

EFFECTIVENESS OF FINANCIAL REPORTS AFTER INSTITUTIONALISATION OF FIRMS: APPLICATIONS IN SOME COMPANIES IN TURKEY

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ABSTRACT

After the concepts of transparency, equity, accountability and responsibility, which are included in literature as corporate governance principles, are adopted by firms and auditors to audit such firms, the conditions forming the environment of reliance such as implementation and disclosure of accounting standards, protection of interests of all stakeholders and avoiding any interest conflict, availability of rules and planning internal and external audits will be created. The purpose of this study is to contribute to the literature checking whether faults or frauds have been reduced following creation of corporate governance principles and the environment of reliance adopted not only by firms but by independent audit firms.

Keywords: Independent Audit, Corporate Governance Principles, Fault and Fraud.

INTRODUCTION:

Countries and markets being more dependent on each other due to an increase in trade, Protection of the rights of firms, stakeholders and various interest groups has become important; in the meantime, forming administration of firms with consistency, clarity, accountability and transparency constitute the four legs of institutionalisation has become a necessity. Firms utilise financial statements to demonstrate their financial statuses while reaching an investment decision, or which there is a need for common accounting language. After the accounting has begun to seek for a common language, and especially in stock partner corporations, a different kind of accounting order and understanding of audit has occurred. The principle of public disclosure is highly concentrated and transparency in institutional information has become a goal due to institutionalization need of the corporations. Since the technology has advanced and borders have been removed, investors are interested in international investment opportunities more and more, and firms concentrate on benefiting from international markets as much as possible and on funding opportunities.

Owing to accounting scandals experienced, companies need reliable information, and a need for the financial statements free from faults and frauds disclosed to the public in investment decision occurs, for which they must be audited thoroughly by independent auditors. The biggest problem here is that the reliability of the information which users have on the independent auditors are questioned due to accounting scandals and they discredit the accuracy of outcomes of the audit reports. It is meaningful that although there are fraudulent financial reporting incidents in Turkey, no unfavourable report has been encountered.

IMPORTANCE OF INSTITUTIONALISATION:

After the collapse of so many institutions such as Enron, WorldCom, Commerce Bank and XL Holidays, in response to the financial crisis, one of the mechanisms developed to gain the investors' confidence and faith back again and to improve them is corporate governance (Sunday 2008). Corporate governance is a regulation guiding the relationship among employers, directors, investors and other shareholders and providing the rights and gains of domestic and foreign investors and private and state owned corporation in other words, they are private and state regulations incorporating laws, regulations and professional practices regulating the relationship among both employers and investors (Oman 2001).

While 'corporate governance' definitions are changing over the time, definitions have been made on two basic cycles. Behaviour, performance efficiency, growth and financial structure of corporates are defined considering the rights of shareholders and other stakeholders. Second definition is related to normative environment. In other words, governance of corporates are handled considering legal system, judicial system, financial markets incorporating the corporates and rules in the markets. At this juncture, there is a need that how such mechanisms are taking part in performing corporate governance are shaped in terms of investors and firms (Claessens 2006). The concept of 'corporate governance' in literature rather includes the distribution of rights and responsibilities of a member in the board of directors of firms, executive directors, shareholders and stakeholders. Also, creation of rules and methods regarding reaching firm decisions is within the scope of the said concept. Such issues as which decisions will be reached by which intuition, what legal or non-legal liabilities there will be while reaching a decision are within the scope of the corporate governance concept. The purpose of such concept is to enable firms to operate more efficiently, more effectively and more profitably (Oman 2001).

In line with the purposes adopted by corporate governance, the importance of accounting principles and rules, on which the firms' information and report systems are based, has been realised from the point of informing interest groups which are related to firms. In this respect, it is beyond doubt that institutionalisation in the firms can be realised by means of reliable information to a large extent. While firms publish such information in financial statements are reporting their activities, they provide information for potential investors, creditors, firm directors, credit institutions and state. At this stage, auditors may perform activity outcomes in full, completely and accurately benefiting from financial statements. Such explanations show that corporate governance system and accounting practices interact mutually. Showing accurate and proper form of financial status available in a firm is realised by means of a proper corporate governance. Powerful information systems depend on application of reliable reporting standards and reliable standards depend on correct and impartial application of basic concepts of accounting (Üstündağ 2001).

THE RELATIONSHIP BETWEEN INDEPENDENT AUDIT FIRMS AND FAULTS AND FRAUDS IN FINANCIAL STATEMENTS:

The biggest difference between accounting faults and frauds is intention. While accounting faults occur beyond knowledge, lack of knowledge or inattentiveness, accounting frauds are those performed deliberately by the parties. As a fraud is performed intentionally on documents and records, it may not be expected to occur automatically in the accounting system. In this process, the firm is expected to be audited both internally and externally. For the purposes of detection of 'faults and fraud' in the firm, after the internal audit, opinions of the independent audit through which final result are obtained are important.

Misleading or misguiding information presented in the financial statements lie behind almost entire recent problems in firms. Firm management failing to reveal such misreporting or not desiring to avoid it has resulted in accounting scandals. While financial statements containing faults or frauds lead to such adverse consequences as harming reliability of information users, harming public reliance on accounting and auditing profession, decreasing efficiency of capital markets and affecting economic growth and wellbeing of countries adversely, one of the biggest consequences is preventing corporate governance principles, especially reliance, quality, transparency and clarity which must take place in the process of financial reporting (Wells, 2008).

There are two aspects of faults and frauds concerning independent audit.

- Faulty Financial Reporting (FFR)
- Embezzling (Employee Fraud)

FFR is performed if (AICPA, SAS No.99: par.06);

- The outcomes of important calculation items in financial statements are changed,
- Important information, certificates or documents are falsified,
- Assessment, recording, reporting parts of accounting principles and policies are carried out inaccurately,
- Year-end financial figures of firms are misstated.

Independent audit is monitoring information and developments thereof in financial statements of firms by partners, investors, prospective investors, directors, firm employee, creditors, trade unions, trade associations, state, social security institutions, competitor firms etc., which is requested by such parties (Çelen 2001; 26; Doğan vd 1996; 133). Institutionalisation of independent audit firms and accurate and reliable outcomes given by them play a great role in decreasing the accounting faults and frauds. According to Doğan & Hatunoğlu (1996), an independent audit system running accurately have certain benefits, which help in.

- Determining whether financial statements executed based on records and documents of a firm,
- Preventing frauds by directors or employees of a firm,
- Increasing reliability of financial reports,
- Increasing credit opportunities,
- Increasing efficiency of internal control system, and
- Giving reliable information to clients about profitability, efficiency and financial structure of a firm.

LITERATURE REVIEW:

The concept of Corporate Governance has begun along with fast globalisation attempts in the world and become more important when corporates has sought to change their regime due to technological and competition conditions. While some studies indicating such concept has commonly been utilised by Europe, the USA and Japan since 19th century, it began to be used in 1990 s. Necessity of corporate governance principles increases in both domestic and foreign markets in financial sector. More importantly, it has been realised that accurate and reliable information may be acquired through the firms having corporate governance principles. Thus, it is known that corporates contribute to the economy by encouraging them to have such principles (Sapodadia 2012). Therefore, corporate governance increases the firm performance, firm value and also provides significant advantages for economies of countries at a macro level (Najjar 2012). Within the frame of academic studies, it is seen that the role and practice of corporate governance has increased since 2008 financial crisis. It is seen that corporate governance was used for the first time in the USA in 1970 (Cheffins 2011). Significance of corporate governance has been gradually increasing since Enron and Arthur Andersen crisis in the USA in 2001-2002 (Khanchel 2007). In 1999, "Corporate Governance Principles" was adopted to be an international reference for decision makers, investors, corporates and other stakeholders. Corporate Governance that meets the complete expectations of target audiences of firms and aiming at their institutionalisation to reach a sustainable performance level in long term is constructed on four main principles which are "fairness, transparency, accountability and responsibility" (Nestor & Thompson 2001).

At this point, many studies have been made on relationship among independent audit, corporate governance and faults and frauds in financial reports and how they affect each other. Important studies, and especially domestic and foreign literature containing institutionalisation and results of independent audit firms are included in this study.

Checking the studies as far as the accounting scandals, it is stated that there is a requirement and a gap in governance but it does not shaped. Lipton and Lorsch (1992:64) speculate that as the governance structure gets greater, the effects of controls of managers reduces and it becomes harder to make strategical decisions and to establish a coordination in firms, which, as they refer, give rise to a novel governance understanding.

Wallace and Naser (1995: 311) and Al-Mulhem (1997) have made a study determining that there is a positive relationship between the type, size and institutionalisation of independent audit firms and information presented by firms when type of firm don't have any effect. However, Modahki (1996) could not found any relationship between the level of information publicized and audit firms, in a study he made on Saudi Arabia firms. (Çürük, 2004, 152). Again, according to the results of researches made by Gerety and Lehn (1997: 598), it is found that corporate governance structures and the size of the independent audit firms are not meaningful in performance of accounting frauds as well as the fact that the salaries given depend on accounting outcomes.

It is seen in the researches that ineffective operation of the employee in management and the audit system has given rise to an increase in accounting faults and frauds (Rezaee 2002). Kane and Velury (2004: 982-983) has approached to representation problem (real-proxy) and stipulated that a high efficient audit service will be obtained thanks to an increase in institutionalisation of audited firms. In another words, desired audit service will be more quality if corporate directors and corporate owners are different form each other. At the same time, corporate governance concept has become more of an issue upon such new regulations. Following corporate scandals, interest in such issue has risen and the corporate governance concept to rise efficiency of independent audit has come along. Agrawall and Chadha (2004: 373) have examined the relationship between corporate governance mechanism and accounting problems of corporates and reached a conclusion that there is a positive relationship between them. According to Porter (2006:490), if independent audit firms perform a quality and accurate audit, expectations of public will be met, legal responsibilities of auditors will decrease and the environment of reliability will increase, which will be realised by quality accounting standards and institutionalisation of audit firms.

It is seen that capital cost decreases, more profitability is established and positive feedbacks are received with respect to the market and state from the firms having a well-functioning corporate governance mechanism. Claessens (2006), in his study has made on corporate governance, touching upon corporate governance principles in general, and checking how it affects the capital cost and its impact on diminishing the degree of governance problems. He finally has looked into how it affects the performance of and the financial structure a firm. Fundamental policies of the industries and research objectives are put forward in the study. Transparency is one of the favourable corporate governance principles is simply to share all information clearly to be beneficial for economic decisions by a corporate stakeholders in evaluation of the corporate. Thus, clear and official information shall be obtained from the stakeholders about corporate activities and financial status of the corporate. It has investigated corporate reporting strategy of a corporation under corporate foundations and emphasised the importance of sharing financial information. According to GAA, corporate transparency is not only favourable for institution's interest but it also plays a great role in increasing the economic efficiency and information efficiency in capital markets. Besides, it is effective among auditor, regulatory and implementer authorities.

Göçen (2010:109) examined Parmalat case for the relationship between corporate governance and independent audit. In this study, the importance of internal control, an effective function of corporate governance and the rules to be followed by the auditor are explained. According to the result thereof, it is concluded that "equality, transparency, accountability and responsibility principles of corporate governance essentially support the control mechanism targeted by internal and external audit".

Imhoff (2003:121) in the study has revealed that the actual guardianship at the stage of forming the board of directors of corporations hinders functioning of an effective corporate governance and corporate governance principles are not fulfilled sufficiently. In this case, an accurate financial reporting cannot be provided.

Najjar (2013:57) mentioned that the studies which assess firm performance employing corporate governance principles and concluded that such principles increase corporation discipline and information users are given accurate financial reporting, thus protecting corporate shareholders.

Examination and Interpretation of Independent Audit Reports of Some Corporations in 2009-2014:

The firms making decisions utilising the financial reports incorporating issues, unrecorded transactions and failures to implementation of corporate governance principles resulting from financial reports in the world decide to make unfavourable investments due to inaccurate and unreliable information. Especially, due to

countries and markets being dependent on each other gradually and borders being removed, reliable information need of the information users have gradually increased. At this point, firms, thanks to adopting corporate governance principles, assure both internally and users outside. Additionally, while investors have information about firms, they need audit opinions and make decisions as a result of opinions about audited firms.

Corporate governance is established on four legs which are shareholders, public, stakeholders and board of directors, based on equity, transparency, accountability and responsibility principles. On the other hand, necessities such as external audit of financial statements of firms and presenting and explaining opinion thereon have stood out owing to institutionalisation. Independent audit firms present their audits and opinions, based on the regulation, as follows (<http://kgk.gov.tr/eng/>; Public Oversight, *Accounting and Auditing Standards Authority*):

In accordance with independent audit regulation, the audit evidences are sufficient and appropriate information, documents and statements obtained and determined by the auditor for the purposes of opinion presentation to guarantee regarding whether important inconsistencies exist within the frame of audit criterion regarding the audit (Article 9). Audit report is a document whose responsibility is assumed by audit firm or auditor, which is executed and signed in accordance with Firm regulations to be presented for the utilisation of auditor opinion created in conformity with assurance level determined and other issues to point out, if any, by the users, as a result of evaluation of evaluations of audit evidences (Article 10). Audit report is executed in accordance with the form and principles determined by the Firm at the end of the audit. Under the opinion title, such report includes:

- a) *An opinion in favour in case of nonexistence of inconsistency or contradiction which may be considered important in accordance with the audit criterion separately or collectively regarding the audit.*
- b) *A limited opinion in favour in case of existence of important inconsistencies or contradictions or in the event that any sufficient and appropriate audit evidences cannot be collected in accordance with the audit criterion separately or collectively regarding the audit, however such inconsistencies or contradictions do not affect the audit in general.*
- c) *An adverse opinion in the event that, upon collecting sufficient and appropriate audit evidences, the inconsistencies or contradictions found out are important separately or collectively and affect the audit in general.*
- d) *An opinion regarding avoiding any opinion presentation in the event that any sufficient and appropriate audit evidences cannot be collected which can be the basis of the audit opinion in important issues affecting the audit in general, or in case of subsequent uncertainties preventing opinion formation although sufficient evidences are collected (Article 30).*

Such information users as the employee, directors, investors or state benefit from such opinions presented by independent audit firms and they want such information to be reliable and accurate. Because corporations has become large in size, and because stakeholders of the corporations has increased in number in parallel with increasing corporation volumes, such corporations wish to work with independent audit firms adopting corporate governance principles and perform their activities. The fundamental duty of independent audit firms is to fulfil reliable information need and prevent directors of corporations and independent auditors from making decisions at their will in parallel with their interests.

The direction of relationship between firms adopting corporate governance principles and independent audit opinions is studied in this study. The data of Corporate Governance Association of Turkey (TKYD), founded in 2003, aimed at establishing a communication network among private sector, public bodies, media, regulatory bodies, non-governmental organisations and academic world to develop practices of corporate governance are used as base. According to Corporate Governance Association of Turkey, corporate governance rating grade was given based on some of public companies. Independent audit opinions included in Public Disclosure Platform (KAP) were determined in 2009-2014 based on such companies. Such companies are shown in Supplement 1.

In the study, the corporate governance rating grades of such companies have been checked and relationship of them with independent audit firms have been attempted to find out. While doing this, at the same time, profit/loss impact of such results and whether they have differences based on industry and service business have been examined.

Empirical structure of this study has been founded on a panel data set. There are two basic models used in regression analyses made on panel data set. These are Fixed Effects Model and Random Effects Model.

Fixed effects model which is the simplest and basic model may be put down as follows:

$$Y_{it} = \alpha_i + X'_{it}\beta + U_{it}, \quad U_{it} \sim BBD(0, \sigma_u^2), \quad \dots\dots\dots(1)$$

Where Y_{it} shows observation value of dependent variable in t time for i . unit, X_{it} : shows observation value of independent variable in t time for i . unit and within this framework, X'_{it} shows independent variables factor and U_{it} shows the value of residues in t time for i . unit. Besides, α shows intersection value and β shows sensitivity of dependent variable to independent variable. If we look closely, while β is fixed in all units and all times, α varies from a unit to another one, thus reflecting unit fixed effects. On the basis of the assumption that independent variables and residues are unrelated, fixed effects model may be predicted by Least Squares Method.

It is accepted that the effects of variables which affect dependent variable in regression analyses but are not included in independent variable in the model remain in residues. It is accepted that α is random effects in random effects modelling and distributed independent and similar. Random effects model may be put down as follows:

$$y_{it} = \beta_0 + x'_{it}\beta + \alpha_i + u_{it}, \quad u_{it} \sim BBD(0, \sigma_u^2); \quad \alpha_i \sim IID(0, \sigma_\alpha^2), \quad \dots\dots\dots(2)$$

It is not easy to choose between fixed effects model and random effects model in practice. It is seen that there are distinct differences in predictions of parameters of the model especially when the time dimension is small. Besides, the units included in the model being similar in terms of their characteristic subject of the analysis also makes difficult to choose between two different models, which may occur, for example, while the consumers in certain income or behaviour group are being analysed. It is decided by Hausmann test whether fixed effects model or random effects model will be preferred. And we decide by Hausmann test in predicting both model and which model is appropriate. Fundamental hypothesis of the test is that there is no any correlation between independent variables and unit effects. It means predictors of both models are consistent and the difference between both predictors is very low and thus, random effects model producing more effective predictor will be preferred. An alternative hypothesis is built as that independent variables are correlated to the unit effect. In that case, as random effects predictor will be deviant, the difference between both predictors will be big and as fixed effects predictor will be consistent, fixed effects model will be preferred. Hausmann test statistic is calculated as follows:

$$H = (\beta_{SE} - \beta_{RE})' [Avar(\beta_{SE}) - Avar(\beta_{RE})]^{-1} (\beta_{SE} - \beta_{RE})$$

In this equity, RE subscript shows predictors of random effects model and SE subscript shows fixed effects model and besides, $Avar(\beta_{SE})$ and $Avar(\beta_{RE})$ indicate, subsequently, asymptotic variance covariance matrixes obtained from prediction of random and fixed effects models.

Hausmann test statistic is compared to the χ^2 value corresponding to selected significance level and degree of freedom; if test statistic exceeds χ^2 value, basic hypothesis is rejected and it is concluded that fixed effects model is appropriate.

Hypotheses of the study are as follows:

Hypothesis 1: Audit opinion (Opinion: O) affects corporate governance grade (corporate governance: CG).

Hypothesis 2: Profit-loss (P/L) status of the firm affects corporate governance grade.

Hypothesis 3: The firm being industry-services (I/S) affects corporate governance grade.

Such hypotheses are tested both by fixed and by random effects model, and as a result of Hausmann test, fixed effects model is seen to be appropriate. Findings of this model are given in the table below. The results obtained in this model is shown in Supplement 1. According to the Hypothesis 1, the audit opinion in favour increases corporate governance grade. As seen in the table, this hypothesis is accepted in 10% significance level. On the other hand, according to the Hypothesis 2, the firm making profit increases governance grade. As seen in the table, this hypothesis is accepted in 5% significance level. Finally, according to the Hypothesis 3, corporate governance grades of firms operating in industry sector tend to be higher. However, as observed in the table, this hypothesis cannot be accepted even in 10% significance level. Namely, the sector in which the firm operates does not affect corporate governance grade.

CONCLUSION:

Corporate governance emerged in 1990s as a result of researching corporation governances to provide high benefits for corporation owners, stakeholders and investors. And due to accounting scandals occurred in 2000s, lack of corporation governance and lack of audit came on agenda and, once again, the requirement of corporate

governance stood out. Firms must implement institutionalisation principles, one of the indispensable conditions, and be audited accurately for development and survival of them. And independent audit practices must be carried out with a certain quality and at a level in order for them to be accurate and dependable. An audit practice with certain qualities and audit reports executed as a consequence thereof are highly in favour of firms and information users. On the contrary case, auditors and firm owners become responsible if in case of an audit report in which appropriate opinions are not presented. And to prevent this, each audit firm making independent audit is expected to make a quality audit with due attention and care.

Within such explanations, both firms to be audited and audit firms must adopt and practice institutionalisation process. Corporations failing to keep up with such structuring process may be obliged to pull out of the market at short notice. The structure of firms only caring about shareholders will change to compete with globalisation. Firms have realised their responsibilities against information users and institutions operated well have noticed importance of professional ethics and social value and impacts of such on their performances. In this study, the relationship between the audit opinion in favour and corporate governance grade is studied. As a result of such conclusions reached, it is thought that institutionalisation is high in corporations for which independent auditors' present opinions in favour.

In this context, studies have been made based on corporate governance grades of 39 corporations studied and given by Corporate Governance Association of Turkey and it has been found out that the degree of institutionalisation is high where independent opinions are in favour. On the other hand, a relationship in the same direction has been found between independent opinions in favour and profitability of corporations. It has been observed that independent auditor opinions are highly in favour in profiting corporations. Nevertheless, no favourable relationship has been found between firms being in industry or service sector and independent opinion. The literature has been attempted to contribute into with this study determined also as a factor emphasising importance of institutionalisation for corporations and increasing profitability.

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SUPPLEMENT 1:

Table 1

Dependent Variable: CG				
Method: Panel Least Squares				
Sample: 2009 2014				
Periods included: 6				
Cross-sections included: 39				
Total panel (unbalanced) observations: 200				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
CG	83,43969	1,56866	53,19168	0
G	0,673639	0,357564	1,883966	0,0611
KZ	1,889958	0,90425	2,090084	0,0379
SH	-0,961493	0,63549	-1,512995	0,1319
R-squared	0,056702	Mean dependent, yes		86,86365
Adjusted R-squared	0,042264	S.D. dependent, yes		4,520423
S.E. of regression	4,423866	Akaike info criterion		5,831702
Sum squared resid	3835,836	Schwarz criterion		5,897669
Log likelihood	-579,1702	Hannan-Quinn criter.		5,858398
F-statistic	3,927235	Durbin-Watson stat		0,402664
Prob(F-statistic)	0,009437			
References: Implementation Results				

SUPPLEMENT 2:

Table 2: Rating By Given Corporate Governance Association of Turkey (TKYD)

Vestel Electronics Inc.	Tofaş Turkish Automobile Factory Inc.
The Green Real Estate Investment Trust Inc	Turkish Tractors and Agricultural Machinery Inc
Hurriyet Newspaper and Printing Inc.	Tüpraş Turkey Petroleum Refineries Inc.
Otokar Bus Body Industry Co.	Anadolu Efes Brewery and Malt Sanayi Inc.
Yapı Kredi Banking Inc.	Coca Cola Drink Inc.
Şekerbank	Arçelik Inc.
Asya Katılım Banking Inc.	Turcas Oil Inc.
TAV Airports Holding Co.	Turk Prysmian Cables and Systems
Business Leasing	Logo Software Industry and Trade Co.
Industrial Development Bank of Turkey	Doğan Holding Group of Companies
Park Electric Co	Petkim Petrochemical Holding Inc
Turk Telekom Inc.	Aygaz Inc.
Albaraka Turk Participation Bank	Ihlas Home Appliances
Yazıcılar Holding	Ihlas Holding
Egeli & Co. Investment Holding Co.	Turkey Halk Banking Inc.
Boyrer Inc.	Pinar Meat Industry Co.
Investment Securities Inc.	Global Yatırım Holding Inc.
Guarantee Factoring Services Inc.	ENKA Construction and Industry Inc.
Doğuş Automotive	Pinar Milk Products Industries Inc.

References: <https://www.kap.org.tr/en/>, Public Disclosure Platform.
