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GUEST EDITORIAL

Governance Issues in Accounting

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Abstract

Purpose of this paper - This paper identifies some key issues for the analysis of corporate governance based on the articles within this special issue including the guest editor's perspectives.

Design/methodology/approach - The five papers included in this special issue are summarized and their main contribution to the literature is highlighted.

Findings - The papers collectively deal with the role and impact of corporate boards on the quality of information provided to capital markets.

Practical implications - The theoretical and empirical research included in the special issue advance the understanding of corporate governance which provides impetus for practitioner and policy change.

Originality/value - The normative concepts of best practice need to be validated by empirical testing in the context of firms and their institutional settings. This suite of papers provides evidence of the effectiveness of corporate governance in improving accounting quality.

Keywords Corporate governance, accounting, best practice.

Paper type Research paper.

1. Introduction

The papers published in this special issue of *Accounting Research Journal* explore the impact of corporate governance practices within the framework of accounting issues.

Corporations must provide stakeholders with relevant, reliable, and timely information to maintain efficient global capital markets. Accounting, auditing, and the corporate governance environment are essential components in the flow of information to capital market participants. However, recent accounting failures have illustrated the need for substantive improvements in these systems.

This special issue illustrates the importance of financial statements and the role governance plays in maintaining accounting quality. Within the financial reporting environment, global pressures motivate managers to manage earnings and to delay and/or

conceal bad news. In this context the first and third paper examine the role of governance in constraining how some companies manipulate their financial statements. The second paper examines the frauds that are committed in financial statements in the post-Enron regulatory environment. The fourth paper investigates the monitoring role of institutional investors and how the type of investor and political connections of firms impacts their association with the external audit. Finally, the fifth paper assesses the association between corporate governance practices and firm risk. Together, this suite of papers provides insight into the role of corporate governance in ensuring a transparent and accountable capital market.

2. Corporate governance research

Creditors and investors must have faith in the reliability and quality of earnings if they are to entrust their resources in a firm. Prior research in accounting and finance has separately investigated the association between corporate governance and earnings management and the classification of the firm's financial health (e.g. Bowen et. al., 2008; Mather and Ramsay, 2006; Yeh and Lee, 2004). In this special issue, Demirkan and Platt integrate these research paradigms. They select a discrete sample of U.S firms in the manufacturing industry to show how managers' incentives to manipulate earnings are associated with the company's financial condition which is a function of the firm's governance quality. This study demonstrates the importance of financial classifications of firms for creditors and investors when they evaluate potential investments.

Supporting corporate governance are the regulatory initiatives associated with commercial laws and codes of corporate governance that aim to regulate managerial power. Many of the policy prescriptions contained in codes of recommended corporate governance practice depend on universal notions of best practice. The normative concepts of best practice need to be validated by empirical testing in the context of firms and their institutional

settings. A good deal of the concepts of best corporate governance practices and associated research has adopted an agency theory approach. Traditional agency theory is derived from the separation of ownership from control and emphasizes the role of corporate governance as one of aligning the agent's goals with the interests of shareholders (Fama and Jensen, 1983). In contrast, institutional theory adopts an open system perspective where organizations are strongly influenced by their environments (DiMaggio and Powell 1983; Bealing et al. 1996). Lane and O'Connell use institutional theory to hypothesise that the SEC increased the number and scale of its enforcement activities to ensure maintenance of its societal legitimacy as a consequence of the major accounting scandals. Their study extends the Committee of Sponsoring Organizations of the Treadway Commission 1987-1997 (COSO Report, 1999) by examining U.S. Accounting and Auditing Enforcement Releases (AAERs) to provide insights into the characteristics and realities of financial statement fraud in the post-Enron regulatory environment. In comparing the characteristics of financial statement fraud pre and post issuance of the COSO report they provide evidence that high profile accounting scandals have been instrumental in changing the focus of SEC investigations.

The plethora of research on corporate boards demonstrates the importance of this area within corporate governance research. Directors' responsibilities include assurance that the firm is well governed and that the information provided to stakeholders is reliable. There is also considerable research that has examined the association between board independence and earnings management (Hutchinson et al., 2008; Klein, 2002; Peasnell et al., 2005; Xie et al., 2003). However, much of the research on board independence has not considered the motivation and incentives of non-executive directors that are not truly independent. He, Wright, Evans and Crowe investigate this issue by examining the role of non-executive directors in effectively monitoring the quality of accounting information, paying particular attention to the part played by affiliated directors in Australian firms. Further their study is

carried out post governance reforms, which in turn tests the effectiveness of the recommendations made by the 2003 Australian Stock Exchange Principles of Good Corporate Governance and Best Practice. Their study highlights the need for boards to take care in the selection and reward of non-executive directors, particularly those with affiliations with the firm.

There is an ever increasing call for institutional investors to take a more active monitoring role in the governance of the firms in which they invest, particularly since the global financial crisis. Institutional shareholders have a responsibility to generate long term value on behalf of their beneficiaries and therefore play an important part in scrutinizing firms' corporate governance practices. In addition, the quality of the external audit function, as part of firms' governance, is responsible for ensuring the reliability of reporting and control processes of the firms they audit. Thus, more active institutional investors are likely to pressure audit firms to carry out more substantive testing of the firm's systems and this relationship is likely to depend on the institutional setting. Wahb, Zain, James and Haron study the relationship between institutional investors and the external auditor in Malaysia, a country with a developing capital market, and provide insights into a diverse range of institutional characteristics that impact corporate monitoring costs. They find that firms' monitoring costs (audit fees) increase with institutional ownership for investors that do not have a relationship with the firm. They also find that, due to the greater perceived inherent risk, politically-connected firms have higher monitoring costs. This paper demonstrates the factors that impact firms' monitoring costs.

The final paper in the special edition by Wang and Oliver also considers the role of board independence but considers the association between board independence and the risk profile of the firm. Agency theory assumes risk-neutral shareholders prefer managers increase firm value by undertaking all positive net present value projects. However, risk-

averse managers prefer to undertake less risky positive net present value projects and may therefore reject risky but profitable projects (Hutchinson, 2003). Firm risk refers to the underlying volatility in the firm's earnings stream and has been identified as a source of agency conflict (Bathala and Rao, 1995). The agency conflict arises because managers are more concerned about their employment risk and firm survival than profit maximization of shareholders. To reduce these agency conflicts, firms use supervisory and incentive alignment mechanisms that alter the risk and effort orientation of agents to align them with the interests of principals (Tosi and Gomez-Mejia, 1989). Wang and Oliver study of Australian firms finds that firms with more executive directors on the board have lower risk. However, affiliated and independent directors, have no significant influence on the level of performance variance. The results of their study imply monitoring by independent boards is ineffective in mitigating the agency conflicts associated with managers' risk avoidance.

3. Conclusion

The five papers presented in this Special Issue, although diverse, share a common theme. The authors have highlighted the importance of contextual factors in corporate governance research that is based on different organizational and institutional environments. Theoretical and empirical research should progress understanding of corporate governance which will, in turn, prove useful for practitioners and policy makers.

The studies discussed above are in many ways complementary, as they focus on corporate governance mechanisms that inform capital markets. Taken together, they represent a comprehensive overview of current corporate governance research and suggest a number of opportunities for future studies.

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