Compliance with the provisions of the Corporate Governance Code by companies listed on the Romanian capital market with respect to the formation and functioning of audit committees

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Abstract. *The corporate governance pillars have been intensively discussed in the literature and the formation and functioning of the audit committees have a special place in this world. Considering the existing conclusions retained by the literature on the influence of the audit committees on the performance of the companies, we intend to analyse the current status quo of the level of compliance for the listed Romanian companies in this field. Corroborating the recommendations of the corporate governance code provided by the Bucharest Stock Exchange along with the provisions of the norms that regulate statutory audit in Romania, we find a positive evolution of the level of compliance for the Romanian companies with respect to the formation and functioning of the audit committees.*

Keywords: corporate governance, audit committee, comply or explain, audit, Romanian capital market.

Introduction

The phenomenon of corporate governance has been amplified under the scrutiny of the authorities following scandals followed by resounding bankruptcies such as the notorious Enron case. Since then and until now, the global economy has gone through a series of economic cycles, the most marked recession being that of 2008-2009, but also through periods of stability marked by slight increases, as it is from 2012 to 2020 (World Bank data), when the Covid-19 pandemic effects have influenced the markets. The subject of bankruptcies is retained by the literature, and corporate governance in this context is present, giving multiple evidence that corporate governance systems influence the activities undertaken by companies. Elements related to corporate governance systems can be taken into account in the predictive models of corporate bankruptcy (Chan et al. 2016, Nwogugu 2006). Among the pillars of corporate governance, audit committees and their functioning have a special place.

The audit committee is part of the structures having good governance, and in Romania, the formation of this type of committee at the level of listed entities is provided both as a recommendation within the Corporate Governance Code and by the specific legislation applicable to statutory audit. The subject of audit committees has not been bypassed by the literature, which retains the important role it has in governance structures. The importance of the audit committee is highlighted in relation to the reputation of the entity and public perception (Perez-Cornejo et.al. 2019, Rupley et.al. 2011), with risk management (W.Tai et.al. 2018; Baicu et al., 2020) as well as with financial performance and cost reduction (Bajra and Cadez 2018, X.Cai et al. 2015; Minciu et al., 2020). The role of the audit committee in ensuring the independence of the financial audit is also underlined by Cercello and Neal (2003), which shows that an audit committee with greater

independence and relevant experience is more effective in protecting financial auditors from a removal following the issuance of an unfavourable audit opinion.

We intend to cover within this paper the Romanian status quo of applying the corporate governance systems with respect to the formation and functioning of the audit committees. For this we will consider all the sources of corporate governance in Romania that influence the audit committees, both recommendations and regulations. Past papers retain the failure of the Romanian companies of forming board committees (Albu and Girbina 2015).

Literature review

International and local evidence

There are multiple studies in the literature that mention the link between the characteristics of the audit committees and the financial performance of companies. Hamdan et. al. (2013) shows a direct relationship between the functioning of the audit committee and the financial performance of companies in Jordan. On the other hand, a study that takes into account the financial performance of companies listed on the regulated market in Athens in the period 2008-2012 (Zhou et. al., 2018) shows that companies that have a more numerous board of directors also have better financial performance, but do not conclude in the sense of a direct relationship of the company's performance with the formation of audit committees.

Regarding the evidence for Romania, the audit committees are observed in papers that emphasize that there is not enough awareness regarding the importance of forming these committees (Fulop 2014, Bota-Avram 2012) and also a complete misunderstanding of the concepts, that resulted into the role of the audit committees being replaced by the boards of directors (Bota-Avram 2012). Without trying to look for mitigating circumstances for this misunderstanding of concepts, it should be noted that there are studies carried out for Romania, which highlight a non-alignment of the requirements of the regulator with the recommendations made under the Corporate Governance Code (Dobroteanu et. al. 2011). Feleaga et. al. (2012) also discuss the implementation of recommendations on the formation and functioning of audit committees and distinguish in their conclusions between state-controlled companies that have a lower degree of adoption of these recommendations and privatised companies or listed on the regulated market, where this degree is higher. In any case, as a result of the study of the literature, we have not encountered any studies that minimise the importance of the audit committees. Stefanescu and Turlea (2013) mentioned that "the audit committee is the foundation of corporate governance and generates added value through the transparency of financial information and the confidence it gives to stakeholders and the public in general". Existing studies (Albu and Girbina 2015) however, demonstrate for past periods that the application of the principles of the formation of committees at council level registers a low degree of compliance, similar to the implementation of procedures related to conflicts of interest or for the identification of transactions with affiliated parties. However, these past studies have their echoes heard by the companies that should comply with the corporate governance recommendations. A recent study by Mazars shows that in 2018 a series of recommendations under Section B of the BVB's Corporate Governance Code, related to risk management and internal control systems, registered a higher degree of compliance in 2018 than in 2017 (Mazars 2019). One of the explanations submitted by the authors of the study relates precisely to the entry into force of Law No. 162/2017 and the introduction of fines for non-compliance with the provisions relating to the formation of the audit committee, namely the organisation of the internal audit function, although the provisions of the law were in force in 2017.

In view of the above, we propose through this investigative approach to deepen the subject of the audit committees in the case of Romania. This paper contributes to the literature by answering the question of how the Romanian listed companies responded to the corporate governance rules regarding the audit committee, in the recent period also marked by new legislative paradigms and a new structure of recommendations formulated by the Corporate Governance Code. At the same time, on the basis of the expert papers consulted, the expectations are to see an increase in the degree of application of the recommendations on the training and functioning of audit committees.

Local regulations and Corporate Governance Code

The context in which this study was born is closely related to the obligations and recommendations regarding the formation of audit committees other than the decisions taken by the regulators, along with the conditions that should be met in order to be listed on the regulated market. In order to better understand the whole context, it should be mentioned that in Romania the concept of audit committee appeared in the early 2000s, when the concept was closely related to credit institutions (Stefanescu and Turlea, 2013).

Currently, the concept of audit committee is mentioned both by Law No. 162/2017 on the statutory audit of the annual financial statements and consolidated annual financial statements, and amending some normative acts, as well as by the Corporate Governance Code of Bucharest Stock Exchange ('BSE'). The major difference between these acts is the obligation to apply them. While the application of BSE's Corporate Governance Code is a matter of principle and the reporting takes the form of a formal "comply or explain" statement, the nature of law is binding. Thus, according to the provisions of the law, in Romania, entities of public interest must have formed an audit committee. It is quite clear and beyond any doubt that a company whose instruments are traded on a regulated market is an entity of public interest, both in accordance with Romanian and European legislation or international recommendations. Thus, the entities listed on the BVB are subject to this double and potentially redundant regulations of forming an audit committee.

Comparative analysis of the BSE's Corporate Governance Code and of the legislation

In the analysis of the legislation and of the recommendations regarding audit committees, we will take into account the provisions of Law No. 162/2017 as well as the recommendations provided by the BSE's Corporate Governance Code. We summarised these provisions in Table 1 below, grouping the instructions according to their nature. In the table below, appraising includes eo ipso monitoring, while monitoring does not include appraising, as the document does not mention in any way the finality of the monitoring process.

**Table 1. Comparative analysis of the provisions of Law No. 162/2017
and of the BSE's Corporate Governance Code**

Criteria	Law no. 162/2017	Corporate Governance Code
Existence of audit committees	yes	yes
Committee's dimension	no	yes - at least three members
Non-executive presence	Formed entirely of non-executives	At least one non-executive independent member

Criteria	Law no. 162/2017	Corporate Governance Code
Independence	The majority of the members should be independent	For Premium listed companies, the majority of the members should be independent
Professional expertise	At least one member must have competence in the field of accounting and statutory audit	At least one member must have proven and appropriate audit or accounting experience
The president of the committee	Should be independent	Independent non-executive
Responsibilities:		
- Internal control	Monitoring	Appraising
- Internal audit	Monitoring	Appraising
- Statutory audit	Informing the board on the audit opinion; monitoring; independent appraisal of the auditors; in charge of the auditor appointment	n/a
- Financial reporting	Monitoring, appraising and issuing recommendations	n/a
- Risk management	Monitoring	Appraising
- Affiliated parties	n/a	Appraising; issuing an opinion on affiliated parties transactions policy
- Frequency of meetings	n/a	n/a
- Frequency of reporting	n/a	at least on annual basis
- Functional reporting	n/a	Internal audit department reports to the board of directors through the audit committee

Source: Authors' analysis, based on Law no. 162/2017 and the Corporate Governance Code.

The above analysis summarises the main provisions of the two acts and highlights a greater emphasis of the statutory audit in Law No. 162/2017 compared to the BSE's Corporate Governance Code, which focuses its ideas more around the concepts of risk, internal control and internal audit. The above comparative analysis aims to highlight the main differences between what is mandatory to apply (i.e. Law No. 162/2017) and what is only a recommendation (i.e. the BVB's Governance Code). It is also worth mentioning that non-compliance with the provisions of law entails the risk of a fine from 50,000 lei to 100,000 lei, while non-compliance with the recommendations of the BVB entails only the obligation to explain the reason why they were not respected.

For the sake of completeness it should be noted that the Corporate Governance Code applies to all companies listed on the BVB, while Law No. 162/2017 applies to public interest entities that

fall under its incident (i.e. listed companies, credit institutions, insurance companies, non-bank financial institutions, payment institutions, pension funds, financial investment services companies, investment management companies, collective investment undertakings, central depositories, clearing houses, market operators, national companies, companies with majority state capital, autonomous public entities).

Also for the sake of completeness, it should be noted that the above table highlights the differences between the law and the corporate governance code per se, and does not emphasise the provisions stipulated by all the materials published by the BSE regarding corporate governance, namely the Compendium for Good Practices of Corporate Governance, respectively the Manual on Corporate Governance Reporting. They provide additional information regarding the interpretation of the provisions of the corporate governance code.

Methodology

The research methodology is based on the analysis of the declarations of conformity (comply or explain statements) published by the Romanian companies listed on the Bucharest Stock Exchange. It involves the construction of an index of application of the provisions of the corporate governance code (Albu and Girbina 2015) for the recommendations synthesised in category B of the declaration of conformity. In this respect, we analysed the comply or explain statements for 2017, 2018 and 2019 (the latest publicly available), published by the companies listed in the premium and standard categories at BSE. During this assessment, we pointed out on a 3-level scale the degree of compliance, as well as the accuracy of the explanation for non-compliance.

Therefore, the index is built on three levels, with 0 noting non-compliance, with 1 compliance in full, and with 0.5 non-compliance accompanied by explanations, if the explanations have been found not-satisfactory enough in order to be noted with 1. If for the first two levels described, the scoring can fall under objective rules (compliance or not), for intermediate scoring the subjectivity of the authors results in a limitation of this study. In order to diminish the subjective scale in scoring, the quality of the explanations offered was evaluated on the basis of the instructions provided by the Manual on Corporate Governance Reporting published by BSE. Further to our analysis, we will verify the application of these principles, based on the instructions included in the Compendium of Good Practices of Corporate Governance and the information included in the annual reports published by companies or on the websites of the companies analysed.

Specifically, we will structure the analysis on the basis of information related to the committee component. Although the compendium provides additional instructions regarding the committee's attributes, solely a numerical analysis based on whether or not these criteria are met, will not be relevant as the attributes must be evaluated in their depth and substance. A tick-the-box approach cannot assess how the responsibilities of the audit committee have been fulfilled or not. The quality of the formation of the audit county is a topic debated by the literature. Krishnan (2005) mentions measuring the quality of the audit committee in terms of three dimensions: size, independence and experience. Thus, the levels envisaged for the component of the committees are:

- analysis of the committee from the point of view of the presence of independent nonexecutive directors;
- analysis of the independence of the chairman of the committee;
- analysis of the separation between the position of chairman of the audit committee and chairman of the board of directors;

- analysis of the existence of a member of the committee with relevant experience in auditing/accounting.

In the analysis we reviewed the annual reports published for 66 companies for 2017, 64 companies for 2018 and 69 companies for 2019, verifying the information contained in the declaration of compliance with the corporate governance code and corroborating them with other information contained in the report. Thus, the analysis involved an extensive investigation of the reporting, corroborating information included in various sections of the annual reports in order to determine with a small error the factual situation.

We also correlated the data obtained as a result of the analysis carried out with the financial performance of the companies and their size. Thus, for the representation of financial performance, we chose as measures the return on assets and the return on capital (Ali and Nasir, 2015, Aanu et. al., 2014), calculated as in Table 2 below, and for the size of companies we considered the average number of employees and total assets.

Table 2. Financial indicators

Financial indicator	Abbreviation	Formula
Return-on-assets	ROA	Net profit / Total assets
Return-on-equity	ROE	Net profit / Total equity

Source: Jewel and Mankin (2011) and De Wet and Du Toit (2007).

Conclusion – preliminary findings

Based on the analysis of the comply-or-explain statement for 2017, 2018 and 2019, we see a positive evolution of the index that measures the degree of application of corporate governance recommendations for all recommendations in category B of the declaration of conformity. The 2018/2017 increase that can be observed in Table 3 below was consolidated in 2019.

Table 3. Index of compliance with BSE's corporate governance code

Code	Recommendation of the corporate governance code	2017	2018	2019	2018 / 2017	2019 / 2018
B.1	The Board should set up an audit committee, and at least one member should be an independent non-executive. The majority of members, including the chairman, should have proven an adequate qualification relevant to the functions and responsibilities of the committee. At least one member of the audit committee should have proven and adequate auditing or accounting experience. In the case of Premium Tier companies, the audit committee should be composed of at least three members and the majority of the audit committee should be independent.	55,65%	69,53%	71.09%	24,94%	2,24%

Code	Recommendation of the corporate governance code	2017	2018	2019	2018 / 2017	2019 / 2018
B.2	The audit committee should be chaired by an independent non-executive member	52,42%	66,41%	68.75%	26,69%	3,52%
B.3	Among its responsibilities, the audit committee should undertake an annual assessment of the system of internal control.	45,97%	60,16%	64.06%	30,87%	6,48%
B.4	The assessment should consider the effectiveness and scope of the internal audit function, the adequacy of risk management and internal control reports to the audit committee of the Board, management's responsiveness and effectiveness in dealing with identified internal control failings or weaknesses and their submission of relevant reports to the Board.	43,55%	60,94%	63.28%	39,93%	3,84%
B.5	The audit committee should review conflicts of interests in transactions of the company and its subsidiaries with related parties.	42,74%	60,94%	61.72%	42,58%	1,28%
B.6	The audit committee should evaluate the efficiency of the internal control system and risk management system.	43,55%	60,94%	64.84%	39,93%	6,4%
B.7	The audit committee should monitor the application of statutory and generally accepted standards of internal auditing. The audit committee should receive and evaluate the reports of the internal audit team. standards of internal auditing. The audit committee should receive and evaluate the reports of the internal audit team.	46,77%	67,19%	67.97%	43,66%	1,16%
B.8	Whenever the Code mentions reviews or analysis to be exercised by the Audit Committee, these should be followed by cyclical (at least annual), or ad-hoc reports to be submitted to the Board afterwards.	47,58%	67,19%	67.97%	41,21%	1,16%
B.9	No shareholder may be given undue preference over other shareholders with regard to transactions and agreements made by the company with shareholders and their related parties.	94,35%	96,09%	96.88%	1,84%	0,82%

Code	Recommendation of the corporate governance code	2017	2018	2019	2018 / 2017	2019 / 2018
B.10	The Board should adopt a policy ensuring that any transaction of the company with any of the companies with which it has close relations, that is equal to or more than 5% of the net assets of the company (as stated in the latest financial report), should be approved by the Board following an obligatory opinion of the Board's audit committee, and fairly disclosed to the shareholders and potential investors, to the extent that such transactions fall under the category of events subject to disclosure requirements.	45,97%	52,34%	57.03%	13,86%	8,96%
B.11	The internal audits should be carried out by a separate structural division (internal audit department) within the company or by retaining an independent third-party entity.	82,26%	86,72%	89.84%	5,42%	3,6%
B.12	To ensure the fulfillment of the core functions of the internal audit department, it should report functionally to the Board via the audit committee. For administrative purposes and in the scope related to the obligations of the management to monitor and mitigate risks, it should report directly to the chief executive officer.	49,19%	70,31%	74.22%	42,94%	5,56%

Source: Authors' own calculations.

Formation of audit committees

In the analysis of the formation of audit committees, out of a total of 64 companies analysed, only 42 formalised the request for the creation of a separate committee within the governance systems. A relevant point is that of the total companies analysed, 6 were insolvent in 2018. Thus, they had a special administration regime, provided by the legislation specific to the reorganisation procedures, the management of the board of directors ceasing at the time of the start of the insolvency process. In percentage terms, it is observed that 25% of the companies listed on the BVB did not constitute an audit committee, although this is contained in both the BVB recommendations and the specific legislation. As mentioned above, noncompliance must be explained. Different approaches to non-compliance can be extracted from the analysis of the information contained in the annual reports. If some of the companies have shown minimal diligence towards the subject, mentioning that the formation of committees is a topic on their agenda for the next year, more worrying is the approach of companies that have completely ignored this topic or mentioned that the tasks of the audit committee are fulfilled by a person or by the entire board of directors. Such an approach might lead to the idea that the requirement of the formation and functioning of the audit committees is not fully understood by the entities.

Independent non-executive directors

As is also apparent from the requirements of the governance code presented above, an essential aspect in the functioning of audit committees is the quality of its members. In the foreground we

can talk about the existence of at least one independent non-executive member at the level of the committee, according to the provisions of the corporate governance code. On the other hand, Law No. 162/2017 provides the fact that the majority of the members of the committee must be independent. Johnston and Nowland (2017) have also mentioned previous studies that demonstrate that the independence of audit committee members increases the effectiveness of quality supervision of financial reporting, but also mentions that attendance at the Chief Executive Officer's audit committee meetings is beneficial for the company. Analysis of the reports showed that out of the total of 42 firms that set up an audit committee, only 26 firms explicitly mentioned in the report or included relevant information proving that they comply with this rule, while 2 firms reported that they did not comply with this approach.

As a percentage (reported to the total number of companies that formed an audit committee), one-third of companies did not provide information on the independence of audit committee members. This lack of reporting does not necessarily lead to the fact that those companies did not comply with the provisions in force, but indicate slack of transparency. At the same time, the lack of reporting can be attributed to the fact that at the level of the analysed companies, there is a low degree of awareness of the relevance of the provisions on the formation of audit committees. Two companies that stated that they did not meet these requirements, based their argumentation by explaining the relationship between the company and the member/members of the audit committee, but did not provide arguments for why the rule is not respected. This behaviour is in line with previous studies relevant to Romania (Albu and Girbina 2015), in terms of the quality of explanations offered by companies that do not fully comply with the provisions of the corporate governance code.

By reference to the sample companies studied, the percentage of companies that are compliant with the rules regarding the existence of independent non-executive members is approximately 40%. However, this percentage is accompanied by inherent limitations, given the large number of companies that have not provided details in this regard.

Committee Chairman

In accordance with the provisions of the corporate governance code, as well as Law No. 162/2017, the chairman of the audit committee must be a non-executive independent. This is required to be reported separately in the 'comply-or-explain' statement on compliance with the corporate governance recommendations. In this analysis we took into account this report made in the above statement and checked where possible, based on the nominal reporting of the audit committee component. In the event that the company did not report the audit committee component separately, neither in the annual report nor indicated where its component can be found on the company's website, the information included in the declaration of conformity prevailed. Thus, out of the total of 42 companies that formed an audit committee, 33 said that the president is an independent non-executive member, and only 4 reported otherwise. Thus, it was found that a greater degree of importance was given to this aspect. As mentioned, this requirement is explicitly formulated as a separate recommendation within the corporate governance code. Although there is not enough information to allow us a clear conclusion in this situation, we can reasonably assume that this higher degree of compliance is also due to the fact that this requirement exists per se in the body of the statement, without the need for an in-depth analysis of the principles and materials regarding corporate governance. Formalism in reporting is a fact retained by the literature in Romania, and this explanation would once again confirm the mentality and approaches applied in practice at the time of reporting.

Also in the light of the quality of the chairman of the audit committee, we have followed in what way the companies have respected the guidance that the chairman of this committee does not hold the position of chairman of the board of directors at the same time. In this respect we have analysed the information regarding the component of the board of directors and the audit committee. The results show that only 22 of the companies took this recommendation into account, while for 19 of the companies it could not be determined whether this overlap of qualities exists. More than half of the companies that set up an audit committee have taken this separation into account. But by looking at all the listed companies that should have set up an audit committee and taken into account good governance practices, the real percentage is about 35%. A possible explanation for the low score in this category may be the existence of this recommendation at the level of the compendium of best practices, while neither the governance code of the BVB nor Law No. 162/2017 make no mention of this.

Relevant expertise within the Committee

Both, Law No. 162/2017 and the BSE's corporate governance code, mentions that at least one member of the audit committee must have proven audit or accounting experience. Although it is not very clear from the text of the law or from the good governance practices mentioned by the code or by the ancillary materials published by BSE, what means audit or accounting experience and since they do not mention the obligation of being a member of a professional body, we carried out a particular analysis based on consulting the names of the members of the audit committees and verifying their training as well as their professional expertise. This was done by consulting the CVs published in the annual report, on the company's website or from other external sources.

The analysis of this data revealed that 22 companies reported that at least one member of the audit committee has relevant experience in accounting or auditing. We have included here not only professional accountants, but also members of the audit committee with academic experience. The percentage is low if we think that the recommendation is not a new one, but was also included in the previous version of the corporate governance code. Thus, we cannot reason that the relatively recent change of the governance code (year 2016) or even the more recent adoption of Law No. 162/2017 did not provide sufficient time for the directors' mandates to expire and a new nomination to be made in accordance with new rules. Equally worrying is the lack of information for 19 companies, for which we could not determine whether they would not be part of the personal audit committee with relevant experience. The recommendation on the existence of a member accounting experience in audit committees is not new at all. Sarbanes Oxley law and the Combined Code also refer to this obligation. These results complement those obtained by Fulop (2014), which also finds a high percentage of companies for which it is difficult to obtain conclusive information in this regard.

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