



## **Corporate Regulations and Quality of Financial Reporting: A Proposed Study**

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### **ABSTRACT**

Most of the corporate demises evidenced poor quality of financial information reporting. Besides others, this is due to inefficiency of board which couldn't ensure effective monitoring of management. Subsequently, the regulators have focused independence of the board among others. Accordingly, the recently introduced Malaysian Code on corporate governance (MCCG 2012) also recommended independence of the board like many other CG regulations around the world. Therefore, this paper proposes to examine few attributes of the new code regarding independence of the board in relation to quality of financial information reporting. These attributes includes separate leadership, independent chair and proportion of independent directors on board and nomination committee. To find distinct impact of the code, the paper divides study period into 2 years pre (2010-2011) and 2 years post (2013-2014) context of the code. The proposed study will fill the literature gap particularly in developing economies like Malaysia. The study will also provide important guidance for regulators, shareholders, security commission, Bursa Malaysia and other stakeholders in Malaysia.

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

**JEL Classification:** 224

### **1. INTRODUCTION**

Corporations report financial information so that update their stakeholders like public, government, shareholders, employees, bankers, suppliers, shareholders and creditors about their financial matters (Bello, 2009; Johnson et al., 2002; Kantudu and Samaila, 2015). The important decisions of stakeholders like lending and investment depend upon the reported financial information (Akerlof, 1970). The qualitative reporting of financial information assists them in making decisions and thus corporations should ensure the quality of financial information (Hassan and Bello, 2013; Kamaruzaman et al., 2009). The reporting of financial information is qualitative if reliable, relevant and disseminated timely (Kamaruzaman et al., 2009). In short, the reporting has good quality if represent reality which is error and bias free (Bello, 2009; Bushman et al., 2004; International Accounting Standard Board [IASB], 2008). However, ensuring such a quality

of financial information reporting that is fully free from bias and errors isn't possible. This is because some statistics reported in financial statements are based on estimations and projections about future which may or may not be true (Johnson, 2005). This is also admitted by IASB and thus requires a certain level rather full accuracy of the financial information (IASB, 2008).

The topic got popularity after misrepresentation of financial information in the corporate fiasco of Enron, WorldCom, Marconi, and Parmalat, etc. (Hashim and Devi, 2007). This heated up public demand for qualitative financial information reporting which pushed regulators to focus independence of the board among others for ensuring good quality of financial information reporting (Cohen et al., 2004). Likewise, Malaysia also focused independence of the board in Malaysian Code on corporate governance (MCCG 2012) after misrepresentation of financial information in corporate scandals of Perwaja Steel, Technology Resources Industries,

Transmile, Megan Media, Malaysian Airlines System and Port Klang Free Zone, Linear Corporation, Kenmark Industrial Co. Berhad and Sime Darby (Angabini and Wasiuzzaman, 2011; Norwani et al., 2011). Therefore, this paper proposes to investigate how recommendations of the code regarding independence of the board like separate leadership, independent chair, proportion of independent directors and independence of nomination committee affected the quality of financial information reporting in a stratified random sample of 300 Malaysian non-financial listed companies. To find distinct impact of the code, the paper proposes division of study period into 2 years pre (2010-2011) and 2 years post (2013-2014) context of the code.

## 2. LITERATURE REVIEW

### 2.1. Separate Leadership and Quality of Financial Information Reporting

The separation of chairman from the CEO reduces powers of the latter (Cadbury Committee, 1992) which contributes to boards' independence. Agency theory supports the separation on account of ensuring effective monitoring that improves quality of financial information reporting (Hamid, 2008; Jensen, 1993). The separation also fortifies internal control that contributes to the quality of financial information reporting (Beekes et al., 2004; Hamid, 2008; Kantudu and Samaila, 2015). Therefore, firms which practice separate leadership have good quality of their reported financial information than those with CEO duality (Beekes et al., 2004). Firms with CEO duality have low quality of financial information reporting (Byard et al., 2006; Hamid, 2008; Jensen, 1993) as they are indulged in earning management practices (Rahman and Haniffa, 2005). The duality entrusted too much powers in individual (Beasley, 1996) that results in poor internal control (Abbott et al., 2000). These negatively affect the quality and credibility of financial information reporting (Beasley, 1996). Therefore, CG regulations oppose the duality of CEO. Accordingly, the MCCG 2012 also recommended the separation of two roles.

However, these arguments negated by many studies which found that leadership structure has no significant impact on the quality of financial information reporting (Ahmed et al., 2006; Bradbury et al., 2006; Petra, 2007). These studies also found that dual leadership does not negatively affect the quality of financial information reporting (Dabor and Adeyemi, 2009). The inconclusive past literature with a focus on developed countries and introduction of MCCG 2012 necessitate further investigation of the relationship between separate leadership and quality of financial information reporting in a developing country like Malaysia. Therefore, this paper proposes to examine how separate leadership impacted quality of financial information reporting in pre (2010-2011) and post (2013-2014) context of the code on the basis of following hypotheses.

H1 (a): Separate leadership has positive association with firms' financial reporting quality before MCCG 2012.

H1 (b): Separate leadership has positive association with firms' financial reporting quality after MCCG 2012.

### 2.2. Independent Chair and Quality of Financial Information Reporting

Independent chair of the board better leads the board by virtue of good knowledge of the firm and industry (Carrott, 2008). It has comparatively more time to conceptualize and address different issues of the firm (Condit and Hess, 2003). In addition, it has an edge to acquire information from different sources in the market (Haniffa and Cooke, 2002). These in turn, discourage the practices of earning management which ensure good quality of financial information reporting (Hashim and Devi, 2010). Firms with independent chair have superior quality of financial information reporting to those without in Malaysia (AL-Dhamari and Ismail, 2014). Accordingly, the MCCG 2012 recommended independent chair of the board in Malaysian listed companies. However, on other hand, it is also found that non-executive chair of the board has a complicated association with quality of financial information reporting (Haniffa and Cooke, 2002).

It is also cautioned that independent or non-executive chairman shouldn't be an ex-CEO of the firm in order to avoid any conflict of interests or roles (Carrott, 2008; Conger and Riggio, 2007). If independent chairman has no previous link or relation with firm, there will be no or less bias which will enhance the quality of financial information reporting (Al-Zyoud, 2012). To sum up, previous limited literature mostly concentrated in developed countries and introduction of MCCG 2012 necessitate examining how independent chair impacted the quality of financial information reporting in a developing country like Malaysia. Therefore, this paper proposes to investigate the relationship on the basis of following hypotheses in pre and post context of the code.

H2 (a): Independent chair of the board has positive association with firms' financial reporting quality before MCCG 2012.

H2 (b): Independent chair of the board has positive association with firms' financial reporting quality after MCCG 2012.

### 2.3. Proportion of Independent Directors and Quality of Financial Information Reporting

Independent directors on the board ensure effective monitoring of CEO, executive directors and management which improve the quality of financial information reporting (Hamid, 2008; Jensen, 1993). They are free from management that fortifies independence of the board (Beasley, 1996; Rahman and Haniffa, 2016) which improves the quality of financial information reporting (Beekes et al., 2004). They ensure the system; methods and principles of accounting being employed are valid, acceptable and better serve the desired objectives with transparency (Kent and Stewart, 2008). They enhance efficiency of the board by ensuring the quality, quantity and timing of the dissemination for financial information (Kantudu and Samaila, 2015). These are endorsed by many empirical studies which found positive association between independent directors and quality of financial information reporting (Dabor and Adeyemi, 2009; Firth et al., 2007; Vafeas, 2005). In contrast, it is also claimed that independent directors are less competent due to their limited knowledge which dents their monitoring that affect the quality of financial information reporting (Ahmed et al., 2006; Bradbury et al., 2006; Ho and Wong, 2001; Petra, 2007).

To sum up, the inconclusive previous literature regarding the impact of independent directors on quality of financial information reporting (AL-Dhamari and Ismail, 2014) (Ho and Wong, 2001; Klein, 2002; Petra, 2007; Xie et al., 2003) and introduction of new code (MCCG 2012) necessitate further examination of the relationship in Malaysia. Therefore, this paper proposes examining the impact of independent directors on the quality financial information reporting in pre (2010-2011) and post (2013-2014) context of the code on the basis of the following hypotheses.

H3 (a): The proportion of independent directors on the board has positive association with firms' financial reporting quality before MCCG 2012.

H3 (b): The proportion of independent directors on the board has positive association with firms' financial reporting quality after MCCG 2012.

#### **2.4. Independence of Nomination Committee and Quality of Financial Information Reporting**

Agency theory advocates independence of the board for effective monitoring of management (Fama and Jensen, 1983; Fama, 1980; Jensen, 2000). The theory posits that establishing Independent Nomination Committee strengthens independence of the board which improves firms' financial reporting quality (Hamid, 2008; Jensen, 1993). Independent nomination committee reduces influence of CEO on the nomination process of new directors. This in turn, ensures nomination of the directors truly independent and free from the influence of CEO and management (Williamson, 1985). In absence, or a compromised independence of the nomination committee, CEO and management nominate grey directors who lack real independence. Moreover, management file employment contracts with one hand and get it sign with other in absence of Independent Nomination Committee (Williamson, 1985). Therefore, many corporate governance regulations and codes around the world require establishing Independent Nomination Committee. Likewise, MCCG 2012 and Bursa Malaysia's listing requirements also necessitated the establishment of Independent Nomination Committee in all public listed companies of Malaysia (MCCG, 2012; Bursa Malaysia, 2015). The regulatory development regarding independent nomination has been triggered by Cadbury Committee. The committee recommended the establishment of Nomination Committee with majority of non-executive directors in 1992 (Cadbury Committee, 1992).

In contrast, on the basis of stewardship theory, it is argued that establishing independent Nomination Committee limits the effective role of CEO and management in the nomination of new directors (Callahan et al., 2003). Some researchers opposed independence of the board and Nomination Committee. They argued boards with the chairmanship of CEO and majority of executive directors easily get firm specific information from management (Adams and Ferreira, 2007). It is also argued that the effectiveness of independent directors is questionable due to lack of firm specific information (Jensen, 1993). To sum up, literature regarding the relationship between Independent Nomination Committee and financial information reporting quality is extremely limited and inconclusive which necessitates further investigation of the relationship. Moreover, the regulatory intervention in form of MCCG 2012 and Bursa listing requirements in March

and November, 2012 respectively highlight the thirst for further investigation of the relationship in Malaysia. Therefore, based on agency theory, this paper proposes to examine the relationship between Independent Nomination Committee and financial reporting quality of the Malaysian listed companies in pre and post context of the code. Following are the hypotheses for this proposed further investigation.

H4 (a): Independence of Nomination Committee has positive association with firms' financial reporting quality before MCCG 2012.

H4 (b): Independence of Nomination Committee has positive association with firms' financial reporting quality after MCCG 2012.

### **3. RESEARCH METHODOLOGY**

The paper suggests a stratified random sample composed of 300 non-financial listed companies from all sectors except banks, insurance and financial companies. The total population in form of listed companies was 960 on Bursa Malaysia at the end of 2009 (www.bursamalaysia.com). Stratified random sampling reduces the systematic bias by giving equal chance of selection to every unit of population. The data for separate leadership structure, independent chair and proportion of independent directors on board and Nomination Committee will be collected through content analysis of the annual reports of the sample firms while financial data for estimating the quality of financial information reporting will be extracted from DATASTREAM. Separate leadership and independent chair of the board will be measured as dummy variables which will be coded as 1 for yes and 0 otherwise. Proportion of independent directors on board and Nomination Committee will be measured by proportion of independent director to total number of directors on board and Nomination Committee. Following previous literature, the quality of financial information reporting will be gauged by Modified Jones Model (Beest et al., 2009). The paper proposes descriptive statistics, Pearson's and Spearman's correlation matrixes and multiple regressions through STATA package 13 for analyzing data of both sub periods i.e. pre (2010-2011) and post (2013-2014) context of the code separately. The results of both periods are also proposed to be compared by conducting paired t-test and Welch ANOVA so that the distinct impact of the code is assessed, if any.

### **4. SIGNIFICANCE AND CONTRIBUTION OF THE PROPOSED STUDY**

The agency theory and many CG regulations advocate independence of the board for reducing information asymmetry. Accordingly, the MCCG 2012 also recommended independence of the board in Malaysia. However, no empirical study has investigated that how MCCG 2012 impacted quality of financial information reporting particularly after enactment of the code. Moreover, previous literature is not only limited but also inconclusive with a focus on developed countries (Klai and Omri, 2011). Therefore, the proposed study will contribute to literature and will also guide the regulators in developing countries particularly Malaysia.

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