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CORPORATE GOVERNANCE MECHANISMS AND FINANCIAL REPORTING QUALITY: A THEORITICAL REVIEW

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ABSTRACT
Corporate Governance mechanisms are set of authorities and responsibilities that encompass all mechanisms designed to control managers and reduce conflict of interest between managers, shareholders and stakeholders. The paper theoretically reviewed past literatures on how the internal mechanisms of corporate governance (proxied by board size, board independence, ownership structure and audit committee independence) affect financial reporting quality. The paper concludes that the result of the theoretical review has mixed result and therefore recommend more empirical research on the effect of corporate governance on financial reporting quality.

Keywords: *Corporate governance, financial reporting quality, board size, board independence, ownership structure and audit committee independence.*

INTRODUCTION
Corporate governance is a means or framework through which companies are directed, controlled and resources are managed towards effective attainment of corporate objectives (Nurudeen & Hasnah, 2015). This shows that corporate governance is a fundamental framework for the success of every company. Cohen, Krishnamorthy and Wright (2004) asserted that one of the most important functions performed by corporate governance is to ensure the quality of financial reporting process. The provision of high quality financial information is important because it influences the providers of capital and stakeholders positively in making investment, financing and allocation

decisions that enhance the overall market efficiency (IASB, 2008). The Financial Accounting Standard Board (FASB, 1999), states that financial reporting quality is the accuracy with which information about firm's operations are presented in financial reports. In attaining financial reporting quality by corporate entities, corporate governance mechanisms stand as a vital instrument.

Nidhi (2017), defined corporate governance mechanisms as set of authorities and responsibilities which have influential power on management decisions and eliminate the manager's discretionary space which involves processes and governance structures of the corporation. Damak (2013), views corporate governance mechanisms as a system that encompasses all mechanisms designed to control managers and reduce conflict of interest and asserts that there are two distinct types of mechanisms: external mechanisms such as market forces, government policies, financial institutions and internal mechanisms such as the board of directors, segregation of control, ownership structure and the audit committee. This study is interested in examining only the internal mechanisms of corporate governance because internal mechanisms are controls which are internal to the corporation, monitor the progress and activities of the corporation and take corrective action when the business goes off track. Moreover, the internal mechanisms are those monitoring methods and ways that helps management of corporations in enhancing shareholders value.

The failures of large corporations home and abroad in the past few decades like Cadbury, Onwuka- Hitech, African Petroleum, Enron and worldcom has led to an increase in the demand for financial reporting quality and how these corporations are governed in general. Financial reports are the means which shareholders and stakeholders access the wellbeing and going concern of a corporation. Therefore, the quality of these reports becomes paramount to its users,

This study specifically looks at how corporate governance mechanisms (proxied by board size, board independence, ownership structure and audit committee independence) affect financial reporting quality of companies. The study is divided into three sections: introduction, literature review, conclusion and recommendation.

LITERATURE REVIEW

Corporate Governance Mechanisms

Effective corporate governance is essential if a business wants to set and meet its strategic goals. A corporate governance structure is often a combination of

various mechanisms that combine controls, polices and guidelines that drive the organization towards its objectives while also satisfying the needs of its stakeholders. Nidhi (2017) defined corporate governance mechanisms as a certain set of authorities and responsibilities which has an influential power on management decisions and eliminates the managers' discretionary space. The two types of mechanism that revolve around the corporation are the internal and external mechanisms. The internal mechanisms are those internal control and methods used by the firms to help management in enhancing the value of shareholders which includes board of directors (composition/structure of the board), ownership structure, audit committee, compensation of board and segregation of control whereas external mechanisms are those mechanisms created by stakeholders of the firm to make companies operations in accordance with policies that regulate the firm's operations. These external mechanisms include market forces, intermediaries, managers for labour market (Nidhi, 2017). Similarly, Julie (2018), also affirmed that internal mechanisms are those set of controls that serve the internal objectives of the corporation and its stakeholders, including employees, managers and owners. They include structure/composition of the board, segregation of control, the audit and ownership structure while external mechanisms are those controls outside the organization which serve the objectives of entities such as regulators, government, trade unions and financial institutions. Therefore, internal mechanisms are those forces within the firm while external mechanisms are forces outside the firm (Khondaker & Marc, 2016).

Specifically, Junaidu (2015) assert that a combination of these mechanisms makes up the Code of Corporate Governance which are regarded as the set of 'best practice' recommending the behaviour and structure of the board of directors of a firm. It is designed to address deficiencies in the corporate governance system by recommending a comprehensive set of norms on the role of the board of directors, board committees, relationship with shareholders and top management, auditing and information disclosure, ownership structure, and segregation of control.

The Board of Directors*:* An important corporate governance mechanism that aligns the interest of the shareholders and managers are the board of directors. The board of the directors are responsible for controlling officers and whose function is essential to minimize the costs resulting from the separation of ownership and control in modern organization (Damark, 2013). The board are

responsible for monitoring the quality of information contained in financial statement. As such, Anderson, Mansi and Reeb (2004), argued that board of directors are responsible for monitoring, evaluating, and disciplining the management of a company, and oversight financial reporting is one of the most important responsibilities of the board. The role of the board of directors in corporate governance, specifically their responsibility to measure financial reporting quality cannot be overemphasized. Users of financial statements are interested in the quality of earnings as well as the quality of reporting because such information influences their decision making.

Dimitripoulos and Astreriou (2010), argued that the information quality of a financial reports varies in accordance with the composition and sizes of corporate boards of listed firms. Evidences have shown that board composition is significant in determining financial reporting quality (Klein, 2002; Osmar & Noguer, 2007). Board composition is aimed at ensuring independence, size, and diversity without compromising competence and experience. Specifically, gender diversity among corporate boards stands out to be one of the key mechanisms to improve corporate governance as well as an active matter in policy making in many countries (Farero et al, 2015). An effective board should monitor financial discretion and should ensure that accounting choices made by the management are valid (Kent & Stewart, 2008).

Board Committees*:* Board committees are subsidiary to the board of directors that perform particular functions (Damark, 2013). One of these committees is the audit committee who are independent directors. Robinson and Owen-Jackson (2009), assert that the audit committee are selected members of companies who take active part in overseeing the companies accounting and financial reporting quality policies and practices. They are involved in those activities which are assigned by the board of directors in ensuring that financial statements are free from material misstatements thereby ensuring financial reporting quality (Nidhi, 2017). Indeed, financial reporting quality became of utmost importance following the phenomena of corporate collapse. The phenomena of corporate collapse around the world led to the regulation of reforms in both accounting field and stock exchange (Allen, 2000).

These corporate collapse led to agitations to review the structures of corporate governance in Nigeria which brought about the need for audit committee in checking financial reporting process. Menon and William (1994), asserts that the audit committee is one mechanism available to the board of directors to limit

the conflict of interest between managers and stockholders. The importance of this committee has led to its wide adoption around the world of which the Cadbury Committee (1992) assert that the audit committee is an important governance mechanism that would protect the interest of shareholders and ensure transparent reporting and improves audit quality.

Prior studies have advocated that the audit committee plays vital role in ensuring financial reporting quality. For instance, the works of Haron, Jatang and Pheng (2005), Said, Zainuddin and Haron (2009), opined that the audit committee as standard committee contributes to effective corporate governance and ensures reliable financial reporting quality. In order to improve the effectiveness of the audit committee, DeZoort, Hermanson, Archambeault and Reed (2002), considered four determinants of audit committee's effectiveness in ensuring financial reporting quality namely; composition, authorities, resources and diligence. They claim that in composition of the committee, members should be independent, financial literate, be objective and have integrity. Diligence is the willingness of the committee members to work as a team, while resource component stressed that three to six members are considered suitable for the committee and criteria will be interdependent where there is fulfillment of the audit committee's authority. Muhammed, Abdul-Hamid and Md-Nassir (2006), further add that an effective audit committee should possess sophisticated accounting knowledge, review of financial statements, traditional role in accounting and auditing in order to ensure auditor's independence, good management and internal control.

Ownership Structure*:* This is another means of controlling the management part of the company. Scholars have argued that ownership concentration is an important factor that affects a firm's performance and reporting quality (Shleifer & Vishny, 1986; Zeitu & Tian, 2001). This way a business can maintain its best monitoring and controlling system for the better performance of all the functioning of the business firm.

Ownership structure has been classified by many authors in diverse ways which mostly reflect their special interests. Jensen and Merckling (1976), classified owners based on equity, debt and outside equity. Similarly, Gerndoff (1998), as cited in Mike (2006), differentiates between majority owners, minority owners, long term owners, wild cat investors, foreign and domestic investors, risk spreaders, active and passive owners. Djakov (1999), also separated ownership based on management, employees, local outsiders and the state. Vitality (2003),

also distinguished ownership structure by level of concentration of ownership rights as well as by identity of inside and outside owners where the inside owners refers to managers and employees while outside owners refers to individuals, organizations and state owners; and also between foreign and native owners.
Studies about corporate governance have suggested that ownership structure can affect financial reporting quality (Fan & Wong, 2002). Early studies like Shleifer and Vishny (1986), have advocated that the presence of block holders may curb the discretionary behavior of managers and motivate them to adopt profitable strategies and disclose relevant and reliable information. This was supported by the works of Karamanou and Vafeas (2005), Han (2005) and Wang (2006) argued that concentrated ownership reduces the level of discretionary accruals and increases the voluntary disclosure made by managers. Moreover, De Bos and Donker (2004), reported that ownership concentration reduces earnings management in American firms which improves financial reporting quality. However, other studies asserts that concentrated ownership reduces the relevance of financial information (Fan & Wong, 2002, Donnelly & Lynch, 2002, Firth, Fung & Rui, 2007).

Concept of Financial Reporting Quality (FRQ)

Financial reporting is the disclosure of financial information to management and the public about how a company is performing over a specific period of time (Shawn, 2003). It is seen as a means of communicating financial information to users of such information. It is often regarded as the end product of accounting as it assists users of such information in measuring and monitoring economic performance of a business entity to enable economic decisions (Warren & Reeve, 2004). These reports are conveyed through the financial statements. The International Accounting Standard Committee (IASC) defines financial statements as the documents that provide information regarding the financial position, performance, and the capability of a firm that is useful to a variety of users in making economic decisions. Furthermore, the IASC stated that the content of a financial report must include: statement of financial position at the end of the period, statement of income for the period, statement of changes in equity, statement of cash flow and notes comprising a summary of important accounting policies adopted by the firm and other explanatory information.

The value of a financial report is usually determined by its quality. That is why financial reporting quality became of utmost importance to its users. Therefore, the demand for financial reporting quality by these users became on the increase and has received a lot of debate among financial regulators, investors and professionals (Xiaosong, 2010).

Financial reporting quality has been defined in different ways due to differences in reporting environment, legislation and regulators. Moreover, Ormin and Tuta (2014), opined that the different views are characterized by the unit of precision, relevance, actuality and usefulness of the report. The Australia's Accounting Standard Board (AASB), the Accounting Standard Board in United Kingdom (ASB) and the International Accounting Standard Board (IASB) assert that financial reporting quality represents financial statements that offer precise and rational information about the financial status and economic wellbeing of an entity. In the same vein, the FASB, (1999) defined financial reporting quality as accuracy of information presented in a financial statement more specifically the cash flow statement which enable equity investors determine the viability of future strategic decisions they make. Tang, Chen and Zhijun (2008,) defined financial reporting quality as the extent to which the financial statements provide true and fair information about the underlying performance and financial position of a firm. Moreover, Aroob (2017), argued that the most commonly accepted definition of financial reporting quality is defined by Jonas and Blanchet (2000) that a quality financial report is a report that has full and transparent information that is not designed to mislead its users. Providing decision useful information is the primary objective of financial reporting (Ferdy, Geert & Suzanne, 2009). Therefore, decision useful information are information concerning the reporting entity that is valuable to equity investors, lenders and other stakeholders in making decisions in their capacity as capital providers and stakeholders (IASB, 2010). Therefore, the concept of financial reporting quality is all-encompassing in financial information and non-financial information disclosures useful for decision making.

Segregation of Control: The separation of the roles of the chairman and the Chief Executive Officer (CEO) has raised conflicting argument among scholars (Hassnain & Siti, 2017). For instance, the agency theory and Stewardship theory's view about the segregation of control and financial reporting quality show an obvious contrast. Agency theory posits that independence of board is

enhanced as a result of separation between CEO and chairman's responsibility which strengthens its monitoring role thereby improving the quality of information reporting. Hamid (2008); Samaila and Kantudu (2015), affirmed that the separation of the chairman from the CEO strengthens internal control of the firm and has positive impact on financial reporting quality of the firm.

Stewardship theory supports inside executive directors on the board and presumes that CEO duality can lead to better control. Samaila and Kantudu (2015), argues that the appointment of a CEO to the position of a chair can lead to concentration of power and possible conflict of interest resulting in the reduction of monitoring. The extra power weakens monitoring role of the board (Cadbury Committee, 1992) which results to poor internal control system (Abbot, Parker & Peters, 2004). Rahman and Haniffa (2005), studied firms' leadership style in Malaysia and reported that firms that practice CEO duality are more inclined towards earnings management than firms with separate leadership which are inclined to fraudulent transactions and irregularities in financial statement (Beasley, 1996). According to Ibrahim, Ahmad, John and Rahman (2016), duality increases violations of accounting principles which subsequently affect financial reporting quality.

Effect of Board Size on Financial Reporting Quality

Board size is concerned with the number of persons that make up the board of directors. According to Waidi (2017), the size of the board of directors is often used by some scholars to measure the quality of corporate governance and also a determinant of financial reporting. The issue of what size constitutes the ideal number of the board is still being debated among scholars (Ibe, Ugwuanyi & Okanya, 2017). The Nigerian Code of Corporate Governance 2018 as amended assert that the board should be of sufficient size to effectively undertake and fulfil its business; to oversee, monitor, direct and control the company's activities and be relative to the scale and complexities of operations. Though the code did not specify the minimum or maximum number of directors that should be on the board, The Securities and Exchange Commission (SEC) Code being the apex regulator of the capital market expressly specified that the size of the board should not be less than five directors with a majority of independent non- executive directors. The size of the board is seen as an important mechanism in attaining corporate objectives. According to Amstrong et al (2010), board size varies due to difference in the size of the corporation and

difference in country's code. Ordinarily, larger corporations will require larger board size than smaller corporations since board size is an effective mechanism in making corporate valuable corporate decisions.

Waidi (2017), assert that board size is another determinant of financial reporting quality which is often used by some scholars to measure the quality of corporate governance. However, empirical evidence has been inconsistent about the effect of board size on financial reporting quality (Mohammad & Philip, 2018). Some scholars have argued that larger board size is an effective corporate governance mechanism that has effect on financial reporting quality. Larger boards are able to commit more time and effort to monitor management and give better advice (Monks & Minow, 1995). This is supported by the works of (Klein, 1998, Adams & Mehran, 2003, Anderson, Mansi & Reeb, 2004, Coles, Daniel & Naveen, 2008). Similarly, Angrawal and Knoeber (2009), found that larger boards are breeding space for individuals with experience and expertise while Ellstrand, Daily, Johnson and Dalton (1999), found that large boards prevent CEOs dominance.

On the contrary, other scholars have disagreed to the assertion that large board size is better off. Early studies like Jensen (1993), Lipton and Lorsch (1992), asserts that large board size lowers the monitoring function of the board as a small number of directors enables a high degree of coordination between them and managers which in-turn increases financial reporting quality. This assertion was supported by other scholars like Dimitripolos and Asteriou (2010) who argues that larger boards are less efficient monitors than small boards because they have a lower level of membership coordination. Similarly, Vefeas (2005), Bradbury, Mark and Tan (2006) also argues that the monitoring role of larger boards becomes more difficult as it increases coordination and communication problem which leads to lower financial reporting quality.

Effect of Board Independence on Financial Reporting Quality

An independent board of directors brings a high degree of objectivity to the board for sustaining stakeholders trust and confidence. The Nigerian code of corporate governance (2018) as amended issued by the Nigerian Securities and Exchange Commission (SEC, 2011) states that an independent director is a non-executive director, non-substantial shareholder of the company who's shareholding directly or indirectly does not exceed 0.1% of the company's paid up capital. Also in addition to that, the director has no business or professional

relationship with the company and must have not been a previous employee of the company. According to Beasley (1996) the ability of the board of directors to act as an effective monitoring mechanism is dependent upon its independence from management. Moreover, Fama and Jensen (1983), opined that one of the key functions of non-executive directors is to ensure that the board does not collude with management.

Extant literatures have established a relation between board independence and financial reporting quality. Waidi (2017), affirmed that many scholars are of the opinion that board independence has impact on financial reporting quality. However, this impact seems to have mixed results. Some scholars like Klai and Omri, 2011, Nesrine and Abdulwaheed, 2011, Htay, Soualhi, Arif and Rabitta, 2013, Alves 2014, Kantudu and Samaila 2015, Monday and Nancy 2016, Akeju and Babatunde 2017, Waidi 2017, Ibrahim and Jehu 2018 and D'onza and Lamboglia 2014 documents a positive and significant relationship between board independence and financial reporting quality. However other strands in literature holds that board independence is negatively and insignificantly related to financial reporting quality using abnormal accruals as a measure (Klein, 2002, Petra, 2007, Bradly, Mark & Tan, 2006, Doan, Thai, Luu & Nguyen, 2018). They suggested based on their findings that the presence of independent directors cannot guarantee financial reporting quality because independent directors are not competent enough to control managers. This is supported by the works of Asegdew (2016); Al-Asiry (2017) that board independence does not lead to high financial reporting quality. Furthermore, Onuorah and Imene (2016), in their studies on corporate governance and financial reporting quality in selected Nigerian companies from year the 2006 to 2015, documents that board independence negatively affects financial reporting quality using discretionary accruals of firms..

Effect of Ownership Structure on Financial Reporting Quality

As the economies of the world become more and more globally integrated, the increased volatility of corporate ownership portfolios observed in the recent years due to increase in corporate failure globally has led to a renewed interest in ownership structure of firms. Ownership structure is concerned with the identification of share owners whether families, institutional investors, banks, government or other companies and how they affect a company's corporate strategy and performance.

Ownership structure has been classified by many authors in diverse ways which mostly reflect their special interest. For instance, Jensen et al., (1976), classified owners based on equity, debt equity and outside equity. Similarly, Gerndoff (1998) as cited in Mike (2006), differentiated between majority owners, minority owners, long term owners, wild cat investors, foreign investors, domestic investors, risk spreaders, active owners and passive owners, known owners, absent owners and strategic owners. Djakov (1999), also separated ownership based on management, employees, local outsiders and the state. Ownership structure can also be differentiated based on foreign or domestic ownership and institutional or individual ownership. Vitality (2003), distinguished ownership structure by the level of concentration of ownership rights as well as by identity of owner; inside and outside owners where the inside owners refers to managers and employees while outside owners are individuals, organizations and state owners; and also between foreign and native owners.

Foreign ownership refers to control of a business or natural resources by individuals who are not citizens of that country. Herbert (1995), posit that the term 'foreign ownership' encompasses all forms of foreign private investment which confers control and ownership over a package of resources in a foreign country. This package includes embodied or disembodied technology, financial capital, expertise in financial, marketing and management skills etc. (Ioraver & Wilson, 2013).

Foreign firms are also presumed to possess superior ownership and international advantages than their domestic firms which makes them to be more dynamic in their management style (Laing & Weir, 1999). This superiority arises due to their advancement in technology, greater business experience, capital and entrepreneurial skills. Similarly, Herbert (1995) identified and classifies the sources of these advantages into privileged ownership specific advantages firms enjoy such as advantages of proprietary technology, managerial, marketing or other skills specific to organizational function, large size reflecting scale and scope economies, and large capital. These foreign advantages are of advantage to foreign owners as against domestic owners. However, the management of domestic owners can use different techniques against foreign investors, such as declaring some of their shares illegal, losing voting records, and so on in order to gain superiority (Vitality, 2003). Moreover, domestic owners also protect their right by having better connections to other shareholders and physical forces.

The effect of ownership structure on financial reporting quality cannot be overemphasized. Prior literatures on corporate governance and ownership structure have argued that foreign ownership has dynamic role to monitor and control management of companies (Karbhari, 2005). The larger the shares

controlled by foreign parties, the more the foreign parties allocate themselves position in the company as board of directors aimed at aligning the interest of management and shareholders to improve financial reporting quality (Wiranata & Nugrahanti, 2013). Similarly, Adebiyi and Olowookere (2017), argued that due to the importance of timely financial reports to investors, foreign ownership monitor management effectively by increasing pressure on them to release corporate reports including audited financial statements. Thus, the effect of ownership structure on financial reporting quality has been reported with mixed results. Haniffa and Cooke, (2002), Soheilyfer, Tamimi, Ahmadi and Takhtaei, (2014), Ho and Tower, (2011), Rasha, (2017) found a positive association between ownership structure and financial reporting quality. On the contrary, Fan and Wong (2002), Ben-Ali (2008), Htay et al., (2013), Qaiser, Abdullah and Margurite (2017), found a negative relationship between ownership structure and financial reporting quality. Similarly, Muhammed et al., (2017) in their studies on effect of ownership structure on the quality of financial reporting of manufacturing companies listed in the Indonesia Stock Exchange (IDX) from 2013 to 2015 found that ownership structure does not affect the quality of financial reporting with accrual earnings management as indicators. Whereas, Shin (2004) and Farthi (2013) found an insignificant relationship between ownership structure and financial reporting quality. The different findings of prior literature show that the issue of the nexus between ownership structure and financial reporting quality is far from being settled.

Effect of Audit Committee Independence on Financial Reporting Quality

Independence of an audit committee implies that members of the committee do not have any relationship with the management of a company that will jeopardize effective discharge of their responsibilities. An audit committee that is truly independent is believed to carry out its responsibilities honestly without any interference from those upon whom duties it performs an oversight function. Most accounting irregularities have been attributed to inability of audit committee in fulfilling their financial reporting oversight duties due to lack of independence (Aderemi et al, 2016). According to Krishnan (2011), an independent audit committee is likely to guarantee an effective internal control and strengthen its effectiveness which thereby increases financial reporting quality. It is believed that an independent audit committee ensures an effective monitoring of management as its relates to financial matters thereby ensuring reliability on financial reports by its users.

Abott (2002), document that an increase in number of independent members in audit committee reduces cosmetic accounting. This implies that the more independent members of the committee are the less likely financial statements fraud and irregularities, as independence of audit committee members guarantee

effectiveness, reliability of financial reports and mitigates manipulative and selfish motives of managers (Cohen, 2011).

Empirical works on the effect of audit committee independence on financial reporting quality shows a mixed result. For instance, Xie, Davidson and Dadalt (2003), Abdullahi and Nasir (2004), Lin, June and Yang (2006), Adurrahman and Ali (2006), Yusof (2010) found no relationship between audit committee independence and financial reporting quality. Whereas, Klein (2002), Saleh, Iskandor and Rahmat (2007), Adeyemo et al., (2016) documents that audit committee independence enhances financial reporting quality

CONCLUSION

The primary objective was to examine whether Corporate Governance mechanisms has effect on Financial Reporting Quality of companies based on a review of past empirical and theoretical literatures of the theme under study. *It was concluded from the study that the effect of* Corporate governance mechanisms on financial reporting quality has a mixed result, some studies showed that corporate governance mechanisms has effect on FRQ while other studies showed divergent result holding the premise that corporate governance mechanisms do not have effect on FRQ. The paper therefore recommends that more empirical study on effect of corporate governance on FRQ which will aid in clearing air on the divergence in results

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