FINANCIAL REPORTING, CORPORATE COMMUNICATION AND GOVERNANCE*

*Andrea Melis***

Absract

This paper describes the issues of financial reporting and corporate communication in connection with corporate governance. The analysis is based on the studies conducted in the Anglo-American and the European academic literature both from a normative and a positive perspective. It is discussed why accounting standards are not able by themselves to avoid corporate "miscommunication", and how a good corporate governance system is a *sine qua non* to improve the quality of corporate communication and financial reporting. The analysis also shows how the effectiveness of the systems of financial reporting and corporate governance seems to be highly correlated.

Keywords: financial reporting, corporate communication, corporate governance

1. Introduction

The aim of this paper is to describe and analyse the issues of financial reporting and corporate communication in connection with corporate governance. The analysis will be focused on the issues that arise at corporate level.

The type of company that will be taken into consideration is the corporation, which is characterised by the separation between ownership and control (Berle, Means, 1932) and, taking a wider approach, between management and stakeholding (John, Senbet, 1998). Its ownership structure is not necessarily widespread, but may present some degree of concentration (E.C.G.N., 1997; La Porta et al., 1999). Its control structure may be characterised by the dominant presence of various stakeholders, who act as controlling agents, such as top management (e.g. Berle, Means, 1932; Marris, Mueller, 1980; Roe, 1994a), large institutional investors (e.g. Mallin, 1995; Useem, 1996), blockholders (e.g. Onida, 1968; Zanda, 1974, Melis, 2000) and large creditors (e.g. Roe, 1994b).

Firstly, it will be given a theoretical framework which describes the relationship between the financial reporting system and the system of corporate governance.

Secondly, it will be discussed how an effective financial reporting system that is able to produce a good quality of information may have a positive influence on the soundness of the system of corporate governance.

Then, it will be analysed how a sound system of corporate governance may improve the quality of the financial reporting system as well as the quality of corporate communication to the strategic stakeholders (i.e. the stakeholders that are fundamental to the corporate process of value creation). This will show how the two systems are characterised by a relationship of interdependence.

---

* A previous version of the paper was presented at the Financial Reporting and Business Communication Research Unit Fifth Annual Conference, Cardiff Business School, UK, 5th –6th July, 2001. The author would like to thank all the participants for the seminar for their comments as well as express gratitude to Chris Mallin for her useful comments on a previous version of the paper. The normal caveats on the author's responsibility apply.

** Andrea Melis, Lecturer of Accounting, at the Department of *Ricerche aziendali*, University of Cagliari, Viale S. Ignazio 17, 09123 Cagliari, Italy. Fax: (+39) 0706753321, Email: melisa@unica.it

2. Financial reporting and corporate governance: a theoretical framework

Before discussing the relationship existing between the systems of financial reporting and corporate governance, it is necessary to give a definition of both terms.

The term "financial reporting" incorporates not only financial statements, but also includes other means of communicating financial and non-financial information, e.g. management forecast, stock exchange documents, etc. (SFAC N.1, 1978).

Regarding the concept of "corporate governance" there is the problem of its definition due to the lack of consistent usage of the term (Keasey et al., 1997; Tricker, 2000).

For the purposes of this paper "corporate governance" is defined as the system which deals with the wielding of power over corporate entities (Tricker, 1998), outlining the structures and processes associated with strategic decision-making and control within a corporation (Melis, 2002).

Whereas the financial reporting system is rather formal and institutionalized, the corporate governance system is relatively abstract and undefined. It is believed that the effectiveness of the systems of financial reporting and corporate governance is positively correlated.

On the one hand, financial reporting constitutes an important element of the corporate governance system. In fact, some failures of corporate governance may be reduced by an adequate financial reporting system. On the other hand, some problems of the financial reporting system find their origin in deficiencies of the system of corporate governance (Whittington, 1993).

The key issue in understanding how their relationship is shaped is to analyse their theoretical roots. Disclosure may be considered the foundation of any system of corporate governance (Cadbury, 1999; Mallin, 2002). A system of corporate governance needs a good level of disclosure and an adequate information to eliminate (or at least reduce) information asymmetries between all parties in order to balance the powers of the corporate stakeholders, making corporate insiders accountable for their actions.

Disclosure is also one of the fundamental goals of the financial reporting system.

Since Amaduzzi (1949), it has been argued that financial statements (and the whole financial reporting system) are to be considered the result of a conflict of interests and balance of power between different stakeholders. The information disclosed by the financial statements describes what the corporate insiders want to be disclosed about the corporation's activities and performance.

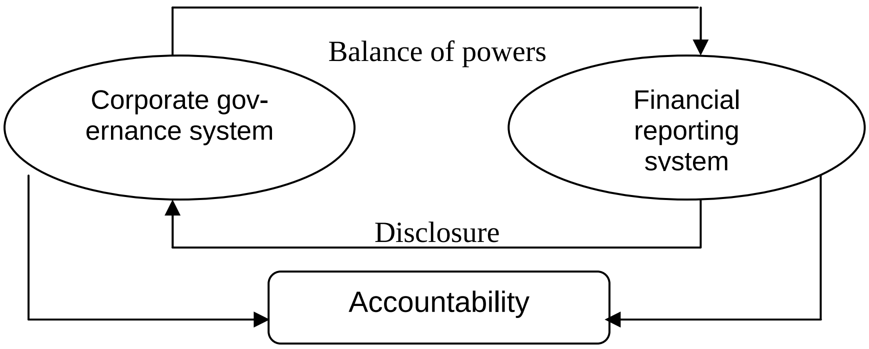

Figure 1. The essence of the relationship between the two systems at corporate level

If corporate insiders are unaccountable, or accountable only to some powerful stakeholders (e.g. a large creditor or a blockholder), they will have the incentive to disclose only the information that is functional to those specific interests. If they are accountable only to some powerful stakeholders, they will draw up the financial statements according to the interests of the powerful stakeholder they are accountable to. It may therefore be argued that the financial reporting system needs an adequate balance of the corporate stakeholders' powers to be able to give a true and fair view of the corporation to all strategic stakeholders. It also seems correct to argue that each system is influenced positively by the other one. The output produced by one system constitutes the input needed by the other and vice versa. Both of them pursue the accountability of the most powerful stakeholders towards the other legitimate stakeholders.

Figure 1 shows the essence of the relationship between the two systems at corporate level, excluding, in accord to the purpose of the paper, the larger framework constituted by the laws produced at national and international levels.

3. How a good financial reporting system may improve the effectiveness of the system of corporate governance

The system of financial reporting may play a key role improving the soundness of the corporate governance system. One of the key functions of the financial reporting system is to limit top management's discretion, constraining top management to act in the shareholders' interest (Jensen, Meckling, 1976; Watts, Zimmerman, 1978), or, in a wider perspective, in the interest of all the strategic corporate stakeholders (Melis, 2002).

Making corporate insiders accountable is clearly also a key goal of any corporate governance system. The use of generally accepted accounting principles serves the need of a better quality of the information given by the financial statements and a consequent more effective accountability of the controlling agents (Pizzo, 2000).

The institution of more and more detailed accounting principles and procedures limits the controlling agent's discretion in the drawing up of the financial statements (Melis G., 1995).

This may have a positive influence on the corporate governance system, since by controlling and manipulating the quality of corporate information disclosed in the financial statements, the dominant stakeholder (i.e. the one that effectively controls the corporation) would be able to influence the uncertainty attached to the estimates that shareholders (and, in general, all the strategic stakeholders) make of any given variable (Forker, 1992). By doing so, the dominant stakeholder would make monitoring procedures less effective, thus he/she would become less accountable to the other strategic stakeholders.

The corporate governance system is affected by the degree of information asymmetries existing between the corporate stakeholders.

In a corporation, whose structure tends to be highly complex, the financial reporting system represents the main means to give an adequate information about the economic and financial corporate situation so that it should be able to reduce the information asymmetries between the parties.

By producing the financial accounting information which is necessary to satisfy the informational needs of the corporate stakeholders, a sound system of financial reporting facilitates the monitoring of the top management's performance (and, in general, the controlling agents' performance) by the other strategic stakeholders who are not directly involved in the corporate management (Whittington, 1993, Cadbury, 1999).

This is indeed one of the key functions of the financial reporting system (e.g. Accounting Standards Board, 1995), although an effective financial reporting system is only a necessary but not sufficient condition for a good corporate governance system.

An effective financial reporting system is not sufficient to solve all the corporate governance problems, since corporate stakeholders may be unable (or may not have the incentive) to process the information given or even the "informed" stakeholder may not be able to exercise its monitoring because of high related costs (Whittington, 1993).

The quality of the corporate communication reduces the information asymmetry between shareholders (and potential investors) and dominant corporate insiders. Shareholders (including the potential ones) gain a better knowledge of the corporation, see the degree of risk of their investment in the corporation decrease and, consequently, ask for a lower "premium", i.e. a lower remuneration rate for their invested capital, so that the capital becomes "less expensive" for the corporation (Botosan, 1997). Similarly to the idea emphasised above for the shareholders and potential investors, a good quality of the corporate communication is that it may reduce the information asymmetry also between creditors and dominant corporate insiders. Empirical evidence (see Sengupta, 1998) shows that corporations with high disclosure quality ratings from financial analysts face a lower interest cost of issuing debt, and vice versa.

An improvement in the disclosure quality seems to have a positive influence on the reduction of the cost of finance for the corporation, since it decreases the risks faced by the finance providers.

By reducing the cost of finance (both from shareholders and creditors), the quality of the financial reporting system addresses an important function of the corporate governance system, i.e. to constitute a corporate competitive advantage in the capital markets.

For all the above mentioned reasons, it seems correct to argue that a sound system of financial reporting, which produces a good quality of corporate communication by giving a true and fair view of the corporation, may have a positive influence on the effectiveness of the corporate governance system. However, the corporate governance system and the system of financial reporting are not characterised by a one way relationship. Not only does the financial reporting system may improve the corporate governance system, but it may also argued that the corporate governance system may have a positive influence on the quality of the corporate communication and the overall effectiveness of the financial reporting system.

4. How the system of corporate governance may improve the quality of financial reporting and corporate communication

The system of corporate governance may play a key role in the improvement of the quality of the financial reporting system and corporate communication.

Firstly, an effective corporate governance system is able to identify which are the strategic stakeholders to whom the financial reporting system should address the flow of information about the corporate activities. These stakeholders may be either corporate insiders or outsiders and have different information needs, according to the different role they have inside or outside the corporation (Coda, 1970; Terzani, 1995). For example, a shareholder may be interested in the ability of the corporation to remunerate his/her shares (via dividends or capital gains in the stock exchange market), while a creditor may want to be assured that capital is maintained intact so that the corporation will able to pay back its debts. An employee may have an interest to understand whether the corporation will be able to keep his/her job position or not. Despite the fact that in the long term all the different interests may converge in the overriding goal of value creation and corporation's survival (Dezzani, 1981), in a shorter period different stakeholders may have different interests and informational needs. By identifying their needs, the corporate governance system makes the role of the financial reporting system more effective, improving the quality of corporate communication towards all the strategic stakeholders.

Secondly, an aspect of corporate governance which has given rise to great concern is the dominant personality phenomenon (Forker, 1992).

The presence of a dominant stakeholder (top management, blockholder, large creditor, etc.) may influence negatively the quality of corporate communication, by making the financial reporting system pursuing his/her own interests, rather than pursuing the overriding "true and fair view" objective. If unaccountable, the dominant stakeholder has an incentive to have an opportunistic behaviour. He/she is likely to select accounting procedures to maximise his/her own utility (Gordon, 1964), manipulating the information in the financial statements to pursue that goal.

In fact, the presence of a dominant stakeholder was found to be associated with poor disclosure (Forker, 1992) and an overall inadequate quality of corporate communication (Fiori, 1999). From a normative perspective, the presence of a dominant stakeholder should not have a significant influence on the quality of corporate communication, since the information flow should not be manipulated by the stakeholder who controls the corporation (Dezzani, 1981).

In this perspective the financial statements are considered an "information medium", which should meet the principles of "neutrality", i.e. the information should not be functional to any particular stakeholder's interest, and "disclosure", i.e. the conflict of interest should not be solved in the drawing up of the financial statements, but, in a second phase, during the process of value distribution (Dezzani, 1981).

Although from a normative perspective financial statements should give a true and fair view of the corporation's activities, there is evidence of manipulation of corporate communication when powerful insiders are not made accountable to the other strategic stakeholders, i.e. when the system of corporate governance is not working properly. From a positive perspective, the financial statements are considered as a "behavioural instrument", i.e. as a medium to pursue the interests of the dominant stakeholder (Viganò, 1973; Dezzani, 1981).

Although the existence of generally accepted accounting principles that pursue the principle of "true and fair view", it is argued that the practice of using the financial statements (and the financial reporting system as a whole) as a "behavioural instrument" seems far to be avoided (Melis, 2003). The cases of Enron, Maxwell, Vivendi, WorldCom, etc., are excellent examples of the above-mentioned practice. The presence of an unaccountable powerful stakeholder can limit the quality of corporate communication, since he/she has the incentive (and the power) to choose the valuation criteria, within the ones allowed by the generally accepted accounting principles, which better address his/her own interests. So that financial statements do not offer a true and fair view of the corporation as an on going concern, but give an image of the corporation which is highly functional to the dominant stakeholder's interests, whomever he/she may be (top management, large creditor, blockholder, etc.). In fact, empirical evidence (see Oricchio, 1997 for a review) shows that the system of financial reporting may be structured in such a way to pursue the interests of the stakeholder that controls the corporation, at the expense of the interests of the weaker stakeholders, who are not able to have a true and fair view of the corporation they have a stake in.

Not only do dominant stakeholders exercise their power to influence the accounting standards-setting process at national and international level (Zeff, 1978), but also use the discretion allowed by generally accepted accounting principles to influence the information given by the corporate financial statements according to their interests.

The institution of the generally accepted accounting principles has not eliminated one basic limit of the financial reporting system, i.e. the possibility of different accounting treatments being applied to essentially the same facts. There is still room for flexibility (and consequent subjectivity) when differences of opinion (which may or may not derive from divergence of interests) about, for example, depreciation can lead to significant variations in reported profits. Another example are the differences which may derive from the adoption of *First In First Out* or *Last In First Out* in a stock inventory valuation, with the consequence that different results can be reported, each formally complying with the overriding requirement to show a true and fair view.

By their own nature, accounting principles standards provide a framework which allows a certain degree of flexibility. In fact, this flexibility may make generally accepted accounting principles less effective in limiting the controlling agent's discretion, and may give birth to the so called "creative accounting" (Naser, 1993). Besides, it may be argued that the institution of more detailed less flexible generally accepted accounting principles cannot eliminate this discretion, because the valuation process of corporate activities is intrinsically subjective (Melis G., 1995).

This is essentially due to the contradiction between the periodicity principle and the going concern principle. Although the former requires a break of flow into comparable time segments, the latter assumes the operations as a continuous flow.

It is then fundamental the spirit that characterises the choice between different alternatives.

When the exercise of these choices is not made to pursue the spirit of the "true and fair view" principle, financial statements give a corporate image which is functional to the interest of the most powerful stakeholder. This is likely to happen at the expense of the weaker stakeholders.

For this reason, the Cadbury Report (1992) recommends the board of directors to pay a great attention to this issue, aiming for the highest level of disclosure. It is a corporate board's duty to assure that the financial statements meet the spirit, not only the letter, of the true and fair view principle. By making corporate insiders accountable, a sound system of corporate governance may reduce the risk of the presence of the dominant phenomenon.

An effective system of accountability, which is a key subset of the corporate governance system (Keasey, Wright, 1993; Coda, 1997), should be able to reduce the potential abuses of power by the controlling agents (whose role may vary from corporation to corporation) against the other strategic stakeholders, by making them accountable for their actions and effectively monitored.

The quality of corporate communication towards its strategic stakeholders may also be improved by a more effective external auditing process.

The corporate governance system may also contribute to the improvement of the external auditing process, due to the role of the Audit Committee, which liaises with external auditors.

The fact that a corporation is characterised by a sound system of corporate governance seems to give a relevant incentive to the auditing firm to do a job that is good not only from a formal point of view, but also effectively improves the internal control system of the corporation (Coda, 1997).

External auditors tend to be more closely associated with auditees (top management) than with external reportees (other corporate stakeholders). If the corporate governance system does not work properly, external auditors' closer association with auditees may result in the incentive to accept the corporate insiders' view of events rather than having an independent view of those events, thus reducing the value of financial reports to reportees (Staubus, 1992).

5. Concluding remarks

This paper has analysed and discussed the relationship existing between the financial reporting system, corporate communication, and corporate governance.

Although it is at most only suggestive in helping to highlight some issues, which are worthy topics and surely deserve further research, some conclusions can be drawn at this stage.

Policy makers should be aware that the framework of generally accepted accounting principles cannot guarantee by itself the quality of corporate communication and the pursuing of the "true and fair view" principle. A sound system of corporate governance seems necessary to achieve the purpose of the "true and fair view" given by the financial statements, and to improve the overall quality of the financial reporting system. However, it should also be taken into consideration that the quality of information produced by the financial reporting system is fundamental for a corporate governance system to be effective. The power of the most powerful corporate stakeholder can only be balanced if the other strategic stakeholders have the information they need to exercise their influence and hold the former accountable. Therefore, it seems correct to argue that the effectiveness of the systems of financial reporting and corporate governance is highly correlated, with any improvement in either system having a positive influence on the other, and vice versa.

References

1. Accounting Standards Board, *Draft Statements of Principles*, 1995
2. Amaduzzi A., *Conflitto ed equilibrio di interessi nel bilancio dell'impresa*, Bari: Cacucci, 1949
3. Botosan C., *Disclosure Level and the Cost of Equity Capital*, The Accounting Review, N. 3, 1997
4. Cadbury A., *What are the Trends in Corporate Governance? How will They Impact your Company?*, Long Range Planning, Vol. 32, N. 1, 1999
5. Cadbury Report, *The Financial Aspects of Corporate Governance*, London: Gee, 1992
6. Coda V., *L'informazione degli azionisti in una prospettiva ideale*, Rivista dei Dottori Commercialisti, luglio - agosto, 1970
7. Coda V., *Trasparenza informativa e correttezza gestionale: contenuti e condizioni di contesto*, in AA.VV., *Scritti di Economia aziendale in memoria di Raffaele D'Oriano*, Vol. I, Padova: Cedam, 1997
8. Dezzani F., *La "neutralità" del bilancio d'esercizio oggetto della certificazione e i principi contabili generalmente accettati*, in AA.VV., *Bilancio di esercizio e amministrazione delle imprese. Studi in Onore di Pietro Onida*, Milano: Giuffrè, 1981
9. E.C.G.N., *The Separation of Ownership and Control: A Survey of 7 European Countries. Preliminary Report to the EC*, Brussels: European Corporate Governance Network, 1997
10. Fiori G., *Il principio della "rappresentazione veritiera e corretta" nella redazione del bilancio di esercizio. Considerazioni critiche e profili evolutivi dell'informazione societaria*, Milano: Giuffrè, 1999
11. Forker J., *Corporate Governance and Disclosure Quality*, Accounting and Business Research, Vol. 22, N. 86, 1992
12. Gordon M., *Postulates, Principles and Research in Accounting*, The Accounting Review, April, 1964
13. John K., Senbet L.W., *Corporate Governance and Board Effectiveness*, Journal of Banking and Finance, N. 22, 1998
14. La Porta R., Lopez de Silanes F., Shleifer A., *Corporate Ownership Around the World*, Journal of Finance, Vol. LIV, N. 2, April, 1999

15. Keasey K., Thompson S., Wright M., *Introduction: the Corporate Governance Problem - Competing Diagnoses and Solutions*, in K. Keasey, S. Thompson, M. Wright (edited by), *Corporate Governance. Economic, Management and Financial Issues*, (Oxford: OUP), 1997
16. Keasey K., Wright M., *Issues in Corporate Accountability and Governance: an Editorial*, Accounting and Business Research, Vol. 23, N. 91A, 1993
17. Jensen M., Meckling W., *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, Journal of Financial Economics, N. 3, 1976
18. Mallin C., *Voting: the Role of Institutional Investors in Corporate Governance*, London: ICAEW, 1995
19. Mallin C., *The Relationship Between Corporate Governance, Transparency and Financial Disclosure*, Corporate Governance: An International Review, Vol. 10, N. 4
20. Marris R., Mueller D., *The Corporation, Competition and the Invisible Hand*, Journal of Economic Literature, Vol. XXIII, 1980
21. Melis A., *Corporate Governance in Italy*, Corporate Governance: An International Review, Vol. 8, N. 4, 2000
22. Melis A., *Creazione di valore e meccanismi di corporate governance*, Milano: Giuffré, 2002
23. Melis A., *Informazione esterna d'impresa: neutralità e conflitti di interesse*, Il Controllo legale dei Conti, forthcoming 2003
24. Melis G., *Sulla natura economica dei valori iscritti nel nuovo bilancio europeo*, Annali della Facoltà di Economia di Cagliari, Vol. XI, Milano: Angeli, 1995
25. Naser, K., *Creative Financial Accounting. Its Nature and Use*, London: Prentice Hall, 1993
26. Onida P., *Economia d'azienda*, Torino: UTET, 1968
27. Oricchio G., *Valenza informativa dei bilanci ordinari e teorie motivazionali e comportamentali degli amministratori: alcune riflessioni*, Rivista Italiana di Ragioneria e di Economia Aziendale, luglio – agosto, 1997
28. Pizzo M., *Il "fair value" nel bilancio d'esercizio*, Padova: Cedam, 2000
29. Roe M., *Strong Managers, Weak Owners. The Political Roots of American Corporate Finance*, Princeton: Princeton University Press, 1994
30. Roe M., *Some Differences in Corporate Governance in Germany, Japan and America*, in T. Baums, R. Buxbaum, K. Hopt (edited by), *Institutional Investors and Corporate Governance* (Berlin: WdeG, 1994
31. Sengupta P., *Corporate Disclosure Quality and the Cost of Debt*, The Accounting Review, Vol. 73, N. 4, 1998
32. Staubus G., *The Development of Accounting in Firms: the Role of Conflicts of Interests*, Haas School of Business Working paper, January, 1992
33. SFAC, *Objectives of Financial Reporting by Business Enterprises*, FASB, November, 1978
34. Terzani S., *Introduzione al bilancio di esercizio*, 5th ed., Padova: Cedam, 1995
35. Tricker R., *Platitudes Parading as Paradigms. Reactions to the Preliminary Report of the UK Hampel Committee on Corporate Governance*, Corporate Governance - An International Review, Vol. 6, N. 1, 1998
36. Tricker R., *Corporate Governance - the Subject Whose Time has Come*, Corporate Governance - An International Review, Vol. 8, N. 4, 2000
37. Useem M., *Investor Capitalism: How Money Managers are Changing the Face of Corporate America*, New York: Basic Books, 1996
38. Viganò E., *L'informazione esterna d'impresa*, Rivista dei Dottori Commercialisti, N. 3, 1973
39. Watts R., Zimmerman J., *Towards a Positive Theory of the Determination of Accounting Standards*, The Accounting Review, Vol. LIII, N. 1, 1978
40. Whittington G., *Corporate Governance and the Regulation of Financial Reporting*, Accounting and Business Research, Vol. 23, N. 91A, 1993
41. Zanda G., *La grande impresa. Caratteristiche strutturali e di comportamento*, Milano: Giuffrè, 1974
42. Zeff S., *The Rise of Economic Consequences*, The Journal of Accountancy, December, 1978