analyzed in terms of economic, political and institutional perspective, taking in consideration that the developments in accounting history were influenced by the evolution within the global political economy
[13]	Their paper explores the effect of standards setters in the standards-setting process, particularly for Financial Accounting Standards Board (FASB) members, highlighting the role of FASB regulators in the process of accounting standards-setting.
[2]	This study explores the impact of different determinant factors on the strength of auditing and reporting standards in 41 European countries, providing empirical evidence that support the idea that judicial independence and the efficiency of the legal framework, ethical behavior of firms, efficacy of corporate boards and characteristics of stock market are significant for the auditing and financial reporting standards-setting process.
[1]	Their paper develop a model in order to evaluate the strength of auditing and reporting standards in individual countries from geographical region of sub-Saharan Africa, using data from 28 countries. Among the variables used within this predictive model, six major determinants of the auditing and reporting standards are analyzed such as: legal framework, corporate governance, financial market framework, higher education, and foreign market influence and shareholder regimes. This study also suggests the potential influence on the auditing and financial reporting standards of other factors, such as educational, cultural and legal ones.
[27]	His study analyzes three important regulatory developments in 2009 for accounting systems by private entities in Europe, highlighting the influence of factors such as rule of law, regulation for the accounting systems and practices.
[15]	By using the case of Germany, this study provides empirical evidences that suggest that the accounting system and practices, including the successful adoption of financial reporting standards are strongly influenced by the various factors such as social, political and economic environment.
[28]	Their study presents a synthesis of the main obstacles that might influence the implementation of international auditing standards, and offering a perspective on what should be done in order to ensure a successful implementation of International Auditing Standards based on the comparative analysis. In their vision, one of the factor that influenced the development and the enforcement of auditing and reporting standards is the great amount of financial scandals from the latest years, and the absolutely need to rebuild the confidence in the accounting and auditing fields.

[18]	In his study, the author starts from the idea of approaching the process of governance as a regulatory network of interacting bodies, which influences the standard-setting processes in many countries. His major objective is to analyze the impact of this regulatory network impact on the accounting and auditing standards-setting in the context of Canada. His findings show that *"standard-setting is embedded in a network structure that allows for multiple influences"*. Also, the connections between various accounting firms and regulatory bodies need to be better researched and documented.
[19]	Their paper analyzes the effect of country-level legal, extra-legal and political institutions on auditing quality, using the average audit fee as a variable of audit knowledge and specialty, providing empirical evidence that prove the effect of country-level institutional strength on the demand for higher audit quality and knowledge.
[29]	The researcher develops a content analysis of the accounting standards of three countries: South Africa, Mauritius and Tanzania and IFRS providing empirical evidences that suggest the link between legal system characteristics and accounting systems and standards-setting process.
[21]	This paper develops a detailed analysis of the main obstacles to global financial reporting at a high level of quality, by discussing two relevant aspects such as comparability and convergence. Also, the influence of politics on the accounting standards-setting process is discussed. His concluding remarks require more rigorous enforcement mechanisms for the national accounting standards in order to consolidate the effort to ensure the compliance with IFRS.
[30]	In their study, they use two variables at country level in order to investigate the impact on auditing and reporting standards, such as judicial independence and the efficiency of the legal framework, and both factors were found to be statistically relevant.
[31]	On behalf of World Bank, their report emphasizes the challenges to the successful implementation of international accounting and auditing standards, underlying in the same time the significant impediments that had been generated difficulties for the successful implementations of auditing and financial reporting standards. Some of the most significant factors that influence the accounting and auditing standards-setting process are at least: legal framework; lack of appropriate linkages between general purpose of financial reporting and regulatory reporting; the mismatch between accounting and auditing requirements and their ability to comply and the market demands; but also the effectiveness of regulatory bodies in the monitoring and enforcement of accounting and auditing standards
[32]	By using a sample of 31 countries, their study analyze if financial reporting is more transparent and if national accounting standards require accrual based reporting in countries with stronger investor protection. Their findings suggest that corporate governance is a relevant determinant factor and higher quality financial reporting standards and the compliance with them through higher quality auditing activities are more likely to exist in countries characterized through a strong investor protection.
[33]	Having as a starting point the existing literature that suggests a large number of factors that might determine the international differences in financial reporting, this study proposes to study the influences on financial and

	accounting systems from the perspective of one model which includes two variables: the strength of equity markets and the degree of cultural dominance.
[34]	By developing a cross-study across 49 countries, their study highlights that legal rules and framework differ in content from one country to another, and even more they are determinant factors for the quality of financial reporting in that country.
[35]	Their research study stressed the idea of the existing a direct influence of legal systems on the accounting systems and practices of a country.

Source: the authors' projection based on relevant literature review

As we can observe from the synthesis of the relevant literature review presented above, the influence of various factors on the auditing and accounting standards-setting process was largely discussed within the academic literature. But, at least from our knowledge, there are too few papers that aim to investigate the impact of various governance indicators on the process of implementation and application of auditing and accounting standards. In our opinion, the influence of factors such as rule of law, political stability, government effectiveness, regulatory quality and control of corruption cannot be neglected. Unlike the rest of the literature, then, our article aims to empirically investigate the relationship between the good governance clusters as they are defined by World Bank and the strength of auditing and financial reporting standards, trying to provide empirically evidence that might confirm or infirm the potential impact of governance dimensions on the auditing and financial reporting standards-setting process.

3. RESEARCH DESIGN AND DATA USED

The main purpose of this empirical survey refers to whether the quality of governance has a positively influence on the strength of auditing and reporting standards, following to construct this empirical analysis from two perspectives such as: first is from the perspective of geographical location, second is from the perspective of classification of world economies by income groups. The regression analysis within this paper is based on two major dataset including indicators of governance quality developed by World Bank and the ranking assigned to the strength of auditing and reporting standards measured for 144 countries by World Economic Forum.

The data referring to the indicators of governance refer to the year 2016 and were available from the report issued by World Bank within the project "*The Worldwide Governance Indicators*" which is based on information provided by more than 40 data sources provided by over 30 various organizations worldwide and is being updated on an annual basis since 2002 [36]. Considering the methodology developed by Kaufmann [37] - [38] this long-term project developed by World Bank aims to measure the quality of governance through six governance aggregate indicators such as: 1.Voice and Accountability; 2.Political Stability and Absence of Violence; 3.Government Effectiveness; 4.Regulatory Quality; 5.Rule of Law and 6.Control of Corruption. All these six aggregate indicators are developed based on the methodology described in their previous companion paper "*Aggregating Governance Indicators*" [38] by using an unobserved components model, which are similar to six relevant characteristics for the concept of governance like:

- Voice and accountability – contains various aspects of the political process, civil liberties and political rights, measuring the extent to which citizens are able to take part in the selection of their governments.

-Political stability and absence of violence – combines several indicators which measure the potential likelihood that the government in exercise could be replaced through unconstitutional or violent methods.

-Government effectiveness – measures the perception over the inputs necessary for effective governance, such as the quality of public service provision, the competence of civil servants, the level of bureaucracy, and the independence of the civil services from political influences and the credibility of government.

-Regulatory burden (changed later in next reports in '***Regulatory quality***') – captures the effects of the policies which are felt as market-unfriendly such as price controls or inadequate bank supervisions or excessive regulation which might negatively influence business development.

-Rule of law – includes some indicators that estimate the extent to which public and citizens have confidence in and abide by the rules of society, containing the effectiveness of the judiciary systems and the security of property rights.

-Graft (also changed later in '***Control of corruption***') – summarizes the public's perception about the control of corruption, including various forms of public power exercises for illegally private gains such as "additional payments to get things done", but also its negative influences on the business environment.

Next dataset used was the ranking assigned to the assessment of financial reporting and auditing standards regarding company financial performance from the *Global Competitiveness Report* issued by the World Economic Forum, which contains a range of significant indicators that emphasize significant information about the economic developments and the necessary conditions for ensuring long-term prosperity, being considered as one of the most comprehensive assessment reports on global competitiveness [39]. First version of this report was published in 2004 [40].

The major objective of this report is to determine a global indicator like 'global competitiveness', which includes approximately 115 variables and 12 pillars grouped on three sub indexes *(1.Basic requirements sub index; 2.Efficiency enhancers sub index; 3.Innovation and sophistication factors sub index)* that influence the level of competitiveness at each country-level [39]. The indicator used – **'strength of auditing and reporting standards'** is a component of the *1st pillar: Institutions* presented within this report.

Next dataset used in our survey was determined by the classification of the economies of all countries with population of more than 30,000 citizens divided on income groups such as low income, lower middle income, upper middle income, high income non OECD, high income OECD reported in the World Bank report '*Country and Lending Groups'* issued in July 2016 [41]. The experts from World Bank classified the economies using as main criterion the gross national income (GNI) per capita. These income classifications are set each year on July 1, starting from the premise of establishing the validity of this official classification during the World Bank's fiscal year (which ends on June 30). So that, it was used the World Bank's classification set on July 1, 2012 which remains in effect until 1 July 2017 and within this classification, economies are divided according to 2016 GNI per capita, determined using the World Bank Atlas method. The data sources for all variables used in this empirical study are summarized in Table 2.

Table 2: Description of variables and data sources

Variable Name	Source	Description	No. of countries
1.Voice and accountability	[36]	It ranges from approximately -2.5 (weak) to 2.5 (strong) governance performance)	215 countries
2.Political Stability and Absence of Violence			
3.Government effectiveness			
4.Regulatory quality			
5.Rule of law			
6.Control of corruption'			
Strength of auditing and reporting standards	[39]	It ranges from approximately from 1 = extremely weak to 7 = extremely strong	144 countries
Income classifications	[41]	Economies are divided according to 2016 GNI per capita, using the World Bank Atlas Method, resulting the following groups: * *low income* - $1.025 or less (33 countries); * *lower middle income*, $1.026 - $4.035 (52 countries); * *upper middle income*, $4.036 - $12.475 (49 countries); * *high income*, $12.476 or more, classified also in non-OECD (16 countries) and OECD members (31 countries).	181 countries

Given the objective of this study, the exploring the influence of governance quality on strength of auditing and reporting standards, from the above mentioned reports and datasets there were extracted data for the selected variables and the multiple regression statistical method was applied trying to obtain empirical evidence in order to validate/invalidate the next research hypothesis: *H: All these six indicators of governance (1.Voice and Accountability; 2. Political Stability and Absence of violence; 3.Government effectiveness; 4. Regulatory Quality; 5.Rule of Law; 6. Control of Corruption) have a positive influence on strength of auditing and reporting standards for each country (as it is measured by World Economic Forum).*

4. EMPIRICAL RESULTS AND DISCUSSIONS

Given all these datasets included in our survey as there were mentioned before, the final sample used for achieving this cross-country analysis included 144 countries, for which all the necessary information was available in all reports considered within our study. From the perspective of geographical regions, the multiple regression results are displayed in Table 3 and 4, where the dependent variable is the strength of auditing and reporting standards as it was measured by World Economic Forum for 144 countries, and the independent variables are represented by all six governance clusters as they are defined and evaluated by World Bank in its reports. Regarding the countries from Europe and Central and North America, the findings confirm the intuition set out at the beginning of this paper, namely that governance dimensions have a statistically significance for the strength of auditing and financial reporting standards, while for countries from South America and Asia, only four of these six governance indicators seems to have a relevant impact on accounting and auditing standards-setting process, such as *'government effectiveness', 'regulatory quality', 'rule of law'* and *'control of corruption'*. Strong differences emerge between countries from Africa and the other continents, when the ranking assigned to the strength of auditing and reporting standards is regressed on each of the six governance indicators, one at a time. In case of Africa, our research hypothesis has to be rejected, because of our findings that show that all these six governance clusters do not have a significant influence on the strength of auditing and reporting standards.

Table 3: Regression of the strength of auditing and reporting standards on first three governance indicators

Continent	Voice and accountability			Political Stability			Government effectiveness		
	(Constant)	Slope	R^2	(Constant)	Slope	R^2	(Constant)	Slope	R^2
Europe	4.043	0.951	**0.675**	4.400	0.859	**0.550**	4.249	0.734	**0.774**
	(34.101)*	(8.652)		(40.713)*	(6.635)		(52.863)*	(11.105)	
Central and North America	4.346	0.999	**0.544**	4.627	1.142	**0.537**	4.612	0.811	**0.624**
	(24.376)*	(3.935)		(28.479)*	(3.880)		(31.488)*	(4.646)	
South America	4.339	0.404	0.244	4.471	0.201	0.086	4.452	0.424	**0.310**
	(28.257)	(1.606)		(24.481)	(0.870)		(30.772)*	(1.896)	
Africa	4.324	0.354	0.087	4.377	0.517	0.253	4.627	0.836	0.284
	(27.545)	(1.796)		(32.758)	(3.392)		(27.117)	(3.668)	
Asia	4.781	0.201	0.034	4.812	0.362	0.212	4.593	0.758	**0.624**
	(30.712)	(1.140)		(39.472)	(3.154)		(57.758)*	(7.843)	

*Note: Number in parentheses are t-statistics; *statistically significant at 1% level.*
Source: own calculations based on the datasets presented above

Table 4: Regression of the strength of auditing and reporting standards on last three governance indicators

Continent	Regulatory quality			Rule of law			Control of corruption		
	(Constant)	Slope	R^2	(Constant)	Slope	R^2	(Constant)	Slope	R^2
Europe	4.012	0.932	**0.736**	4.270	0.718	**0.754**	4.425	0.606	**0.740**
	(37.741)*	(10.030)		(51.409)*	(10.499)		(58.489)*	(10.126)	
Central and North America	4.314	1.025	**0.618**	4.746	0.730	**0.577**	4.693	0.701	**0.463**
	(26.240)*	(4.583)		(30.252)*	(4.214)		(26.761)*	(3.348)	
South America	4.460	0.438	**0.592**	4.543	0.360	**0.401**	4.438	0.343	**0.362**
	(40.328)*	(3.410)		(31.112)*	(2.314)		(32.221)*	(2.132)	
Africa	4.509	0.731	0.221	4.539	0.693	0.234	4.441	0.612	0.179
	(27.613)	(3.105)		(27.316)	(3.225)		(27.835)	(2.719)	
Asia	4.613	0.732	**0.533**	4.737	0.780	**0.655**	4.797	0.686	**0.587**
	(52.148)*	(6.493)		(62.484)*	(8.388)		(56.947)*	(7.256)	

*Note: Number in parentheses are t-statistics; *statistically significant at 1% level.*
Source: own calculations based on the datasets presented above

Considering the same variables, but applying the multiple regression analysis from the perspective of the World Bank income group's classification, the results displayed in Table 5 and 6 are somewhat surprising due to the fact that the influence of governance indicators are most emphasized, from statistically point of view for the countries included in *high income OECD* and *upper middle income* categories, while for countries classified in *high income non OECD* category, only two governance clusters like '*rule of law'* and *'control of corruption'* seem to have a relevant influence on the strength of auditing and reporting standards.

Surprisingly, the *'political stability'* which contains certain indicators which express the potential likelihood that the government in exercise could be replaced by using unconstitutional methods, seems to be the governance cluster that affect the least the strength of auditing and reporting standards, while only for the countries classified in *upper middle income* category it is highlighted somewhat a relevant influence on the auditing and accounting standards. On the other side, the most determinant governance dimension on the strength of auditing and financial reporting standards seems to be *'rule of law'* which confirms the results obtained by previous researchers, when it is stressed the idea of a relevant influence of the effectiveness of the judiciary and legislative systems on the successful implementation of accounting and auditing standards.

Table 5: Regression of the strength of auditing and reporting standards on first three governance indicators

Income category	**Voice and accountability**			**Political Stability**			**Government effectiveness**		
	(Constant)	**Slope**	**R^2**	**(Constant)**	**Slope**	**R^2**	**(Constant)**	**Slope**	**R^2**
Low income	3.740	-0.198	0.025	4.101	0.295	0.087	4.279	0.514	0.098
	(18.227)	(-0.785)		(21.148)	(1.510)		(15.290)	(1.614)	
Lower middle income	4.189	0.117	0.015	4.122	-0.049	0.005	4.440	0.619	**0.210**
	(33.645)	(0.632)		(31.695)	(-0.351)		(30.645)*	(2.676)	
Upper middle income	4.599	0.342	**0.159**	4.645	0.341	**0.158**	4.578	0.766	**0.380**
	(49.319)*	(2.680)		(48.629)*	(2.667)		(57.197)*	(4.830)	
High income: non OECD	5.347	-0.170	0.057	5.295	0.153	0.017	5.094	0.370	0.157
	(29.617)	(-0.853)		(19.948)	(0.459)		(19.905)	(1.493)	
High income: OECD	3.580	1.390	**0.429**	5.002	0.360	0.102	3.909	0.992	**0.596**
	(9.495)*	(4.671)		(25.718)	(1.811)		(17.464)*	(6.543)	

*Note: Number in parentheses are t-statistics; *statistically significant at 1% level.*
Source: own calculations based on the datasets presented above

Table 6: Regression of the strength of auditing and reporting standards on last three governance indicators

Income category	Regulatory quality			Rule of law			Control of corruption		
	(Constant)	**Slope**	**R^2**	**(Constant)**	**Slope**	**R^2**	**(Constant)**	**Slope**	**R^2**
Low income	3.854	-0.024	0.000	4.112	0.284	0.034	4.179	0.412	0.071
	(16.541)	(-0.079)		(14.211)	(0.925)		(16.220)	(1.355)	
Lower middle income	4.294	0.492	0.127	4.540	0.670	**0.230**	4.285	0.244	0.034
	(34.515)	(1.982)		(27.198)*	(2.842)		(24.345)	(0.973)	
Upper middle income	4.556	0.540	**0.323**	4.669	0.531	**0.264**	4.666	0.442	**0.193**
	(54.273)*	(4.263)		(52.001)*	(3.688)		(49.266)*	(3.018)	
High income: non OECD	5.049	0.421	0.147	4.900	0.699	**0.332**	5.070	0.486	**0.309**
	(17.612)	(1.439)		(19.809)*	(2.443)		(25.070)*	(2.317)	
High income: OECD	3.776	1.143	**0.599**	3.937	0.969	**0.549**	4.483	0.598	**0.554**
	(15.620)*	(6.579)		(16.340)*	(5.942)		(28.916)*	(5.997)	

*Note: Number in parentheses are t-statistics; *statistically significant at 1% level.*
Source: own calculations based on the datasets presented above

5. CONCLUSIONS

The cross-country survey presented within this paper show that the most influencing governance dimensions on the strength of auditing and reporting standards are the ones that express the effectiveness of government to formulate and effectively implement sound policies *('government effectiveness', 'regulatory quality')*, but also the confidence that public and citizens have in the rules of society and the effectiveness of the judiciary system *('rule of law' and 'control of corruption')*. Because the impact of governance clusters on the strength of auditing and reporting standards is felt differently by high income and upper middle income economies compared with low and lower income countries, the conclusion of this study is that our findings partially support the research hypothesis issued above, that governance indicators have a statistically significant influence on the strength of auditing and financial reporting standards. Also, the authors admit that additional investigation is required to further analyze the influence of the governance dimensions that have been emphasized as being significant, and probably a challenge of the future will be to look for potential solutions that might have a contribution to the overcoming of the obstacles that might negatively affect the process of successful implementation of financial reporting and auditing standards.

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