

# Corporate Governance and Quality of Financial Information Reporting: Empirical Evidence from Emerging Market

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## Abstract

*Manipulation of earning and false representation of financial information from corporations is a major concern of shareholders these days. Being the pivotal role of the board, CG regulations focus its independence in structure and composition for ensuring validity, accuracy and transparency of financial information reporting. Accordingly, the recently introduced Malaysian code on corporate governance (MCCG 2012) also focused independence of the board. This paper, therefore, investigated some recommendations of the new code in relation to quality of financial information reporting in a stratified random sample of 300 non-financial listed companies for 5 years from 2010-2014. By employing pooled OLS with Discrol-Kraay corrected standard errors to a panel composed of 1500 observations, it is revealed that independent directors and new code has a positive relationship with quality of financial information reporting. However, separate leadership and size of the firm have significant negative while independent chair has an insignificant relation with quality of financial information reporting. The study contributes to the inconclusive limited literature particularly in the context of developing countries. The findings also provide insights for shareholders, banks, financial institution, security commission and Bursa Malaysia.*

**Keywords:** Corporate Governance, Quality of Financial Information Reporting, Non-Financial Malaysian Listed Companies, MCCG 2012

## Introduction

Reporting of financial information is a medium of communication between corporations and its stakeholders. It updates public, government,

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shareholders, employees, bankers, suppliers, creditors and other stakeholders about the financial position and other activities of the firm (Bello, 2009; Johnson, Khurana, & Reynolds, 2002; Kantudu & Samaila, 2015). Therefore, good quality of the reported financial information facilitates decision-making of investors and other stakeholders (Kamaruzaman, Mazlifa, & Maisarah, 2009). The quality of financial information reporting is good if the reported information is reliable, relevant, meaningful, comparable and compatible (Hassan & Bello, 2013). Compliance to different accounting and regulatory standards, error-free and timely dissemination are those other characteristics which contribute to the quality of financial information reporting (Bello, 2009; Bushman, Chen, Engel, & Smith, 2004; IASB, 2008).

However, it is not easy to ensure error-free quality of financial information reporting. It is because some information of financial statements are based on assumptions which temper the quality of reported financial information (Johnson, 2005). The International Accounting Standard Board also accepts this by requiring certain level instead of the full accuracy of the financial information (IASB, 2008). The reporting quality of financial information is evolved as a topic of great interest when public questioned transparency, integrity, and reliability of financial information particularly after the fraudulent transactions of Enron, WorldCom, Marconi, and Parmalat, etc. (Hashim & Devi, 2007). Malaysia which has no exception in this regard also faced many accounting fiascos in the recent past. These failures revealed the inefficiency of Malaysian boards to control fraudulent reporting of financial information (Angabini & Wasiuzzaman, 2011; Norwani, Mohamad, & Chek, 2011). Subsequently, Malaysia introduced new CG code (MCCG 2012) which mainly addressed the independence of the board among others (MCCG, 2012). Therefore, this paper investigates how the recommendations of separate leadership, independent chair and proportion of independent directors on the board impacted reporting quality of financial information in a stratified random sample of 300 non-financial Malaysian listed companies from 2010 to 2014.

The remaining of this paper is organized as the following section synthesizes previous literature while the third section discusses control variables. Section four and five explain measurement of variables, sample and univariate analysis. The next sections report results of diagnostic tests, multiple regression and significance of the study.

## **Literature Review**

### *Separate Leadership and Quality of Financial Information Reporting*

Separating chair of the board from CEO strengthens the independence of the board (Cadbury Committee, 1992). The separation also strengthens internal control which improves quality of financial information reporting (Beekes, Pope, & Young, 2004; Hamid, 2008). Therefore, firms with separate leadership have a better quality of financial information reporting than others (Beekes et al., 2004). The duality of CEO weakens monitoring (Cadbury Committee, 1992) and internal control (Abbott, Park, & Parker, 2000) and thus firms with CEO duality are highly inclined to fraudulent transactions and financial irregularities (Beasley, 1996). These, in turn, not only increase the risk of firms' default (Dechow, Sloan, & Sweeney, 1996) but also affect the quality of financial information reporting (Byard, Li, & Weintrop, 2006; Hamid, 2008; Jensen, 1993). Accordingly, like most of the CG regulations around the world, MCCG 2012 discouraged CEO duality in Malaysia.

However, on contrary, some studies found that CEO duality has no concern with the quality of financial information reporting (Ahmed, Hossain, & Adams, 2006; Bradbury, Mak, & Tan, 2006; Petra, 2007). The duality does not affect the credibility of financial information (Dabor & Adeyemi, 2009). The mixed findings and the introduction of new code (MCCG 2012) necessitate further investigation of the relationship between separate leadership and quality of financial information reporting in Malaysia. Following hypothesis is established for this investigation.

*H1: Separate leadership has a positive association with the quality of financial information reporting.*

### *Independent Chair and Quality of Financial Information Reporting*

Boards' chair held by an independent director is known as independent chair (Coombes & Wong, 2004). Independent chair strengthens the independence of the board which ensures effective monitoring of management (Hashim & Devi, 2010; Petra, 2007, 2005). This, in turn, reduces the probability of earning management practices which enhance the quality of financial information reporting. The independent chair has a positive relation with reporting quality of financial information in Malaysia (Hashim & Devi, 2010). Firms with the independent chair have good quality of financial information reporting than those without (AL-Dhamari & Ismail, 2014). Therefore, MCCG 2012 like other CG regulations around the world recommended independent chair of the board in Malaysia.

However, on contrary it is also found that non-executive chair of the board has the complicated and unknown type of relationship with quality of financial information reporting in Malaysia (Haniffa & Cooke, 2002). Therefore, due to mixed findings and introduction of MCCG 2012, there is a need to further investigate the relationship. This paper investigates the relationship on the basis of the following hypothesis.

*H2: Independent chair of the board has a positive association with the quality of financial information reporting.*

#### *Independent Directors and Quality of Financial Information Reporting*

Being free from the influence of management, independent directors ensure effective monitoring role of the board by strengthening its independence (Beasley, 1996; Dechow et al., 1996) which improves the quality of financial information reporting (Beekes et al., 2004). Independent directors ensure appropriate methods and transparency of accounting records (Kent & Stewart, 2008) which contribute to the quality and timely dissemination of financial information (Firth, Fung, & Rui, 2007; Kantudu & Samaila, 2015; Vafeas, 2005). They also ensure compliance with Generally Accepted Accounting Principles (GAAP) (Dechow et al., 1996) which increase the credibility of financial information (Dabor & Adeyemi, 2009). Accordingly, MCCG 2012 like many CG regulations around the world recommended an increase in the independence of the Malaysian boards.

On contrary, it is argued that independent directors have no concern with the quality of firms' financial reporting. It is because they have limited knowledge of firm and industry (Ahmed et al., 2006; Bradbury et al., 2006; Petra, 2007)(Ho & Wong, 2001). Based on mixed findings and introduction of MCCG 2012, there is a need to investigate the relationship between independent directors and quality of financial information reporting in Malaysia (AL-Dhamari & Ismail, 2014)(Ho & Wong, 2001; Klein, 2002; Petra, 2007; Xie, Davidson, & DaDalt, 2003). Therefore, this paper further investigates the relationship on the basis of the following hypothesis.

*H3: The proportion of independent directors on the board has a positive association with the quality of financial information reporting.*

### **Research Methods**

#### *Sample and Univariate Analysis*

A sample of 300 non-financial Malaysian listed companies selected through stratified random sampling from all sectors except banks, insurance and financial companies out of total 960 companies listed on Bursa Malaysia at the end of the financial year 2009

(www.bursamalaysia.com). The data for separate leadership structure, independent chair and proportion of independent directors collected from annual reports of the sample firms while financial data for calculating the quality of financial information reporting extracted from DATASTREAM.

#### *Measurement of Variables*

Separate leadership (SL), independent chair of the board (IC) and CG Code (Cod) have measured as dummy variables coded 1 for yes and 0 otherwise. The proportion of independent directors (BI) measured as the proportion of independent director to a total number of directors on the board. The quality of financial information reporting (RQ) is measured by Modified Jones Model of earning management (Beest, Braam, & Boelens, 2009). Firm size (FS) has measured by the log of total assets.

#### *Control Variables*

##### *CG Code (MCCG 2012)*

As the study period includes the time of introducing MCCG 2012 and all the CG attributes of the study are recommendations of the new code, therefore, the paper controls for the potential effect of the new code.

##### *Firm Size*

Large firms have good internal control systems and competent auditors which increase the reliability of their financial information (Warfield, Wild, & Wild, 1995). In contrast, it is also argued that larger firms face the high pressure of investors and thus they manipulate earnings which affect the quality of their financial information reporting (Barton & Simko, 2002). Regardless of positive or negative but obvious impact, firm size has included as a control variable in this paper.

Finally, following is the econometric model of this study.

$$RQ_{it} = \beta_0 + \beta_1 SL_{it} + \beta_2 IC_{it} + \beta_3 BI_{it} + \beta_4 FS_{it} + \beta_5 Cod_{it} + \varepsilon_{it} \dots \dots \dots \text{Model}$$

Where;

RQ = Reporting Quality of Financial Information

SP = Separate Leadership

IC = Independent Chair

BI = Proportion of independent directors on the board

FS = Firm Size

Cod = CG Code (MCCG 2012).

$\varepsilon$  = Error term

## Results

### *Descriptive Statistics*

Table 1 Descriptive Statistics

	Minimum	Maximum	Mean	Std. Dev	Mode
RQ	-1.77	7.72	5.02	0.9901	-
SL	0.00	1.00	-	-	76 %
IC	0.00	1.00	-	-	49.30%
BI	.23	1.00	0.4684	0.1229	-
FS	4.07	7.36	5.5902	0.5889	-
Cod	0.00	1.00	0.6000	0.4901	-

Table 1 shows an average value of 5.02 for the quality of financial information reporting measured by Modified Jones Model of earning management. Separate leadership and independent chair of the board accounted for an average of 76% and 49% respectively. The statistics show that CEO duality isn't a major concern; however, the independent chair is yet to improve in Malaysian listed companies. Average independence of Malaysian boards is around 47% while the size of the firm is 5.59 as reported in Table 1.

### *Correlation Matrixes*

Table 2 shows a correlation between CG attributes and quality of financial information reporting. The statistics below the diagonal line represent Pearson's while above the line accounts for Spearman's correlation.

Table 2 Pearson's and Spearman's Correlation Matrix

	RQ	SL	IC	BI	FS	Cod
RQ	1	.142**	.098**	-.056*	.620**	-.033***
SL	.099**	1	.358**	-.046***	.142**	.096**
IC	.066**	.358**	1	.139**	.099**	.075**
BI	-.058*	-.056*	.135**	1	-.034	.105**
FS	.503**	.144**	.105**	-.049*	1	.050*
Cod	-.045***	.096**	.075**	.103**	.051*	1

Both the correlation matrixes show that independent directors and new code have significant negative correlation with the proxy of earning management among others. This implies that independent directors and MCGG 2012 enhanced the quality of financial information reporting by discouraging earning management practices. The significant positive association of code with all CG attributes included in this study explains

that code has improved compliance to CG practices. Separate leadership, independent chair and firm size have significant negative correlation with quality of financial information reporting. The significant positive findings show that separate leadership, independent chair and size of the firm have a positive association with earning management practices which affect the quality of financial information reporting. Overall, there is no multicollinearity as none of the correlation reported in Table 3 is above the threshold (0.80).

### *Multiple Regression*

After identifying no multicollinearity, the paper investigated heteroscedasticity and serial correlation before running the regression. The results Breusch-Pagan/Cook-Weisberg Test ( $\chi^2(1) = 0.00$  and Prob.  $> \chi^2 = 0.9961$ ) confirms equal variance and thus no heteroscedasticity in the data. Similarly, the Durbin Watson (DW) statistics of 1.97 shows no auto-correlation. The  $P < 0.05$  of the serial correlation test indicates that error terms of the two-time periods are correlated. Thus, the result  $F(1, 319) = 7.451$ , Prob.  $> F = 0.0067$  shows serial correlation (Baltagi, 2005; Mehmood & Mustafa, 2014; Wooldridge, 2002). Pesaran's test of cross-sectional independence = 1.595, Pr = 0.1106 implies no cross-sectional independence. Keeping in view the findings of diagnostics, the paper employed Pooled OLS with Driscoll-Kraay standard errors (Hoechle, 2007).

Table 3 Pooled OLS Regression

RQ	Coef.	Std. Err.	t	P>t	Conf. Interval	
SL	0.0637	0.0226	2.82	0.005	0.0193	0.1081
IC	0.0250	0.0534	0.47	0.640	-0.0800	0.1300
BI	-0.2100	0.0723	-2.91	0.004	-0.3523	-0.0678
FS	0.8404	0.0158	53.28	0.000	0.8093	0.8714
Cod	-0.1436	0.0289	-4.96	0.000	-0.2005	-0.08667
Con	0.4436	0.1308	3.39	0.001	0.1863	0.7008

Observations = 300\*5=1500, R-Square = 25.95, F (5, 319) =135.46, Prob.  $> F = 0.0000$ , Root MSE = 0.8533

### **Discussion**

Table 3 shows that separate leadership has a significant positive association with earning management which is the proxy of reporting quality of financial information. This implies that separate leadership has a negative impact on the quality of financial reporting in Malaysia which rejects H1 of this study. The findings are consistent with the studies which don't oppose CEO duality on account of affecting reporting quality of financial information (Dabor & Adeyemi, 2009). Similarly,

independence of the chair has no significant concern with the quality of financial information reporting. The findings which reject H2 of this study are consistent with (Haniffa & Cooke, 2002) in Malaysia. Independent directors improve quality of financial information reporting as evidenced by its significant negative association with the proxy of earning management. The findings which support H3 of this study are also consistent with many previous studies (Firth et al., 2007; Kantudu & Samaila, 2015; Vafeas, 2005). The significant positive association between firm size and earning management implies the inclination of larger firms to manipulation of earning for satisfying their shareholders and other stakeholders (Barton & Simko, 2002). The findings support the introduction of MCCG 2012 that has discouraged earning management practices and improved quality of financial information reporting.

#### **Significance of the Study**

The paper contributes to the mixed and limited literature particularly in the context of developing countries which have recently focused the quality of financial information reporting (Klai & Omri, 2011). The paper also contributes by investigating some recommendations of MCCG 2012 in relation to reporting quality of financial information as none of the studies investigated the relationship particularly after enactment of the new code in Malaysia. The findings of the study are useful for regulators and policy makers to know the impact of recent developments and think about the reforms in future. Overall, the findings update investors, shareholders, financial institutions and insurance companies regarding the impact of boards' independence on quality of financial information reporting in developing countries particularly Malaysia.

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