The Effect of Corporate Governance on Financial Reporting Quality

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Abstract:- The key aim was to assess the impact of corporate governance practices on quality of financial reporting in conventional banks in the kingdom of Bahrain. The research used a quantitative research design. The study involved 124 respondents including auditors, financial managers, and board members of conventional banks in Bahrain. A structured survey questionnaire was used for data gathering. The results showed that Corporate governance is practiced in the banking sector in Bahrain. In addition, financial reporting in the conventional banking sector in Bahrain is of high quality. Finally, among all the practices of corporate governance, only transparency and participation are significant at 0.05 while Consensus oriented and Equitable & Fair treatment are significantly correlated to indicators of financial reporting quality.

I. INTRODUCTION

Brown, Falaschetti, & Orlando (2010) assured that the world economy has been experiencing the toughest period in terms of financial scandals. The past two decades seem to be the most difficult for the financial community all over the world. Not only organizations but also entire countries suffered from the drastic effects of the recent financial scandals. Such scandals are actually questionable particularly with implementing the accounting standards.

In fact, Omri & Klai (2011) showed that these scandals did really minimize the confidence of the investors in the managerial practices and those who issue the financial reports. With the occurrence of the financial scandals, it is recognized that there is a worldwide failure in terms of financial disclosure quality. This failure stands behind the current requirement for enhancing the quality of the financial information plus reinforcing the managerial control via establishing appropriate corporate governance practices and structure.

In addition, Shailer (2004) claimed because of the increased significance of corporate governance as a concept, it was defined from various perspectives that reflect various points of view about corporate governance and its importance. The concept has also been abbreviated as CG.

Klai & Omri (2011) suggested that when corporate governance is considered, there is concentration on mechanisms of governance that include concentrated shareholding, board independence, and director shareholding and auditor reputation.

One of the most important sectors in the Kingdom of Bahrain is the banking sector. There is an agreement that the banking sector is the sector that supports all other sectors to finance them. Bahrain is known as the hub of the Islamic banks in the GCC area. The sector contributes to Bahrain’s (GDP) Gross Domestic by 17.2%. This shows that the financial sector in the kingdom of Bahrain is a dynamic sector that plays beneficial roles in the growth and development of the kingdom finance.

Considering the value of the Banking sector and the crucial role of Corporate Governance as discussed in the earlier section, this research investigates the relationship between corporate governance and quality of financial reporting in the conventional banking sector in Bahrain.

II. REVIEW OF RELATED LITERATURE

The article of Akeju & Adeshina (2017) was given the title "Corporate Governance and Financial Reporting Quality in Nigeria". This publication was aimed at investigating the relationship between corporate governance and financial reporting quality in Nigeria. The researchers collected data for this article from several forty firms that are listed in the Nigerian Stock Exchange (NSE) and covered the period from 2006 to 2015. The relationship was investigated between the mechanisms of corporate governance that include (board characteristics, audit committees, board independence, board size, and growth). The outcomes of the statistical analysis showed that there is a positive relationship between corporate governance and the quality of financial reporting. Accountability and transparency are found to be the most influential of all corporate governance elements.

The contribution of Zia (2017) was aimed at identifying the relationship between the mechanisms of corporate governance and the quality of financial reporting in the sector of finance in Pakistan. This piece of foreign literature is considered an in-depth investigation that focuses on the most widely accepted and applied corporate governance
mechanism structure and identifying the most widely recognized indicators for reporting quality in Pakistan. The researcher collected her primary data from several twenty-six financial firms in Pakistan for a period starting from 2005 to 2014. The Least Square Regression was used for data analysis. The outcomes of this regression analysis guided the researcher to find out that there is a positive and insignificant relationship between disclosure, ethical behavior, and board independence as corporate governance elements and financial reporting quality.

The study of David, Ferris, & Gregor (2013) has the title of "Limits on Convergence in International Corporate Governance Practices". The researchers decided that the major aim of this study is to investigate the practices of corporate governance in firms in many different countries plus assessing the status of convergence or divergence. The researchers held comparisons between international firms’ level governance measures, antitakeover defenses, firm audit attributes, and compensation design attributes with those of U.S. firms. Finally, the findings of this paper prove that the evidence for convergence is more mixed than previously believed, with firms in some nations converging, others static, and a number diverging from U.S. practices.

The study of Juhmani (2017) was entitled "Corporate governance and the level of Bahraini corporate compliance with IFRS disclosure". The study was planned to investigate the correlation between corporate governance and International Financial Reporting Standards (IFRS) disclosure one year before issuing the first Corporate Governance Code (CGC) in Bahrain. In this study, corporate governance is assessed using components of CG that include: board composition, audit committee characteristics, and ownership structure. The real collected data was analyzed through ordinary least-squares regressions. This analysis was used to assess the relationships between the level of Bahraini corporate compliance with mandatory IFRS disclosure requirements as a dependent variable and eight CG mechanisms as independent variables and five other firm-specific attributes, as control variables. Data analysis proved that three corporate governance mechanisms which are board independence, audit committee independence, and Chief Executive Officer Duality have been found to correlate to the IFRS disclosure level. This shows that mechanisms of corporate governance are influential in the practices of financial reporting. Yet, the outcomes of the data analysis prove that the other corporate governance mechanisms which are board size, audit committee size, block holder ownership, managerial ownership, and government ownership do not correlate to the level of IFRS disclosure. From this finding, it is assured that CGC is significant and plays the role of an effective enforcement mechanism that enhances firms in Bahrain to entirely comply with IFRS disclosure.

The publication of Alrawahi, AlStrawi, &Sanad (2016) investigated the relationship between corporate governance and its compliance with the international accounting standard (IAS-1) in firms that are listed in Bahrain Bourse. The research assured that when financial reporting standards are in harmonization, asymmetry of information goes down especially when decisions are made. The same thing occurs in terms of CG. This is because CG reduces agency conflicts and this increases financial reporting transparency. Bahrain encourages business organizations to be in compliance with the international financial reporting standards and Bahrain’s code of corporate governance thirty-nine firms that are listed in Bahrain Bourse was selected. Analysis of the collected data guided the researchers to find out that there is a high level of CG principles implementation. There is a positive and significant relationship between implementing CG code and compliance with implementing IAS-1.

The work of Ahmed &Hamdan (2015) was concentrated on identifying the effect of CG on firms’ performance in Bahrain. The researchers showed that CG represents an essential implication when there are intentions to attract investments and to establish confidence in the marketplace. CG plays critical roles in minimizing risks and enhancing corporate performance. The researcher’s focus was to investigate the effect of CG policies on firms’ financial performance. The sample included firms that are listed in Bahrain Bourse. The sample included forty-two out of forty-eight listed firms in the period of 2007 to 2011. Analysis of the collected data proved that the selected firms adopt effective CG practices. There is also empirical evidence that a significant relationship exists between CG and financial performance of these listed firms in terms of their ROA and ROE. There is no empirical evidence for any correlation between earning per share (EPS) and a measure for financial performance and CG.

The study of Ahmed (2014) entitled “The impact of risk disclosure impact the investment decisions taken by the MNCs shareholders in the kingdom of Bahrain” was aimed at investigating the relationship between risk disclosure and the management ability to make managerial decisions in MNCs. The study was applied to a sample of multinational corporations in Bahrain. Data analysis guided the researcher to find out that there is a significant relationship between risk disclosure and the management ability to make managerial decisions. It was also found out that implementing different disclosure vehicles serve different user groups in different ways. A wide range of approaches to risk reporting is applied. Most of all, it was concluded that Disclosure of risk in financial statements enables the management of the company to make adequate investment decisions.
III. METHODOLOGY

The study used a quantitative research design involving 124 respondents who are auditors, financial managers, and board members of conventional banks in the Kingdom of Bahrain. These respondents were conveniently sampled. To collect the primary data for this research, a structured questionnaire was used. The questionnaire is divided into two major sections. The two sections comprise 57 items.

The first is specified for the collection of demographic data about the respondents. The second section is specified for the collection of data about the research variables and that drives to answer the research questions. The second part includes an assessment of the corporate governance practices implementation in the banking sector in Bahrain in terms of Accountability, Transparency, Disclosure, Ethical behavior, Consensus-Oriented, Equitable & Fair treatment, Effectiveness, and Participation. Finally, the last section includes 19 items also in a 5 point Likert Scale assess the quality of financial reporting in the banking sector in Bahrain in terms of Relevance, Reliability, Understandability, Faithful representation, and Timeliness.

Responses to the questions were tallied by the researcher after the collection. The completed questionnaires were collected and the responses were organized, coded and processed on Microsoft Excel. The mean of each item in the questionnaires was determined. The mean was calculated to determine the respondent’s average perceptions of the different variables that were investigated and the respondents overall perceptions. Regression analysis applied to determine the relationship between the two variables.

IV. FINDINGS AND ANALYSIS

A. Profile of the Respondents

Male respondents’ represent 71.77% while female respondents represent 28.23%. Respondents are from 31 to 44 represent 43.55%. Those 60 or more represent 22.58%. Those who ages range from 45 to 59 years make up 21.77%. The lowest percentage is for those 30 or below as they constitute 12.10%. In terms of their overall work experience, the respondents 6-9 years’ experience represent 42.74%. Those who have 10 to 19 years represent 29.84%. Those who have 20 years’ experience represent 18.55%. The respondents who have 5 years or below represent 8.87%.

Corporate Governance–Accountability

The result of the study shows that the five items that represent accountability as a component of corporate governance, accountability are applied by the board of directors in the banking sector since the average mean score for the five items, which is 4.38 and the average standard deviation, which is 0.72. The item with the highest mean score (4.53) stating “The board is committed to engaging in effective two-way communication with the stakeholders” is very effectively applied. Item four comes next with (4.40) stating “They respond to expectations of different stakeholders”. The 3rd item got (4.39) stating “Laws and regulations are adequately applied ”. The fifth item got (4.32) showing "The board is obliged and responsible to give explanations for their conduct and actions". The items with the lowest mean are the second (4.28) stating that "The core functions of conducting business are carried out."

Corporate Governance – Transparency

From the table above for the mean scores and standard deviations for the five items for transparency of the board, it is deduced that transparency is very effectively implemented in the banking sector in Bahrain as the average mean score for the five items is 4.40 and the average standard deviation is 0.72. The item with the highest mean (4.54) is the 9th indicating "Timely information is freely available and accessible for those who are affected by governance policies and practices. Then the 10th as its mean score is 4.50 indicating, "Decision is made in line with established rules and regulations". Then the 7th as its mean is 4.38 showing “The applied rules and regulations are clear”. Item six got 4.35 show "Information is made available to different stakeholders in an understandable manner”. The lowest mean 4.24 is achieved by item 8 showing "Timely information is freely available and accessible for effective economic decision-making".

Corporate Governance – Disclosure

With disclosure as a component of corporate governance practices in the banking sector in Bahrain, it is found out that disclosure is implemented as the average mean score for the five items of this section is 3.89 and the average standard deviation is 0.916. Item 13 got the highest mean score 4.01 showing that "The social and environmental position of the organization is reflected through the published information it”. Item 14 comes second as its mean score is 4.00 showing that "All the investors have access to clear, factual information". Then item 15 with 3.88 as a mean score showing that "The organization clarifies and makes publicly known the roles and responsibilities of the board to provide shareholders with a level of accountability”. Item 11 got 3.81 showing that "There is a timely and accurate disclosure of material matters concerning the organization's performance and activities". Item 12 got the lowest mean 3.76 stating, "The issued financial information accurately reflects the financial position of the organization”.

Corporate Governance – Ethical Behaviour

Regarding ethical behavior as a component of corporate governance, it is found out it is effectively implemented as the average mean score for the five items making up this section is 4.02 and the average standard deviation is 0.897. The item with the highest mean is the 16th as its mean is 4.15 stating, "Ethical decisions are made both for good public relations and risk management”. Then item 17 as its mean is 4.05 stating, "There is a code for ethical conduct for the
directors and executives who promote responsible decision making”. Item 18 got 4.01 stating “Compliance and ethics programs are established for the sake of minimizing organizational risks”. Item 19 comes in the 4th rank as its mean is 3.99 showing that “There are ethical procedures and principles of conduct that are regarded as self-regulation within the organization.”. The item with the lowest mean 3.91 is the 20th stating "The board acts ethically and responsibly when deciding related to the organization’s assets and stakeholder’s interests and investments”.

- **Corporate Governance – Consensus-Oriented**
  Concerning Consensus-Oriented as a component of corporate governance, it is found that it is fairly effective in terms of implementation as the average mean score for the five items of this section is 2.73 and the average standard deviation is 1.27. The item that got the highest mean 3.42 and the only effective one amongst the five is item 22 stating “A broad consensus takes place for how to achieve the best interest of the entire stakeholder group”. Then comes item 21 as its mean is 3.26 showing “Consultation between board members is a major issue that is aimed to understand the different interests of stakeholders”. Then item 23 as its mean is 2.74 showing "Decisions are taken where the vast majority of board members are in agreement”. Item 25 comes next as its mean is 2.63 showing that "When agreements between members are difficult to reach, a small group is formed to reach a compromise”. The lowest mean score is 1.60 for item 24, which is the only very ineffective one in this section showing "When agreements between members are difficult to reach, a small group is formed to reach a compromise”.

- **Corporate Governance – Equitable and Fair Treatment**
  Regarding equitable and fair treatment, it is identified that this component is implemented in the banking sector as the average mean score is 3.55 and the average standard deviation is 3.55. Item 30 comes first with the highest mean score of 4.10 showing that “Relevant, timely, understandable and easily accessible information are available for shareholders”. Then comes item 29 as its mean is 3.76 showing "All shareholders are effectively communicated”. Then item 27 as its mean is 3.75 showing "Shareholders can practice their rights”. The mean score of item 26 is 3.52 showing, "Rights of shareholders are respected". The lowest mean score is 2.63 for item 28 showing "All shareholders are treated on equal footings with no kind of distinction between them”.

- **Corporate Governance – Effectiveness**
  Effectiveness is the 7th component of corporate governance that is investigated in this research. From the average mean score of 4.03 and average mean score of 0.980 for the five points making up this section, it is found out that it is effectively implemented. The item with the highest mean 4.24 is item 31 showing "The processes implemented to produce favorable results meet the needs of its stakeholders. The mean score for item 34 is 4.12 showing that "The structure of the board is appropriate”. Then comes item 33 as its mean is 4.12 stating, "Meetings of the board are run efficiently”. Then item 32 as its mean is 3.96 showing that "The board activities are planned in advance”. The lowest mean score is 3.77 for item 35, which states "Performance of the board and director is assessed regularly”.

- **Corporate Governance – Participation**
  Concerning participation of the board members, which is the 8th component of corporate governance, it is very effectively implemented as the average mean score for the three items is 4.47 and the average standard deviation is 0.653. Item 37 got the highest mean score, which is 4.50. Then item38 got 4.48 got. The lowest mean score 4.43 was for item 36

- **Quality of Financial Reporting - Relevance**
  Relevance is one indicator that shows the quality of financial reporting in the banking sector in Bahrain. The average mean score for this indicator is 4.04 and the average standard deviation is 0.900 showing that there is a high quality of financial reporting in terms of relevance. Item one got the highest mean score of 4.29 stating, "The financial data enables its users to make adequate decisions”. The item with the second highest mean score is the 2nd 4.18 stating, "The issued financial data influences users in their economic decisions". In the third rank comes item 6 as its mean is 4.05 stating, "The disclosed data is forward-looking information". Item five comes in the 4th rank as its mean is 4.04 and shows that "The disclosed data illustrate opportunities and risks for the business”. Then comes item 3 as its mean score is 3.90 showing "The issued financial data helps users to test, correct, and confirm current and past events". The item with the lowest mean score 3.82 is the 4th, and shows "The issued financial data is the fair value”.

- **Quality of Financial Reporting – Reliability**
  The other indicator for quality of the financial reporting is the reliability of the data. This indicator is high quality as the average mean score for the three items is 4.12 and the standard deviation is score is 0.883. Item 9 has the highest mean score of 4.26 stating, "The issued data is verifiable". Then comes item 8 as its mean score is 4.22 showing "The disclosed data is free from material mistakes”. Item 7 got the lowest mean which is 3.90 showing "The disclosed data is free from bias”.

- **Quality of Financial Reporting - Understandability**
  In terms of understandability of the financial data as the third indicator for quality of the financial data, it is found out it is high quality as the average mean score is 4.23 and the average standard deviation is 0.755. Item 10 got the highest mean 4.31 showing "The essential qualities of the issued data are understandable”. The second rank is granted for item 11 whose mean score is 4.25 showing "The financial data can be effectively communicated to the users”. Then comes item 13 as its mean score is 4.22 stating, "Tables and graphs
facilitates understandability of the issued data'. The lowest mean score 4.17 is for item 12 stating, "The data is presented and classified in a clear manner".

➤ Quality of Financial Reporting – Faithful Representation

In terms of Faithful representation of the financial data as the fourth indicator for quality of the financial data, it is found out it is high quality as the average mean score is 4.28 and the average standard deviation is 0.762. Item 14 got the highest mean 4.34 showing "The issued data reflect the organization's real financial position ". The second rank is granted for item 15 whose mean score is 4.31 showing "The financial statements explain how well the obligations and economic resources are ". Then comes item 17 as its mean score is 4.26 stating, "The financial report clarifies assumptions and estimates and explains the usage of the accounting principles in the company clearly ". The lowest mean score 4.22 is for item 16 stating, "The financial reports represent the events and transactions fully".

➤ Quality of Financial Reporting – Timeliness

In terms of timelines of the financial data as the fifth indicator for quality of the financial data, it is found out that it is high quality as the average mean score is 4.28 and the average standard deviation is 0.801. Item 19 got the highest mean 4.32 showing "The financial report covers a period between the year-end and the issuing data ". The second rank is granted for item 18 whose mean score is 4.24 showing "The information is provided for decision makers before losing its powerful and good influences ".

Table 1:– Multiple Regression between components of corporate governance and quality of financial reporting in the banking sector in Bahrain (** significant at 0.05, *significant at 0.10)

<table>
<thead>
<tr>
<th>Coefficients</th>
<th>Standard Error</th>
<th>t Stat</th>
<th>P-value</th>
<th>Lower 95%</th>
<th>Upper 95%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>0.076047</td>
<td>0.40397</td>
<td>0.1882</td>
<td>0.85101</td>
<td>-0.724148</td>
</tr>
<tr>
<td>ACC</td>
<td>0.114587</td>
<td>0.10265</td>
<td>1.1162</td>
<td>0.26663</td>
<td>-0.088747</td>
</tr>
<tr>
<td>TR</td>
<td>0.248242</td>
<td>0.11817</td>
<td>2.1006</td>
<td>0.0378**</td>
<td>0.0141593</td>
</tr>
<tr>
<td>DIS</td>
<td>0.085556</td>
<td>0.09645</td>
<td>0.8870</td>
<td>0.37691</td>
<td>-0.1054967</td>
</tr>
<tr>
<td>EB</td>
<td>0.037655</td>
<td>0.11741</td>
<td>0.3207</td>
<td>0.74902</td>
<td>-0.1949192</td>
</tr>
<tr>
<td>CO</td>
<td>0.262204</td>
<td>0.14810</td>
<td>1.7704</td>
<td>0.07930*</td>
<td>-0.0311588</td>
</tr>
<tr>
<td>EqF</td>
<td>-0.19026</td>
<td>0.11057</td>
<td>-1.7206</td>
<td>0.08801*</td>
<td>-0.4092891</td>
</tr>
<tr>
<td>Ef</td>
<td>0.122626</td>
<td>0.10930</td>
<td>1.1185</td>
<td>0.26566</td>
<td>-0.0942505</td>
</tr>
<tr>
<td>P</td>
<td>0.250935</td>
<td>0.09653</td>
<td>2.5994</td>
<td>0.0105**</td>
<td>0.0597209</td>
</tr>
</tbody>
</table>

Table 2 shows the regression analysis to test the effect of Corporate Governance on the quality of financial reporting. As what can be gleaned from the table, the computed adjusted R Square 0.499394 indicating that the model explains almost 50% of the variation in the independent variable (financial reporting quality). In fact, the computed F value is lesser than 0.05 (F<0.05). Thus, the first null hypothesis is rejected. Over-all corporate governance has a significant effect on financial reporting quality. This finding is consistent with the finding of Akeju&Babatunde (2017).

However, looking at the individual indicators of corporate governance, only transparency and participation are significant at 0.05 while Consensus oriented and Equitable & Fair treatment at 0.10 level of significance. Interestingly, the
equitable and fair consensus has an inverse effect to financial reporting quality suggesting that the more an organization practices equity among shareholders in terms of governance the less it will contribute to better financial reporting in terms of quality. This finding complies with the findings of (Alrawahi, AlStrawi, & Sanad, 2016) where there is no compliance with the findings of Keay (2017).

Thus, the regression results lead to the following decisions:

<table>
<thead>
<tr>
<th>Hypothesis</th>
<th>Decision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ho: Over-all corporate governance has a significant effect to Financial Reporting Quality</td>
<td>Accepted</td>
</tr>
<tr>
<td>Ho: Accountability has a significant effect to Financial Reporting Quality</td>
<td>Accepted</td>
</tr>
<tr>
<td>Ho: Transparency has a significant effect to Financial Reporting Quality</td>
<td>Rejected</td>
</tr>
<tr>
<td>Ho: Disclosure has a significant effect to Financial Reporting Quality</td>
<td>Accepted</td>
</tr>
<tr>
<td>Ho: Ethical behavior has a significant effect to Financial Reporting Quality</td>
<td>Accepted</td>
</tr>
<tr>
<td>Ho: Consensus oriented has a significant effect to Financial Reporting Quality</td>
<td>Rejected</td>
</tr>
<tr>
<td>Ho: Equitable and fair treatment has a significant effect to Financial Reporting Quality</td>
<td>Rejected</td>
</tr>
<tr>
<td>Ho: Effectiveness has a significant effect to Financial Reporting Quality</td>
<td>Accepted</td>
</tr>
<tr>
<td>Ho: Participation has a significant effect to Financial Reporting Quality</td>
<td>Rejected</td>
</tr>
</tbody>
</table>

Table 2: Summary of Hypothesis Testing

V. CONCLUSIONS

Based on the aforementioned findings some conclusions are reached. One, Corporate governance is effectively practiced in the banking sector in Bahrain. Second, Financial reporting in the conventional banking sector in Bahrain is of high quality. Finally, among all the practices of corporate governance, only transparency and participation are significant at 0.05 while Consensus oriented and Equitable & Fair treatment are significantly correlated to indicators of financial reporting quality.

RECOMMENDATIONS

Based on the results of the study, the researcher recommends the following. First, consultation between board members must be given due attention. Second, there is essentiality to understand the different interests of stakeholders. Third, it is important that audit committees face the problem to not reaching vast majority agreement of board members. Fourth, there should be more endeavors to value shareholders. Fifth, long-term strategies should be applied for more inclusion of the employees with the management in the decision-making process. Finally, future research must approach the relationships between the two investigated variables but in other sectors and the need to approach corporate governance practices and organizational performance is also recommended. Finally, better communication channels are to be employed for contacting shareholders.

REFERENCES

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