المجلة الإلكترونية الشاملة متعددة التخصصات
العدد الرابع والعشرون شهر (٥) ٢٠٢٠

The impact of applying corporate governance principles on enhancing the credibility of financial reports

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Abstract

Purpose - This study aims at investigating the impact of corporate governance on the credibility of financial reports.

Findings - corporate governance principles do have a favorable impact on enhancing the credibility of financial reports.

Originality/value – The research is original and born out of the desire to improve corporate governance and the credibility of financial reports

Keywords: Corporate governance, Financial reporting, Credibility.

1. Introduction

Substantially, the value of corporate governance risen dramatically in 2002 when a chain of events culminated in the bankruptcies of several U.S. corporations and the losses of thousands of jobs. Thus, the destiny of a firm as well as the economy, in general, is determined by the method firms are governed (Naser-Abdelkareem & Abusharbeh, 2016). Investors are drawn to the firms with good corporate governance standards, such as openness and independent managers, since, according to the Organization for Economic Cooperation and Development (OECD, 2004), corporate governance affirms of control rights and associated obligations across various company stakeholders including executives, investors, and lenders who establish policies and procedures for decision-making on corporate matters.

A principal factor of the quality of financial statements seems to be the implementation, evaluation and surveilling of efficient internal control systems. In particular, elevated-quality internal controls restrain the deliberate manipulation of data submitted to outsiders, minimize the risk of accidental operational and guesstimating reporting mistakes, and lessen the inherent risks of business processes and strategies that could impact the quality of the information that has been reported (Brown, Pott, & Wömpener, 2008). No universal definition of internal control has been developed since each writer has personal own perspective about what is internal control. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 1992 developed a definition of internal control as an operation in which board of directors and other staff of an organization are held responsible to provide a credible guarantee that the aims of the company are going to be met, depending on the COSO definition, the board of directors is considered a key party in the internal control system that could manage and monitor the companies activities (EL-Nabi, 2016).

Corporate governance impacts the credibility of the operations of the companies since the running company system can affect the transparency and performance of the companies (Beekes, 2006). Corporate governance, according to Fung (2014), Is intended to reduce preposterous corporate activities and maintaining a fair work environment. Fung's study also explains that weak corporate governance is considered dangerous, while investors see good corporate governance as a symbol of a powerful company.

Tang, Chen and Zhijun (2008) present a definition for the quality of financial reporting as a means of providing true and fair information on the underlying financial and performance status. Jonas and Blanchet (2000), offer a widely agreed concept, they claim that quality financial reporting is comprehensive, straightforward, and not intended for vague or deceptive users. Quality financial information reporting must be prepared for all companies. FRQ (Financial Quality Reporting) is the most important financial mechanism element. In general, it is acknowledged that a variety of variables determine the consistency and high level of financial reporting reported by the organization (Hassan and Bello, 2013).

Financial reporting aims first and foremost to offer high-quality financial information about an economic entity. For economic decision-making, financial reports are beneficial. For further transparent corporate information disclosure, corporate governance mechanisms are needed (Htay, Said, & Salman, 2013). Stakeholders therefore request improved financial reporting and corporate transparency as additional efficient corporate governance practices mitigate the ambiguity of the stakeholders regarding investment decisions of corporations (Beest, Braam, & Boelens, 2009). Disclosures of firms are of interest to stakeholders. Quality of disclosure is an important function for parties concerned to guarantee that the financial reports represent the reliability of the firm and decrease any information asymmetry.

Weak financial reporting has been recorded in several mainstream corporate scandals in the past decades (Lobo and Zhou, 2006), and shareholders request high-quality reporting (Chhaochharia & Grinstein, 2007). Studies have already shown that companies or firms embrace high-quality external and internal governance instruments to establish high-quality financial reporting for shareholders, as well as better quality auditors (Internal and External) (Srinidhi, He & Firth 2014; PuchetaMartinez & GarcíaMeca 2014). The frameworks of corporate governance differ, however, depending on the country, indicating legal and business settings (Claessens & Yurtoglu, 2013).

2. Problem Statement

In recent decades, the significance of corporate governance has increased exponentially. Strong corporate governance is considered to boost the value of companies as it can greatly reduce issues with agencies (problems resulting from the misbehavior of executives), and boost trust among investors (EL-Nabi, 2016), in addition, good corporate governance is regarded not just to its ability to minimize the risk of fraud and corporate breakdown, but will also generate wealth through enhanced economic performance (Azizah & Islam, 2014). Although it has been proven globally that corporate governance is a useful internal control tool to develop the whole performance and despite the awareness spreading attempts about the significance of corporate governance, records of organizations failures keep on highlighting the significant part that corporate governance technique plays, particularly boards of directors and audit committees in organizations (EL-Nabi, 2016).

The latest international accounting scandals have contributed to further FRQ criticism (Agrawal & Chadha, 2005). Various large firms like those of WorldCom, Parmalat, Marconi, etc.

were implicated in such corruption. The inability to include financial information has rendered it important to strengthen the FRQ and even strong control of managers with a better-governing structure. (Brown and Caylor, 2006; Beekes and Brown, 2006; Karamaou and Vafeas, 2005). In the course of investment decisions, financial information directly aids capital investors. It benefits regulators, creditors, owners, and business partners, due to the fact that it not only demonstrates the firm's historical performance but nonetheless determines the prospective productivity prediction of the firm (Bushman and Smith 2001; 2003). Therefor this study is going to answer the following questions,

1- What are the principles of corporate governance?
2- Why credibility of financial reports is important?
3- What is the impact of corporate governance principles on financial reports credibility?

3. Methodology

This part describes the research methods used to conduct a study that allows the researcher to achieve this study goal, the process of collecting and analyzing data and then obtain results on research goals and objectives, which is what research design means (Kothari, 2004). For the purpose of this study, the descriptive research design is used.

4. Corporate governance

Organization for Economic Co-operation and Development (OECD) referred to the rules governing corporate governance, which included five areas, including; shareholder rights, equal treatment of shareholders, the role of stakeholders, disclosure and transparency, and responsibilities of the board of directors (Jazar, 2016).

Madani and Abdel-Hadi (2017) expressed corporate governance as a means by which a balance can be achieved between the powers enjoyed by the company's management on the one hand and the protection of shareholders 'rights on the other hand in a manner that ensures the continuity and sustainability of the company.

Yameen, Farhan & Tabash (2019), pointed out that corporate governance is based on two elements, which are sound management and transparency. Governance is also defined as a system that permits the orientation of business organizations and activates control procedures to ensure proper functioning (Bhagat & Blak, 2016). Several definitions for governance have provided, and the most famous of these is the definition of the Organization for Economic Co-operation and Development (OECD), which defines corporate governance as a set of relationships between the parties operating in the company (management of the company, board of directors, shareholders, stakeholders) and the goals to be achieved by relying on these relations (Jazar, 2016).

Both the Board of Directors and the audit committees are considered essential mechanisms for corporate governance. Asaad (2015) indicated that building an effective board of directors is an important starting point for activating the application of governance rules. This board designs the investment and strategic plans of the company that reflects the goals to be achieved measure the level of executive managers 'commitment to achieving these goals, and preserving the rights of investors and stakeholders. Al-Ramahi, Barakat & Shahwan (2014) clarified that the audit committees are considered among the tools that increase the level of effective governance, as they contribute to increasing the accuracy and transparency in the presentation of financial information disclosed by companies.

4.1 The significance of corporate governance

Governance represents a system that spreads its mutual influence on many economic, social, legal and political fields. On the economic level, governance seeks to enhance the company's value, develop its competitive level, and attract local and international investments to expand and grow, making it able to create new job opportunities and achieve financial stability. Politically and socially, governance affects public life, income and living standards, and from a legal standpoint, governance is the primary pillar that provides standards for disclosure, transparency, and integrity in the business environment.

With good corporate governance, the board of directors can have the suitable incentives to obtain objectives, boost the efficiency of control measures to prevent any attempt of manipulation, distortion, and deceit, and reduce the passive results of information asymmetry phenomenon (Ballesta & Meca, 2007), which would also achieve the interests of different sides and increase the effectiveness of the use of resources for the interest of the corporation and the achievement of its objectives (Byard & Weintrop, 2006).

Emre (2012) stated that activating governance contributes to enhancing the efficient use of the company's resources and reducing the risks resulting from it by improving the level of performance. Governance also contributes to achieving a suitable return for investors and enhancing the level of competitiveness of the company by maintaining its level of economic and financial stability (Lee, Ku & Chen, 2012). Al-Sartawi (2015) pointed out that effective governance affects the trading volume of companies and thus enhances their production and service capacity.

Madani and Abdel-Hadi (2017) indicated that there is a correlation between the application of corporate governance principles and their impact on the level of securities efficiency. Every principle of governance contributes to improving the level of efficiency of the stock market, directly or indirectly.

Corporate governance is primarily focused on identifying the relationship between shareholders, boards of directors, executives and other stakeholders with a view to improving the level of corporate performance and enhancing the ability of officials to make management decisions. Al-Rifai (2008) emphasized that well-managed companies have a better level of performance and are able to attract a large number of investors, where in this case investors can realize their ability to achieve greater returns. Corporate governance also contributes to preserving shareholder and minority rights by enhancing their ability to manage their investments effectively and in a timely manner, and by monitoring the level of corporate commitment to transparency and accounting standards, which means that corporate governance is one of the pillars that support the stock market (Madani & Abdel-Hadi, 2017).

4.2 Corporate governance Principles

Corporate governance norms founded on the foundation of the Principles of Corporate Governance implemented by the Organization for Economic Cooperation and Development (OECD). Their adoption is supposed to guarantee: the foundation for efficient adoption of the principles of corporate governance; shareholders' rights and essential ownership functions; equal representation of shareholders; the right role of all stakeholders participating in corporate governance; information disclosure and transparency concerning the company and the right role and accountability of the boards set up within the company. Governance standards are listed in detail as following (OECD, 2015).

1- **Integrity and ethical behavior:** Integrity should be a fundamental requirement in choosing corporate officers and board members. Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making.

a) With consideration to its influence on economic performance as a whole, the integrity of the market and the opportunities it offers for market participants and the fostering of transparent and effective markets, a corporate governance framework should be established.
b) The legal and regulatory requirements impacting corporate governance practices are supposed to be enforceable, transparent and in compliance with the rule of law.
c) The way responsibilities are divided is supposed to be explicitly expressed to guarantee that interest of the public is served among different authorities.
d) Stock market regulation is supposed to endorse efficient corporate governance.
e) In order to perform their duties professionally and objectively, supervisory, regulatory and enforcement authorities are supposed to have the authority, integrity and resources to do so. In addition, their rulings are supposed to be timely, transparent and properly addressed.
f) Cross-border co-operation is supposed to be improved, namely via bilateral and multilateral arrangements for information exchange.

2- **Rights and equitable treatment of shareholders**: Organizations should respect the rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by openly and effectively communicating information and by encouraging shareholders to participate in general meetings

   a) Basic shareholder rights should incorporate: (1) secure means of registration of ownership; (2) conversion or transferring of shares; (3) timely and on a daily basis access of relevant and material information about the company; (4) engaging in general shareholder meetings; 5) elect and remove Board members; and 6) share in the company's earnings.

b) Shareholders should be sufficiently informed about, and have the right to approve or participate in, decisions concerning fundamental corporate changes such as: 1) amendments to the statutes, or articles of incorporation or similar governing documents of the company; 2) the authorization of additional shares; and 3) extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company.

c) Shareholders should be able to engage actively and vote in general shareholder meetings and be informed of the rules regulating general shareholder meetings, namely voting procedures.

d) Shareholders should be permitted to consult, subject to exceptions to prevent abuse, each other on matters pertaining to their basic shareholder rights as specified in the Principles.

e) All shareholders of the same series of a class should receive equal treatment. Capital structures and arrangements, allowing certain owners to gain a degree of control which is disproportionate to their equity should be unveiled.

f) The transactions involving related parties should be permitted and carried out in ways that guarantee proper conflict of interest management and protect the interests of the company and its shareholders.

g) Minority shareholders should, or in the interest of, controlling shareholders that act explicitly or implicitly, be protected from abusive acts and have efficient ways of redress. Abusive self-dealing is supposed to be forbidden.

h) Corporate control markets should be permitted to operate efficiently and transparently.

3- **Interests of other stakeholders:** Organizations should recognize that they have legal, contractual, social, and market-driven obligations to non-shareholder stakeholders, including employees, investors, creditors, suppliers, local communities, customers, and policymakers.

a) The rights of stakeholders that the law or reciprocal agreements established should be respected.

b) Where the interests of stakeholder are secured by the law, stakeholders concerned should have the chance to get meaningful redress for the violation of their rights.

c) Performance-improving mechanisms for employee engagement are supposed to be allowed to progress.

d) When engaging in the corporate governance process, stakeholders should have timely and daily access to relevant, sufficient and reliable information.

e) Stakeholders, namely individual employees and their representational bodies should be able to express their worries regarding illegal or unethical practices to the Board, and their rights should not be undermined for doing so.

f) An efficient, efficacious insolvency framework and effectual enforcement of creditor's rights should supplement the corporate governance framework.

4- **Disclosure and transparency:** Organizations should clarify and make publicly known the roles and responsibilities of board and management to provide stakeholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information.

a) Disclosure is supposed to incorporate but is not restricted to, material information regarding: (1) company financial or operational results, (2) company goals, (3) major share ownership and right to vote, (4) remuneration policy for board and main executives, and board members, namely their credentials, screening process, other company directorships and if the board perceives them as independent, 5) governance structures and policies, specifically the content, and the mechanism of execution, of any corporate governance code or policy, in addition to the process by which it is incorporated, 6) related party transactions, 7) possible risk factors, 8) personnel and other stakeholders' concerns.

b) In compliance with accounting, financial and non-financial high quality criteria disclosure, information should be documented and divulged.
c) In attempt to inform the Board and the shareholders externally and objectively of the financial status and performance of the company in all material aspects, the auditor, who is independent, skilled and qualified, should execute an annual audit.
d) External auditors are supposed to be responsible to the shareholders and owe a duty to the company to carrying out the audit process with proper professional consideration.
e) Information dissemination channels should insure that users obtain relevant information fairly, timely and cost-effectively.
f) An efficient strategy to resolving and endorsing the provision of analysis or advice provided by analysts, investors, rating agencies and others that is relevant to judgement call-making by investors, free from material conflicts of interest that might threaten the analysis or advice's credibility, should complement the Corporate Governance Framework.

5- **Role and responsibilities of the board:** The board needs sufficient relevant skills and understanding to review and challenge management performance. It also needs adequate size and appropriate levels of independence and commitment.

6- The members of the board should operate in the best interests of the company and shareholders on a thoroughly informed basis with proper diligence and consideration.
7- Where judgment calls of the board are potentially to have a different impact on different shareholder groups, the board should regard all shareholders equally.
8- High ethical criteria should be applied by the Board. The interests of stakeholders should be taken into consideration by it.
9- The Board should satisfy certain core roles, namely: (1) review and guidance on corporate strategy, main action initiatives, risk policy, yearly budgets, and business goals; the establishment of performance goals; execution supervision and corporate performance; and the supervision of significant capital expenditures, acquisitions and divestitures, 2) opting, offsetting, overseeing and, if required, replacing key executives and supervising succession planning; 3) the supervision of the efficacy of governance of the company practices, as well as applying changes as required, 4) guaranteeing formal and transparent nomination of the board and election processes, 5) the supervision and management of possible conflicts of interest among management, board members and shareholders, namely abuse of corporate assets with the related party transactions, 6) alignment of the key executives and of the board of remuneration with shareholders and the company and their longer-term interests, 7) Assuring the credibility of the accounting of the corporation and financial reporting systems, namely independent audit, and that the suitable control systems are in place, specifically, the systems for risk control, financial and operational control, and conformity with the law and the relevant norms, 8) Monitoring the disclosure and communications process.
10- On corporate affairs the board should be free to exercise objective, independent judgment.

11- The Board members should have accessibility to reliable, relevant and timely information to meet their responsibilities.
12- When representation of an employee on the board is required, processes to render the representatives of an employee more accessible to information and training, more efficient and contribute more to board skills, information and independence should be established

5. Financial reporting credibility

Financial reporting as per Nassar, Uwuigbe, Uwuigbe, and Abuwa (2014) can be defined as a detailed summary of any organization's financial results and situation; it actually offers details about the organization to a thorough set of users to make economic and financial decisions of a high standard. The fundamental purpose of financial statements is to provide accurate knowledge of economic decision-making. Reliability in financial reporting is described as the released financial statements which are being compiled accurately to provide users with valuable information in making financial decisions (Tontiset & Kaiwinit, 2015). IAS 1 states “Financial reports present the performance of management as stewards of resources trusted to them”.

Financial reporting idea has attracted significant attention from both existing and future investors and other key stakeholders (Okereke, 2009). The key aim of writing financial statements is to increase the consistency of users' decisions, nonetheless, users can only make quality judgments through the existence of reliable financial details (Uwuigbe et al., 2016). The fineness of financial information continues to be a primary cause of concern for both existing and future investors, according to Sloan (2001). Consequently, Financial reports must be submitted to users in a timely way to facilitate the efficient use of this information in order to ensure that financial information is of quality (Alexander & Britton, 2000).

In a very similar way, Mainoma (2002) held that, in order to achieve the goals of preparing financial statements, financial details should be deemed accessible to users in a timely way to serve as an efficient guide to make a good judgment. Therefore, timeliness has attracted the agreement that it is an important qualitative feature of quality financial reports (Belkaoui, 2002). It is also a noticeable tool that can be used in the emerging capital markets' to minimize rumors, leaks, and insider trading (Owosu-Ansah, 2000).

6. Corporate governance and financial reports credibility

The value to maintain high-quality financial reporting in corporate governance mechanisms stems from agency theory. This insight has put the theoretical and empirical research at the center of managerial decision making, as well as numerous external and internal monitoring and bonding mechanisms. As per the Anglo-American interpretation of the agency theory, due to the separation between ownership and control, there are conflicts between dispersed shareholders and professional managers (Jensen & Meckling, 1976). Agency theory takes into account the role of governance in mitigating disputes between principals and agents, which is at the center of corporate governance research (Jensen & Meckling, 1976). Traditional research typically highlights formal incentives and control mechanisms that safeguard external shareholders from self-serving and opportunistic managers. The production of external financial reports that allows unbiased shareholders to assess managerial performance is one such control mechanism. Managers, nevertheless, have opportunities to manipulate shareholders by presenting financial data that does not reflect the true underlying business performance (Healy & Wahlen, 1999). There are, however, numerous mechanisms of internal and external governance that safeguard minority shareholders from managerial opportunistic reporting.

A significant body of literature demonstrates that institutional investors are key monitoring agents and usually play an important role in enhancing firm performance and the quality of financial reporting (e. g. Chung, Firth & Kim, 2002). The independent directors' boards have well reported their governance role in minimizing managerial opportunism (Cohen, Krishnamoorthy, & Wright, 2004). There are reasons behind why state-owned enterprises (SOEs) financial reporting is in lower quality than their own private counterparts. Firstly, bureaucratic interference, inadequate opportunities, and lack of competitiveness within the SOEs are often correlated with impoverished corporate governance, lower corporate efficiency, mismanagement of resources, and non-ethical behaviors, like those of corruption and fraud (Habib & Jiang, 2015). Impoverished monitoring mechanisms enable managers to exploit financial information and conduct fraud, at the extreme. Second, compulsory ownership segmentation into many classes contributes to divergent interests among multiple classes of shareholders, which causes greater agency issues for SOEs. Greater asymmetry and insufficient monitoring of information further accentuate issues in state enterprises, generating more managerial opportunistic reporting. Ultimately, from a standpoint of a managerial entrenchment, the concentration of ownership in SOEs facilitates managerial self-dealing for private benefit, restricting information disclosure to foreign entities. (Wang & Yung, 2011,).

Wang and Campbell (2012) notice that state ownership, in fact, dissuades earnings management, despite common wisdom that the financial reporting quality of state-controlled firms is lower. Wang and Yung (2011) evidenced this as well. Ding, Zhang and Zhang (2007) notice that the management of income is greater than the privately state-owned listed firms, even though this effect is attenuated in the event that the private owner is also the major shareholder. The favorable impact of state ownership for the quality of financial reporting is potential to be attributed to the fact that the government is possible to be a strong external monitor to safeguard enterprises from managerial opportunism in state enterprises. Conversely, government protection of state enterprises is potentially to alleviate the pressure on managers to distort firm-specific information in SOEs.

7. Summary

Good and effective corporate governance brings about numerous number of positive implications, from enhancing the efficient use of the company's resources and reducing the risks resulting from it by improving the level of performance, affecting the trading volume of companies, thus enhancing their production and service capacity, to minimizing the risk of fraud and corporate breakdown, as well as generating wealth through enhanced economic performance. Furthermore, through its regulation of the behaviors of all parties of a corporation, enforcing equal treatment, driving organizations to recognize that they have legal, contractual, social and market-driven obligations to all parties involved, requiring skills and knowledge of board members, and pushing organizations to be transparent with their roles and responsibilities, corporate governance standards seem to have a favorable impact on enhancing the credibility of financial reports, thus, benefiting regulators, creditors, owners, and business partners.

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