CORPORATE GOVERNANCE AND THE FINANCIAL REPORTING PROCESS

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ABSTRACT: Our study approaches corporate governance in the context of the financial reporting process. From a theoretical point of view we draw on literature arguing that informational transparency connects corporate governance mechanisms and the financial reporting process with benefits for stakeholders. The empirical analysis being developed focuses on developing a corporate governance disclosure index for companies listed on the Bucharest Stock Exchange. Looking at similar studies in literature we further consider potential determinants of the disclosure index being computed. The employed research methodology relies on regression analysis. The obtained results document a low level of corporate governance disclosure and the external auditor belonging to the Big4 as a determinant of sample companies' corporate governance disclosure practices.

Key words: Corporate governance, accounting information, financial reporting, disclosure index

JEL codes: M41, G30

Introduction

Corporate governance is a highly debated and an increasingly challenging topic of worldwide research. Many changes that appear in legislation, most of them due to the financial crisis that spread all over the world in the latest years, transformed corporate governance into an even more attractive and dynamic research area (Ştefãnescu, 2011). At the intersection of corporate governance and the financial reporting process we find informational transparency which is essential for investors. Our paper explores the pattern of corporate governance related disclosure among companies in Romania with a view to ascertaining empirically if the observed patterns are in any way influenced by company specific variables including: size, profitability, status of external auditors and the sectors to which sample companies belong. The obtained results indicate among others a low level of disclosure.

Research design and methodology

For data collection, the main method being used was the observation method which is considered quite often, explicitly or implicitly, as the first and easiest method of research. In order to achieve our goal, firstly, we selected a sample of 26 companies (10 belonging to the financial sector and 16 non-financial sector companies), from tier one of the Bucharest Stock Exchange. For this sample we assessed the level of disclosure related to the following indicators reflecting board attributes:

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➢ Board structure;
➢ size of the Board;
➢ independence;
➢ Meetings' frequency;
➢ distinction between the Chairman and the CEO;
➢ remuneration; and
➢ existence of a code of ethics.

Sources being used in this regard were the official data published by companies listed on the Bucharest Stock Exchange (BSE), the Annual Report (2011), the Directors' Report (2011), Corporate Governance Code and the "Comply or Explain" declaration's most updated version. We further developed a disclosure scoring criteria awarding scores of 1-5 based on a Likert scale for items disclosed and '0' otherwise. The total disclosure score for each company was computed based on the following formula:

$$T_j = \sum_{i=1 \leq 5}^{m_i} d_i \qquad (1)$$

Where:

T_j is the disclosure of company$_j$ in respect of individual items of disclosure.

M_i is the maximum number of items covered in the disclosure index.

d_i is the disclosure score of each individual item.

The Disclosure Index (DI) will further represent our study's dependent variable and was computed as follows:

$$DI_j = \frac{T_j}{n_j} \qquad (2)$$

Where: N_j is the number of disclosure items relevant to company j.

All the above mentioned sources were used in order to compute the disclosure index for all companies in our sample. *Appendix 1* and *Appendix 2* provide detailed information on this process. Once established the dependent variable we further used research literature in order to identify potential independent variables (Ienciu, 2012). We therefore included the following variables in our analysis: company size, profitability, status of external auditors and the sector to which the entity belongs.

Company size was measured by the total assets of each company. The value of total assets was expressed in Ron, and in the case of international company Erste Group Bank AG.k, some currency exchange was necessary. Data was taken from companies' financial statements for 2011. Likert scale assessment was again done as follows:
➢ total assets between [2.188.355–181.434.622.880], codify 1-very low;
➢ total assets between [181.434.622.880- 362.867.057.405], codify 2-low;
➢ total assets between [362.867.057.405- 544.299.491.930], codify 3-medium;
➢ total assets between [544.299.491.930- 725.713.926.455], codify 4-high;
➢ total assets between [725.713.926.455–907.164.360.980], codify 5-very high.

Profitability was measured through earnings per share for each company. Data was taken from companies' financial statements for 2011. Likert scale assessment was again done as follows:
➢ profitability between [(-2.430.124.990) – (-1.206.978.547)], codify 1-very low;
➢ profitability between [(-1.206.978.547) – 16.167.896], codify 2-low;
➢ profitability between [16.167.896– 1.239.314.339], codify 3-medium;
➢ profitability between [1.239.314.339– 2.462.460.782], codify 4-high;
➢ profitability between [2.462.460.782– 3.685.607.226], codify 5- very high.

The status of external auditors was determined by whether or not companies were audited by one of the Big4 (Deloitte, Ernst & Young, KPMG, Pricewaterhouse Coopers) in the country. We therefore attributed the following values: 1 - for the entities audited by Big4 and 0 - for the entities audited by other auditing companies. Companies were also separated based on them belonging to the financial sector (1) or not (0).

Considering the purposes of our study, we used linear regression analysis. Descriptive statistics such as the Mean, Minimum, Maximum scores were used to depict the extent of corporate governance disclosure obtainable by our sample companies. Similarly, since part of the study involves an exploration of the possibility of a relationship between the extent of corporate governance disclosure and corporate characteristics including: size, profitability, auditors' status, company sector, the use of correlation and regression analyses were considered valid in providing the statistical parameters for the interpretation of our results and findings as previously done in literature (Damagum, 2009). For purposes of estimating our regression parameters we thus applied the following model:

$$DI = a_0 + a_1 TA + a_2 PR + a_3 Big4 + a_4 Sect. + \varepsilon \tag{3}$$

Where:

DI represents the corporate governance disclosure score level for company;
TA is total assets representing the size of each company;
PR is the profitability level of each company;
Big4 reflects the status of the external auditor of each company;
Sect. represents each company's belonging sector;

Accordingly, the level of corporate governance disclosure is the dependent variable while the other four are the independent variables.

Developing the analysis and interpreting results

In *Appendix 1* and *Appendix 2* we present the scores awarded for each of the seven indicators and the therefore computed Disclosure Index. The following table offers some descriptive statistics over our entire sample:

Table no.1

Elements considered in computing the DI: Descriptive statistic

	N	Minimum	Maximum	Mean	Std. Deviation
Board structure	26	0	5	2,96	1,637
Size of the Board	26	1	5	3,00	,938
Independence	26	0	5	1,54	1,476
Frequency of meetings	26	0	5	2,54	1,860
CEO/Chairman role separation	26	0	5	1,38	1,299
Remuneration	26	0	5	2,15	1,848
Existence of a code of ethics	26	0	5	1,69	1,914
Valid N (listwise)	26				

Source: authors' computation

We can see, if we look at the mean scores above, that all entities have a huge deficit in the area of CEO/Chairman's role duality (1,38). Governance "best practice" in developed economies

advises the Board appointing the President from among persons who are not part of management. In granting this indicator scores we analyzed whether the CEO and the Chairman position were taken by different persons. In our sample analysis we found that in the majority of entities (62%) these two functions are held by the same person. In the rest of the companies, the two positions are held by different individuals or this is not presented.

We also observe some deficiencies in terms of independence (1,54) and at existence of a code of ethics. In the case of independence, the BSE governance code stipulates that board structure should ensure a balance between executive and non-executive members so that no individual or small group of individuals can dominate the overall decision-making process of the Council. Furthermore, a sufficient number of board members must be independent directors, understanding that they have not directly or indirectly, any business relationship with the issuer or other persons involved, of such importance that influence their objectivity opinions (Feleagă et.al., 2011). Some cases specified the existence of the executive and non-executive members, but did not detail, and the independent directors are missing, as well as the audit committee.

According to the BSE governance code, the Board should establish an audit committee to assist in fulfilling its responsibilities for financial reporting. This committee should be composed exclusively of non-executive directors and contain a sufficient number of independent directors (Feleagă et.al, 2011).

With regard to the code of ethics, if we again take into account governance "best practice" in developed economies, the implementation of a code of ethics is necessary. According to Feleagă N. (2011), in Europe, on average, 73% of companies have a code of ethics significantly. In Romania, only 47% of companies provide information on the existence of a code of ethics.

The size of the board depends on the entity's business, the size of the entity, and not least the regulations in Romania. This we can see clearly from this table and the indicator records the highest score for our sample. Principle VIII of the BSE Corporate Governance Code provides that the Board shall have a membership which ensures efficiency of its ability to monitor, analyze and evaluate the work of directors, and the fair treatment of shareholders (www.bvb.ro). The mean number of members of the analyzed entities is six and is in accordance with company law which requires a minimum of 3 and a maximum of 11 members. Disclosure of information about the index chosen is quite high. Romanian mean is lower than the European mean that is formed of 12.5 members (Albert-Roulhac and Breen, 2005), a result that can be explained by size of business and ownership structure.

In the case of board structure we used three indicators as follows: internationalization, age and diversity of members. Such information was often disclosed, recording a mean score of 2.96. the following table presents information related to the disclosure index computed for the sample companies.

Table no.2

Descriptive statistics: DI indicators

	N	Minimum	Maximum	Mean	Std. Deviation
DI	26	,1714	,8571	,436254	,1700025
Valid N (listwise)	26				

Source: authors' computation

We can see by taking a "snapshot" of the situation that mean DI is under half (0,43). Looking back on the analysis made by Damagum Ya'u Mohammed in his doctoral thesis "The Role

of Accounting in Corporate Governance: Comparative Approach Between Romania and Nigeria", we see that Nigeria entities meeting corporate governance disclosure levels above 80%.

The possibility of certain variable affecting the corporate governance reporting levels of both financial and non-financial service companies in the Romanian economy was documented in the current study starting from literature regarding the effects of variables such as company size, profitability etc., on the information disclosure strategies of companies (Buzby, 1975; Firth, 1979; Cooke, 1992; Gray and Roberts, 1995; Damagum, 2009).

In this part of the article we aim to achieve an econometric analysis of the degree of disclosure of information, based on a linear regression in order to capture the correlation of Disclosure Index and size of the entity, profitability, status of external auditors and entities' sector. Initial information collected on total assets, profitability, entity's auditors and the consolidated financial statements for 2011 is summarized in *Appendix 3* and *Appendix 4*. The following table offers some descriptive statistics on the variables included in our analysis:

Table no.3

Dependent and independent variables: descriptive statistics

	N	Minimum	Maximum	Mean	Std. Deviation
DI	26	,1714	,8571	,436254	,1700025
Size	26	1	5	1,15	,784
Profitability	26	1	5	2,62	,752
Status of external auditors	26	0	1	,62	,496
Entities' sector	26	0	1	,38	,496
Valid N (listwise)	26				

Source: authors' computation

From the above table we can see the following aspects: the mean value of DI is 43.62%, which reflects a medium degree of corporate governance disclosure; according encoding that we made, the mean of total assets has the value of 1,15, which belongs to interval [2.188.355-181.434.622.880 Ron]; the mean for profitability has the value of 2.62 which belongs to interval [(-1.206.978.547) -16167896 Ron].

In the following table we present the correlation matrix between variables being used for our sample. We use this matrix to analyze relationships between variables with regard to correlation coefficients.

Table no.4

Correlation Coefficients

			DI	Size	Profitability	Status of external auditors	Entities' sector
Spearman's rho	DI	Correlation Coefficient	1,000	,334	,190	,391[*]	,185
		Sig. (2-tailed)	.	,095	,354	,048	,366
		N	26	26	26	26	26
	Size	Correlation Coefficient	,334	1,000	-,375	,158	,253

		,095	.	,059	,440	,212
	Sig. (2-tailed)					
	N	26	26	26	26	26
Profitabilit y	Correlation Coefficient	,190	-,375	1,000	,546[**]	,243
	Sig. (2-tailed)	,354	,059	.	,004	,231
	N	26	26	26	26	26
Status of external auditors	Correlation Coefficient	,391[*]	,158	,546[**]	1,000	,300
	Sig. (2-tailed)	,048	,440	,004	.	,136
	N	26	26	26	26	26
Entities' sector	Correlation Coefficient	,185	,253	,243	,300	1,000
	Sig. (2-tailed)	,366	,212	,231	,136	.
	N	26	26	26	26	26

*. Correlation is significant at the 0.05 level (2-tailed).
**. Correlation is significant at the 0.01 level (2-tailed).
Source: authors' computation

We therefore observe that auditor's status affects corporate governance disclosure.

Table no.5

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	,612[a]	,375	,256	,1466786

a. Predictors: (Constant), Entities' sector, Profitability, Status of external auditors, Size
Source: authors' computation

Model is used to interpret the determination coefficient, R-Square (R^2). The value of R indicates whether or not there is a correlation between the dependent variable (DI) and the independent variables. This indicator can range between -1 and 1. In our case, the result is a value R = 0,612, respectively, R^2 = 0,375, which shows that is a poor connection between DI and independent variables.

Table no.6

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	,271	4	,068	3,146	,036[a]
	Residual	,452	21	,022		
	Total	,723	25			

a. Predictors: (Constant), Entities belong sector, Profitability, Status of external auditors, Size
b. Dependent Variable: DI
Source: authors' computation

The 0,036 Sig. suggest the independent variables explaining the variation of the dependent variable.

Table no.7

Regression results showing the effects of the four variables on corporate governance disclosure

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	,206	,156		1,320	,201
Size	,104	,048	,482	2,196	,039
Profitability	,016	,053	,073	,308	,761
Status of external auditors	,102	,075	,298	1,369	,185
Entities' sector	,010	,064	,030	,162	,873

a. Dependent Variable: DI

Source: authors' computation

From the above table we can extract the data necessary to write the following model:

$$DI = 0,206 + 0,104\,TA + 0,016\,PR + 0,102\,Big4 + 0,010\,Sect. + (0,156$$
$$+ 0,048 + 0,053 + 0,075 + 0,064)$$

(4)

Conclusions

Considering the aspects revealed in trade literature we conclude that corporate governance has always been an important research area. We therefore add to the body of literature dealing with corporate governance disclosure. We generally assess that not all companies listed on the Bucharest Stock Exchange meet minimum standards of transparency. Many companies were not aligned yet to existing recommendations, implemented in 2001, or other latest guidelines which take into account the Board of Directors.

According to the rules of corporate governance, the company should establish an Audit Committee consisting of Board members, non-executive directors, the majority of whom are independent, but the study shows that few companies have audit committees considered truly independent. In this study we find companies applying little of the corporate governance recommendations. Based on our sample we document that factors such as the size of the entity, profit or entities' sector do not influence corporate governance disclosure. On the other hand we observed that a small influence comes with the status of external auditors. Our results support similar studies arguing that the accounting profession in Romania at both the practical and policy levels would require additional overhauling so as to ensure that both public and private companies in the country are able to produce high quality accounting record and information that can compete favorably with those from other parts of globe that are of international standards (Damagum, 2009).

Among the limitations of our study we mention the following: we did not have access to all 27 entities that were on BSE's first tier; and the use of a Likert scale in assessing scores for items disclosed has been identified to be capable of inducing some elements of subjectivity. Cannon DM et al. (2008) argues that corporate governance is more important for global growth than state policies (Cannon et al., 2008). Our argument is that the interdependences between accounting and governance requires further analysis under circumstances characterizing nowadays realities.

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Appendix no.1

Disclosure Index Calculation non-financial entities

Nr.	ENTITIES	INDICATORS							Maximum scores ranging	Total score obtained	DI
		Board structure	Size of the Board	Independence	Frequency of meetings	CEO/ Chairman role separation	Remuneration	Existence of a code of ethics			
1	ALRO S.A.	0	3	1	2	5	5	3	5(*7=35)	19	0,5429
2	ANTIBIOTICE S.A.	4	3	1	3	1	3	5	5(*7=35)	20	0,5714
3	AZOMURES S.A	4	3	1	2	1	0	5	5(*7=35)	16	0,4571
4	BIOFARM S.A.	0	2	3	5	1	3	0	5(*7=35)	14	0,4
5	C.N.T.E.E. TRANSELECTRICA	2	2	2	4	1	4	2	5(*7=35)	17	0,4857
6	CONCEFA SA SIBIU	1	3	0	0	0	1	4	5(*7=35)	9	0,2571
7	ELECTROMAGNETICA SA BUCURESTI	4	4	0	0	1	0	0	5(*7=35)	9	0,2571
8	IMPACT DEVELOPER & CONTRACTOR S.A.	4	1	0	0	1	1	0	5(*7=35)	7	0,2
9	OIL TERMINAL S.A.	2	3	0	1	0	0	0	5(*7=35)	6	0,1714
10	OLTCHIM S.A. RM. VALCEA	4	3	1	5	3	4	4	5(*7=35)	24	0,6857
11	OMV PETROM S.A.	0	4	2	2	5	0	0	5(*7=35)	13	0,3714
12	ROPHARMA SA BRASOV	4	3	2	3	2	4	0	5(*7=35)	18	0,5143
13	S.N.T.G.N. TRANSGAZ S.A.	4	3	2	2	2	3	3	5(*7=35)	19	0,5428
14	SC FONDUL PROPRIETATEA SA	5	1	3	3	1	5	2	5(*7=35)	20	0,5714
15	SOCEP S.A.	3	3	0	0	1	0	0	5(*7=35)	7	0,2
16	TURBOMECANICA S.A.	2	2	1	2	1	0	0	5(*7=35)	8	0,2286
	Total score	**43**	**42**	**19**	**43**	**26**	**33**	**28**	**5(*16=80)**		

Appendix no.2

Disclosure Index Calculation financial entities

*Scores ranging from 1 to 5 points

Nr.	ENTITIES	INDICATORS							Maximum scores ranging	Total score obtained	DI
		Board structure	Size of the Board	Independence	Frequency of meetings	CEO/ Chairman role separation	Remuneration	Existence of a code of ethics			
1	BANCA COMERCIALA CARPATICA S.A.	4	3	3	2	3	4	3	**5(*7=35)**	22	0,6286
2	BANCA TRANSILVANIA S.A.	3	4	0	4	0	4	0	**5(*7=35)**	15	0,4286
3	BRD - GROUPE SOCIETE GENERALE S.A.	4	5	4	2	0	2	0	**5(*7=35)**	17	0,4857
4	ERSTE GROUP BANK AG.	5	5	5	4	1	5	5	**5(*7=35)**	30	0,8571
5	S.S.I.F. BROKER	5	3	3	5	1	0	0	**5(*7=35)**	17	0,4857
6	SIF BANAT CRISANA S.A.	3	3	4	5	1	3	2	**5(*7=35)**	21	0,6
7	SIF MOLDOVA S.A.	4	3	1	0	1	0	4	**5(*7=35)**	13	0,3714
8	SIF MUNTENIA S.A.	0	3	0	0	1	2	2	**5(*7=35)**	8	0,2286
9	SIF OLTENIA S.A.	4	3	0	5	1	2	0	**5(*7=35)**	15	0,4286
10	SIF TRANSILVANIA S.A.	2	3	1	5	1	1	0	**5(*7=35)**	13	0,3714
	Total score	**34**	**35**	**21**	**32**	**10**	**23**	**16**			

Source**:** Authors' projection

Values of the dependent variable and independent variables for non-financial entities

No.	Entities	DI	Size of the entities /2011 -RON-	Profitability/ 2011 -RON-	Status of external auditors	Entities belong sector
1	ALRO S.A.	0,5429	2.601.771.000	242.889.000	1-Deloitte	0
2	ANTIBIOTICE S.A.	0,5714	449.313.171	20.298.909	0	0
3	AZOMURES S.A	0,4571	1.412.362.247	365.196.441	1-KPMG	0
4	BIOFARM S.A.	0,4	184.918.511	14.220.788	0	0
5	C.N.T.E.E. TRANSELECTRICA	0,4857	4.851.555.000	137.806.000	1-KPMG	0
6	CONCEFA SA SIBIU	0,2571	137.743.301	-51.905.451	0	0
7	ELECTROMAGNETI CA SA BUCURESTI	0,2571	323.373.668	15.075.281	0	0
8	IMPACT DEVELOPER & CONTRACTOR S.A.	0,2	408.352.467	-22.261.046	0	0
9	OIL TERMINAL S.A.	0,1714	378.359.615	545.419	0	0
10	OLTCHIM S.A. RM. VALCEA	0,6857	2.188.335	-198.241	1-KPMG	0
11	OMV PETROM S.A.	0,3714	33.819.553.700	3.685.607.226	1-Ernst&You ng	0
12	ROPHARMA SA BRASOV	0,5143	421.047.146	1.210.436	0	0
13	S.N.T.G.N. TRANSGAZ S.A.	0,5428	4.089.037.220	379.571.465	1-PWC	0
14	SC FONDUL PROPRIETATEA SA	0,5714	11.759.899.658	518.067.291	1-Deloitte	0
15	SOCEP S.A.	0,2	106.795.772	7.092.137	0	0
16	TURBOMECANICA S.A.	0,2286	161.532.320	-19.411.417	1-Deloitte	0

Source**:** Authors' projection

Appendix no.4

Values of the dependent variable and independent variables for financial entities

No.	Entities	DI	Size of the entities /2011 -RON-	Profitability/2011 -RON-	Status of external auditors	Entities belong sector
1	BANCA COMERCIALA CARPATICA S.A.	0,6286	3.864.163.000	33.174.000	1-Ernst&Young	1
2	BANCA TRANSILVANIA S.A.	0,4286	25.745.165.072	131.870.976	1-KPMG	1
3	BRD - GROUPE SOCIETE GENERALE S.A.	0,4857	48.027.709.809	465.265.368	1-Deloitte	1
4	ERSTE GROUP BANK AG.	0,8571	907.164.360.980	-2.430.124.990	1-Ernst&Young	1
5	S.S.I.F. BROKER	0,4857	93.110.859	-15.599.615	0	1
6	SIF BANAT CRISANA S.A.	0,6	733.929.663	63.006.519	1-KPMG	1
7	SIF MOLDOVA S.A.	0,3714	1.154.223.764	192.922.595	1-Deloitte	1
8	SIF MUNTENIA S.A.	0,2286	1.322.734.209	65.336.350	1-KPMG	1
9	SIF OLTENIA S.A.	0,4286	814.982.623	83.442.670	0	1
10	SIF TRANSILVANIA S.A.	0,3714	887.458.207	207.727.564	1-PWC	1

Source**:** Authors' projection