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THE CHALLENGES OF CORPORATE GOVERNANCE AND AUDIT IN RELATION TO FINANCIAL PERFORMANCE – TRENDS, LIMITATIONS AND DIRECTIONS TO FOLLOW

PhD Student **Alexandra Narcisa CIOBAN (LUCAN)**
Ştefan cel Mare University of Suceava, Romania
alexandrac@seap.usv.ro

Professor PhD **Elena HLACIUC**
Ştefan cel Mare University of Suceava, Romania
elenah@seap.usv.ro

Abstract:

Through this paper we propose to identify and present the latest trends in valuing the corporate governance and audit features in relation to the company performance, measured in financial terms. Our research is qualitative, as it covers a wide range of approache from the perspective of academics and practitioners in the field. In this regard, we consulted the most important resources in the world scientific electronic documentation, such as: Thomson Reuters Web of Science, SpringerLink platform, PROQUEST Central, Oxford Journals, Emerald Journals and other research platforms. The contribution of this research it is valuable both for researchers in the area of financial accounting and practitioners, and aims to identify the recent challenges of the corporate governance and audit in influencing the financial performance of major companies around the world. We analyzed a variety of scientific publications on this subject, more than 70 empirical studies conducted in the US, China, Russia, Japan, India, Malaysia, the Arab countries, UK, Germany, Spain, Romania, etc. After having conducted the research, we carried out a platform with representative variables for corporate governance, audit and financial performance which will serve for future studies in the field. This will facilitate the researchers' choice for building econometric analysis models since we also surprised existing limitations.

Key words: performance, corporate governance, audit, financial performance indicators, empirical studies.

JEL classification: M41, M 42, G34,

1. INTRODUCTION

Globalization as an extremely active phenomenon in large corporations' life, the development of new information and communication technologies have given rise to new dimensions underlying the new economy which demonstrated its vulnerability through the most dynamic instrument through which information circulates. If we consider market instability and increased competition, customer infidelity, organizations' fragility, uncertainty of tomorrow due to social, political, religious scandals, all this require managers to make decisions against time in complex unknown situations.

The corporate governance (CG) in accordance with the best practices in the field comes to support and organize the power and the division between shareholders, directors and managers. A supportive item is represented by the audit, with two areas of coverage: internal audit and financial audit.

The impact and influence that these two mechanisms, GC and audit have, in financial performance is a topic of major importance, not only for the novelty of the concepts, but because the topic is „burning" for researchers, practitioners, investors, credit institutions, entrepreneurs and even for state representative bodies. In this research, we aim to identify and present the latest trends in the assessment of GC and audit in relation to financial performance, and to highlight existing limits. The study contributes to the accounting literature by the first part of the paper, where we highlighted the recent trends in governance characteristics such as: the size and independence of the Board, the frequency of meetings between the members of the Board, CEO duality, Advisory

Committees, institutional investors, indemnities granted to the management board, and auditing: audit quality, audit fees, the number of audit missions, the auditors' opinions concerning the performance. We notice in the paper that the vast majority of researchers measure the financial performance through rates of return, indicators such as EVA, Tobin Q, EPS, net income, retained earnings. We can say that our study is a trusted foundation for future empirical research by presenting in Part II, the main analysis variables corresponding to GC, to audit and performance.

2. LITERATURE REVIEW ON CORPORATE GOVERNANCE

Corporate governance is a set of „rules of the game" by which companies are managed internally and supervised by the Board of directors, in order to protect the interests of all stakeholders (Feleagă, 2011). Since the specialized literature on corporate governance is vast and sometimes controversial, we tried, trough this paper, to define „the rules of the game" by reviewing the main governance mechanisms.

Recent research on the field showed that monitoring and incentive plans are key ingredients for CG mechanisms. These mechanisms include the board structure with size, implications and responsibilities of board, then we can mention shareholders rights and specialized committees. In the following lines, we intend to develop the mechanisms of GC and show their implications on financial performance through the main empirical studies in the field.

2.1. BOARD STRUCTURE

An essential mechanism of corporate governance is represented by the **Board of directors**. It is set up to monitor the activities of managers in the company and helps to mitigate conflicts of interest (Black et all, 2003). Peter Drucker, the founder of modern management recalls in his work ″Management Practice" (2006) the responsibilities of the Board of directors as follows: establishing long-term strategic policy for profit, determining allowances, compensations or bonuses for the management staff, assessing the managers' performance and improving internal control systems.

Previous studies have shown that the *percentage of independent members of the Board influence positively and significantly the financial health of the company*. Foo and Zain (2010) took a sample of 481 companies listed on the Malaysian Stock Exchange and found out that those Board of directors which are more independent and diligent are associated with greater liquidity. This can be explained by the presence of independent directors in the Board of directors which shortens the period of the cash conversion cycle and the full disclosure of information on the other hand.

From the analysis of specialized articles and papers, it appears that the way of construction of the Board is closely related and even essential for the effective performance of the company. Heslin and Doanldson (1999) in their work „The Theory of Organizational Portfolio of the Board Composition" propose a new perspective on the determinant factors and consequences of the board composition. The paper reflects some implications of the new theory necessary for understanding the dynamic relationship between **board composition** and company performance. Thus, the new theory argues that companies with poor performance will tend to have more members of the executive committee, but will replace them with several **non-executive independent members** as financial conditions improve. It is assumed that non-executive members of the board are considered to have a greater degree of independence than executive board members. Therefore, non-executive members ensure adequate monitoring of the management activities and thus ensure a high financial performance.

On the same level can be placed the researches of Obradovich, Gill and Biger (2015), who argued in their paper, the importance of independent directors, since these ones are more able to advise and assist the Board, which helps to effectively manage the working capital, to make important decisions, which are useful in improving the company's financial health. A significant and positive relationship between the structure of the Board of directors and the financial performance calculated with **return on assets rate (ROA)** was obtained in the research belongings to Mariana Bunea and to Eugeniu Turlea(2016). The results obtained from the analysis showed a *close association between the productivity of the assets* of companies analyzed *(ROA) and the independence of Board members* and a poor to non-existent correlation between the composition of the Board and the financial profitability of companies calculated with **return on equity rate (ROE).**

Our attention has also been drawn by Victor-Octavian Müller's (2014) perspective, who, in his work, believes that **financial performance is the most important for the interested parties** in general and especially for shareholders, as this is an essential source for financing the current economic activity, thus helping to maintain and increase the business value, to share the quotas, which, in their turn, can attract investors and thus their funds. The results of the research confirmed the initial assumptions set by the author and showed a significant positive impact of the characteristics of corporate governance (especially the independence of the Board and the proportion of foreign managers) on the contemporary and subsequent financial performance expressed by **ROA**. We have to remind here that there is a negative relationship between ROA and CEO duality.

In the same consent are Mashayekhi and Bazaz (2008) who found a significant positive **relationship between non-executive members of the board and financial performance**. They concluded that the independence of the Board increases diversification, which will contribute both to lower risks and to improve performance.

Several researchers (Landier et all, 2013) from the prestigious Princeton University of United States have written a representative item for our topic in which they debate the issue of the **independence of the General Manager (CEO)** and the impact of this feature on performance. The results of the study demonstrated in a robust way, that those companies with a smaller number of independent directors have a lower level of profitability and provide to the shareholders lower performance following significant investments. But these results are not affected when the traditional management measures are controlled, such as the Board independence and size, the rights of shareholders, etc.

Othman and his collaborators (2009) studied three features of governance, namely, **the size of the board, its composition and the remuneration** of the executives for listed companies in Malaysia and they examined the relationship between the structure of the Board and the shareholders' wealth. They reported that the three elements play an important role in influencing the shareholders' wealth measured by EPS and by the return on investments.

Another feature of corporate governance which is intensely debated is the **CEO duality**, which involves performing the functions of general manager and chairman by the same person responsible for the tasks associated with these positions. Analyzing big businesses, we find that duality of the leadership has become common in corporations. Gill and Biger (2013) collected data from an impressive number of production companies and found that corporate governance improves efficiency of receivable effects, payable amounts and the efficiency of cash conversion cycle. Thus, a lack of independent management board creates difficulties for the ability to respond to an eventual failure at the general management level.

The attributes of the Board, such as: **the managers' age, the board independence, CEO duality, the board size** in relation to financial performance and investors' decisions were evaluated using a panel of 1155 companies from China in the period 1999-2004. The study (Bo et all, 2016) thus concluded: the corporate boards of directors who have several young managers, more independent directors, with a CEO who is not the chairman, influence positively the business performance and sustain proper investment decisions.

A recent paper (Malik & Makhdoom, 2016) confirms the *strong and positive relationship between corporate governance and financial performance*. The authors, analyzing the corporations from Fortune Global 500, have concluded that ***smaller sizes of the Board of directors create better performance***. The **frequency of meetings** between the Board of directors members was also shown to have an inverse relationship with the company performance. The study supports the independence of the Board of directors in order to improve transparency in the decision-making process within the Board. Also, the paper shows that *the compensations and indemnities* granted to the Board of director, have *an inverse relationship with the company performance*.

The same result was obtained by Hahn & Lasfer (2016) from the study conducted on companies in United Kingdom. They found that there were increasingly fewer **meetings of the Board**, mainly due to the significant increase in the proportion of non-executive foreign directors in the Board. As a consequence, those very companies recorded low yields of shares and an increase in conflicts due to huge compensation paid to the management that are not commensurate with the increase in financial performance.

We can say that the problems of executives remuneration and those related to corporate governance continue to attract attention at an academic, political, and mediatic level. Empirical evidence on the relationship between **management compensation** (which include salaries, bonuses, incentives, retirement benefits, payment scheduling) and financial performance are widely analyzed by Baixauli-Soler J.S and Gregorio Sanchez-Marin(2015). They obtained a positive correlation between CA incentives and performance, correlated to the shareholders' rights. The managers and directors of corporations in certain economic subfields, have had huge salaries, which are often contrasted with the relatively low salaries received by managers of other economic branches. The US case, which makes huge payments to the CEO and to Japan, where CEO salaries are low, is an epitome of this. At the same time, the huge differences in corporate governance structures between these economies are often highlighted.

2.2. SPECIALIZED COMMITTEES

Opinions on the influence of the structure and **number of committees** on performance are divided. Guira et al.(2010) found there is no correlation between the existence of specialized committees and corporate performance. Mcconomy&Bujaki (2000) have found a *positive correction between the number of advisory committees and implications for corporate profitability*. Also, the setting up of the audit committee can prevent financial fraud and provide higher market credibility to financial statements by creating a positive reaction in order to improve the company's share price.

Aldamen et al. (2012) indicate that the existence of specialized committees such as **the audit committee** monitor effectively the activities of the management board, since such committees are more likely to make objective decisions, without negotiation and deliberation. Their analysis revealed that the existence of audit committees of smaller size, as number of members, who have more experience and financial expertise, is strongly correlated with an increased financial performance.

2.3. THE RIGHTS OF SHAREHOLDERS/INVESTORS

Berle and Means (James, 1933) had suggested nearly a century ago that a form of dispersed ownership leads to poor performance, as a high concentration of shares tends to exert greater pressure on managers in order to maximize the value of the shares. In a study conducted on a sample of 216 companies in Spain and the UK it has been found that the legal protection offered to investors in each country influence governance mechanisms. The results show that a concentration of ownership and investor protection are substitute mechanisms when the value of the company increases (Castrillo et all, 2010).

Lately we put an increasing emphasis on the role of large shareholders as owners, in particular on the role that **institutional investors** play in corporate governance. Manzaneque M. et al. (2016) found that the directors appointed by institutional shareholders resistant to pressure, such as investment funds, pension funds, capital, etc., have a negative impact on financial non-performance and probable failure in business. Thus, a higher percentage of institutional investors within the entity is an incentive for managers to be efficient and focused on increasing the company value.

3. LITERATURE REVIEW ON AUDITING

Along with the specific characteristics of corporate governance mentioned above, the specialized literature brings to light the auditing as well, as a high support for the Board. Both interal and external audit are important mechanisms for monitoring the corporate governance structure, particularly in terms of ensuring the accuracy and integrity of financial reporting and the detection and prevention of fraud.

Florin Dobre (2016) managed, through his work, to highlight the interdependence between corporate governance and the financial audit. The results of the study showed that the **remuneration of auditors** is influenced by the characteristics of the managing board and by the financial performance that the entity has obtained. Thus, when entities have a dual management system, when the executive director is different from the general manager, bigger amounts of money are allocated for the audit process. Between **the profitability** of the entity **and the audit fees**, the authors obtained *a negative relationship*, as well as for the existence of an **audit committee**. Also, the higher a company is, or the higher the number of executive members of the Board is, the lower the remuneration of the auditor is, and the financial auditor's features seem to have little impact on audit fees.

Reviewing the studies elaborated in the audit field, we noticed that the problem of **audit fees** is a delicate one for companies around the world. A significant influence in their growth is held by the incumbency of financial and accounting reporting companies according to International Accounting Standards (IFRS). As stated by Cristina de Fuentes and Eva Sierra-Grau (2015) in a study conducted during 2002-2009 on Spanish companies, the transition from a national reporting system to an international one, with stringent requirements, resulted in a significant increase in audit fees due to the complexity of the work done by auditors and existing workload.

Another aspect analyzed by researchers related to the auditing feature in the company, is the **quality of the audit**. The quality of auditing missions is particularly influenced by the type of auditor, *specifically by its belonging to the Big 4 group*, since they provide increased credibility to the information from audited financial statements. A representative work is that of Maria Grosu et al. (2015), in which she highlights the fact that, until 2012, the audit market was dominated by the auditors from Non Big 4, and with the transition to IFRS, there is a higher preference for entities listed on BVB for the auditors belonging to Big 4. This is due, according to the authors, to the increased expertise and resources available to large auditing companies in the application of IFRS in other states, also sent to the offices in Romania.

Auditors' opinions on the financial statements and their impact on financial performance is another topic of our research. A recent study (Fülöp, Cordoş, 2013) revealed the significant associations between the type of audit opinion, audit quality (Big4 or nonBig 4) and the applied accounting referential. According to the results obtained, issuing an audit opinion is significantly influenced by the membership of a particular auditor, by the accounting referential applied and by the object of activity of the company audited. Specific to the period under review, the authors noted that after the transition to IFRS, the number of unqualified audit opinions has increased compared to the period before 2012, when the accountability reporting was done acoording to the Romanian accounting regulations.

Gîrbină et al.(2012), while analyzing the principles of implementation of the corporate governance in companies listed on the stock exchange, concluded that until the financial year 2011, there are in the auditors' reports many qualified opinions, justified by the poor application of accounting rules on revenue recognition, valuation of assets and ranking liabilities, impairment of assets, provisioning, etc. According to some researchers (Rodger et al., 2009), **auditors' opinions are at the heart of corporate governance** as they deal with important issues of accountability and control, contract and agency issues, performance and incentives. Legislators, the media and regulator authorities require that auditors play an active and independent role in matters related to corporate governance.

4. SOME RESEARCH CONCERNING FINANCIAL PERFORMANCE

The measurement of financial performance also presented problems in the corporate governance studies in terms of instruments used. Much attention has been paid in the specialty literature to measures such as the **return of assets rate (ROA),** *return of equity rate (ROE), increase of sales and economic value added, (EVA), equity prices. Positive relationships between GC and the performance of the company measured by* **ROA, ROE and Tobin Q**, were demonstrated by Thomas H. Noe (2011) and by Krafft et collab.(2014), with the emerging conclusion being that the corporate governance develops and depends from an endogenic point of view on the specific characteristics of the company and its environment.

Esla & Allam (2015) showed through their work that performance measures such as: the **return on assets (ROA) and the return on equity (ROE***) are closely related to the corporate governance.* However**, earnings per share (EPS)** as a measure of performance, showed *no significant change* as a consequence of applying the corporate governance. Adams and Veprauskaite (2013) conducted a study to explore the impact of corporate governance mechanism on the financial performance of the company. They used a probationary period of five years (2003-2008). The analysis found that **the CEO duality and the percentage of shares held by CEO,** has *a significant negative impact on* the financial performance expressed by **ROE, ROA and Tobin's Q indicator.** The parameter of the variable represented by the frequency of meetings within the Board is significant and negative for all three dependent variables used to express performance. Also, the coefficient of the dummy variable (CEO duality) is also significant and negative, but only if used as the dependent variable of economic viability. The coefficient of the variable represented by the company size was found to be significant and positive when used as dependent variable of ROE and ROA. Instead, this one is negative after its use as a measure of performance of the Tobin's Q indicator. The overall conclusion obtained by the researchers is that between the CEO dynamics and the performance of companies investigated there is a negative relationship.

5. THE IMPORTANCE AND LIMITS OF CORPORATE GOVERNANCE AND AUDITING IN RELATION TO FINANCIAL PERFORMANCE

We aim to highlight in what follows, the importance of analysis of corporate governance and audit in relation to the company's performance and limits retrieved as a result of this reviews.

Taking into account the national and international interest for this topic, we aimed to investigate the evolution of articles published on the topic „corporate governance within financial performance” and those on „influence of the audit on the financial performance”.

In this regard, we consulted the most important resources in the world scientific electronic documentation, such as: Thomson Reuters Web of Science, SpringerLink platform, PROQUEST Central, Oxford Journals, Emerald Journals and other research platforms. The contribution of this research it is valuable both for researchers in the area of financial accounting and practitioners, and aims to identify the recent challenges of the corporate governance and audit in influencing the financial performance of major companies around the world.

At first instance, we used the database Thompson Reuters Web of Science, where we looked for published articles which contain in the title, abstract or keywords terms related to these topics.

Figure no. 1 shows the evolution of the number of scientific articles published and the number of quotations on „corporate governance within financial performance” in the last 20 years. We obtained a total of 6024 titles that were indexed in the database. The total number of quotations is huge, 111 906 times, with an average quotation per article of 18.58. From the graph presented, we can see that the interest in the topic presented is increasing, culminating in 2010. Certainly, the economic crisis that began in 2007 has had a major impact in this evolution. If we refer to the number of quotations, we can see a continued growth, with the year 2015 being the one in which researchers have debated the subject the most intensely.

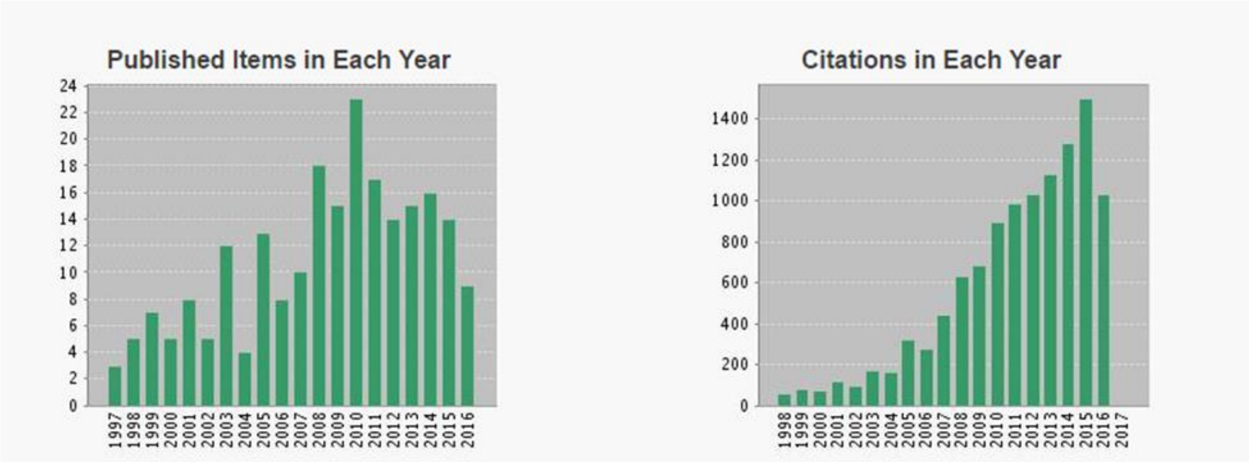

Figure no. 1. Evolution of the number of scientific publications and their interest on the subject of "corporate governance"and "financial performance" in the category of Business Economics
Souce: Thompson Reuters Web of Science

Figure no. 2 presents the number of scientific articles published and the number of quotations on „the influence of audit on the financial performance” of the past 20 years. We obtained a total of 715 titles that were indexed in the database. The total number of quotations is 10887 times, with an average quotation per article of 15.23. The graph shows a major interest for the topic since 2009. As for governance, the highest number of quotations was in the year 2015.

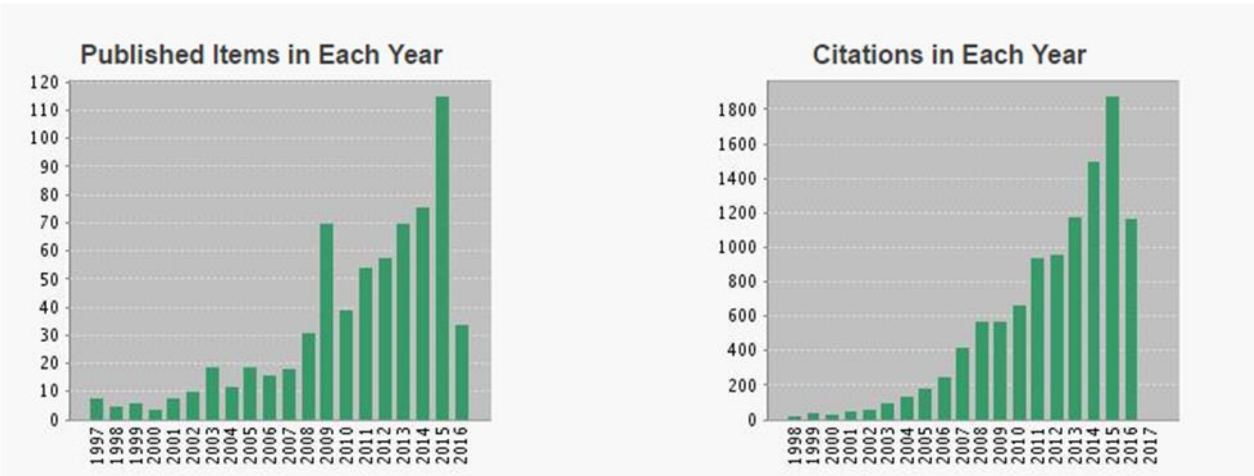

Figure no. 2. Evolution of the number of scientific publications and their interest on the subject of "audit"and "financial performance" in the category of Business Economics
Souce: Thompson Reuters Web of Science

From the above figures we can see that the researchers' interest to the subject GC audit in relation to financial performance is growing, citations of articles culminating in 2015, which demonstrates that the topic is ”hot”.

We took into account also the Central ProQuest platform to highlight the ”pulse” of the areas analyzed. From Figures 3 and 4 we can see that both scientific publications on GC and those with audit in relation with financial performance were part of a significant increase since 2010, and culminates in 2016.

We draw attention to the fact that the subject ”corporate governance” is quite current, the first item containing the concept appeared first on 1973, when the audit concept has been discussed since the early 1937. However, scientific events stood aut after 2000.

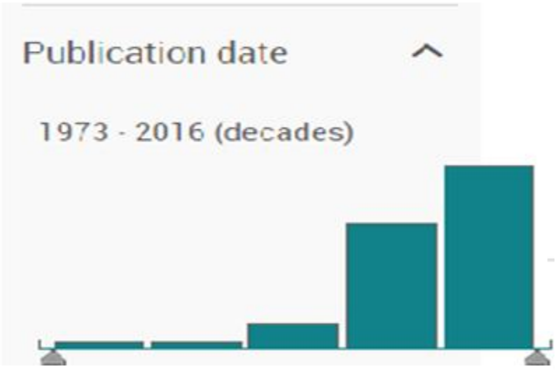

Figure no. 4. The evolution of scientific publications on GC and financial performance - ProQuest Central

Source: ProQuest Central database

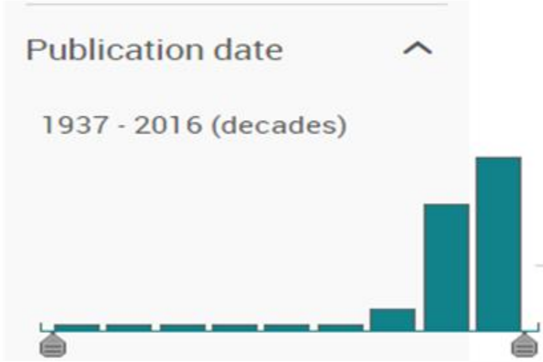

Figure no. 3. The evolution of scientific publications on audit and financial performance - ProQuest Central

Source: ProQuest Central database

In order to have certainty on the interest for researchers in the fields analyzed, we proceeded to analyze the number of scientific publications on other platforms as we can see in Table 1. A simple search by keywords: corporate governance and financial performance, and audit and financial performance in the category Social Sciences, we obtained the following results:

Tabel no. 1 The evolution of scientific publications on Audit and GC in relation to financial performance – top platform / database

Nr. crt.	The platform/data base	Number of scientific publications : GC and financial performance	Number of scientific publications: audit and financial performance
1.	Proquest Central	27.242	51.053
2.	SpringerLink,	25.591	28.385
3.	Oxford Journals	2.853	1.475
4.	Science Direct	16.929	13.742
5.	Wiley Journals	27.815	31.634
6.	Emerald Journals	15.208	16.270

Source: own processing

We raise the question, what would be the limits of corporate governance? As we stated in the first part of the article, governance means the way entities are managed. In this circumstance, we must not identify ,, the actors " nor to define ,, the stage" on which they serve. Judging from the analysis of the numerous studies conducted in the field, the perceptions differ depending on the purpose of governance. For some, principles and good practice are important, for others, GC means the relations between owners and corporations, about the exercise of power by the shareholders, institutional investors, and for some researchers , governance means social responsibility focused on stakeholders.

Although from the 90's, academics interest on the topic exploded, researchers long time have failed to provide an explanation on how governance operates. Today, governance borders are removed quickly by the fact that good governance is recognized by investors and regulators. Since the management process is affecting global financial markets, we can say that the importance of corporate governance in ensuring long-term success of the company is special. We can say therefore that limits our research are highlighted aspects of political, social and cultural of nations worldwide.

6. CONCLUSION

It is corporate governance important? Audit has a significant role in the company? These two concepts of GC and auditing may influence financial performance of an organization? Through this article we intend to answer the above questions. We chose to clarify these issues by analyzing 70 empirical studies carried out by researchers worldwide.

The scientific publications evaluated have shown that, the mechanisms of corporate governance affects financial performance, some positively, others in a negative way, but it is certain they have a significant impact on it. Thus, the board leadership structure, with features such as board independence, CEO duality, the number of meetings of the board members, compensation and indemnities, the existence of advisory committees and institutional investors are correlated with performance indicators.

If we take into discussion the audit, we can say that both its quality, the number of audit missions, audit fees and the stability collaboration with audit firm, are strongly correlated with financial performance in terms of rates of return (ROA, ROE, ROI), Tobin Q indicator, economic value added (EVA), etc.

Through graphs and table, we tried to highlight a summary of the main platforms containing scientific articles using variable GC, audit and financial performance. The period between 2010-2016, according to the schedule above, is the period when our subject was "hot" for academics. We observed also that interest researchers to the topic chosen is increasing.

In conclusion, we can say with confidence that the study contributes to the understanding of the relationship between the corporate governance, audit and the financial performance by examining and differentiated analysis of a significant number of articles. This research motivates us to conduct further research and to launch new lines of GC and audit analysis concerning the performance defined in relation to other economic and financial indicators.

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