THE IMPACT OF EUROPEAN INTEGRATION ON ROMANIA'S AUDIT SECTOR

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It can be argued that maintaining the competitiveness of the audit market is of paramount importance to standard setters since the quality of financial statements prepared by public companies depends on a fair and transparent competition among auditors. Since Romania has joined the European Union in 2007 a lot of effort has been put into the preservation and expansion of a competitive audit market. Some would question whether joining the European Union has impacted in any discernable way the Romanian audit market which is distinguishable from that of its non-European Union counterparts. The current paper is dedicated to exploring these trends by combining an extensive literature review with empirical data gathered during the first nine years of Romania's European journey.

Keywords: *auditing, European Union, Romania*, *market structure*

JEL Classification: M42

Introduction

From a geopolitical perspective, European integration can be seen as an excercise in globalization. The development of a single, interconnected market across the European Union provides the researcher with an opportunity to identify the features of such a phenomenon.

Since its inception in 1993 at Maastricht, the European Union has made significant territorial advances into Eastern Europe, absoring many of the former Warsaw Pact members in its ranks, as well as former Yugoslavian Republics such as Croatia and Slovenia. It can be argued that the expansion of the European Union has partly contributed to a new financial order on the Old Continent (Shiller, 2009), through policy-making and standard-setting. Because of the ever increasing financial integration which comes with the expansion of the European Union (EU), the impact of audit work is no longer confined to isolated equity markets. Risks of financial contagion have pressured European officials in developing and promoting quality accounting and audit standards across all EU jurisdictions.

Even if we dismiss the audit and accounting regulations set by the European Union as a deciding factor for financial market integration, there is mounting evidence which indicate the contribution of IFRS standards to the imposition of neo-liberal discourses on a global scale (Hopper, et al., 2016). Financial markets are no longer a „casino" for the privilaged few and, with the advent of the Internet, have become accesible to an ever wider range of investors and stakeholders. Investors can trade equities for small amounts of cash with modern and easy-to-use transaction platforms. The quality of the financial information contained in the disclosures of publicly-traded companies affects a wide range of shareholders and thus convergence in both accounting and auditing has become a global phenomenon. Following Hopper et al' (2016) critical reasoning , we can argue in a narrow sense that globalization of the accounting international environment through the removal of trade barriers and the promotion of accounting convergence as advocated by EU officials have fundamentally altered the relationship between international accounting firms and national jurisdictions.

A decade has passed since, on the 1st of January 2017, Romania has formally joined the European Union. Since then, the Romanian financial markets have generated enough data to supply us with metrics relevant to the study of European Integration from the

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perspective of the audit market. The current study taps this rich data set for the purpose of answering questions relating to the evolution of the audit profession and audit market structure in the context of a jurisdiction which has joined the European Union. Since such a study cannot be performed without a control population, Turkey was selected to fill that role. The Turkish market is also a significant regional emerging market with a NATO alignment and its leadership is holding talks with the relevant European stakeholders with the purpose of obtaining EU membership.

The paper is thus structured in two significant parts. The first part covers the relevant history of the Istanbul Stock Exchange and Bucharest Stock Exchange with methodological aspects regarding the selection of the sample. The second part deals with the audit market concentration within the two jurisdictions and the possible underlying causes.

1. **Audit history in the two jurisdictions and sampling**

Both Turkey and Romania emerged from the ruins of the Ottoman Empire as distinct social and political entities. As a vassal of the Ottoman Empire, Romania's early administrators and accountants learned a lot from their Ottoman counterparts and vice-versa. The two jurisdictions ware exposed to Western accounting thought during the nineteenth century.

However, until the early 20th century there was no formal organization which dealt with issues relevant to the accounting profession within their respective jurisdictions. The professional authority of the accounting profession in Romania (CECCAR) was recognized in 1921 (Fotache & Pavaloaia, 2015), while its Turkish counterpart (The Turkish Association of Expert Accountants and Organisers of Enterprises) was organized later in 1942 (Uçma & Beycan, 2008).

The accounting profession in both jurisdictions is also preceded by its equity markets. The Istanbul Stock Exchange was founded in 1866, while its Romanian counterpart was developed later in 1882.

The activity of CECCAR was disturbed by WW2 and was abolished for much of the 20th century by the communist authorities until its reestablishment in 1992 (Tiron Tudor & Muntiu, 2007). After a wave of privatisations paved the way for private capital in the Romanian market, the Bucharest Stock Exchange is re-established in 1995.

A legitimate concern for the audit of the financial statements was addressed during Emil Constantinescu's presidential term. During the 1997-1998 period, the World Bank imposed conditions for financial aid. Three of the four conditions addressed the need to develop a framework which dealt with audit missions. That environment included the adoption of International Standards of Audit and the creation of the institution responsible for the activity of financial audit (Albu, et al., 2010).

Two significant steps were taken for the meeting of those conditions. First, the definition of the audit activity was issued in 1999 and secondly, the Chamber of Financial Auditors of Romania (CAFR) was established later in 2000 as an independent entity to settle the affairs of the audit profession (Laptes, et al., 2014). The period during which the conditions of the World Bank ware implemented saw little private investment, even though the privatization was at an all-time high (Floricioiu & Loghin, 2011).

It could be stated that the reforms which happened before 2000 were slow-paced and that real progress occurred prior to the conclusion of the negotiations with the European Commission in December 2004, when the acquis communautaire had to be implemented, with further improvements occurring between 2005-2006 when the Romanian authorities had to ensure the regulations ware harmonized with the existing

European directives (Floricioiu & Loghin, 2011). Significant audit regulations issued by the European Union during this time included Directive 2006/43/EC (Laptes, et al., 2014).

The impact of European Directives on the Romanian legislation can also be seen in the enactment of OUG 90/2008, which implements Directive 2006/43/EC into the Romanian context (Laptes, et al., 2014).

While preserving a capitalist system since its inception in 1923, the Republic of Turkey has faced considerable challenges in implementing a modern framework for the accounting and audit professions (Mert, 2013). Despite keeping its flagship stock market open through the Cold War, Turkish authorities faced significant challenges in the implementation of an institutional framework for the audit profession. After the implementation of a German legal framework for accounting and audit in 1938, the accounting profession was formally established in 1942 (Uçma & Beycan, 2008), later than its Romanian CECCAR counterpart. During this period, a High council of Auditing was also set up for state economic enterprises.

The renamed Turkish Accounting Experts Association became an early member of the IASC (International Accounting Standards Committee) in 1972 and a member of IFAC (International Federation of Accountants) in 1977 (Uçma & Beycan, 2008). The last significant development from the Turkish markets refers to the establishment in 1994 of The Turkish Board of Accounting and Auditing Standards and the issuing of Turkish translations for International Auditing Standards a decade later (Uçma & Beycan, 2008).

The history for the two accounting markets reveals some common features which recommend using the Turkish market as a control for the Romanian market. These are a delayed establishment of the institutional framework for the audit market, the late 19th century development of the stock markets in their respective jurisdictions as well as the initial reliance on an influential jurisdiction for legislation (Germany for Turkey and France for Romania).

For the purpose of this paper, a sample consisting of 278 equities from the Istanbul Stock Exchange and 105 equities from the Bucharest Stock Exchange ware selected. These equities had uninterrupted financial reporting from the 2006 financial year to the 2015 financial year. These issuers would represent the core of both stock markets during the period, and the minimum threshold on which to build the models.

The total assets expressed in Euros of the company were considered a proxy for size and their variation a proxy for growth. Since market capitalization can be computed from the outcome of sporadic transactions on the equity markets, accounting measures were considered more reliable. More assets on the balance sheet means greater audit risks and by default greater audit fees for the professional. The average weighted growth of each sample, drawn from multiplying the share of the equity in the aggregated amount of assets reported by all issuers from the selected stock exchange with the growth of the total assets reported by each equity in the sample, supplies us with the image of growth and decline in the potential audit markets. The data was retrieved from the Thomson Reuters Eikon database at 29.10.2016.

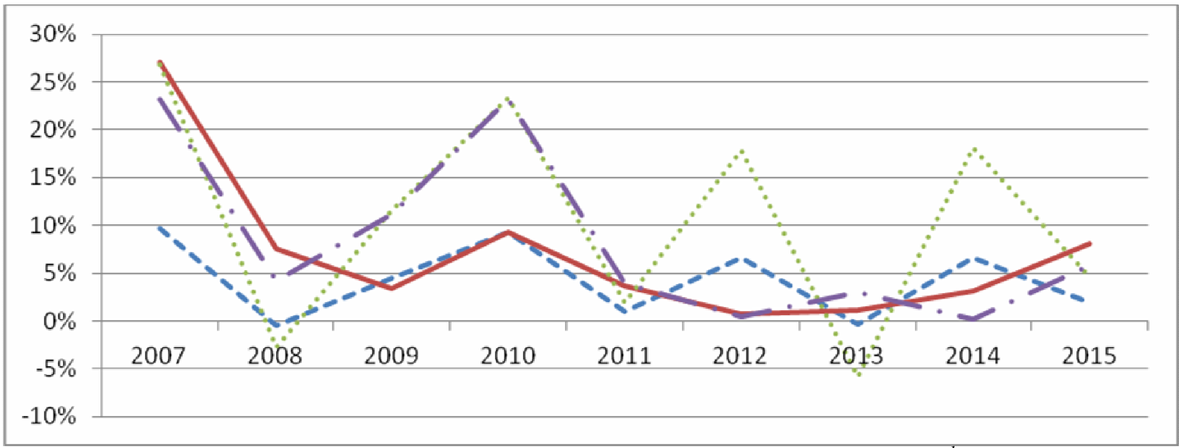

Figure 1 Variances in the growth of the two equity markets[1]

In Figure 1 we can observe similar growth patterns emerge between the samples and their respective aggregate amounts. By using 4 distinct Mann-Whitney tests we can determine if the growth patterns exhibited by the sample equities correspond to their aggregate amounts. This is obvious from looking at the data from Table 1 below.

Table 1 Outcome of the Mann-Whitney tests in p-values

	Romanian total	**Turkish Sample**
Romanian sample	0.482	0,283
Turkish total	0.313	0,11

In Table 1 we can observe that there are no significant differences between the samples to suggest that the control population is not adequate for the test population or that the samples are inadequate with respects to the behaviour of their overall population. None of the four significant Mann-Whitney tests can dismiss their corresponding null hypothesis.

2. Audit Market Concentration

The concentration of the audit market is a significant aspect of the audit regulatory process, especially when we consider such branches of auditing as statutory audit missions. The probability that an auditor will secure a client can depend on a variety of factors, such as audit fees, technical skill and reputation. In 1984, Big Eight companies had higher audit fees than small and medium audit companies. These audit firms had discounts for continuing audit engagements which made continuing engagements more probable (Francis, 1984). We can consider that Big Eight companies had the benefit of offering larger discounts to their clients than smaller companies for similar audits, and thus could more readily preserve a client than a smaller company.

One of the earliest studies on the market share of the Big Eight, later Big Four companies, suggests that there was no significant upward shift towards Big Eight concentration of the audit market in the case of the United States (Paul & Eichenseher, 1986). A study by Doogar and Easley (1998) reveals that contracting practices, client size distributions and differences in auditor productivity jointly determined audit firms' market shares in the American audit market. In other advanced jurisdictions, such as the United Kingdom, Pong (1999) finds evidence that the Big Six companies held approximately 75% of the market and their market share was still consolidating.

In another significant pursuit in regards to the audit market concentration, Wolk et al (2001) find that in the US audit market since 1988 the audit market has undergone a

[1] Legend: square dot for the Turkish sample, solid for the Romanian sample, dot dash for the entire Turkish equity market, long dash dot for the entire Romanian equity market

gradual concentration of the market share. The methodology used relied on metrics such as Herfindahl indices to capture the concentration of the market.

While there are limitations when it comes to investigating financial information originating from emerging market issuers, there is also a significant body of evidence to suggest that the emerging market audit sector is also witnessing a significant concentration. DeFong et al (1999) find that the market share of large audit firms can change with the adoption of new accounting standards, if those auditors issue modified opinion reports for their clients. A paper focusing on the Malaysian audit market reveals that Big 6 companies held 60% of the audit market (Iskandar, et al., 2000).

An analysis stretching over 42 jurisdictions reveals that the concentration of the audit market does not affect earnings quality for investors per se, however it becomes problematic if the market shares of Big 4 auditors are unbalanced (Francis, et al., 2013). The key feature of the study is that the audit market was analysed in a two-tier system which considered Big 4 auditors a distinct category from the other players on the market. While Big 4 auditors form a category of their own in many such studies, the picture might be misleading.

In such emerging markets like Romania, there are many companies which are part of an international group, and thus their consolidated financial statements are presented as part of the financial statements reported by the whole group. The simple Big 4/Non-Big 4 dichotomy can thus be considered inadequate for the purpose of this study.

The international literature review supports the view that competition in the audit market has the effect of consolidating the market share of large audit firms. Regarding the scientific literature derived from the two cases of emerging markets (Romania and Turkey); there is also a significant body of scientific literature dealing with the audit market.

In the case of Romania, the main findings deal with a variety of issues concerning audit missions. Hategan (2013) reveals that the audit of European programmes in the Romanian market has been concentrated in the portfolios of a handful of local auditors.

Tracking the market concentration for the Romanian and Turkish samples since Romania has become a member of the European Union is a daunting challenge for the researcher. The first obvious challenge to the scientific endeavour is the lack of proper disclosures regarding the audit benefits received during the audit mission. The aggregated consideration received from each audit client for all the equities generates for us the available audit market. Allocating that amount among the individual auditors based on the financial disclosures supplies us with the market share. However, such an algorithm cannot be developed for the comparative analysis, as these amounts are not disclosed in the annual reports of the issuers.

Thus, the analysis requires that the market share be derived through other methodologies. Even if the growth of the equities can be assessed using the previous analysis, it can only supply a determinant of the final audit fees as received by the audit company as they only pertain to audit risks, which are but a small component of the amounts demanded from the client by the audit firm.

The only incomplete method of determining the market share postulates that the key component of the audit market is its expanding customer base. While a large client can supply an entity with much of its revenue, audit rotation legislation prevents the auditor from permanently securing that particular client, unlike other markets where goodwill and other intangible qualities can insure that the customers remain loyal to one auditor or another. To remain anchored in the long run, an audit firm must consider the acquisition of a large and diverse client pool, from which it builds its reputation and reach.

The approach presented by this paper treats each client as an equal part of the overall audit market. The market share is thus measured in the number of audit clients acquired during the financial period, and the concentration is measured using the approach partly outlined by Wolk et al (2001), which employed Herfindahl indices. While the emphasis is on original audit reports there are nerveless several entities which submitted unaudited financial statements to their investor base. Even though subsequent restatements and revisions of those financial statements may have been accompanied by an audit report, the original statements were unaudited.

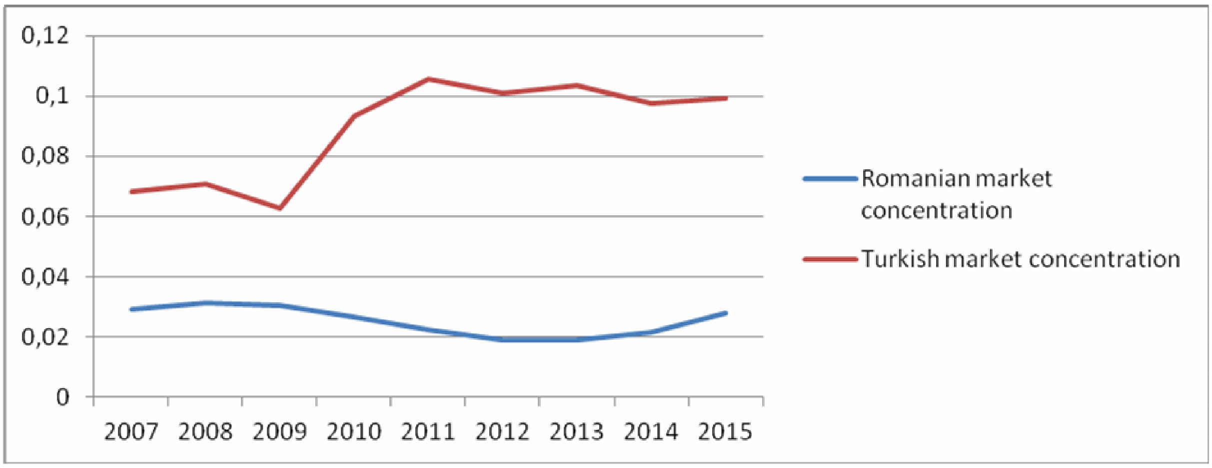

Figure 2 Changes in the audit market concentrations for the Romanian and Turkish markets

As the above chart reveals, the older Turkish equity market is more concentrated than its Romanian counterpart. The slight decline in the aggregate volume of assets held by Romanian issuers before 2014, coupled with a slight increase since 2014, appears to correlate with the evolution of the audit market. The trend reveals no significant upward shift in the market concentration in the case of the Romanian market, while the opposite trend appeared to happen in the case of the Turkish audit market. A Mann-Whitney test was used to determine if the two opposing trends are distinct or not. The usage of a Mann-Whitney test is critical to our understanding of the Herfindahl indices, since it allows us to assess whether the two samples are derived from independent populations, and the differences are not a result of random sampling.

In our case, the p-value for the Mann-Whitney test is less than 1%, and we can conclude that the evolutions of the two market concentrations are separate phenomena, even though the lack of a third population can affect the conclusion that the evolution of the Romanian audit market bears the hallmark of the European integration.

In the case of Romania, we can see a decline in the audit market concentration after it peaks in 2008. According to Laptes et al (2014), during 2009 we actually witness the decline in terms of actual numbers of audit firms. A possible explanation for this phenomenon would lie with the rearrangement of the market after so many entities left. It might just be possible that the surviving companies ware more experienced in dealing with the realities of the market than those prior to 2007, and more capable of securing a client from the ranks of publicly listed companies.

A second more valid explanation would have to deal with Hategan's research (2013). Joining the European Union has meant more than expanding the audit market for listed equities. A whole array of audit missions became available for professionals, both enterprises and individuals, like the audit of European projects. This expansion of the market has reduced the pressure on audit firms to secure a publicly-traded audit client in their portfolios, while in the case of Turkey the lack of such opportunities has probably meant that audit firms had no choice but compete for publicly-traded clients.

Conclusions

Unless a change in accounting regulations catches the Big 4 companies and their network of partners off guard, it is unlikely that their position will change significantly over the course of the following decade.

Features, such as leverage over the standard setting process and a global network permit Big 4 companies to operate easily across multiple jurisdictions, either directly through wholly-owned subsidiaries or through local partners. Needless to say, it is unlikely that there will likely ever be a spectacular fall like the one which affected Arthur Andersen after the Enron fallout.

However, Romanian auditors can hope to gain the right amount of skills which enable them to ensure a strong foothold on the local market. We could argue that European integration could actually enable the emergence of a competitive audit market, where the Big 4 firms do not have a monopoly over accounting and audit services.

However, the conclusions in this study are unfortunately limited by their scope and the lack of genuine transparency in financial disclosures pertaining to audit fees and non-audit services, which would offer a clearer image of the Romanian audit market.

For future papers, recommendations include the integration of value relevance models into audit quality narratives. Since the number of listed equities at the Bucharest stock exchange was small, compared to it much larger Turkish counterpart, conclusions derived from any value relevance model are exposed to abnormal values of Cook's distance and thus require novel designs for implementation

Regardless, more data is still required to successfully describe the impact of European integration on Romania's audit market.

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