International Research Journal of Commerce and Law
Volume 5 Issue 10, October 2018 ISSN: 2349-705X Impact Factor: 4.616
Journal Homepage: http://ijmr.net.in, Email: irjmss@gmail.com
Double-Blind Peer Reviewed Refereed Open Access International Journal

CORPORATE GOVERNANCE AND THE QUALITY OF FINANCIAL REPORTS: A LITERATURE REVIEW

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ABSTRACT

There has been a heightened concern for quality financial reports prepared by managers which has in turn become a global issue and concern. The governance structure of any entity will affect the quality of its reports. These reports communicated to shareholders and stakeholders are expected to show the true state of affairs of the entity and whether this information contained in the report are faithfully represented as well as the relevance of the accounting numbers contained in them is another issue for discuss and a central focal point of this paper. The aim of this paper is to examine the role corporate governance play in ensuring that quality reports are prepared and presented to the intended users of such reports.

The methodology adopted for this paper is the content analysis as well as exploratory where extant literatures have been reviewed to ascertain the relevance of the corporate governance on the quality of financial reports. The paper concluded that corporate governance is a determinant of quality financial reports and influenced through the corporate mechanisms such as the audit committee, compensation committee, risk management committee, internal control and external audit. The paper recommended that there should be a well constituted corporate governance board for all companies and harmonization of codes of corporate governance enhancing uniform practice everywhere. It was also recommended that selection of members of the board should be individuals with integrity and honor who will serve the interest of the stakeholders and deliver honorably.

Keywords: Corporate Governance, Financial Reports, Accounting Numbers, Shareholders, Stakeholders, Harmonization

1.0 INTRODUCTION

Financial reporting is a very useful tool and instrument in which investors in any organization uses to make investment and economic decisions. The preparation of these reports to a very large extent depends on the governance structure that prevails or exists in the reporting organization.

The contents of these reports should as a matter of policy convey vital information as to the true state of affairs of the organization faithfully representing every accounting value as contained in the reports. Corporate governance structure is to ensure that quality financial reports are prepared and relied upon for its stakeholders in making informed economic and investment decisions.

Financial reports have now become a useful tool to the users of the information in the financial statements because their decisions are based on the contents in the financial statements and the system of governance is greatly influenced by certain mechanisms which will either make the quality of such information to be high or low. Corporate governance issues took a central stage in the wake of the collapse of Enron and WorldCom in the United States which led to the enactment of the Sarbanese-Oxley Act in July 2002 (Okereke, 2008). However, in Nigeria, corporate failures have been adduced as being a fall out of non-observance of the code of corporate governance. The saga in Cadbury Nigeria Plc and some banks are some of the examples that have questioned the confidence in financial reporting as well as the entire financial system. In response to this the Financial Reporting Council of Nigeria (FRCN) in 2002 issued a national code of corporate governance to address some of these issues which sets the benchmark.

Corporate governance according to Agrawal and Chadha (2005) "is the process by which companies are being governed and controlled and the rate of which accounting scandals had occurred in the international financial community has raised many questions and criticisms about the quality of financial reports". There is therefore urgent need to improve the quality of financial reports and monitor the control of managers by putting in place good governance mechanisms in order to avoid corporate failure (Vafeas, 2005). Good corporate governance is a corporate set up which leads to the maximization of shareholders' value legally, ethically, and for sustainability while the principle of equity and fairness is not compromised but maintained for all stakeholders (Murthy, 2006).

Today, corporate governance becomes a major key determinant in identifying a company's strengths and weaknesses and one of the pertinent functions performed by corporate governance is to ensure the quality of the reporting process (Cohen et al., 2004). However, financial reporting quality is the precision with which financial reporting conveys information about an entity's operations and activities (Biddle et al., 2009).

The sole aim of preparing financial reports and maintaining high quality financial reports is to avoid the users being misled in making their decisions as it relates to the entity and the information truly represents the performance and net worth of the organization.

There has been a heightened concern for quality financial reports prepared by managers which has in turn become a global issue and concern. The governance structure of any entity will affect the quality of its financial reports. These reports communicated to shareholders and other stakeholders are expected to show the true state of affairs of the entity and whether this information contained in the report are faithfully represented as well as the relevance of the accounting numbers contained in them is another issue for discuss and a central focal point of this paper. The saga in Cadbury Nigeria Plc and some banks are some of the examples that have questioned the reporting system and the confidence in financial reporting as well as the whole entire financial system.

Recent crisis has called for so many questions about the governance policy that have existed and practiced by companies internationally which has prompted regulators to propose new laws which is perceived as best practices of governance. These practices help companies to reduce mismanagement and remedy problem of governance mechanisms.

2.0 OBJECTIVE AND METHODOLOGY OF THE STUDY

The aim of this paper is to critically examine the role of the governance structure in the financial reporting quality. The type of decision making is based on the quality of financial information which is available to investors' and stakeholders. Financial information determines the type of decisions investors will make.

The methodology adopted for this paper is the content analysis and exploratory research designs where extant literature was reviewed to ascertain the role of corporate governance in the quality of financial reports. Agency, stewardship and stakeholder theories were reviewed.

3.0 THEORETICAL BACKGROUND OF THE STUDY

This study is hinged on the Agency theory. Three theories considered to germane were reviewed for this study. The theories reviewed include Agency theory, Stewardship theory and Stakeholder theory.

3.1 Agency Theory

This theory is relevant to this study as it is crucial in explaining the role of corporate governance in the quality of financial reporting because of the need for the agents to produce financial reports that will be credible and providing information that will be useful to the stakeholders in making investment and economic decisions. (Jensen &Meckling, 1976)

Jensen and Meckling (1976) explains agency as the relationship that subsist between the principal and the agent who is expected to carry out some assignments as directed by the principal. However, both the agent and the principal have self-interests that are not aligned resulting into agency conflict bringing about agency cost. The principal is expected to reduce this agency conflict by reducing the self-interest of the agent and its inadvertent causes.

This study suggests that certain measures can be taken by the principal to ameliorate the agency conflict by defining job descriptions. External third party who is usually the auditor can also be appointed to check the agent which is expected to improve the benefits of the principal.

3.2 Stewardship Theory

This theory can be understood from the stand point that those entrusted with fiduciary responsibilities and duties are expected to give account of the use of resources entrusted to them.

Agents most of the times act in their best interest and are privy to certain information not known to the principal and create a gap of information asymmetry. Alkabani (2008) in his study observed "the usefulness of the financial information generated by the system would affect the degree of variance in voluntary disclosure and the choice of reporting".

However, the duty of the auditor who is the third party provides an assurance for the users of the financial statements and unifies the role of financial reporting, auditing, and corporate governance.

3.3 Stakeholders Theory

As opined by Freeman (1984), "when a firm treats a supplier as a valued member of the stakeholder, rather than just a source of materials, they will respond when the firm is in need". The stakeholder group interest must also be aligned with the organizational goal since they are the providers of capital and the treatment of the stakeholder group will attract a reaction from those affected.

The success of the management is largely dependent on the fusion of stakeholders into the chain and consideration for stakeholders' expectations in all aspects of direction of decisions will affect the future of the establishment or entity (Donaldson et al., 1995).

The focus of the stakeholder theory is how the management makes decisions that will positively affect all the stakeholders. This is a key towards the success or failure of the firm.

4.0 LITERATURE REVIEW

Prior studies have posited that corporate governance is a system by which organizations are directed and controlled (OECD, 2004; Ticker, 2009; Rezaee, 2012). Oghojafor, George and Owoyemi, (2012) and Plender (2003) defined it as "the structure, processes, rights and responsibilities of various stakeholders within a corporation". These authors suggested that the regulations of the internal structures and processes ensures proper direction, administration, and control which supports the position of corporate governance being responsible for value maximization of the entity (Onuoha, 2014).

The Central Bank of Nigeria in 2006 reported that "*40% of the quoted companies in Nigeria had followed the code of corporate governance. The corporate failures in the Nigerian banking sector such as the Intercontinental Bank, Oceanic Bank and the manipulation of inventory by Cadbury that lead to the removal of the Chief Executive Officer (CEO) and the Chief Finance Officer (CFO) out of office were not surprising at all*".

Some researches adduced the corporate failures to wide spread corruption, dishonesty of managements and weak internal control systems in the 1990s and the early 2000s (Owolabi, Owolabi, & Olotu, 2013). According to the Organization for Economic Cooperation and Development (OECD) in 2004 said that "corporate governance can be viewed as the protection of the rights and expectations of the shareholders, employees and other stakeholders through systematic structures and processes that specify the distribution of rights and responsibilities among the members of the corporation".

Agamah (2013), highlighted "that transparency and accuracy of disclosures; respect for shareholders' rights; proportion of non-executive directors on the boards; general ethical standards; integrity and credibility of management are issues of great corporate concern for attracting investors to the emerging markets".

Corporate governance understood from the stand point of transparency creates an increased level of faith and assurance among the various stakeholder groups and helps them deciding to support the company in so many ways and avenues (Onuoha, 2012; Owoyemi, 2009). Faith in stewardship would decrease by stakeholders when corporate governance is comprised of dishonest practices and inexperience.

Any system that brings about confusion, tension, high staff turnover, low morale of personnel and low productivity would however be considered as a bad governance system (Amao & Amaeshi, 2008). Conversely, in the words of Oghojafor et al., (2012), "it seems right that when a management system gives rise to resource increase, high staff morale, increase in organization's positive visibility as well as good practices index will provide positive account of what quality governance represents".

4.1 Limitations to Effective Corporate Governance

Effective corporate governance can be limited due to a number of factors which is inexhaustible but some researchers have given some of the limitations which would be considered. Sinha and Sinha (2007) identified some of these limitations to be shortage of information for monitoring, inadequate communication processes and unavailability of timely information. Effectiveness to corporate governance may be limited when the shareholders are constrained to having access to adequate information on the operations of the entity upon which they are expected to make decisions on whether to replace the board or not (Amao & Amaeshi, 2008).

Several factors such as culture, the economy and other social issues play an important role in influencing the quality of governance. In the works of Adeosun and Ganiyu (2013), was of the view that "every management is expected to protect its corporate reputation by ensuring that operations follow a transparent process in achieving its goals and objectives. The findings suggest that quality governance can be the parameter for the confidence stakeholders have in the entity".

4.2 FINANCIAL REPORTING QUALITY

In discussing corporate governance, it becomes necessary to evaluate the role of management in the preparation of financial reports to its stakeholders who are the investors to make investment decisions (Elliot & Elliot, 2011). The financial statements which is presented comprises of: the statement of financial position which was formerly the balance sheet, statement of comprehensive income (income statement), cash flow statement and notes to the accounts. The aim is to provide accurate and timely data that describes fairly the economic value of the entity. Where the company belongs to a group of companies there will be a consolidation of both the parent and subsidiary presenting the two entities as one economic unit. Transparency and accountability are indices of integrity which provides assurance of the quality of financial information and reports.

Ensuring quality reporting will depend on the work of the auditor who is expected to express an opinion about the entity in verifying the accuracy of the financial statements in accordance with the Generally Accepted Accounting Principles (GAAP) as well as the International Financial Reporting Standards (IFRS) as adopted in 2012 and attesting to the internal control system and the going concern status of the entity. The International Standard on Auditing makes it clear that the auditor must communicate key audit matters to its stakeholders of which the going concern status as well as compliance to internal controls forms part of the key matters.

According to Shalimova and Stezhko (2016), the auditor is expected to ensure compliance, neutrality and adequacy of his report that will be presented based on the financial statements that have been audited to a satisfied level of credibility before the users. These features serves as a basis of assessment of the financial reports and the extent to which the auditor will perform his work which he is expected to do with professional skepticism will depend on the high importance placed on governance and the constituents of the audit committee in ensuring quality reporting.

4.3 CORPORATE GOVERNANCE ELEMENTS

From the literature reviewed in this study, it has been established that corporate governance is important in any modern business and asides the structures, processes and mechanisms, the corporate governance mechanisms that will be discussed monitors and manages risks associated with the entity. According to Owolabi et al. (2013), he asserted that "the structure of governance comes from the political arena and the climate of the economy which are significant determinants of corporate leadership". The reviews have however pointed to the fact that oversight responsibilities of the committee as internal audit, internal controls, reporting, external activities, code of ethics, risk management practices which explains the functions of corporate governance in the history and taxonomy of international corporate finance.

Corporate governance therefore plays a role which is so pertinent and fundamental because it forms an integral part to the degree of confidence stakeholders place on the performance of financial reports of the management. A number of these elements will be discussed in this study. They include: the corporate governance committee, audit committee, compensation committee, nomination committee, risk management committee and internal and external audit (Organization for Economic Co-operation and Development, OECD, 2004).

4.3.1 Corporate Governance Committee

This committee is usually composed of executive and non-executive directors who have the responsibility for developing and monitoring the governance principles of the company as well as the roles and responsibilities of the directors. The committee is responsible for the agenda and what is to be discussed with the management. They are expected to ensure that there is sufficient information on matters that is meant for board review. The governance committee also ensures that best industry practices are maintained and speaks more of the company's integrity.

4.3.2 Audit Committee

This committee is saddled with the responsibility of oversight for financial reporting and disclosure and oversight over the internal control process as well as monitoring performance of the internal audit function. The committee's function of the external auditors includes receiving their reports on several issues such as the accounting system, any fraudulent practices or illegal acts so discovered during the engagement.

Section 359 (6) of the Companies and Allied Matters Act, 1990 as amended outline the functions of the audit committee to be: "*ascertaining whether the accounting and reporting policies are in accordance with legal requirements and ethical practices; reviewing the scope and planning of audit requirements; reviewing the findings on management matters; reviewing the effectiveness of the company's accounting and internal control system; making recommendations to the board regarding the appointment, removal and remuneration of external auditors and authorization of the internal auditor to carry out investigations into any activities of the company which may be of concern to the committee*".

4.3.3 Nominating Committee

It is the responsibility of this board to appoint directors to the board by conducting election by the shareholders. The committee reviews their performance, consider their background and diversity of knowledge and conduct the nominating process for qualified candidates and subsequently the election. It is also the role of the nominating committee to ensure transparency and enhance credibility of the process as well as performance of governance.

4.3.4 Risk Management Committee

Risks that threaten the achievement of the goals of the organization are managed and mitigated through risk management practices. Their functions center on formulating policies and strategies that will help reduce and mitigate risk. They are also involved in the discussion and analysis of any litigation with the management.

4.3.5 Internal Control and Internal Audit Committee

The audit committee is expected to ensure that policies used to control operations, accounting system and compliance to regulatory bodies is properly directed. The internal auditors provide reports ensuring its compliance to reporting standards while external auditors provide reports to the audit committee which assist in determining the effectiveness of the accounting and financial reporting process the management is operating. The audit committee can also recruit the services of an independent auditor and other outside advisors as they consider important issues pertinent to the organizational success. This function serves as protective measure for the shareholders to ensure that the quality of reporting is enhanced.

4.4 QUALITIES OF FINANCIAL REPORTS

According to International Accounting Standard Board (2008), financial reports are expected to meet certain criteria before its quality can be ascertained. These qualities are in the form of its enhancing qualitative attributes they must possess. The following are some of these qualitative attributes or characteristics:

4.4.1 Relevance

Relevant information is capable of making a difference to the users of the financial statements. Relevant information has a high predictive value because it helps users to evaluate the potential effects of the past, present and future transactions on future cash flows as well as a confirmatory value. In other words, it helps investors to confirm their previous evaluations.

4.4.2 Faithful Representation

Information must be a faithful representation of the economic phenomena that it purports to represent. It is attained when the depiction of a phenomenon is complete, neutral and free from all material misstatement and errors. The economic phenomenon shows the economic substance of the underlying transaction which is not always the same as its legal form.

4.4.3 Completeness

Information must be complete to avoid misleading the users of the reports and economic phenomenon is complete if it includes all information that is necessary for faithful representation which is purports to represent. An omission can cause information to be false or misleading and is therefore not helpful to the users.

4.4.4 Comparability

Quality information enables the users to identify similarities and differences between two sets of economic phenomena. Consistency refers to the use of the same accounting policies and procedures either from period to period within an entity or in a single period across entities. Comparability is the goal but consistency is a means to an end that helps in achieving that goal. Thus, information about an entity is useful if it can be compared with similar information about other entities and with similar information about the same entity for some periods of time. Comparability is not the quality of an individual item of information but rather a quality of the relationship between two or more items of information. Comparability should not be confused with uniformity as they do not mean the same thing.

4.4.5 Verifiability

Verifiability implies that different knowledgeable and independent observers could reach a general consensus although not necessarily a complete agreement that either the information represents the economic phenomena it purports to represent without material error or bias. That is, an appropriate recognition or measurement method has been applied without material error or bias.

4.4.6 Timeliness

Information should be available to decision makers before it loses the capacity to influence those decisions. The information may not be useful if it is not available when it is needed. Relevant information available at the right time can enhance decisions and lack of timeliness can rob information of its potential usefulness. Some information may continue to be timely long after the end of a reporting period because the users consider it when making any decision.

4.4.7 Understandability

This quality of information enables users to comprehend and understand its meaning. Understandability is enhanced when information is classified, characterized or grouped and presented clearly and concisely. Comparability can also enhance understandability. Presenting information clearly and concisely helps users comprehend it; the actual comprehension or understanding of financial information depends largely on the users of the financial report. Users of financial reports are assumed to have reasonable knowledge of business and its economic activities and to be able to read a financial report. In decision making, users should also review and analyze the information with reasonable diligence. However, when underlying economic phenomena are complex, fewer users may understand the financial information depicting those phenomena.

4.4.8 Neutrality

This is the absence of bias which is intended to attain a predetermined result. Neutral information is free from bias so that it represents faithfully the economic phenomena that it purports to represent. Neutral information does not color the image it communicates to influence the behavior in a particular direction. However, to say that financial reporting information should be neutral does not mean that it should be without purpose or that it should not influence behavior. Completeness and neutrality of information are desirable and a minimum level of accuracy also is necessary for an estimate to be faithfully represented.

5.0 CONCLUSION ANDRECOMMENDATIONS

This paper has examined corporate governance and quality of financial reports and concluded that corporate governance plays a vital and important role in determining the quality of financial reports prepared and presented by managers who are agents to the entity. It was also concluded that the stakeholders see corporate governance as a key determinant of organizational integrity. Corporate governance has gained more prominence due to failure of some big companies globally and countries all over the world are now developing the most appropriate solutions to address corporate governance issues.

Good corporate governance ensures oversight functions of the audit committee and other committees that have been highlighted and explained in this study. The agency theory, stakeholder theory and the stewardship theory were seen to be paramount for quality financial reporting in which the agency theory addressed the issue of agency conflict that may arise as a result of information asymmetry between the managers who are agents and the principal who is the owner of the business (Jensen & Meckling, 1976).

External auditors independently establish credibility of the financial reports prepared and presented by manager. The stewardship report is prepared and presented to stakeholders showing lending credibility on the performance of the entity as well as management. This study affirms through the reviewed of the literature that corporate governance is germane to the quality of financial reporting in the global world today.

Based on the information gathered during this study, the following recommendations were prescribed:

1. That selection of members of the board should be individuals with integrity and honor who will serve and deliver;
2. The corporate governance system should be composed of individuals that will present financial reports that are prepared in line with GAAP and IFRS;
3. The corporate ownership structure is an important monitoring mechanism aimed at curbing managerial opportunistic behavior by requiring high quality financial reports and it should be used as such;
4. The code of corporate governance should be strictly adhered to as this will to a very large extent improve the governance system as well as improving the overall quality of the financial reports and;
5. The implementation of corporate governance should be a prerequisite to corporate financial reporting which impose on management to prepare financial statements showing full information disclosure for informed economic and investment decisions

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