

THE INDEPENDENCE ISSUE AND AUDIT A COMPARATIVE STUDY OF PORTUGAL (EU) AND NORDIC COUNTRIES – A THEORETICAL APPROACH

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Abstract

The objective of this paper is to speak about the issue of independence. To reach this goal corporate governance was considered as an example of good practices that may help organizations prevent fraud. Fraud was considered under a perspective of financial engineering - dedicated to building, enabling and displaying high dividends to shareholders that were non-existent. These events defrauded public opinion on the trust in the auditor and the confidence in the companies and showed the lack of independence of the different players. It must be said that the participation in these frauds was shared, at least, by the top management, the auditors and the accounting personnel. As an immediate consequence some ethical issues and guidelines for the reinforcement of the organization's internal control arose. As concerns the factor of independence, particular stress on the supervising and inspecting functions of the Portuguese Stock Commission –CMVM - was considered. This entity is responsible for the supervision of the listed companies but at the same time it inspects the auditor's work for the companies in its portfolio.

A benchmarking analysis with the Nordic countries of Norway, Sweden and Finland was done. This was undertaken because these countries show some relevant cultural and ethical differences and a peculiar cultural/organizational approach that should be considered.

JEL classification: K22

Keywords: frauds, corporate governance, ethics, independence, Nordic supervision

Received: 26.06.2020

Accepted: 31.08.2020

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INTRODUCTION

The objective of this paper is to speak about the issue of independence framing corporate governance as an example of good practices undertaken in an organization. To begin with, a description of the financial engineering associated with financial scandals – meaning the violation of the independence and exemption principles and the consequent appearance of good practices related to corporate governance will follow. Then, a comparison of these issues, taken from the EU in particular as to Portugal, in contrast with the Nordic perspective, will be considered.

To do this the following scheme will be considered:

- 1) Corporate governance as a response to large-scale financial scandals;
- 2) Financial engineering and fraud;
- 3) The problem of independence;
- 4) EU (Portugal) /Nordic perspective.

CORPORATE GOVERNANCE AS A RESPONSE TO THE LARGE-SCALE FINANCIAL SCANDALS

When speaking about corporate governance it is expected that a good example of good practices will be presented: it is the real output of an organization described both in the management and the audit report as expressed by its top management. One may say that corporate governance is a kind of comfort letter issued by the top management of the company addressed to all the stakeholders. This report is also based on the auditor's report and we must stress that the main reason behind the development of the concept of audit is the different parties' desire to count on the financial and nonfinancial information provided by companies so that they can verify their decisions, according to Mirihan, (2017).

Yet we cannot say that corporate governance is only connected to the audit report. It may be considered as a process made up of legal, contractual and market perspectives having as its goal to enable the maximum return to all *stakeholders*. This way it involves the board of management, the consulting staff, the auditors, and the executives of the organization (Frynas & Stephan, 2015). All these different perspectives are combined with important aspects such as:

- 1) Culture and integrity,
- 2) Harmonized accounting register (IFRS, IAS, ISA).

Culture and integrity are related to each country and specific culture and the related key values from which the ethical problems will emerge (*AICPA Code of Ethics 06-08*).

A Corporate Governance report will translate the application of the latest International Financial Reporting Standards – IFRS and IAS International Accounting Standards (Issued by IASB - International Accounting Standards Board, UK) and the auditor analysis will be guided by the ISA International Standards on Audit (Issued by IFAC - International Federation of Accountants, USA). This will enable some comparison of accounting worldwide because through these common tools one can assume some basis for international or global decisions (Dion, 2001). And besides the deep connection of entities from two different continents – Europe (UK) and America contribute to a formal harmonization and globalization of issues². International Accounting Standards Board (IASB) and the International Auditing and Assurance Standards Board (IAASB), are working more closely together to improve both sets of standards either on accounting or in auditing. Both boards provide feedback for their respective work plans, the development of standards, and their conceptual frameworks to improve the usefulness of the information.

How and why does corporate governance emerge and what relation does it have to all these entities?

After financial scandals the stakeholders mainly were a very important part of it, and the shareholders, were deeply defrauded. Investors, at the time, lost not only the money they thought duly applied in a good investment but at the same time they lost the confidence both in the auditor and the companies.

All of the above mentioned international and representative entities (IASB, COSO, IFAC just to name some) together created procedures, norms and schemes of supervision and control in order to reinforce the internal control of the organizations, in order to protect the shareholders, just to regain auditor credibility and financial statement transparency.

Corporate governance was a new issue and it arises as a set of good practices that organizations should perform in order to gain the public trust.

Let us look just at Table 1 where some big scandals like Enron, Parmalat, and Worldcom are typified. As it can be seen from this table, these cases of fraud have certain mechanisms of construction and here in this paper only some will be named but their construction starts with the sales of the assets or on the debt and a kind of associated financial engineering.

²<https://www.ifac.org/knowledge-gateway/supporting-international-standards/discussion/cooperation-between-iasb-and-iaasb>.

Table 1: Financial scandals in an International Scope

COMPANIES	SCHEDULE	YEAR	PROCESS
XEROX	False financial results on behalf of profits increase along 5 years	2000	The company has paid all fines and presently is operational
ENRON	Increase on profits on behalf of debt dilution (one billion US dollars) across group companies; manipulation of the Texan market; bribery in order to win public contests	2001	Bankruptcy
WORLDCOM	Increase of cash flows done considering the register of 3,8 billion US dollars as capital expenses in the P/L accounting; grant of a loan of 400 million US dollars to the founder of the company	2002	Bankruptcy
MERCK	Money registered in the company amounting to 12,4 billion US dollars concerning copayments that were never got	2002	Survived after paying all the due fines and presently has a Code of Ethics
PARMALAT	Fiscal Paradise triangulation was used as a global trade assumption	2003	Bankruptcy. In 2005 CEO Tanzi was still under trial

Source: Own work

FINANCIAL ENGINEERING AND FRAUDS

Financial scandals are characterized by some features like the ones presented in Table 2. We can say that these scandals evidenced a management with a high risk and not a risk management issue (Schroeder, 2014). Their goal was to grant high dividends to the shareholders on behalf of an increase of assets or a decrease of debt or an increase of income or a decrease of expenses. The final result of these changes is the accrual of profits and consequently the increase in dividends. High dividends appeal more to the investors and this way more money will go into the organization. Yet, when someone does a due diligence report about these companies or achieves a strict audit on these companies a grand 'make-up' is discovered in which the financial statements of the company are just covering a fraud.

As to the involvement of people in order to achieve this alteration or change of values in the financial statements, it can be said that not only the top management of the organization but also some employees and the auditors are involved in this new display of profits (Wolk et al., 2008). The accounting theory among many others such as the legitimacy or the stakeholder theory registered a collapse by that time (Mark, 1995; Donaldson & Preston,

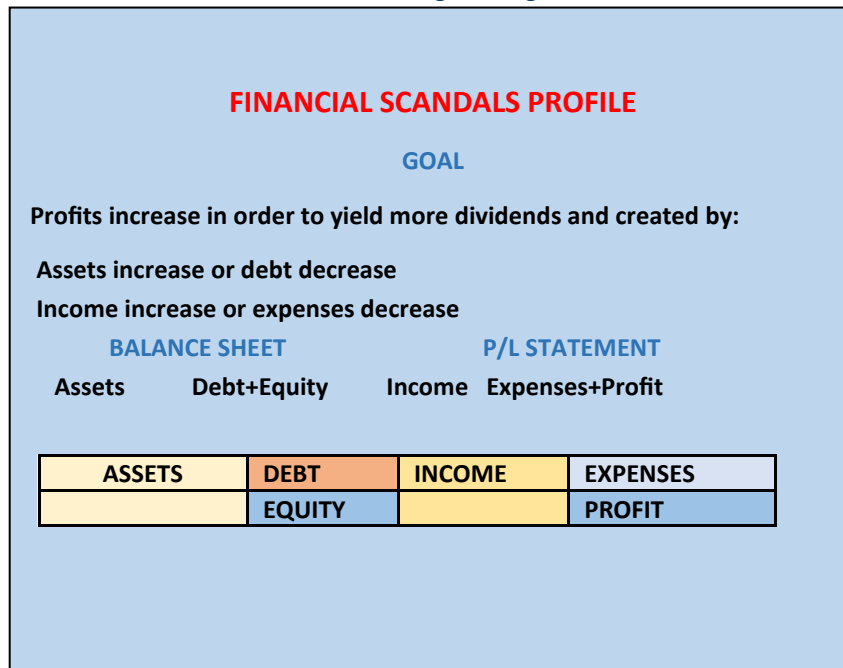
1995). All the theoretical and academic efforts were down after these events.

So at this point of this issue one may ask: what about the independence of the auditor and what about the ethical behavior expected from the top management of organizations?

Some authors (Windsor & Rasmusen, 2009) have considered a connection between the rise of regulatory capitalism and the decline of auditor independence and concluded that the transformed profession has become the transformer but at a price, the loss of public confidence and the decline of auditor independence. Conflicts of interest are still around.

Gaffikin et al. (2012) considered the moral reasoning of public accountants in the development of a Code of Ethics in Indonesia. Yet their findings could be got in any part of the world. "It is concluded that the role of moral reasoning is an important influence on achieving ethical awareness in public accountants and financial managers. The development of a full code of ethics and an effective compliance monitoring system is essential for Indonesia if it is to play a role in the emerging global economy". Rodgers and Al Fayi (2019) consider the strengths and weaknesses of three ethical pathways in a decision-making model (described as the Ethical Process Thinking Model)

Table 2: Financial engineering and frauds



Source: Own work

and the study findings highlight that individuals’ different perceptions and judgments, as well as information signals can lead to different reporting lines (decision choices). The three dominant ethical pathways (i.e. preference-based, rule-based and principle-based) are very important for ethical procedures.

Yet all the researchers focused on this issue agree that the ethical issue is the most important to be preserved in business.

ETHICS AND INDEPENDENCE

AN ETHICAL ISSUE

The individual's action is directly conditioned by the ethical climate of the company, either by those working inside or by the policies therein implemented. Mercier (2004, p. 32) argues that “the individual ethic is related to each goal of living” which is determined by personal experience. In a business context, this is the result of the interaction between the behaviors of superiors and their staff, thus resulting in the ethical climate of the company and furthermore by competitors. Additionally, it is influenced more indirectly by the climate of the professionals and the possible existence of regulations in the profession, as in the case of certified accountants who are governed by

their status and deontological code. The ethical climate of business also arises from the interaction between companies that participate in the company’s activity as customers, suppliers and others (Gaffikin et al., 2012). Living in society, the individual disseminate what they have learned to the heart of the company thus becoming the ethical climate of the society, which includes all the necessary connections to the development of the company's economic activity in the global market (Mihriban et al., 2017).

Analyzing the factors that characterize unethical behavior and the elements that determine the ethical attitude it can be concluded that “ethics is a strategic key for the survival and profitability of the firms involved in a fierce and global competition” (Abdelhak et al., 2019). The importance of ethics in companies has increased with the relevance of the issue of corporate governance in the present global market due to its determinants (Jonny & Geoffrey, 2014). The historical reference above described shows the interest in implementing rules and procedures, so that good governance practices exist for the commonwealth of the society (Bruton et al., 2010). It is not just a current and present concern. Back in the 18th century there was already evidence of this issue, for instance the

³founded in the 19th century in Carolina, USA, having actually more than 330 000 members.

the original draft of the Company of the General Commerce of Grão-Para and Maranhão in South America (Brazil). As t northern America, the American Institute of the Certified Public Accountants whose Code of Ethics (in force since 2014 and revised in June 2019) in its article 21, states that the independence consists mainly of two basic elements:

- 1) Independence of mind allowing an individual to act with integrity and exercise objectivity and professional skepticism;
- 2) Independence in appearance as the avoidance of circumstances that might cause a reasonable and informed third party who has knowledge of all relevant information, including the safeguards, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or member of the attested engagement team is compromised. Instead, the member should determine whether such influences, if present, do create a threat that a member would not act with integrity and exercise objectivity and professional skepticism when performing its work.

After considering the issue ethics, we are presenting now some situations or questions that may reveal some lack of independence.

INDEPENDENCE ISSUE

The independence issue implies some questions:

- 1) How can the auditor be independent if his/her services are subcontracted directly by the top management of the company to be audited?
- 2) What kind of independence is shown by the supervision body of the listed companies – CMVM – Stock Supervising Committee in Portugal- if this supervising entity is responsible for the inspection of the auditor’s work on the companies listed in its portfolio? Where is the exemption and independence of this entity?
- 3) Sometimes companies use personal references or relations to get the auditor appointment and one could ask what kind of independence is this?
- 4) Other times big consulting companies render non-auditing services and auditing services at the same time. They do not use the same brand name but they are companies belonging to the scope of the same consulting group. Where is the independence factor?

These are questions that one could pose and that are related to any audit and to which some improvement suggestions are made:

Table 3: Improvement suggestions

Issues	Suggestions
a-Top management/auditor	Independent contracting entity that would name auditors
b- Supervision inspection	Independent contracting entity that would inspect auditors work
c-Personal references	Rotation of auditors being compulsory after a mandate
d- Non audit /audit	An independent entity should supervise this audit work as well as non-audit services

Source: Own work

As to situations a, b and d, it is a very hard issue because one should convince the present supervising bodies to delegate this duty to an independent third party. To be effective the government should nominate it. On the other side for the companies this would result in a good measure of independence for they should address this entity in order to contract an auditor; besides this duty this entity would also be responsible for the inspection of the auditor’s work. As to the non-audit and audit functions this entity should have the same procedure. Thus, this scheme would result in a supervising and inspecting body placed in the middle of the chain: between the au-

ditors, the companies and the stock exchange commission. As a result, the independence and exemption of the Portuguese stock exchange committee (CMVM) would be real. As to issue c - the rotation of the auditor could be an easy task for the Order of Auditors together with a government decision to implement it.

These suggestions were done after reading what happens, presently, for instance, in the Nordic countries. These countries, quite a while ago, for cultural and geographical reasons, have treated these issues of independence and exemption in a strict and clear way that would be advisable to be followed.

SUPER VISION IN PORTUGAL - EU AND NORDIC COUNTRIES

The “state of the art” of corporate governance is a kind of statutory regulation in the form of company law and other mandatory rules issued by the government or official authorities.

Self-regulation is defined and enforced by the business sector itself and informal norms and practices influence the way corporate governance is carried out in practice. A main part of any corporate governance report is based upon the auditor’s opinion and the objective of this paper is to address two fundamental traits: the supervision and the independence.

In Portugal, the Stock Exchange Commission - CMVM performs the inspection of the auditor’s work and opinion on the companies that are therein listed. There seems to be some lack of independence and exemption as to the supervision. Besides, as to the engagement of the auditor it is done directly between the companies and the auditors.

In the opposite perspective, either as to the geographical location or as to the cultural traits, the Nordic region of Europe, exhibiting strong and homogenous norms and value systems, combined with a high degree of social control, typical of small communities, that define and characterize these societies, reveals some features of transparency and independence that are quite interesting.

So, two of these issues are going to be considered: the supervision of the audit work and the audit independence across the countries of Norway, Sweden and Finland.

SUPERVISION OF THE AUDITOR WORK

Across this description the names of the countries will have associated the respective entity responsible either for the supervision or the auditor engagement.

Norway- *Finanstilsynet’s (The Financial Supervisory Authority of Norway) independent government agency The Act on auditing and auditors (Auditors Act) supervises audit activity. Audit firms which audit annual accounts for entities subject to the statutory audit obligation must be authorized by Kredittilsynet. Authorization is granted to firms that meet the requirements of section 3-5 of this Act. The titles “registered auditor” and “state authorized auditor” may only be used by persons who are authorized according to the provisions of this chapter⁴.*

⁴Source: KREDITILSYNET Norway. Legal authenticity remains with the official Norwegian version as published in Norsk Lovtidend - <https://app.uio.no/ub/ujur/oversatte-lover/data/lov-19990115-002-eng.pdf>.

Finanstilsynet’s (The Financial Supervisory Authority of Norway) tasks in relation to auditors comprise approval of individuals and firms in accordance with the legal requirements applying to the profession as well as registration and supervision. It was formerly named *Kredittilsynet* (the Credit Supervisory Authority), but changed its name to *Finanstilsynet* in December 2009.

Supervision encompasses entities listed in the register of auditors, and includes checking that their activities comply with laws and regulations and that, besides, they are conducted in an appropriate and satisfactory manner.

Finanstilsynet is an independent government agency that builds on laws and decisions emanating from the Parliament (Stortinget), the Government, the Ministry of Finance and on the international standards for financial supervision and regulation.

Through its supervision of enterprises and markets, Finanstilsynet strives to promote financial stability and orderly market conditions and to instill confidence that financial contracts will be honored and services performed as intended. In addition to its preventative work, Finanstilsynet maintains a preparedness for dealing with concrete problems that may arise. Finanstilsynet’s premise is that Norwegian enterprises must be afforded competitive conditions which all in all are in line with those enjoyed by institutions in other EEA member states. Finanstilsynet is responsible for the supervision of banks, finance companies, mortgage companies, insurance companies, pension funds, investment firms, securities fund management, market conduct in the securities market, stock exchanges and authorized market places, settlement centers and securities registers, estate agencies, debt collection agencies, external accountants and auditors.

According to Eilifsen (1998), more than 20 years ago, the salient features of the Norwegian audit environment may be defined by:

- 1) the government's high expectations and demands towards the auditing profession;
- 2) a trusted and active auditing profession acting with considerable authority, especially in matters related to the conduct of an audit;
- 3) a close interaction between the government and the profession, characterized by caution and sensitivity to each other's position than by confrontation;
- 4) the presence of an auditing legislation;
- 5) a well-established and broad statutory audit requirement;

- 6) some auditor responsibility for stewardship verification;
- 7) the statutory auditor's responsibility for control of the auditee's tax obligations; and
- 8) a general supportive climate for international harmonization efforts in the auditing area

Sweden - *Swedish Inspectorate of Auditors (SIA) is the government's expert authority*

In Sweden and dating back to 1973 the supervision of auditors is a task to be performed by the state. At the time this function was transferred to a department within the governmental authority - National Board of Trade - from the private institution Stockholm Chamber of Commerce. In 1995, the organization took its present form. (RN) was established by the Swedish Parliament in the Auditors Act of 1995, succeeded by the present Auditors Act (2001:883), hereafter referred as the Auditors Act.

About the Swedish Inspectorate of Auditors (SIA⁵) - it is the government's expert authority in matters relating to auditors and auditing. In brief, its mission involves:

- 1) securing nationwide access to qualified auditors, so ensuring that the world of trade and industry and the rest of society has access to professionals who are able to audit limited companies, banks, insurance companies, economic associations, foundations, authorities and other associations conducting financial activities;
- 2) responsibility for ensuring the appropriate development of generally accepted auditing standards and professional ethics.

To reach these goals some actions must be undertaken:

- 1) providing an examination regime for auditors, as well as approving and authorizing auditors and registering auditing firms, and
- 2) supervising qualified auditors and registered audit firms.

SIA's activities help to maintain a high quality of auditing and professional ethical requirements, while also ensuring that investors, companies, institutions and other stakeholders have access to reliable economic and strategic information needed for proper financial management

⁵ <https://www.revisorsinspektionen.se/en/English/>.

and sound strategic decision-making. The ultimate purpose is to maintain trust and confidence in the auditors and in the work that they do, as well as in the authorization system.

Finland - *The Auditing Board of the Central Chamber of Commerce examines annually the reports of auditors*

There are two categories of authorized auditors in Finland defined⁶ in the Auditing Act section 2:

- 1) KHT auditors, authorized by the Auditing Board of the Central Chamber of Commerce of Finland and;
- 2) HTM auditors, authorized by Auditing Committees of regional Chambers of Commerce.

According to the Auditing Act and other laws it is also allowed to elect an authorized audit firm as an auditor. So there are two kinds of authorized audit firms in Finland:

- 1) KHT audit firms, authorized by the Auditing Board of the Central Chamber of Commerce of Finland and;
- 2) HTM audit firms, authorized by Auditing Committees of regional Chambers of Commerce.

Supervision of Auditor's Annual report

The Auditing Board of the Central Chamber of Commerce examines annually the reports and documents delivered by the authorized auditors and authorized audit firms in order to check if auditors and audit firms still maintain their proficiency and other required authorization / qualification. The objective of supervision is also to ensure that authorized auditors and authorized audit firms observe the Auditing Act and any provisions given by virtue thereof.

The Auditing Board of the State, the Auditing Board of the Central Chamber of Commerce or the Auditing Committee of a regional Chamber of Commerce have the right to obtain all documents and other records considered necessary for the supervision of the authorized auditor. They may also examine documents and other records on the premises of the authorized auditor. In addition the authorized auditor shall, without unnecessary delay, submit to the supervisory authorities any requested information or reports necessary for the supervision.

⁶ The authorisation and supervision of auditors and audit firms in Finland, http://www.congreso.es/docu/docum/ddocum/dosieres/slegelegislatura_10/spl_80/pdfs/17.pdf.

ENGAGEMENT OF THE AUDITOR

Norway – *Finanstilsynet related to the Minister of Finance*

The Office of the Auditor General of Norway (Norwegian: *Riksrevisjonen*) is the state auditor of the Government of Norway and directly subordinate to the Parliament of Norway. It is responsible for auditing, monitoring and advising all state economic activities, including financial audits, performance audits and corporate control.

Companies have to seek a statutory auditor to conduct an annual audit about the financial situation of their organization. The contact is the Financial Supervisory Authority of Norway - *Finanstilsynet* that depends on the Minister of Finance.

Sweden – *RN related to the Minister of Justice*

Revisorsnämnden (RN) - Supervisory Board of Public Accountants RN is a governmental authority under the Ministry of Justice. RN is the government's authority for all matters concerning auditors. RN has two overall tasks; firstly, to provide the Swedish business world with highly qualified auditors and, secondly, to supervise and regulate those auditors (Dias & Santullano, 2016). If a registered public accounting firm is appointed as an auditor, the name of the principally responsible auditor shall be registered with *Bolagsverket* (official registration of organizations).

Finland – *Auditing Board related to the Chamber of Commerce*

There are two categories of authorized auditors in Finland defined in the Auditing Act section 2:

- 1) KHT auditors, authorized by the Auditing Board of the Central Chamber of Commerce of Finland and;
- 2) HTM auditors, authorized by Auditing Committees of regional Chambers of Commerce.

According to the Auditing Act and other laws it is also allowed to elect an authorized audit firm as an auditor.

In brief, all the three considered Nordic countries evidence strict measures of supervision and engagement that depend directly from governmental entities what enables an accrued value of trust to all the stakeholders.

CONCLUSION

This paper stated in its introduction that its goal would be to deal with the independence issue. To reach this aim financial scandals were described in order to evidence the fraud in the financial statements on behalf of the auditor, of the employee and of the top management involvement. As a consequence of these events a relation between corporate governance was done in the sense of naming some good practices in the company that support the undertaking of strict and deep measures and procedures in order to prevent fraud occurrence. The independence issue was considered associated to the consideration of conflicts of interest. There are no unique decisions that result in an organization but there are some good practices that international benchmarking may enable.

In this study the Nordic countries were considered, and their good practices were identified either inside of the organization - through the application of a strict code of corporate governance or on the outside as concerns the real independence of the supervising entities.

In Table 4 we can summarize the main features found in the Nordic countries against the Portuguese reality.

Table 4: Main features of Nordic countries/Portugal

Countries	Supervision on audit depends on	Engagement of the auditor belongs to
Norway	Finanstilsynet's (The Financial Supervisory Authority of Norway) independent government agency	Finanstilsynet independent government agency related to the Minister of Finance
Sweden	Swedish Inspectorate of Auditors (SIA) is the government's expert authority	Revisorsnämnden (RN) - Supervisory Board of Public Accountants RN is a governmental authority under the Ministry of Justice.
Finland	The Auditing Board/Committees of the Central Chamber of Commerce examines annually the reports	Auditing Board/ Committees of regional Chambers of Commerce
Portugal	CMVM – Portuguese Stock Commission	Organizations

Source: Own work

It may be concluded that the independence issues in Norway, Sweden, Finland were planned quite a while ago and result in a sound defense of the shareholder interest may he be in the minority or majority, thus, presenting financial statements with an accrued transparency and trustfulness. One may say that this represents an added value to any kind of business. Yet, one must stress that this issue must be framed under a cultural approach.

Limitations of the study: the perspective of Denmark was not included and the detailed analysis of the Corporate Governance Code of each country was not described.

Future paths for investigation: an enlarged scope of analysis of all the Nordic countries including Denmark would be interesting and furthermore, the consideration of some companies presenting a corporate governance report from the USA would result in an interesting match.

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