

Governance mechanisms as a means to improve disclosure and enhance the quality of financial reports

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Abstract:

The purpose of this study is to highlight how corporate governance can serve as a foundation for improving the quality of financial reporting within business organizations. To achieve this objective, the descriptive-analytical approach was adopted, involving a review of relevant literature and an analysis of the impact of corporate governance mechanisms-such as board independence, audit committee effectiveness, and ownership structure transparency-on the quality of financial reports in terms of timeliness, relevance, reliability, and understandability.

The study concludes that emphasizing institutional adherence to corporate governance principles positively affects the quality of financial reporting and enhances users' confidence. Overall, corporate governance plays a crucial role in improving the quality of financial reports and guiding users' decision-making.

Key Words: Governance; Financial reports, Quality of information, Transparency, Financial disclosure.

JEL Classification: G34, M41, M40, M48.

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1. Introduction

Financial reports present both quantitative and qualitative information that faithfully represents an organization's financial performance. They constitute a fundamental tool for various stakeholders within the economic entity, enabling them to make informed and rational decisions. Ensuring the quality of these reports is essential for investors, regulatory authorities, and society as a whole. However, such information loses its reliability and relevance unless it is prepared in accordance with transparent and consistent standards that safeguard its credibility.

In this context, corporate governance has evolved into a key organizational framework for reinforcing financial disclosure systems and ensuring the accuracy and integrity of published financial reports particularly in light of the increasing global emphasis on transparency and the reliability of financial information. Nevertheless, the effectiveness of governance mechanisms in enhancing the quality of financial reporting remains a matter of debate, as the practical reality of economic institutions especially in developing countries continues to reveal considerable variation in the application of governance principles and practices.

Accordingly, the study problem can be formulated as follows:

To what extent does the application of governance principles contribute to enhancing the quality of financial reports?

Based on the posed problem, the following hypotheses can be proposed :

- The independence of the board of directors positively affects the quality of financial disclosure.
- The presence of an audit committee within the institution contributes to improving the transparency of financial reports.
- The dependability of accounting information is increased and manipulation is decreased when an efficient internal control system is put in place.

• This study aims to :

- Clarifying the conceptual framework for both governance and the quality of financial reporting.
- Examination of the theoretical connection between financial disclosure quality attributes and governance mechanisms.
- Highlighting the importance of governance as an entry point to ensure the transparency and credibility of financial reports.

• Research methodology :

This study adopted a descriptive-analytical approach to explore the relationship between corporate governance mechanisms and the quality of financial reporting. The inductive method was applied through an extensive review of theoretical literature and previous empirical studies to establish the conceptual framework of governance and its connection to financial reporting. In addition, the analytical method was employed to assess the effects of board independence, audit committee effectiveness, and ownership structure transparency on the qualitative characteristics of financial reports-specifically timeliness, relevance, reliability, and understandability.

• Literature Review :

- **Radwa Magdy and Mohamed Anis, 2016, « Disclosure Quality, Corporate Governance Mechanisms, and Firm value » :** The study developed a composite index

to assess the quality of disclosure among 133 UK firms over the period 2006-2009, encompassing five dimensions : volume, diversity, accuracy, objectivity, and clarity. It examined the influence of corporate governance mechanisms specifically board characteristics, ownership structure, audit committee attributes, and external auditor features-on both disclosure quality and firm value. The findings revealed that the volume of disclosure does not necessarily reflect its quality ; However, certain governance mechanisms, such as CEO duality and firm size, were found to enhance disclosure. Moreover, disclosure quality can either complement or substitute some governance mechanisms in improving firm value.

- **Almaryani Majeed abdulhussein, 2014, Testing the Requirements Availability for Disclosure and Transparency in Financial Reporting for Corporate Governance in Emerging Market Economies: The case of Iraqi Listed Firms :** In their empirical investigation, the authors examined the extent of disclosure and transparency in corporate financial reports within the framework of international corporate governance principles, focusing on the Iraqi market as a representative emerging economy. By analyzing the published financial statements of 34 listed companies over the period 2008–2011, they developed a 20-item index encompassing general company information, board and executive data, and financial and accounting disclosures. The study concluded that the level of compliance with disclosure and transparency requirements among Iraqi companies remains relatively low, and that the nature of business activity significantly affects the extent of material information disclosed, thereby revealing notable sectoral disparities in accounting practices.

Shuwen Chen, 2018, The relationship between corporate governance and information disclosures : Evidence from the Philippines : This study aims to examine the impact of board characteristics and external auditors on the level of disclosure in the financial reports of companies listed in the Philippines. To achieve this objective, the disclosure index developed by the Association of Southeast Asian Nations (ASEAN) was employed as a research instrument to measure the degree of transparency. The index was applied to a sample of 21 companies over the period 2011–2015, resulting in a total of 105 firm-year observations. It comprises 212 disclosure items categorized into three main dimensions : financial information (76 items), non-financial information (68 items), and strategic information (68 items).

The empirical results indicated that audit committee independence has a significant positive effect on the level of disclosure, whereas board size and the frequency of board meetings are negatively associated with it. Conversely, no significant relationship was found for board independence, CEO duality, audit committee activity, or external auditor quality.

Although numerous previous studies have explored the relationship between corporate governance and the quality of financial reporting, most have concentrated on a single governance mechanism or were conducted in developed economies characterized by mature regulatory and disclosure systems. Moreover, many of these studies focused on the quantitative extent of disclosure rather than on the qualitative attributes of financial reports, such as timeliness, reliability, and relevance.

Accordingly, this study seeks to address this gap by:

- Focusing on the qualitative characteristics of financial reports, namely timeliness, relevance, reliability, and understandability;
- Examining the combined effect of selected corporate governance mechanisms-board independence, audit committee effectiveness and ownership structure transparency-on the overall quality of financial reporting.

2. The theoretical framework for corporate governance

2.1 The Concept of Corporate Governance:

Governance is a managerial approach grounded in accountability and responsibility, and built upon the principles of transparency, participation, and consensus. It relies on procedures rooted in integrity and respect for the rule of law, ensuring both the effectiveness and efficiency of performance while promoting fairness and inclusiveness across all dimensions of institutional operations. (Gourine, 2020, p. 186)

According to the Organization for Economic Cooperation and Development (OECD), governance refers to the framework that regulates the interactions among a company's shareholders, board of directors, management, and other stakeholders. It seeks to balance the interests of all parties involved while enhancing the effectiveness of both management and oversight processes. (Boukhrouba & Douah, 2018, p. 333)

In light of the foregoing, corporate governance can be viewed as an integrated system comprising management and control mechanisms designed to serve the interests of all stakeholders within the organization.

2.2 Principles of Governance:

Governance refers to the framework through which an organization's activities are directed and monitored to ensure the achievement of its objectives while upholding the principles of accountability, integrity, and transparency. The level of trust and credibility that institutions enjoy largely depends on the degree of governance practiced within them. It is not sufficient to merely comply with international accounting or auditing standards; rather, rigorous adherence to these standards, along with compliance with relevant laws and regulations, is essential. (Hammad, 2005) The governance system is founded on a set of pillars, principles, and essential components, whose interaction serves as an indicator of the quality and reliability of governance within the institution, in accordance with established practices and regulatory frameworks.

According to (Touaiti & Madjoub, 2019, p. 150) these principles are reflected in the following:

Organizational structure: The effectiveness and credibility of an institution's governance system largely depend on its organizational structure. A well-defined structure ensures equitable distribution of responsibilities, clarifies hierarchical relationships, establishes the limits of authority, and defines delegation procedures. It also sets the criteria for selecting senior and executive management personnel, clearly outlining their duties, responsibilities, and scope of authority.

Disclosure and transparency: The degree of disclosure and transparency represents a key indicator for assessing the efficiency and reliability of an organization's governance framework. Ensuring fairness in providing timely, accurate, and comprehensive information to all stakeholders fosters trust, regulates interactions with the organization, guides employee behavior, informs managerial decision-making, and strengthens the institution's ability to manage relationships based on the information disclosed.

Control and supervision systems: Enhancing the quality and reliability of the governance framework requires effective internal communication and continuous evaluation of its components. To ensure system effectiveness, self-regulation and internal development mechanisms are essential. In addition to preparing general budgets, self-monitoring involves a range of practices such as internal auditing, audit committees, and comprehensive risk management-including credit, market, and operational risks. By assessing performance and ensuring accountability, these systems promote responsibility and reinforce sound governance principles.

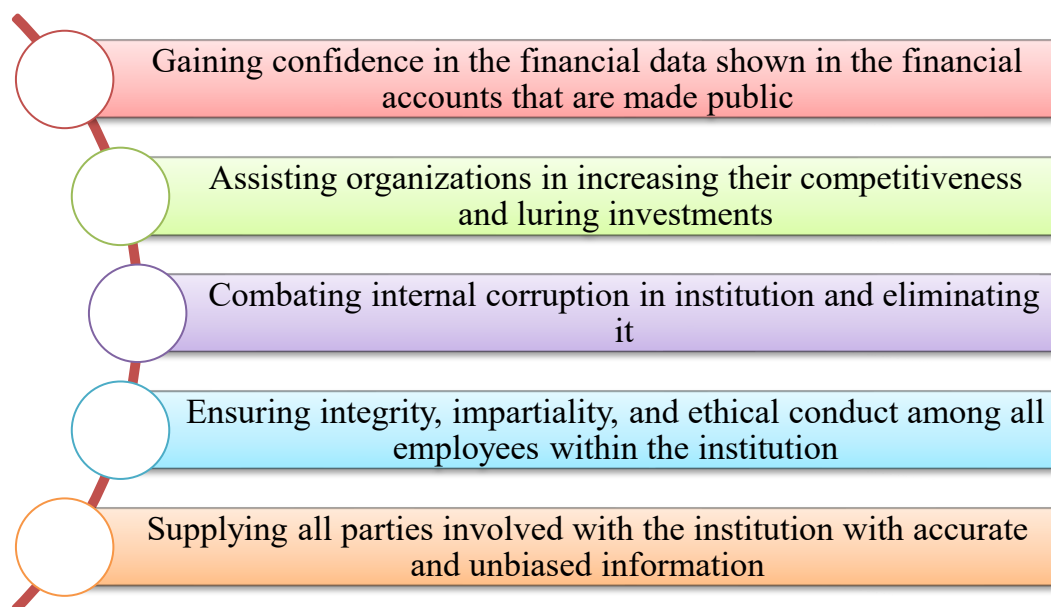
The ethical environment: The ethical environment focuses on embedding the organization's core values and fostering ideal behavior among its members. Stakeholders' commitment to moral principles and respect for others' rights help reduce conflicts of interest and enhance transparency, thereby improving governance effectiveness and strengthening stakeholder confidence in the organization.

Legal systems and regulations: Legal systems and regulations play a pivotal role in reinforcing and sustaining the overall governance environment by defining the general framework of its components and periodically evaluating their outcomes. They provide the necessary instruments to ensure fair procedures and to regulate internal conduct, while also establishing legally binding standards that delineate the scope and structure of the governance system.

2.3 The Importance of Governance:

The importance of corporate governance can be summarized as follows :

Fig.1. Importance of Governance



Source: (Colin, 1997, p. 20)

3. The concept of financial reporting and its quality

3.1 The Concept of Financial Reporting:

Financial reports represent the formal means through which a company's financial position and performance over a specific period are presented. They constitute the final output of the accounting measurement process conducted during that period and play a vital role in

communicating the results of this assessment to various stakeholders-both internal, such as owners and management, and external, such as investors. (Atiya & Abd Rabbo, 2000, p. 41)

A comprehensive set of financial statements including the balance sheet, income statement, cash flow statement, statement of changes in equity, and accompanying notes constitutes another conceptual definition of financial reports. The primary objective of these reports is to facilitate well-informed economic decision-making by providing relevant information about the entity's financial position and performance. (BARETO, 2006, p. 261)

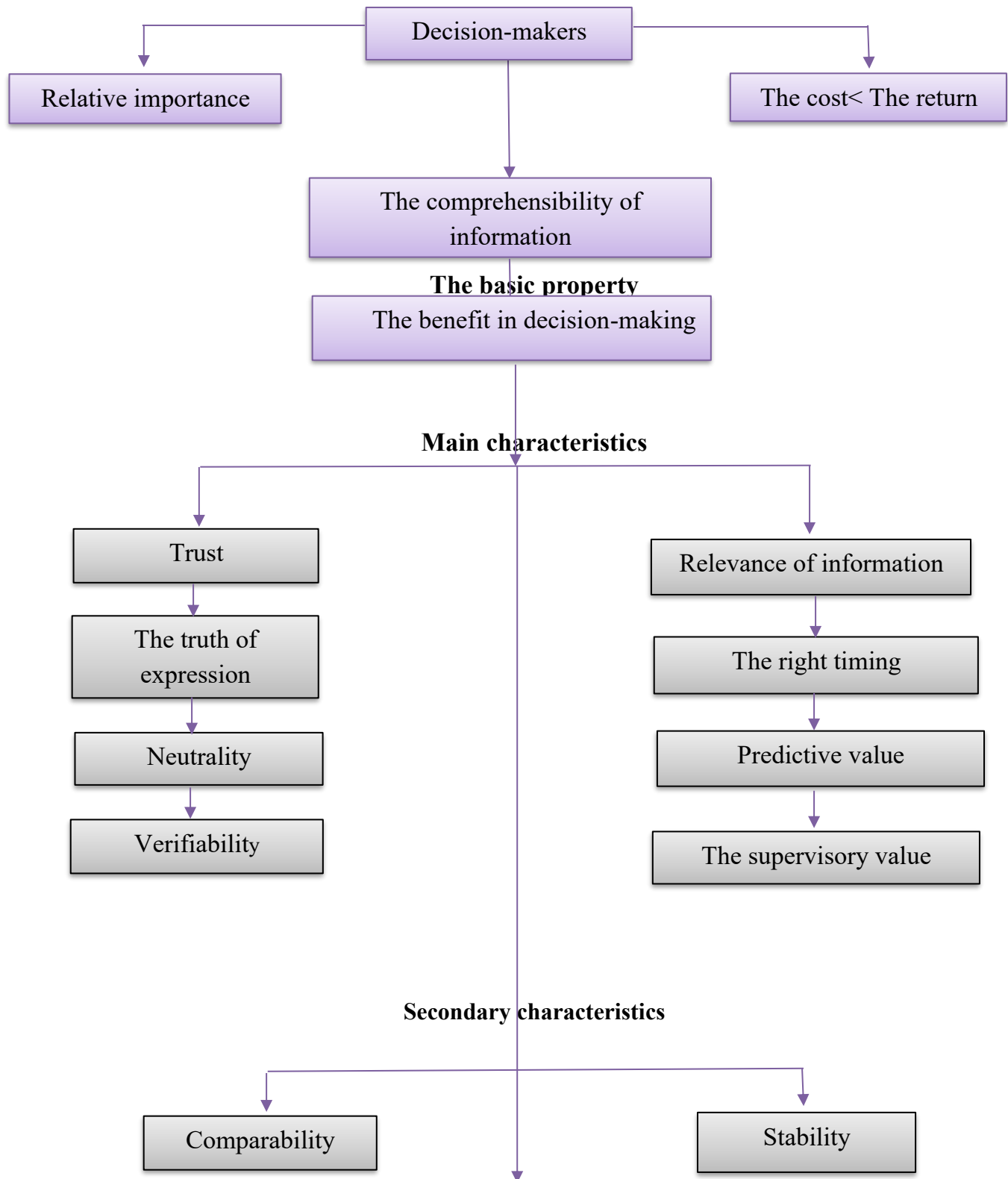
Financial reports include all statements and disclosures provided to external users at the end of the fiscal period, with the purpose of supporting informed business decision-making. Primarily intended for external stakeholders, these reports present accounting information that reflects the company's overall operations and financial performance.

3.2 The concept of financial reporting quality:

Quality is a comprehensive concept that seeks to achieve excellence in the goods or services delivered by an economic entity-such as financial reports, which represent the final output of the entity's accounting system. The inputs of this system consist of data derived from economic transactions and events. The accounting process closely resembles a production system, in which raw data are transformed into a final product. Likewise, accounting procedures and records convert transactional data into useful information presented in the form of financial reports. These reports, in turn, serve as essential inputs for the investment decision-making process after being analyzed and interpreted. (Nour El-Din & Ben Zaf, 2019, p. 63)

In the wake of global financial market liberalization and the growing demand for more relevant and useful information, the importance of financial reporting quality has become increasingly recognized particularly in ensuring financial stability. The quality of accounting and financial information contained within financial reports serves as a fundamental criterion for assessing the extent to which such information fulfills its intended purposes. Moreover, it provides a foundation for evaluating and comparing different accounting methods used for measurement and disclosure in financial reporting.

Fig.2. Qualitative characteristics of the quality of financial report



Source: (Maamri & Gourine, 2019, p. 236)

3.3 The qualitative characteristics of information disclosed in financial reports:

Qualitative characteristics refer to the attributes that enhance the usefulness of the information presented in financial reports. High-quality information provides the most reliable basis for well-informed decision-making. Therefore, the data disclosed in financial reports must possess specific features that allow users to assess its quality and reliability.

According to (Hammad T. , 2010, pp. 89-90) these characteristics include:

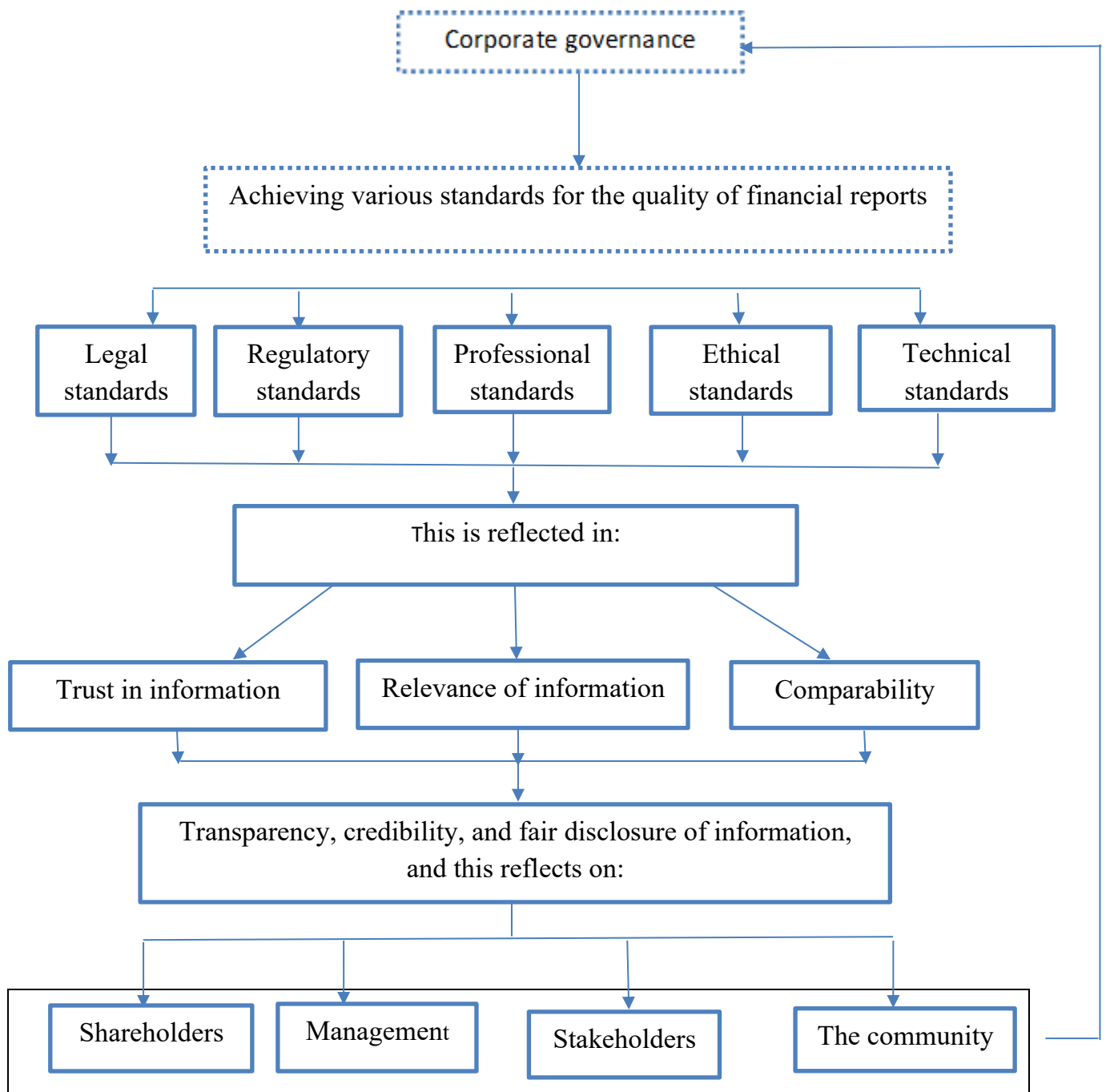
- **Relevance:** Relevance is one of the fundamental qualitative characteristics of disclosed information. Its importance lies in its ability to influence users' decisions by helping them evaluate past or present events, predict future outcomes, or revise previous assessments. This characteristic is particularly critical when information is used for internal decision-making.
- **Credibility:** For information to be useful, it must be trustworthy. Credible information is that which users can rely upon, being free from material bias and significant errors. It reflects the degree to which financial data faithfully represents the underlying economic phenomena.
- **Understandability:** Financial reports should be prepared and presented in a manner that is clear and easily understandable to users. This implies that the information is structured logically and expressed in a concise way, enabling individuals with a reasonable knowledge of business, economics, and accounting to comprehend it without undue effort. However, it is assumed that users are reasonably informed and willing to invest the effort necessary to analyze the information and derive meaningful insights.

4. Governance as a mechanism to enhance the quality of financial reports

4.1 The connection between financial reporting and governance:

Through its fundamental components, the corporate governance system provides a set of professional, ethical, legal, and regulatory principles that contribute to achieving the qualitative characteristics of financial reporting namely consistency, relevance, reliability, and comparability. These principles ensure the transparent communication of clear and trustworthy information, enabling all stakeholders to effectively safeguard their rights and fulfill their responsibilities. This relationship is illustrated in the following figure:

Fig.3. The connection between accounting data and governance



Source: (Gourine, 2020, p. 191)

4.2 The effective governance structure to achieve the quality of financial reports:

One of the key factors that positively influences the extent and quality of financial disclosure in economic entities is the presence of an effective corporate governance framework. Beyond preventing opportunistic managerial behaviors that may lead to the manipulation of financial data, sound governance establishes a structure of supervision and oversight that ensures executive management's commitment to accountability and transparency. This framework comprises a range of organizational mechanisms designed to evaluate management performance and monitor the preparation of financial reports, most notably an independent board of directors, audit committees, and risk and review committees. (OECD, 2015)

- ☞ **The board of directors' autonomy and proficiency:** The independence of board members plays a crucial role in determining the board's effectiveness as a monitoring and

supervisory mechanism. Independence refers to the presence of non-executive directors who have no personal or financial ties to the company that could compromise their objectivity. Greater board independence enables more effective oversight by limiting managerial opportunism and enhancing the quality of disclosed accounting information. This, in turn, strengthens management guidance and performance monitoring in a manner that protects shareholders' interests and contributes to firm value creation.

According to agency theory, the inclusion of non-executive members is one of the core elements of sound corporate governance, as it enhances the board's effectiveness and reduces the likelihood of managerial collusion that may infringe upon stakeholders' rights. Conversely, executive directors due to their hierarchical subordination to management tend to avoid taking strong stances that could threaten their privileges, thereby weakening their supervisory function. (Suleiman, 2009, pp. 111-113)

Empirical studies examining the impact of board independence and member competence on the quality of financial disclosure highlight the importance of having directors with financial and accounting expertise. Such members significantly contribute to improving the quality of disclosure by strengthening the board's ability to promote transparency, enhance firm value through efficient resource allocation, implement sound financial strategies, and uphold prudent accounting practices.

Moreover, directors with solid financial backgrounds possess a deep understanding of accounting concepts, standards, and procedures, which enables them to effectively detect and counter earnings management practices. Consequently, they can critically evaluate financial information, ensuring its accuracy, reliability, and integrity prior to disclosure.

☞ **The presence of a review committee :** One of the most prominent internal corporate governance mechanisms is the audit committee, which plays a crucial role in promoting and enhancing the quality of financial disclosure. The committee is entrusted with several oversight responsibilities, including monitoring the preparation of financial reports, reviewing accounting policies and procedures, and ensuring that senior management complies with legal and accounting standards.

The presence of an independent and effective audit committee reflects a strong system of internal control within the organization, thereby reducing the likelihood of financial misstatements or manipulation and improving the overall accuracy of the information disclosed in financial statements.

Furthermore, the audit committee collaborates closely with external auditors to strengthen transparency and reliability in financial reporting and to ensure the quality and integrity of audit processes. Empirical evidence consistently demonstrates a positive relationship between the existence of an effective audit committee and the level of voluntary financial disclosure (Azzam, 2022, p. 151)

The audit committee plays a pivotal role in safeguarding shareholders' rights and upholding the principle of accountability, thereby encouraging the company to provide external stakeholders with accurate and transparent information. Strengthening the institutional role and authority of the audit committee within the organizational structure is essential to enhancing the quality of financial disclosure and fostering investor and market confidence in the credibility of published financial statements.

5. CONCLUSION

Corporate governance represents a comprehensive regulatory framework designed to enhance the quality of financial reporting within economic institutions. This enhancement is achieved through the establishment of effective oversight and monitoring mechanisms that ensure transparency, reliability, and compliance with accounting standards.

Empirical evidence indicates that improvements in the qualitative attributes of financial information-such as relevance, reliability, understandability, and comparability are strongly associated with the effective application of governance principles, particularly board independence and audit committee effectiveness.

5.1 Study Results: This study has yielded several key findings, summarized as follows:

- Corporate governance plays a pivotal role in enhancing the quality of financial reporting and guiding users' decision-making processes. The board of directors is in charge of upholding governance norms and safeguarding the interests of stakeholders, which enhances the legitimacy and openness of financial reporting.
- The board of directors is responsible for upholding governance principles and safeguarding the interests of stakeholders, thereby reinforcing the transparency and credibility of financial disclosures.
- The quality of financial reporting and the confidence of users are significantly strengthened when institutions consistently adhere to corporate governance regulations and standards.

5.2 Study Recommendations: Several recommendations have emerged from this study, including the following:

- Economic institutions should ensure that their boards of directors include independent, non-executive members possessing the requisite expertise and professional background to effectively oversee management activities and ensure unbiased decision-making processes.
- Empowering audit committees with the necessary authority and resources to conduct comprehensive examinations of financial reports and detect any fraudulent or opportunistic accounting practices is essential.
- Furthermore, institutions should provide continuous training and capacity building at all managerial levels to foster a corporate culture grounded in governance principles such as accountability, transparency, and integrity.

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