

Corporate Governance and IFRS: A Pathway to High-Quality Financial Reporting



Introduction

In response to the rising incidences of financial scandals and corporate collapses globally, corporate policymakers and finance researchers have increasingly focused on designing an effective corporate governance framework. Corporate governance aims to establish mechanisms that mitigate conflicts of interest between owners and managers, thereby enhancing firm performance and safeguarding stakeholder interests. Corporate governance, International Financial Reporting Standards (IFRS), and financial reporting quality are deeply interconnected. Strong governance practices and adherence to IFRS are fundamental to ensuring reliable and transparent financial reporting. IFRS offers a globally accepted framework that significantly enhances the comparability and credibility of financial statements.

The quality of financial reporting is a critical concern for stakeholders worldwide, including shareholders, lenders, and suppliers. Despite its importance, financial misreporting remains prevalent on a global scale. According to Price water house Coopers' (PwC) 2018 Global Economic Crime and Fraud Survey, 49% of financial reports issued by firms fail to meet established quality standards. PwC itself faced a two-year ban in India after failing to detect inflated revenues in the Satyam case, highlighting the serious implications of inadequate financial oversight (Mundy, 2018). Globally most of the financial scandals occurred due to failure of board, management and auditor's negligence in compliance of



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Recently in 2024, a real state China Evergrande Group bankrupted due to failure of board, management and its auditor. Resultantly, Chinese regulatory authorities have imposed a six-month suspension on the auditing operations of PricewaterhouseCoopers (PwC) in mainland China and levied a record fine amounting to 441 million yuan (approximately \$62 million) along with penalty of \$ 6.53 million to CEO. This disciplinary action is a result of PwC's audit practices concerning the financially distressed property development company (BBC news, 2024).

Financial Reporting Setting in Pakistan

Regulatory bodies in Pakistan have progressively established a robust financial reporting framework to support the country's economic development. The adoption of IFRS began in January 2005, culminating in full implementation by January 2014 except IFRS 1. The Companies Act of 2017 further mandated the application of IFRS for all businesses in Pakistan, ensuring that both domestic and international listed companies adhere to these global standards in their financial reporting.

The Securities and Exchange Commission of Pakistan (SECP), the State Bank of Pakistan (SBP), and the Institute of Chartered Accountants of Pakistan (ICAP) are the key regulatory bodies responsible for overseeing IFRS compliance in the country. As a result, publicly listed and trading companies in Pakistan are required to align their financial reporting with IFRS, reinforcing transparency, consistency, and credibility in financial disclosures across the market.

Top Financial Scandals in the Past Decades



Enron Scandal (2001)
\$74billion, 20,000 jobs



WorldCom Scandal (2002)
\$11billion



American International Group (AIG) Scandal (2005) - \$4billion



Lehman Brothers Scandal (2008)
\$50billion



Tyco Scandal (2002)
\$2.92billion



Bernie Madoff Scandal(2008)
\$64.8billion



Waste Management Schandal (1998) - \$1.7billion



Satyam Scandal (2009)
\$1.5billion



HealthSouth Scandal(2003)
\$1.8billion

(Source: 72nd Directors' Training Program of ICMA Pakistan)

Pakistan has faced a troubling history of financial reporting deceptions within the South Asian region due to weakness of corporate governance. The World Bank uncovered widespread financial fraud in the country, identifying 23 companies involved in corrupt and fraudulent activities (Khamainy et al., 2021). These firms produced misleading financial reports, leading to significant investor losses due to misguided decisions based on inaccurate accounting data. Such instances of financial fraud have eroded investor confidence and underscored concerns about the quality and reliability of financial reporting in Pakistan.

According to PwC's 2020 report, 47% of companies in Pakistan had encountered fraud within the preceding two years. Some of the most notable scandals include Hascol Petroleum, TRG, The Abraaj Group, Mehrangate, Taj Company, KASB Bank, the National Savings Scheme, Nestlé, and various microfinance banks. These cases, as highlighted by Awan et al. (2016) and Kemal (2019), resulted in significant losses for investors, largely due to pervasive financial reporting fraud (Rizwan, 2019).

Thus, the only way to improve the quality of financial reporting is the strengthen of corporate governance and compliance of IFRS in true spirit.

Corporate Governance

Corporate governance encompasses the framework of rules, practices, and processes through which a company is directed and controlled. It involves the interactions and responsibilities among the company's management, board of directors, shareholders, and other stakeholders, ensuring that the organization operates with accountability, transparency, and fairness. This governance structure is essential for maintaining the integrity of financial reporting and safeguarding stakeholder interests.

Key aspects include:

- 1) **Board Structure and Independence.** An effectively structured and independent board is essential for providing oversight of management and ensuring that financial reports accurately present the company's financial position in a true and fair manner.
- 2) **Audit Committees.** A robust audit committee is pivotal in overseeing the financial reporting process, ensuring the effectiveness of internal controls, and supervising the external audit function.
- 3) **Transparency and Disclosure.** Effective governance necessitates transparent reporting, wherein financial information is disclosed accurately and promptly.
- 4) **Ethical Standards and Compliance.** Corporate governance encompasses compliance with ethical norms and legal obligations, mitigating the potential for financial misrepresentation.

Quality of Financial Reporting and IFRS

The quality of financial reporting is defined by the correctness, consistency, and comprehensiveness of the financial data supplied to stakeholders. A true and fair picture of a business's financial performance and position is provided by high-quality financial reporting, which helps stakeholders, regulators, and investors make educated decisions.

The basic goal of accounting financial reporting is to give users sufficient and reliable information for making decisions in specific establishments; in order to do this, financial reporting quality is important globally and is still being debated. Investors assess an entity's equity shares using this information. Accounting data that adheres to book keeping standards—specifically, IFRS—better illuminates the evolution of a company's worth. Businesses that use IFRS accounting standards improve the accuracy, comparability, and transparency of their financial reporting. A decrease in the information asymmetry between managers, owners, majority investors, and minority investors is caused by an increase in transparency. Investors determine the firm's value by utilizing firm accounting information from financial statements.

Everyone agrees that the financial crises were a major factor in the collapse of economic endeavours, dramatic joblessness, extreme poverty, and inequality. These hitherto unseen unemployment rates, welfare losses restrained by slower growth, and burdened public spending (Ndanuko and Karugu, 2017). Therefore, to support the growing market's globalization, high-quality and widely recognized accounting standards are needed (Okpara et al., 2010). Financial statements should become more relevant and provide more information when IFRS are implemented (Ndanuko and Karugu, 2017). IFRS is a globally recognized collection of accounting principles that were established through the establishment of both specialized accounting standards and universal norms.

IFRS plays a critical role in enhancing financial reporting quality by:

- 1) **Standardization:** IFRS provides a consistent framework for financial reporting across different jurisdictions, making financial statements more comparable and reliable.
- 2) **Principles-Based Approach:** IFRS's principles-based approach encourages companies to apply professional judgment, ensuring that financial reports reflect the economic substance of transactions.
- 3) **Enhanced Disclosures:** IFRS requires extensive disclosures, promoting transparency and helping stakeholders understand the company's financial situation and risks.

Impact of Corporate Governance on Financial Reporting Quality under IFRS

1) Board Independence and Oversight

Impact: An independent and competent board of directors ensures that management adheres to IFRS principles and that financial reports are free from bias or manipulation.

Example: A board with independent members and financial expertise is more likely to challenge management's assumptions and estimates, leading to more accurate and transparent financial statements in line with IFRS.

2) Role of Audit Committees

Impact: Audit committees, composed of independent directors, enhance financial reporting quality by overseeing the financial reporting process, ensuring that the company's financial statements comply with IFRS.

Example: An effective audit committee will scrutinize accounting policies, estimates, and judgments made by management, reducing the risk of errors or intentional misstatements in IFRS-compliant financial statements.

3) Transparency and IFRS Compliance

Impact: Strong corporate governance promotes transparency, ensuring that companies fully comply with IFRS disclosure requirements. This transparency builds trust among stakeholders and enhances the credibility of financial reports.

Example: Companies with robust governance practices are more likely to provide comprehensive disclosures under IFRS, such as detailed information on revenue recognition, fair value measurements, and related party transactions.

4) Ethical Culture and Financial Reporting Integrity

Impact: A corporate culture that emphasizes ethics and integrity supports high-quality financial reporting, as management is less likely to engage in practices that compromise IFRS compliance.

Example: Companies with strong ethical standards are more likely to adhere to IFRS principles and avoid aggressive accounting practices that could distort financial statements.

5) Internal Controls and Risk Management

Impact: Effective internal controls and risk management practices, often overseen by the board

and audit committee, are essential for ensuring that financial reporting aligns with IFRS requirements.

Example: A company with robust internal controls is better equipped to detect and correct errors or inconsistencies in its financial statements, ensuring compliance with IFRS and maintaining financial reporting quality.

Challenges in Achieving High-Quality Financial Reporting under IFRS

Despite the positive impact of corporate governance on financial reporting quality, challenges remain:

- 1) **Complexity of IFRS Standards:** The complexity and evolving nature of IFRS standards can make compliance challenging, especially for companies in jurisdictions with less mature governance structures.
- 2) **Cultural and Regulatory Differences:** Differences in corporate governance practices across countries can impact the consistency and quality of IFRS application.
- 3) **Management Override of Controls:** Even with strong governance, there is always a risk that management may override internal controls, leading to financial misreporting.

Ways to improve the quality of IFRS financial statements

To raise the caliber of IFRS financial statements, we don't think you have to be an expert in financial reporting. We believe that suggestions listed below can enhance IFRS financial statements without necessitating substantial modifications to their design:

These are just a few of the simple improvements that could improve IFRS financial reporting quality with comparatively little additional work or expense. In addition to compliance difficulties, organizations should take into account qualitative issues if they hope to provide value for their shareholders and other users of financial statements.

- a) Identify other classes of responsibilities and assets, as well as income and expenses, apart from the bare minimum. Additionally, employ labels that shed more light on the characteristics of the classes.
- b) View the financial statements' notes, which include information about particular balances, as more than just an accountants' reconciliation.
- c) Include details regarding the cash flows for the items in the same discussion in the note disclosures regarding income statement items.
- d) When discussing uncertainties, think about presenting the several ways in which the uncertainty might be addressed.

- e) Alongside the consolidated totals on the income statement's face, include segment information on the profit and loss components.
- f) Give a description of the decisions made and their rationale, in addition to the accounting policy decisions that the company has made.
- g) Examine modifications to the estimate or its underlying assumptions with the same level of detail as the balance adjustments they impact if the estimate has a substantial impact on an account or a balance.
- h) If at all possible, attempt to align the disclosure of the present amount with comparative data.
- i) Identify the many components that appear on the financial statements, demonstrate how they connect to one another, and then provide specifics of assumptions when an account is made of multiple components, each of which is an estimate requiring thorough explanations
- j) Give details on significant non-accounting characteristics and total amounts.

Financial Reporting Requirements for State Owned Enterprises (SOEs)

As per SOEs ownership and management policy 2023, these are the enterprises that owned and controlled by Federal Government. Finance division mandated to issue the financial management framework for SOEs financial reporting after conferencing with Auditor General of Pakistan. The preparation and approval of financial statements will remain governed by the Companies Act, 2017. However, certain specific requirements must also be adhered to.

- SOEs are required to submit annual reports to Federal Government within 04 months after end of financial year.
- Financial statements must be prepared in full compliance with IFRS within a three-year period following the approval of the Act.
- The annual report must incorporate the financial information of all subsidiaries.
- The annual report must be accompanied by a declaration stating the following:
 - i. There are reasonable grounds to believe that the SOE will have the capacity to meet its debt obligations as they become due.
 - ii. The financial statements and accompanying notes are in full compliance with the provisions outlined in the SOE Law.

Conclusion

Corporate governance plays a vital role in enhancing the quality of financial reporting under IFRS. By fostering an environment of accountability, transparency, and ethical behavior, good governance practices ensure that financial statements are reliable and reflect a true and fair view of a company's financial position. As IFRS continues to be adopted globally, the interplay between corporate governance and financial reporting quality will remain crucial for building investor confidence and maintaining the integrity of financial markets.

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