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INTERNAL CORPORATE GOVERNANCE AND FINANCIAL REPORTING QUALITY: A REVIEW OF LITERATURE

Barzo Mahmood Qader
School of Business Innovation & Technopreneurship, University Malaysia, Perlis, Malaysia
basalbasal5@gmail.com

Wan Sallha Yusoff
School of Business Innovation & Technopreneurship, University Malaysia, Perlis, Malaysia
wansallha@unimap.edu.my

Abstract

Over the years corporate governance has become a topic of global concern due to several financial scandals and corporate failures. This has drawn the attention of researchers, investors and regulatory institutions. Besides, the most important mechanism of corporate governance is board of directors. Therefore, the purpose of this paper is to review previous studies that examine the relationship between internal corporate governance and financial reporting quality, and to identify possible literature gaps. While the need to assess the connection between corporate governance and financial reporting quality would for a longtime remained a legitimate and interesting area of investigation, the paper recommend that the researchers avoid mistakes of the past. These include over reliance on singular theory and quantitative measures of financial reporting quality. The use of more purposeful process based approach that identifies the cause effect of the relationship would be of tremendous benefit to this vital field of study.

Keywords: Corporate Governance, Financial Reporting Quality, Board Characteristics

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INTRODUCTION

Corporate governance is designed to stimulate the investment environment and to create a stable financial situation in the capital markets by increasing the level of reliability, transparency, and accountability at the firm level (Önce & Çavuş, 2019). The upsurge of accounting scandals befallen recently in the international financial community has raised many criticisms about the financial reporting quality (Agrawal & Chadha, 2005; Brown, 2011). Several prominent companies were involved in accounting frauds, such as Enron, WorldCom, Marconi, Parmalat, etc., which has weakened the investor confidence toward the management team and the financial reports. The widespread failure in the financial disclosure has created the need to improve the financial information quality and to strengthen the control of managers by setting up good governance structures (Beekes & Brown, 2006; Firth et al., 2007; Petra, 2007). Indeed, the financial information serves as a basis for investment decisions of the capital market participants. It is useful for owners, creditors, firm partners and regulators, since it helps to determine the firm's past performance, predict its future profitability and monitor the managers' actions (Bushman and Smith, 2003).

Furthermore, corporate governance, considered both a process and a structure, is employed to manage and direct organizations and affairs of firms to improve corporate accountability and prosperity (Malaysian Code on Corporate Governance, 2012). The importance related to financial reporting quality in reflecting in the effectiveness of corporate governance mechanisms application (Alabdullah, 2018; Alabdullah, et al., 2016), still there is a dire need to deal with the nature of relationship between them on Iraq. Therefore, researchers need to focus on important and influential issues associated with their firm's corporate governance and financial reporting quality. This issue lies in giving attention to the critical issue that is the presence or absence of income smoothing in net income where net income might be smoothed by management and might lead to misleading results. The remainder of this paper is organized as follows: Section two reviews the literature on the relationship between corporate governance and financial reporting quality; Section three provides the conclusion.

LITERATURE REVIEW

Corporate governance and financial reporting quality: An overview

The significance of corporate governance mechanisms for ensuring high quality financial reporting arises from agency theory (Habib & Jiang, 2015). This perspective has brought managerial decision making and various external and internal monitoring and bonding mechanisms to the forefront of theoretical discussions and empirical research. According to the Anglo-American version of agency theory, agency conflicts occur between dispersed

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shareholders and professional managers, because of the separation of ownership and control (Jensen & Meckling, 1976).

Agency theory considers the role of governance to mitigate agency conflicts between principal and agents, and has been the cornerstone theory for corporate governance research (Jensen & Meckling, 1976). Research following this tradition typically emphasizes formal incentives and control mechanisms aimed at protecting outside dispersed shareholders from self-serving and opportunistic managers (Habib & Jiang, 2015) One such control mechanism is the production of external financial reports allowing outside shareholders to evaluate managerial performance. However, managers have incentives to mislead shareholders by providing financial information which does not portray the true underlying performance of the business (Healy & Wahlen, 1999). Various internal and external governance mechanisms, therefore, exist to protect minority shareholders against managerial opportunistic reporting behavior.

Numerous studies in the literature (see, for example, Firth, Fung, & Rui, 2006; Shleifer & Vishny, 1997) demonstrate that corporate governance mechanisms can be divided into two groups: internal and external. They explain that there are three essential internal mechanisms for corporate governance, structure of the board of directors and ownership structure and audit committee. They mention that the important external mechanism is market control for corporation. In the emerging economies, market control is weak; due to this weakness, the internal mechanisms of corporate governance have a key role in corporate governance in such economies (Alabdullah & Ahmed, 2018; Al-Hawary, 2011; Lei & Song, 2004).So, using these internal mechanisms of corporate governance-will reflect on the resulting decision made by the management and consequently on financial reporting quality (Ali, Salleh, & Hassan, 2008; Kapopoulos & Lazaretou, 2007; Lemmon & Lins, 2003).

Moreover, the significance of the corporate governance mechanisms to ameliorate financial reporting quality and good corporate governance aids have a good outcome in decreases the risks of financial reporting problems (Cohen et al., 2004). Dana (2003, p. 44) noted that: "good governance goes in hand with reduced risk of financial reporting problems and other bad accounting outcomes". Evidences from the previous studies of the relationship between poor governance and poor financial reporting quality including earning management, financial restatement and fraud are quite comprehensive (Habbash, 2010; Hashim, 2009; Kao and Chen, 2004; Klein, 2002; Peasnell et al., 2005; Xie et al.,2003).

Furthermore, transparency and accountability, which are one of the principles of corporate governance, provide financial reports which are a tool among business stakeholders to be more reliable and accurate and provide quality reports to information users (Önce & Çavuş, 2019). Therefore, it is argued that one of the most important functions of the corporate

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governance mechanism is to improve the quality of financial reporting (Cohen, Krishnamoorthy, & Wright, 2004, p. 1). Figure 1 shows the corporate governance structure and its impact on financial reporting quality.

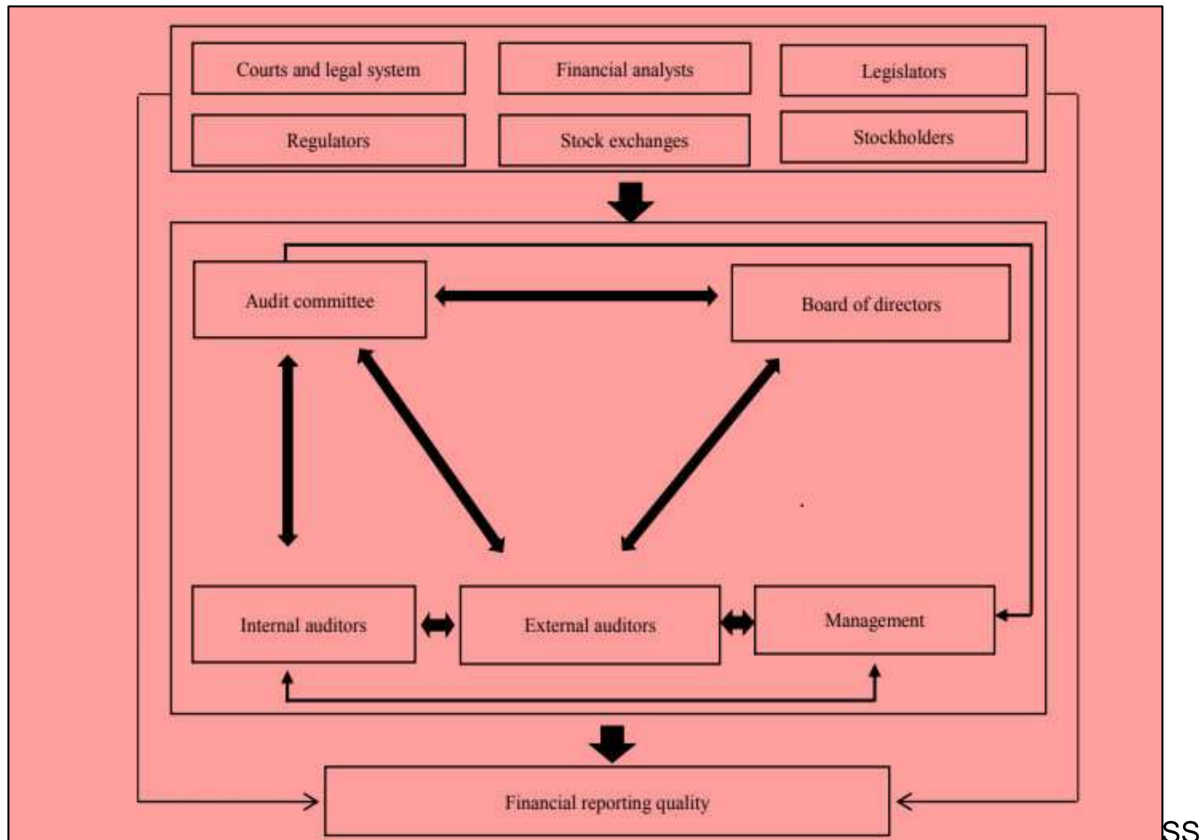

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Figure 1: Relationship between corporate governance and financial reporting quality
Source: Önce & Gülşen Çavuş (2019)

Corporate governance and financial reporting quality: Empirical literature

One of the most important corporate governance functions is to ensure the process of financial reporting quality (Cohen et al., 2004). Watts and Zimmerman (1978, p. 113) stated that: "one function of financial reporting is to constrain management to act in the shareholders' interest". Davis-Friday et al. (2006) indicated that the value relevance of earnings and book value were significantly lessened in the time of the Asian financial crisis and was related to the relatively fragile performance of corporate governance mechanisms in four East Asian countries, i.e. Malaysia, Indonesia, Thailand and South Korea.

Önce and Çavuş (2019) evaluates of the effects of corporate governance on financial reporting quality using companies listed on Borsa İstanbul (BIST). They applied Panel data analysis was using Eviews 9 Package Program. According to the results obtained from the

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value relevance model, the inclusion of enterprises in the Corporate Governance Index also creates a difference in the perceived financial reporting quality of enterprises. Results obtained from two models used in the assessment of financial reporting quality having a high level of compliance with the regulations made within the scope of corporate governance principles confirms that the financial reporting quality of enterprises increases.

Onuorah, and Friday, (2016) studied the impact of corporate governance on financial reporting quality of some selected companies ranging from commodities, brewery, banking, oil and gas and beverages in terms of corporate governance measure indictors on the firm quality of financial reporting in Nigeria. The study used descriptive research design over a period of ten (10) years, spread from 2006 to 2015. The results of the study indicates that Board structure, board experience and the quality of external audit have positive impact on the financial reporting quality measured by the discretionary accruals of firm. However, independent directors on the board of firm and audit quality (audit committee size negatively affect financial reporting quality measured by the discretionary accruals of firm.

However, Al-Fayoumi et al. (2010) examined the relationship between ownership structure and earning management for the period 2001-2005 for the industrial firms. Their results documented that managers' ownership is, in a great extent, ineffective in nature when aligning managers to take value of maximizing decisions. In addition, they observed an insignificant role for block holders in monitoring managerial behavior of earning management. Moreover, Al-Khabash and Al-Thuneibat (2009) provided evidences regarding the existence of earning management from the perspective of both external and internal auditors. They believed that managers deal with increasing or decreasing of earning management activities.

Board of Directors Characteristics

Board characteristics is regarded as one of the internal corporate governance mechanism, which expatiates on the features of the board. The characteristics of the board include size, independence, diligence, diversity (age, gender, nationality, expertise, educational and functional background), and committee structure (Anderson et al., 2004). The administrative activities of the board involve the duty of overseeing and monitoring the organizations financial reporting process (Anderson et al., 2004). They meet at a scheduled time with the organizations' accountant and external auditors to review financial statements, audit procedures and the internal control system (Klein, 2002) targeted at improving the organization's performance.

Akeju and Babatunde (2017) opined that a board characteristic which is an internal corporate governance mechanism improves financial reporting quality in an organization.

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D’onza and Lamboglia (2014) asserted that a board characteristic is a unique monitoring mechanism for detecting and correcting financial statement fraud. This unique feature of the board makes it hard for accountants in an organization to perpetrate and conceal a financial statement fraud. Cohen et al., (2004) argued that one of the most important functions of corporate governance (both internal and external mechanisms) is to ensure the quality of the financial reporting process; this argument was supported by (Myring & Shortridge, 2010).

Ilaboya and Lodikero (2017) reiterated that it is imperative that the board should have some level of integrity and objectivity in the process of carrying out their duties diligently and should also be confidential in matters relating to the board. Fathi (2013) asserted that the quality of financial information is positively related to the quality of the board and the quality of the ownership structure. To this end, this study critically looked at three board characteristics– independence, size and expertise.

Board size and Financial Reporting Quality

There is no consensus in the literature about board size; whether a large number or a smaller board of directorate is better. It is argued that the ideal board size if between seven to eight (Cheng, 2008), because such a board can act effectively and efficiently this is because a small group can easily reach a conclusion (Balakrishnan, et al., 2014) and to engage in genuine interaction and debate. Hutchinson, Mack, and Plastow (2015) argued that the benefit of higher level monitoring by a huge board may be nullified because of poor decision making by a large board, because of controversies.

On the other hand, small boards are believed to alleviate the processing problems and hence more effective (Allegrini & Greco, 2013), but when the small boards become too big then boards are only figurative relatively being a part of the management process (Zona, Zattoni & Minichilli, 2013). But in contrast to this, Yoshikawa, Zhu and Wang (2014) argued that larger boards will outweigh the costs associated with slow decision making, the processing problem, and can easily be controlled by the management.

Several studies have investigated the relation between board size and financial reporting quality, but the results varied widely. For instance, Fathi (2013), Htay et al. (2013), Haji and Ghazali (2013), Chakroun, and Hussainey (2014), Asegdew (2016), Uwuigbe et al. (2018) and Akeju and Babatunde (2017) found a positive relation between board size and financial reporting quality. These results implied that better disclosure quality of the annual reports could be achieved by having greater board size (Htay et al., 2013). Larger board size could provide more competence and knowledge to the firm and may have the capability to monitor excellently, which could consequently lead to higher quality of financial reporting (Haji and Ghazali, 2013).

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Conversely, Yoshikawa and Phan (2003), Byard et al. (2006) and Ostadhashemi et al. (2017) found a negative relation between board size and financial reporting quality. This finding demonstrated that the lesser the board size, the better communication and coordination is which in turn will result in better disclosure quality of accounting information (Yoshikawa &Phan, 2003). However, Firth et al. (2007), Liu and Sun (2010), Chalaki et al. (2012), Soheilyfar et al. (2014) and Navarro and Urquiza (2015) demonstrated that financial reporting quality is not significantly associated with board size. This result could be justified by the fact that board size may not convey board quality if it does not work proficiently (Uyar et al., 2013). While the board's monitoring ability rises as more directors are joined to the board, the benefit may be exceeded by the cost of inferior communication and decision-making allied with larger groups; thus, the efficiency and effectiveness of board's working is significant rather than its size (Uyar et al., 2013).

Board Independence and Financial Reporting Quality

Several studies have also argued that the presence of independent outside directors on the board improves its effectiveness (Zéghal et al., 2011). In this context, other studies have shown that the percentage of independent directors is positively associated with the effectiveness of monitoring managers in preparing financial reports. Beekes et al. (2004) found firms with a relatively high proportion of outsiders on the board to be more conservative. Furthermore, Davidson et al., (2005) showed that, in Australia, having a majority of non-executive directors on the board was negatively associated with the likelihood of earnings management.

Previous researchers studied the relation between board independence and financial reporting quality and the results were mixed. For instance, Haniffa and Cooke (2002), Nasir and Abdullah (2004), Arcay and Vazquez (2005), Cheng and Courtenay (2006), Katmun (2012), Hassan and Bello (2013), Htay et al. (2013), Soheilyfar et al. (2014) and Monday and Nancy (2016) found a significant positive relation between board independence and financial reporting quality. This finding suggested that keep tracking of corporate boards by independent directors will assist them to become more reactive to investors, and will enhance the company's adherence with the disclosure requirements, which consecutively will improve the extent and quality of information disclosures (Cheng &Jaggi 2000).

Conversely, Chakroun and Hussainey (2014) show that board independence affects negatively financial reporting quality. This relationship might be clarified by the fact that firms would not enhance both financial reporting quality and board independence simultaneously; however, they would selected strategically to enhance one with the sacrifice of the other (Chakroun & Hussainey, 2014). However, Haji and Ghazali (2013), Fathi (2013), Asegdew

(2016) and Al-Asiry (2017) found an insignificant relation between board independence and financial reporting quality. This indicates that that board independence does not lead to high quality financial reporting.

In addition, Bravo and Alvarado (2019) studied the analyses whether the role played by independent directors in monitoring the financial reporting process is affected by certain personal characteristics. Specifically, we focus on the tenure and the number of directorships that independent director's hold. Their sample is composed of US listed firms for the period 2008–2012. After performing several robustness checks and sensitivity analyses, they have documented a positive association between board independence and financial reporting quality. However, this association is presented only for certain values of directors' tenure and external directorships. This evidence suggests that the effectiveness of independent directors in their monitoring tasks is affected by these personal characteristics. In particular, our results indicate that long tenures and a high number of directorships compromise the ability to monitor. They further suggest the need for a more specific approach, based on the personal characteristics of independent directors, in order to study their influence on corporate decisions.

Similarly, Aifuwa and Embele (2019) investigates the impact of board characteristics on financial reporting quality of listed manufacturing firms in Nigeria. The population of the study consisted of all listed firms in Nigeria Stock Exchange 169 listed companies. They employed the Generalized Linear Model Regression in testing the hypotheses stated. Findings revealed that board expertise was statistically significant and positively related to financial reporting quality at 5% level of significance, while board independence and board diversity was found to be insignificantly related to financial reporting quality at 5% level of significance. The study concluded that board characteristics partially affect financial reporting quality.

Board Expertise and Financial Reporting Quality

When the board is comprised of experts, there is always a level of confidence in the financial statement reported (Onourah & Imene, 2016). To become an expert in a board, a director must possess adequate educational and professional experience in areas of finance, accounting and auditing. However, Kang, et al., (2007) asserted that experience comes with age. The older the director the better, that is to say, that the presence of older directors on the board will lead to better financial reporting quality. Scholars have given mixed findings on the relation between board expertise and financial reporting quality. A predominant strand in literature submitted that board expertise significantly and positively affects financial reporting quality (Alzoubi, 2014; Klai & Omori, 2011; Kantudu & Samaila. 2015; Onourah & Imene, 2016), while Kankanamage

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(2015) made a submission that board expertise significantly and negatively affect financial reporting quality using earnings management as a measure.

Garcia-Meca and García-Sánchez (2018) study the influence of managerial ability on the quality of their financial reporting. Using a large bank sample from nine different countries and for the time period 2004–2010. The results confirm that managerial abilities play a significant role in the quality of financial reporting in banks, and that capable bank managers are less likely to manage earnings opportunistically. The evidence from this study can help standard-setters and regulators to better understand the business practices and accounting behavior of banks in the light of managerial abilities. Kankanamage (2015) examines the impact of board characteristics on earnings management in Sri Lanka during the period from 2012-2015 The current study uses the ordinary least squares regression (OLS) to examine the effect of board on earnings management for a sample of 160 listed firms in Sri Lanka. Findings revealed that there is a significant relationship between board size, board composition, board financial expertise and board meetings and earnings management of the firms. Thus effective board of a firm is contributing to enhance the financial reporting quality and transparency. He concluded the board characteristics which is one of the key constitute in corporate governance are significant to constrain the earnings management of the listed firms in Sri Lanka.

Table 1: Summary of Corporate Governance and Financial Reporting Quality Literature

Authors	**Location of Study**	**Variables**	**Sample**	**Methods**	**Main Findings**
Önce & Cavus (2019)	Tukey	Earnings Persistence, Value Relevance	72 enterprises data	panel data analysis	Corporate governance mechanisms have an effective function in producing high-quality financial reports.
Alzoubi (2014)	Jordan	Board independence, CEO duality, financial expertise, governance expertise, firm specific expertise & size.	94 Jordanian companies	Generalized Least Square (GLS)	Board independence, financial expertise, governance expertise & size have a negative relation with EM. While CEO duality & board firm-specific expertise have a positive relation with discretionary accruals

García-Meca & García-Sanchez (2019)	Canada, France, Germany, Italy, the Netherlands, Spain, Sweden, the UK, and the USA	Managerial ability, Earnings quality, Size, Market Share, cash flow, age	159 banks from nine countries,	Factorial analysis	Managerial abilities play a significant role in the quality of financial reporting in banks, and that capable bank managers are less likely to manage earnings opportunistically
Mahboub (2017)	Lebanon	Financial reporting quality index, leverage, size, profitability, corporate governance features of board independence, ownership structure, and board size.	22 Lebanese banks	multivariate OLS analysis	Financial leverage, ownership structure and board size has significant and positive relationship with financial reporting quality. While, bank size, profitability and board independence are not significant.
Onuorah & Imene(2016)	Nigeria	Financial reporting quality, Board structure, board experience and quality of external audit	A sample of 5 companies spread across three main sectors of the economy	Econometric analysis using VAR	Independent directors, audit quality negatively affect financial reporting quality. While board structure revealed positive.
Kankanamage (2015)	Sri Lanka	Earnings management, board size, board composition, board financial expertise and board meetings	A sample of 160 listed firms	Ordinary least squares regression	There is a significant relationship between board size, board composition, board financial expertise and board meetings and earnings management of the firms.

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Htay et al. (2013)	Malaysia	Disclosure quality,	12 listed banks in Malaysia	Panel data analysis	The results reveal that better disclosure quality of the annual reports in banking sector can be achieved by having separate board leadership structure, higher proportion of independent non-executive directors, higher board size, lower ownership by the directors, institutional and block shareholders.

CONCLUSION

This paper provides a thorough review of internal corporate governance mechanisms and financial reporting quality. The aim of this study is to review previous studies on corporate governance and financial reporting quality and to identify possible literature gaps. The review is based on causal effect relationship between corporate governance mechanisms such as board size, board independence, and board expertize and financial reporting quality. Albeit, there are stream of studies on corporate governance and financial reporting quality, yet the results are still conflicting which make research in the area to be inconclusive. Nevertheless, this does not render the findings of previous studies invalid. The board roles as documented in literature are diverse ranging from monitoring, strategy, resource co-optation, and advisory amongst others (Jensen & Meckling, 1976; Hillman & Dalziel, 2003 Johnson et al., 1996). These numerous functionality expected of board has makes it virtually impossible for a single theory to accommodate (Kiel & Nicholson, 2007). There is a need for permutation of new theories and models as well as more innovative empirical studies to really understand the importance of corporate board (Jackling & Johl, 2009; Donaldson & Muth, 1998). The use of more integrative approach in the empirical investigation may induce the robustness and validity of the findings (Guerra et al., 2009). Most of the available theories might be out of touch with current corporate realities since they were built on certain premises and parameters that might have been either outdated or overtaken by recent events (Hermalin & Weisbach, 2003).

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Moreover, future studies should consider reviewing other corporate governance components to examine their causal effects on the quality of financial report of the companies. In addition, it is argued that corporate governance researchers have relied on singular theory for so long and this had not helped the field in gaining the much needed appreciation of the relationship between corporate governance and financial reporting quality. Future studies should integrate more theories in explaining this relationship. Furthermore, future studies should also conduct an empirical studies to examine the relationship between corporate governance and financial reporting quality.

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