The effect of corporate governance mechanism on quality of financial reporting

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Abbas Ali Daryaee, Dr Mahmood Samadi Largani, Kamal Eisapour; The effect of corporate governance mechanism on quality of financial reporting

ABSTRACT

Responsibility of directors against their obligations is one of the most significant cases which have been discussed in researches in line with the effect of corporate governance on appropriate financial reporting as well as report of auditor. According to representation theory we shall find a way to decrease contrast of benefits of beneficiaries for optimizing quality of financial reporting. In the current research we analyze relation between corporate governance mechanism and reporting quality with proxy of auditing report. The results show a significant and positive relation between them. Nevertheless, a significant relation between main shareholders and modified report of auditors is due to concentrated ownership together with necessary plans for supervision and control especially in governmental economy.

Key words: Corporate Governance, Quality of Financial Reporting, Auditing

Introduction

Whether financial statements of companies are in conformity with quality standards (accounting standards) or not is a question shows that there is a mechanism which operates these standards and declares that duty of company's auditor is reporting about uniformity of regarding the abovementioned operational criteria. In view of representation theory operation of auditors as one of the important aspects of corporate governance will be resulted to optimized supervision and control of company's directors. Auditing financial statements will disclose information therefore users will find out that the financial reports were prepared in a clear space [1] that is, corporate governance structure could be effective on type of report of auditors as a criterion for transparency of financial information.

Final product of auditing process is a report which the auditor declares his opinion in line with the revised financial statements and we understand that auditing report is a combination of endeavor and judgment of auditor in respect to the entire auditing work [1]. Therefore, auditor's report is product of work holder systems and reflects operation of directors in several paragraphs of the report, thus, any weakness in control structure of the company will be reflected in auditor's report. As the result, we cannot ignore role of appropriate corporate governance in report of auditors. Auditors have significant role in supervision on quality of the information presented by companies. In fact, financial reports are common product of directors and auditors [2]. Now, if the directors presents required information based on a system, which enforce management to accompany representation of clear information in frame of financial statements and explanatory notes (appropriate corporate governance), it would have an important influence on manner of reporting by auditors.

Social role of companies auditing shall be considered in wider structure of corporate governance, that is, various organizational mechanisms are existed for leading and controlling stock companies and their management is existed as an inter-organizational as well as intra-organizational [3]. This kind of control is complex and includes internal and independent auditing, using auditing committees, selecting directors and other supervision mechanisms, that is, according to beneficiaries' theory, auditing structure of the company is in the same direction with benefits of individuals who will take benefit from operation of the company, in the other word, auditors could be considered as beneficiaries and sponsors of rights of other beneficiaries at the same time.

Recent researches show that before effectiveness of auditors report on corporate governance mechanisms, there are corporate governance structures which affect auditor's reports [4, 2, 5]. Considering theoretical fundamentals and former researches and by using model expansion introduced by [2, 5], we consider modified report of auditor as a dependant variable and corporate governance scale

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computed based on the adjusted criteria presented by Institutional Shareholders Services as an independent variable. Difference between our model and their model is pervasiveness of this descriptive model. We believe that beside structure of board of directors, some issues such as disclosure, commercial behavior, regarding legal requirements, auditing, ownership structure, assets and liquidity management and scale of director's training will affect on type of reports of auditors, therefore, the abovementioned issues are considered in scale of corporate governance. [5] evaluated existence of a probable relation between receiving modified report of auditor as one of qualified criteria of the presented information and auditing committee as a one of corporate governance mechanisms. They believe that quality of auditing committee and percentage of independent directors which are its members, quality of the company, and report of losses during 2 years are effective on modified report of auditor. An interview over the former researches show that direct survey of relation between corporate governance scale and type of auditors report has not been subject of any specific research and this study could be considered as a significant point in literature related to researches of financial economy, accounting and auditing and Iranian new market requires these studies more than ever so that necessary fields for performing corporate governance bylaws could be provided. This article introduces literature review in the 2nd part, research hypotheses and methodology in the 3rd part, analysis of discoveries in the 4th part and resulting and offers in the 5th part.

Literature Review:

One of aspects affect on auditor's reporting is scale of disclosure of financial and non-financial information by directors in financial statements. In this regard, Pamela Kent and Jenny Stewart 2008, in a research titled corporate governance and scale of disclosure in transferring to international accounting standards, found out scale of disclosure has a direct relation to various aspects of corporate governance such as structure of board of directors and auditing committee. Corporate governance could be resulted to appropriate reporting and as a result, auditor's report could be acceptable or modified because type of auditor's report shows scale of information quality.

In a research titled effect of corporate governance mechanisms on quality of financial reporting and auditor's reports [4,3] declared that auditors believes that if they could audit member companies at the same time, they have more ability against management sabotages. However, they discovered no significant relation between auditing committee and internal auditor and corporate governance bylaw and reporting quality. Although results of their researches in the year in question was clear due to weakness of corporate governance structures which resulted to financial scandals in many companies in the world.

Responsibility of directors against their obligations is one of the most significant cases which has been discussed in researches in line with the effect of corporate governance on appropriate financial reporting as well as acceptable or modified report of auditor. In this regard [1] declared that the gap between expectations of directors and truths in financial reports which could be resulted to enforcing directors to responding via legal requirements in senate (such as SOX law in USA) shall be decreased. It is clear that this matter could be resulted to presenting a report through auditors which keep benefits of shareholders in private sector and benefits of government in public sector. In the other words, auditor's report can simplify process of corporate governance as a catalyst.

[6] declared that auditing committees in Indian companies had an important effect on report of independent auditors, but auditing committees were not determinant elements in mechanism of corporate governance in this country. That is, although auditing committee has been effectiveness in performing corporate governance, but, as a one of mechanisms of corporate governance, has had a significant effect on expressing opinion by auditors. This matter will happen when members of auditing committee are not independent and we can see this fact especially in new markets.

[5] performed a research on surveying role of independent auditors on corporate governance mechanism and found out that auditors are considered as one of important tools for decreasing representation troubles and their reports as a one of criteria of financial reporting quality could result to strengthening corporate governance mechanism. They also understood that type of auditors has an effective role on structure of corporate governance in new markets.

[7] declared that auditors expect accountants to present financial amounts fairly and correctly. That is, auditors could be an element for presenting information by providers of financial statements. If we accept the above-said matter, corporate governance mechanism is a space which enforces directors and accountants to present such information.

In a research titled structure of board of directors and modified report of auditor [2] evaluated companies admitted in Securities Exchange of Portugal which presented their financial statements based on accounting standards of Portugal. The company has been surveyed for 91 years. Results have shown that correctness of financial information, appropriate operation; development opportunities and divided profits are effective elements on modified reporting of auditors. In other words, they considered appropriate operation as one of members of board of directors in their research and then
evaluated structure of board of directors. It is clear that one of effective elements on corporate governance mechanism is manner of arrangement of directors in board of directors, as in structure of board of directors, directors with no duty can supervise on all works of board of directors from scale of divided profit to selection of managing director.

[6] found out that high scale of dependant members of auditing committee (as one of important elements of corporate mechanism) will result to decrease scale of acceptable reports of auditor. This matter is another reason for effectiveness of corporate governance structure on auditor's reports.

Considering the performed researches in line with survey of relation between corporate governance mechanism such as structure of board of directors and auditing committee and type of auditor's report [2, 5] we intend to gain some information about scale of corporate governance from explanatory notes of financial statements and discuss about selecting as a representative of corporate governance mechanisms (instead of structure of board of directors or auditing committee or etc.) and explaining its relation with type of auditor's report.

**Research Hypotheses & Methodology:**

In this research the following hypothesis has been compiled based on theoretical fundamentals and background of research:

Scale of corporate governance is in relation with modified report of auditor.

For the abovementioned test the following 3 models have been used:

In fact, the 1st 2 models are expansion of model of [5] in line with survey of relation between modified report and corporate governance mechanisms.

1. \( \text{ODUM} = \alpha + \beta_1 \text{SCORE} + \beta_2 \text{QTOB} + \beta_3 \text{FSIZE} + \beta_4 \text{LOSSD} + \mu_i \)

Whereas,

ODUM: dummy variable: if the company received modified report, it will be changed to 1, otherwise to 0.

SCORE: Scale of corporate governance

LOSSD: If the company constantly had loss during the years in question, it will be changed to 1, otherwise to 0.

QTOB: Value of stock market at the end of financial course to ledger value of shareholder's rights as a development criterion of future opportunities:

2. \( \text{ODUM} = \alpha + \beta_1 \text{SCORE} + \beta_2 \text{QTOB} + \beta_3 \text{FSIZE} + \beta_4 \text{LOSSD} + \beta_5 \text{NUM} + \beta_6 \text{NTB} + \mu_i \)

NUM: Number of board of directors

Now we discuss about test of model presented by [5] It shall be noted that the above-said model surveys relation between a part of corporate governance mechanism with modified report of auditor.

3. \( \text{ODUM} = \alpha + \beta_1 \text{SCORE} + \beta_2 \text{FSIZE} + \beta_4 \text{DATYPE} + \beta_5 \text{LOSSD} + \beta_3 \text{LEV} + \beta_6 \text{BLOCK} + \beta_7 \text{DPRIOR} + \mu_i \)

Whereas,

ODUM: dummy variable: if the company received modified report, it will be changed to 1, otherwise to 0.

SCORE: Scale of corporate governance

Many researchers, instead of considering effect of one or more corporate governance mechanisms as a corporate governance criterion, intend to use standard criteria which were adjusted as per properties of capital stock market and economy for computing scale of corporate governance. In this research for computing scale of corporate governance they use list of standards provided by institutional shareholders services of USA, which has been adjusted as per accessing to information about Iranian companies. Manner of work is conforming standards of corporate governance with financial reports and explanatory notes and management reports.

FSIZE: Natural logarithm of selling

There are several arguments that can be used to link size to disclosure as a corporate governance mechanism. As [7] argue, political costs are higher in larger companies, and so larger companies are more likely to show higher levels of disclosure since it improves confidence and reduces political costs. Also, larger companies are supposed to have superior information systems, so additional disclosure is supposedly less costly in larger companies than in smaller ones. Moreover, proprietary costs related to competitive disadvantages of additional disclosure are smaller as company size increases [8]. Certainly the firm size determines the amount and range of firms' activities. Larger firms, because of their more contacts with the shareholders and the existence of more control mechanisms have a less amount of commercial risk, so we expect that large firms have a higher corporate governance score. To calculate the firm's size criteria is the same as the mean of sum of assets, the firm's stock exchange value and amount of sale. We use sales figures as proxy for size because regarding the high rate of inflation in Iran, the sale figures present more relevant information.

LOSSD: If the company constantly had loss during the years in question, it will be changed to 1, otherwise to 0.
DATYPE: If the company was audited by Accounting Org., it will be changed to 1, otherwise to 0.

BLOCK: percentage of main shareholders

[9] note the substitution effects between outside directors, block holders, and incentives to insiders using eighty one U.S. bank-holding companies in his study. Both [10] investigate the board structure determinants before and after Cadbury Report. They either find managerial entrenchment is reduced or non executive directors are increased following the imposition of new standards of “best practice” regarding board structure. [11] show that insider shareholdings and block holdings are negative and significant, whereas institutional shareholdings are positive and significant with corporate governance practice.

As stated above, we examine the four mechanisms used in controlling agency problems: non-executives managers, block holdings, institutional shareholdings and disclosure. In addition, we also include a comprehensive measure of governance using a corporate governance scorecard and measuring governance over a longer time period.

DPRIOR: If report of the former year was modified, it will be changed to 1, otherwise to 0.

For selecting sample of survey, screening sampling method has been used. Necessary companies for survey and test of hypothesis are selected from statistical society in some steps by considering their common particulars. Considering the existed limitations in this research, the companies have been selected based on the following conditions:
- The company must have no change in activity or fiscal year during the above mentioned fiscal years.
- The company shall not be a part of banks or financial institutes (investing companies, financial brokerage, holding companies, leasing companies).
- Fiscal year of all companies shall be at the end of Esfand (20 March).

In this research, library method has been used for collecting data and information. In library part, theoretical fundamentals of research from books, Persian and Latin specialized magazines were collected and then research data were performed via collecting data of the selected companies by referring to financial statements, explanatory notes, weekly and monthly reports of securities exchange and by using Rahavard Novin and Tadbir Pardaz software.

**Empirical Results**:

<table>
<thead>
<tr>
<th>Dependant Variable ODUM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Method: ML – Binary Logit (Quadratic hill climbing)</td>
</tr>
<tr>
<td>Included observations: 240</td>
</tr>
<tr>
<td>Convergence achieved after 5 iterations</td>
</tr>
<tr>
<td>Covariance matrix computed using second derivatives</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Coefficient</th>
<th>Std. Error</th>
<th>z-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>2.494004</td>
<td>1.581626</td>
<td>1.576788</td>
</tr>
<tr>
<td>SCORE</td>
<td>0.229828</td>
<td>0.920420</td>
<td>0.923450</td>
</tr>
<tr>
<td>FSIZE</td>
<td>3.781452</td>
<td>0.546779</td>
<td>4.878777</td>
</tr>
<tr>
<td>DATYPE</td>
<td>1.210528</td>
<td>0.652389</td>
<td>1.565601</td>
</tr>
<tr>
<td>LOSSD</td>
<td>0.9687</td>
<td>0.435344</td>
<td>0.987665</td>
</tr>
<tr>
<td>LEV</td>
<td>-1.88774</td>
<td>-0.493434</td>
<td>-1.908887</td>
</tr>
<tr>
<td>BLOCK</td>
<td>0.98987</td>
<td>0.010998</td>
<td>0.0289</td>
</tr>
<tr>
<td>DPRIOR</td>
<td>-0.3997</td>
<td>-0.080999</td>
<td>-0.399882</td>
</tr>
<tr>
<td>McFadden R-squared</td>
<td>0.269471</td>
<td>Mean dependent var</td>
<td>0.622222</td>
</tr>
<tr>
<td>S.D. dependent var</td>
<td>0.4879</td>
<td>S.E. of regression</td>
<td>0.439123</td>
</tr>
<tr>
<td>Akaike info criterion</td>
<td>1.123127</td>
<td>Sum squared resid</td>
<td>102.345</td>
</tr>
<tr>
<td>Schwarz Criterion</td>
<td>1.198568</td>
<td>Log likelihood</td>
<td>-300.4016</td>
</tr>
<tr>
<td>Hannan-Quinn Criter</td>
<td>1.167856</td>
<td>Restr. Log likelihood</td>
<td>-360.8542</td>
</tr>
<tr>
<td>LR statistic</td>
<td>123.351</td>
<td>Avg. log likelihood</td>
<td>-0.555318</td>
</tr>
<tr>
<td>Prob (LR statistic)</td>
<td>0.000000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Descriptive statistics of research variables

<table>
<thead>
<tr>
<th>Minimum</th>
<th>Maximum</th>
<th>Average</th>
<th>Standard deviation</th>
<th>Variance</th>
</tr>
</thead>
<tbody>
<tr>
<td>ODUM</td>
<td>0</td>
<td>1</td>
<td>0.4</td>
<td>0.78</td>
</tr>
<tr>
<td>SCORE</td>
<td>8</td>
<td>17</td>
<td>13</td>
<td>0.45</td>
</tr>
<tr>
<td>FSIZE</td>
<td>5.54</td>
<td>17.77</td>
<td>8</td>
<td>0.41</td>
</tr>
<tr>
<td>DATYPE</td>
<td>0</td>
<td>1</td>
<td>0.89</td>
<td>0.70</td>
</tr>
<tr>
<td>LOSSD</td>
<td>0</td>
<td>1</td>
<td>0.34</td>
<td>0.12</td>
</tr>
<tr>
<td>LEV</td>
<td>0.5</td>
<td>3.5</td>
<td>1.5</td>
<td>2.00</td>
</tr>
<tr>
<td>BLOCK</td>
<td>1.0</td>
<td>99</td>
<td>60</td>
<td>1.09</td>
</tr>
<tr>
<td>DPRIOR</td>
<td>0</td>
<td>1</td>
<td>0.65</td>
<td>0.12</td>
</tr>
</tbody>
</table>

According to the above tables (p-value=0.000) which is less than error level of 0.05. Therefore hypothesis of zero is refused, that is, as per extractive sample; hypothesis of significance of regression is
accepted. In other side, McFadden adjusted index is equal to 0.02609 which shows that 26.95% of changes of dependant variable (receiving modified report of auditing) could be specified with independent variables of model. Significant relation of corporate governance and modified report of auditors show that optimization of corporate governance mechanisms include directors with no duty, auditing committee, etc. can change operational space of the company toward benefit of all beneficiaries. In the other word, these mechanisms can decrease non-polarity of data and financial reports could be prepared with more information quality and this matter can decrease probability of cheating in financial statements. Results of researches are in conformity with discoveries of [2]. To continue Average of corporate governance sample firms has been shown in bellow.

5. Conclusion:

In this research we discussed about survey of relation between corporate governance mechanisms and quality of reporting by proxy of auditing report. Results show existence of a significant and positive relation between them. Nevertheless, reason of significant relation of main shareholders and modified report of auditors is concentrated ownership together with required programs for supervision and control especially in governmental economies. [9] by presenting hypothesis of profits convergence declares that main shareholders have strategic unity and continuity with management. Therefore, they will take actions for increasing quality of financial reporting. Identification and expression of effective variables on quality of financial information of companies and different aspects of principles of corporate governance can help potential investors in specifying suitable portfolio of investment.

References


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