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# Corporate Governance and Financial Reporting Quality

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**Abstract**

This research delves into the influence of corporate governance on the quality of financial reporting by conducting an extensive review of existing literature. The analysis sourced articles from accounting journals and published materials from 2013 to 2023. Through this examination, we identified areas with inadequate information and gaps in the literature, underlining the necessity for further research. Furthermore, this paper presents pivotal insights and investigates various facets of financial reporting quality. The study reviewed six theories -stakeholders' theory, agency theory, stewardship theory, core competencies theory, transaction cost analysis theory, and resource-based view theory. This study concludes that corporate governance has significant implications for the quality of financial reporting.

**Keywords**: Corporate Governance, Financial Reporting Quality, Agency Theory, Stewardship Theory, Core Competencies Theory

## 1. Introduction

### *1.1 Background to the Study*

The concept of financial reporting quality in financial accounting has been carefully explored by accounting scholars, consequent upon the outcome of significant corporate collapses. The quality of financial reports is critical for ensuring their impact and usefulness in the decision-making process by users (Asyik et al., 2023). In addition to its economic relevance, financial reporting quality extends to non-financial information, providing valuable insights for economic decision-making (Herath et al., 2017; Asyik et al., 2022). The global financial crisis in 2008 further emphasized the need for financial reporting quality to assure investors of the safety of their investments, leading to a greater demand for comprehensive information disclosure, increased specificity, and more frequent regulatory reporting. In accounting, the quality of financial information is evaluated based on its relevance and reliability. Relevance pertains to meeting the information needs of users, while reliability involves faithfully representing underlying economic events.

Corporate governance encompasses a set of guidelines, principles, and rules governing the operations of a business. Well-administered firms are expected to produce high-level financial information. The essence of corporate governance is to serve as a guide from the supposed

tendencies of managers to take advantage of stakeholders, ensuring that their conduct is in line with best practices and in a manner that is not detrimental to the interests of shareholders. It affirms that shareholders' stake in an organization must be protected accordingly.

Good corporate governance practice is an avenue for reducing information asymmetry by ensuring that the appointed managers do not engage in fraudulent financial reporting practices that tend to conceal their poor performance by providing financial reports that are deviant from real economic activities. Thus, it is expected that good corporate governance should serve as a means of ensuring financial reporting quality.

Corporate governance plays a crucial role in ensuring high-quality financial reporting within organizations. Corporate governance influences financial reporting quality through the following:

Board Independence and Oversight: Effective corporate governance structures include independent boards and audit committees. These bodies oversee financial reporting processes, ensuring they adhere to standards and are free from bias or manipulation.
Internal Controls: Good governance promotes robust internal control mechanisms. These controls help in preventing errors, fraud, and misstatements in financial reports, thereby enhancing their reliability and accuracy.

Transparency and Disclosure: Transparent governance practices encourage clear and comprehensive disclosure of financial information. This transparency builds trust among stakeholders, reducing information asymmetry and the likelihood of financial misreporting.
Ethical Standards and Accountability: Strong governance frameworks uphold ethical standards and accountability at all organizational levels. This discourages unethical practices such as earnings manipulation or misleading financial disclosures.

External Audit Quality: Governance influences the selection and oversight of external auditors. High-quality governance ensures auditors are independent, competent, and objective, thereby improving the reliability of audited financial statements.

Long-term Perspective: Effective governance encourages management to adopt a long-term perspective in financial reporting. This minimizes short-termism and promotes sustainable business practices, reflecting the true economic substance of transactions.

Compliance and Regulation: Governance frameworks ensure compliance with relevant financial reporting regulations and standards (e.g., GAAP, IFRS). This adherence enhances the comparability and consistency of financial reports across companies and jurisdictions.

In conclusion, strong corporate governance fosters an environment where financial reporting is accurate, transparent, and reliable. It safeguards the interests of stakeholders and contributes to overall market confidence in the organization's financial health and performance.

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*1.2 Objective of the Study*

The paper aims to survey and synthesize literature on the impact of corporate governance on the quality of financial reporting.

## 2. Literature Review

*2.1 Conceptual Framework*

2.1.1 Financial Reporting Quality

Financial reports are essential tools for showcasing a company's performance and attracting external funds. These reports offer exact descriptions of operations, income, expenses, capital, and cash flow, crucial for stakeholders such as management, customers, regulators, communities, and other interested parties. In accounting literature, various measures are used to assess financial reporting quality, with reported earnings quality being a commonly utilized proxy. High-quality earnings are particularly relevant for investors when engaging the stakeholders and have the potential to forecast future earnings accurately.

In accounting literature, there are many variants for measuring financial reporting quality and researchers have yet to settle for a particular measure as a generally accepted proxy for financial reporting quality. However, reported earnings quality is commonly used by researchers in accounting as a proxy for financial reporting quality. Earnings quality is of significant relevance to investors when contracting with other stakeholders (Valdiansyah&Murwaningsari, 2022). High-quality earnings have a high potential to forecast future earnings (Alhadab& Al-Own, 2017).

High-quality financial reporting serves as a means of reducing information asymmetry between the shareholders and the managers by the legal obligations of the company (Landsman et al. 2012). In the submission of Akgun et al. (2017), financial reporting quality serves as a means of increasing the standard of employees' responsibility for preparing monetary statements. In the suggestion of Dang, Nguyen, and Tran (2020) earnings quality is a means of reducing asymmetry between the managers and stakeholders by ensuring that the stakeholders get true information regarding the performance and position of an entity.

2.1.2 Elements of Quality

According to the International Accounting Standards Board (IASB), assessing financial reporting quality involves evaluating the faithfulness and quality of disclosed information in a company's financial reports. Achieving high-quality requires report to be faithfully represented, comparable, verifiable, timely, and understandable. Therefore, emphasis is placed on transparent and accurate financial reporting, free from misleading information, and precision and consistency are crucial factors in this process.

2.1.3Relevance

Relevance is connected to the usefulness and materiality of information. It demonstrates the ability of information to impact user decision-making. Information in financial reports guide users in their decisions, it is considered relevant. Additionally, information helps users assess and confirm events whether current or past which they deem useful.

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The helpfulness of decision-making, which is afundamental part of relevance, aligns with the conceptual framework (Cheung, Evans, & Wright, 2010).

2.1.4 Reliability

Reliability is an element associated with financial reporting quality. Information in financial reports need to be reliable, valuable, and trustworthy. This standard is attained when the information users rely on is devoid of bias and material errors. Reliability is evaluated based on the grounds of the qualities of faithful, confirmable, and unbiased information (Cheung, Evans & Wright, 2010).

2.1.5 Comparability

This allow stakeholders to evaluate financial statements and analyze the financial position, cash flow, and performance of an entity. This assessment enables users to review across time and among other companies within the same period. According to Cheung at al., (2010), comparability demands that identical events will be reflected by identical accounting facts and figures in two situations.

The disclosure and explanation of implications in financial reports are crucial. There must be consistency in the application of accounting policies and principles, as in comparing results of the present accounting period with those from past periods. Additionally, presenting financial index numbers and ratios is helpful for comparisons with other organizations (Beest et al., 2009).

2.1.6Understandability

The comprehensibility of information in financial reports is essential. Achieving clarity is dependent on communication. The better the information is understood by users, the higher the quality attained (Cheung, Evans, & Wright, 2010). It is a key qualitative characteristic that improves when information is presented and categorized clearly and comprehensively. Well-prepared annual reports enable users to understand their content (Beest, Braam, &Boelens, 2009). Using graphs and tables helps in presenting information clearly, along with using easily understandable language.

2.1.7 Timeliness

Timeliness is a critical qualitative attribute that emphasizes the need for information to be available to decision-makers promptly, preserving its relevance. In the process of evaluating the quality of reporting in an annual report, timeliness is assessed by considering the duration between the year-end and the issuance date of the auditor's report; this includes examining the time taken by the auditor to finalize the report after the conclusion of the financial year (Beest, Braam, &Boelens, 2009).

2.1.8 Faithful Representation

This involves accurately reflecting the true economic position of the reported financial information. This concept emphasizes the importance of fully and accurately representing financial reporting. Neutrality, a sub-component of faithful representation, pertains to objectivity and balance. Research has indicated that the auditor's report adds value to financial reporting

information by providing reasonable assurance about how faithfully the annual report represents economic phenomena (Willekens, 2008).

The quality of faithful representation is also influenced by how business organizations are controlled and directed (Beest, Braam, &Boelens, 2009).

*2.2 Theoretical Framework*

Six theories were examined- stakeholders' theory, stewardship theory, agency theory, transaction cost analysis theory, core competencies theory, and resource-based view theory.

2.2.1 Agency Theory

This theory examined the relationship between managers (agents) and owners (principals) in large firms, where conflicts of interest may arise due to differing priorities.

This theory explores the relationship between managers (agents) and owners (principals) in large firms, where conflicts of interest may arise due to differing priorities. According to Jensen and Meckling (1976), principals believe that appropriately motivated agents will act in their best interest and that effective monitoring can mitigate agency conflicts. Other authors, such as Pike and Neali (1999), Atanda (2015) emphasize that short-term profit should not be the sole focus of managers, and they should prioritize the needs and interests of all stakeholders.

2.2.2 Resource-Based View Theory

This theory, linked with Penrose (1959), Prahalad and Hamel (1990), Barney (1991), and Peteraf (1993), views a company as a combination of distinctive abilities and assets that serve as the foundation for revenue generation. It conflicts with input-output and Five Forces models, as it emphasizes a firm's internal capabilities and resources as the primary sources of competitive advantage. Barney (1991) highlights that not all resources are strategically valuable, and their strategic combination is essential for effective competition in the market.

2.2.3 Stakeholder Theory

This theory rejects the notion that ethics and economics can be completely separated and emphasizes the importance of considering stakeholders' values in business. It poses two fundamental questions: What is the purpose of a firm? And what responsibilities do managers have towards stakeholders? Freeman, Wicks, and Parmer (2004) argue that addressing these questions leads to exceptional performance and helps managers establish relationships with stakeholders that are aligned with their needs. Jensen (2000) asserts that a firm's long-term value cannot be enhanced by disregarding stakeholders' interests and emphasizes the need for managers to balance competing stakeholders' interests.

2.2.4 Stewardship Theory

This proposes that there seems to be no intrinsic issue with executive motivation (Cullen, Kirwan, and Brennan, 2006). Stewardship theory is motivated by factors beyond financial gains, such as a sense of worth, altruism, a good reputation, job satisfaction, and a sense of reasonable purpose. This theory suggests that managers aim to do well, maximize company profits, and generate good returns for stockholders not solely for personal financial gain, but because they

feel a strong duty to the firm. Stewards play a crucial role in protecting and advancing the interests of shareholders, thereby strengthening their positions within the company. This concept highlights the advantages of empowering stewards with autonomy and integrity, thus reducing the requirement for expensive behavioral monitoring and control mechanisms. In stewardship theory, stewards are expected to act rationally and in the best interest of shareholders to maintain the firm's competitive edge in the free market system (Owolabi, 2011). Additionally, stewardship theory is considered an alternative to agency theory, as it differs in its approach to structuring effective and efficient boards (Muth and Donaldson, 1998). Unlike most governance theories, which focus on economic and financial aspects, stewardship theory is sociological and psychological. However, it has been noted that the theory could potentially enable mismanagement of owners' funds due to its board structure (Sundara-Murthy and Lewis, 2003).

### 2.2.5 Core Competency

Core competency is a concept in management theory introduced by Prahalad and Hamel in 1990. Initially based on resource-based theory, they defined core competencies as organizational collective learning, involving the coordination of various skills and the integration of multiple technologies. In corporate governance, this concept emphasizes its significance in coordinating employees' operations to achieve organizational objectives.

### 2.2.6 Transaction Cost Analysis

Transaction cost analysis, proposed by Williamson (1985), offers a sophisticated theoretical foundation for corporate governance. It merges economic theory with management theory to identify the most efficient relationships a company can establish in the market. The theory emphasizes that governance structures are influenced by transaction characteristics and has become the widely adopted theory of corporate governance. Assumed to offer decision-making tools to assist organizations in making cost-effective decisions.

### 2.2.7 Corporate Governance

It is argued that good corporate governance leads to high financial reporting quality, ultimately improving decision-making based on accounting information. A proper governance structure is associated with decreased wealth expropriation by management and controlling shareholders, leading to better resource allocation and improved outcomes. Firms with good governance structures also experience lower capital costs, as owners and lenders are more inclined to invest in such organizations, resulting in improved market performance. Moreover, relationships with these firms are expected to be more stable, fairer, and long-lasting compared to those with less efficient governance.

The connection between corporate governance and a firm's voluntary disclosure has become a significant area of research in recent years. Integrated Reporting is currently a voluntary disclosure practice in all countries except South Africa. A growing research trend is examining the relationship between certain corporate governance variables and the adoption of Integrated Reporting (Hamad, S., Draz, M. U., & Lai, W., 2020).

*2.3 Empirical Review*

Gardi, Aga, and Abdullah (2023) examined the impact of IFRS adoption on the relationship between corporate governance and the financial reporting quality of selected banks in Iraq. The study collected data through surveys from 298 participants representing various private banks. The results of the Sobel analysis indicated a positive and significant mediating effect of IFRS adoption on the relationship between corporate governance and financial reporting quality.

Hasan, Aly, and Hussainey (2022) conducted a comparative study of the United Kingdom and Pakistan to examine the impact of corporate governance on the quality of financial reporting. Their analysis revealed that board size has a negative effect on the quality of financial reporting in both the UK and Pakistan, while ownership concentration has a positive effect. In the UK, board independence has a positive influence on financial reporting quality, whereas audit committee independence has a negative impact. However, the study did not find similar results for board independence and audit committee independence in the UK setting.

Yu-Lin and Ya-Chih (2022) investigated the influence of corporate governance on the financial reporting quality of the United Kingdom companies during the COVID-19 pandemic. Their findings indicated a significant decline in financial reporting quality following the onset of COVID-19, attributed to companies engaging in real earnings management. Additionally, the study found that larger board sizes were associated with a reduction in earnings management during the COVID-19 pandemic. However, the research did not find significant supporting evidence for the mitigating effects of board independence and CEO duality.

Kabwe (2023) comprehensive analysis delved into the impact of various corporate governance attributes on the financial reporting quality in Zambian-listed firms based on extensive data spanning from 2012 to 2018. The findings from the regression analysis notably highlighted the profound influence of board size on financial reporting quality, shedding light on the intricate relationship between corporate governance and financial reporting practices.

Similarly, the study by Ogbaisi and Ezuem (2021) delved into the impact of corporate governance on the financial reporting quality of 42 quoted firms on the Nigerian stock exchange, meticulously examining data over the period from 2016 to 2020. The results gleaned from this research provided valuable insights, revealing that expertise in board accounting, gender diversity, and the independence of the audit committee did not yield significant influence on the quality of financial reporting. However, the study also brought to the forefront the crucial positive impact of board independence, and the frequency of audit committee meetings on financial reporting quality.

In a distinct effort, Ogbeide et al (2021) embarked on an intensive examination of the influence of corporate governance mechanisms on the quality of financial reporting of nine listed banks in Nigeria over ten years from 2008 to 2018. Their comprehensive research unveiled significant negative effects of board size and the audit committee on financial reporting quality, while the presence of female directors was found to have an insignificant impact on financial reporting quality.

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Furthermore, the study by Iseremeya and Evbota (2023) meticulously scrutinized the impact of corporate governance mechanisms on the financial reporting quality of 31 selected listed manufacturing companies in Nigeria from 2010 to 2018. Their profound findings illuminated the intricate dimensions, revealing that board composition, gender diversity, and managerial ownership had a significant but negative impact on financial reporting quality. Interestingly, the study also uncovered the contrasting impact of institutional and foreign ownership on financial reporting quality.

Adding to the corpus of knowledge, Okere et al., (2021) assessed the impact of corporate governance on the financial reporting quality of listed deposit money banks in Nigeria yielded further valuable insights. Their findings revealed that board size and board meeting frequencies did not significantly negatively influence financial reporting quality, adding nuanced perspectives to the link between corporate governance and financial reporting practices.

Accounting for the information above, it is apparent that the majority of the analyzed literature presents contradictory results regarding the impact of corporate governance variables on financial reporting quality. Nevertheless, it is noted that most studies have demonstrated the substantial influence of corporate governance on the quality of financial reporting.

## 3. Observations in the Literature

From the literature review above, it is evident that most of the works reviewed above have shown conflicting findings in the literature as to how corporate governance variables affect financial reporting quality. It is however observed that most of the studies have established the significant influence of corporate governance on financial reporting quality.

## 4. Gaps in the Literature and Suggestions for Future Research

The review of the literature above, shows that most existing studies have proxy financial reporting quality by accrual earnings management. It is also observed that most of the existing studies, particularly in Nigeria have examined the nexus between corporate governance and financial reporting quality from the effect as they have failed to moderate for variables that are likely to influence the connection between corporate governance and quality of financial reporting.

## 5. Conclusion

This study, based on the outcome of reviewed studies conclude that corporate governance have significant implications on the quality of financial reporting.

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