

Enhancing Financial Reporting Integrity: The Moderating Role of Ethical Practices and Corporate Governance Mechanisms.

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Abstract: *Corporate governance and ethical conduct are fundamental to ensuring the integrity, accuracy, and transparency of financial reporting, which in turn fosters trust among stakeholders and contributes to the overall stability of financial systems. This study delves into the intricate relationship between ethics and corporate governance within the realm of financial reporting, exploring the foundational frameworks that underpin ethical decision-making and governance structures. Through a comprehensive review of relevant literature, this research identifies the contemporary challenges faced by organizations in maintaining ethical standards in financial reporting, such as pressures from market competition, regulatory compliance complexities, and evolving technological landscapes. The study underscores the critical importance of ethical behaviour among corporate leaders, highlighting how robust governance structures, such as a well-composed and independent board, play a pivotal role in promoting transparency and accountability. It also examines the role of external oversight bodies and regulatory frameworks in enhancing the reliability of financial disclosures and mitigating the risks of financial misreporting and fraud. By focusing on best practices in corporate governance and ethical compliance, the study aims to offer practical insights into how organizations can strengthen their financial reporting processes to align with global standards of integrity and transparency. Additionally, the research emphasizes the impact of corporate board structure and composition on the ethical quality of financial reporting, noting that diversity, independence, and expertise within boards significantly contribute to the enhancement of governance mechanisms. Ultimately, this study provides a detailed examination of how corporate governance and ethical practices intersect to reinvigorate trust in financial reporting, offering valuable perspectives for scholars, practitioners, and policymakers striving to uphold high standards of integrity in the global economic landscape.*

Keywords: *Financial Reporting Integrity, Ethical Practices in Accounting, Corporate Governance*

1.0 Introduction

Financial reporting serves as the foundation for decision-making by investors, regulators, and other stakeholders. However, recent corporate scandals, many rooted in unethical behaviour and poor governance have raised concerns about the integrity of financial disclosures. These cases have underscored the need for a robust ethical framework in financial reporting, alongside effective and sound corporate governance mechanisms (Hossain & Rahaman, 2014).

This study is anchored on the role of ethics and corporate governance in maintaining the quality of financial reporting, offering insights into how organizations can uphold ethical standards and governance practices.

Corporate governance encompasses the systems and processes that govern a company's operations and ensure accountability to its stakeholders. Ethical considerations in financial reporting are crucial for maintaining the credibility of financial statements and upholding investor confidence. As corporate scandals and financial crises have demonstrated, lapses in ethics and governance can have severe consequences for organizations and the broader financial system (Sweeney, 2010; Tricker, 2019).

Ethics refers to the moral principles that guide behaviour and decision-making. In financial reporting, ethical conduct is critical for ensuring the accuracy and reliability of financial statements. Key ethical principles in this context include honesty, transparency, fairness, and accountability. Ethical financial reporting requires organizations to present their financial position truthfully, without manipulation or intentional misrepresentation. However, in practice, various pressures such as financial performance targets, competitive demands, and executive compensation incentives may drive unethical practices (Choi & Pae, 2011).

Ethics and corporate governance are interdependent in shaping the quality of financial reporting. Ethical behaviour ensures that management acts in the best interest of shareholders, while governance structures provide the oversight necessary to detect and prevent misconduct. When both elements function effectively, they promote accurate and timely financial reporting. However, when governance structures are weak or ethical standards are compromised, the integrity of financial reports is at risk. For example, the

Enron and WorldCom scandals exposed how governance failures, combined with ethical lapses, can lead to misleading financial disclosures and massive financial losses for stakeholders (Jennings, 2018)

2.0 Literature Review

2.1 Ethical Practices in Financial Reporting

Ethical conduct ensures that the financial information presented to stakeholders accurately reflects the company's financial position without manipulation or intentional misrepresentation (Duska, et al 2011). As De George (2010) postulated, ethical decision-making in financial reporting builds trust and fosters long-term relationships with stakeholders, including investors, regulators, and employees.

However, various pressures, such as the desire to meet financial performance targets, competitive demands, and executive compensation incentives, often drive unethical financial reporting practices (Choi & Pae, 2011). These pressures can result in earnings management, fraudulent financial statements, and other forms of misrepresentation, ultimately compromising the integrity of financial disclosures (Bhasin, 2013).

Jennings (2018) highlights that financial scandals such as Enron, WorldCom, and Lehman Brothers illustrate the catastrophic effects of unethical financial reporting. These cases underline the need for a strong ethical culture within organizations, where financial integrity is prioritized over short-term financial gains.

2.2 Corporate Governance and Its Role in Financial Reporting Integrity

Effective corporate governance provides a framework that ensures the alignment of the interests of management with those of shareholders and other stakeholders, enhancing accountability and transparency in financial reporting (Tricker, 2015). Tricker (2019) noted that a well-structured board of directors, including independent directors, plays a critical role in overseeing financial reporting and ensuring that management adheres to ethical standards. Also, the presence of independent directors helps to reduce conflicts of interest and enhance the credibility of financial statements

According to Solomon (2020), corporate governance mechanisms such as independent boards, audit committees, board diversity and external auditors play a crucial role in preventing financial misstatements and ensuring that financial reports are prepared in compliance with accounting standards. The presence of strong governance structures reduces the likelihood of management manipulating financial data for personal or organizational gain (Cohen et al, 2004).

The Sarbanes-Oxley Act of 2002 (SOX), enacted after the Enron and WorldCom scandals, is a notable regulatory framework designed to enhance corporate governance and improve the reliability of financial reporting (Coates, 2007). SOX mandates stricter internal controls, greater board oversight, and more rigorous external audits, all of which contribute to the integrity of financial disclosures.

However, corporate governance failures continue to occur. Wirecard AG's collapse in 2020 highlighted significant governance weaknesses, including insufficient board oversight and inadequate audit processes, which allowed fraudulent activities to persist for years (Hornuf, Rieger, & Wang, 2020).

Audit committees are key component of corporate governance structures. According to KPMG (2020), audit committees are responsible for monitoring financial reporting processes, overseeing the external audit, and addressing any issues related to financial integrity. The effectiveness of audit committees in detecting and preventing financial misstatements is well-documented in the literature (KPMG, 2020; Beasley, 2016).

Internal Controls: Robust internal control systems are essential for detecting and preventing financial reporting errors and fraud. Effective internal controls help ensure the accuracy and reliability of financial information (COSO, 2013).

Whistleblower Programs: Establishing confidential channels for employees to report unethical practices without fear of retaliation can help identify and correct issues early. **Strengthening Oversight Mechanisms:** Regular evaluations of governance structures, internal controls, and audit processes can help identify and address potential weaknesses in financial reporting (Beasley, 2016).

2.3 Regulatory Frameworks and Standards

Regulatory bodies such as the Securities and Exchange Commission (SEC), the International Financial Reporting Standards (IFRS), and the Financial Reporting Council of Nigeria (FRCN) play a critical role in enforcing ethical standards in financial reporting. These organizations establish guidelines and frameworks that promote transparency, accountability, and fairness in financial disclosures. For instance, the Sarbanes-Oxley Act (SOX) in the United States and the UK Corporate Governance Code are examples

of regulatory responses to corporate scandals aimed at strengthening governance and ethical compliance. Regulatory frameworks and standards provide guidelines for ethical financial reporting and corporate governance. The Sarbanes-Oxley Act (SOX) of 2002 was a significant legislative response to corporate scandals, such as Enron and WorldCom, which highlighted the need for stricter regulations on financial reporting and internal controls (U.S. Congress, 2002). SOX mandates enhanced disclosure requirements, greater accountability for financial statements, and stronger internal control mechanisms (U.S. Congress, 2002).

The International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP) are critical frameworks for ensuring consistency and accuracy in financial reporting. IFRS, as highlighted by Barth (2008), promotes transparency and comparability across international borders, while GAAP provides detailed guidance for accounting practices in the United States (Financial Accounting Standards Board, (FASB), 2021).

3.0 Case Studies of Corporate Governance Failures

3.1 Case Study: Enron Corporation (2001)

The Enron scandal remains one of the most infamous cases of corporate governance failure and unethical financial reporting. Enron's management engaged in complex accounting fraud, using special purpose entities to hide debt and inflate profits. The company's governance mechanisms, including its board of directors and audit committee, failed to provide the necessary oversight to prevent the fraud. This scandal led to the bankruptcy of Enron and the dissolution of its auditing firm, Arthur Andersen, as well as the introduction of the Sarbanes-Oxley Act (SOX) in the United States, which aimed to strengthen corporate governance and financial reporting regulations (Jennings, 2018).

Key Lessons from Enron:

- **Failure of Independent Oversight:** Enron's board of directors did not exercise effective oversight, and conflicts of interest between management and auditors were rampant.
- **Lack of Transparency:** The use of off-balance-sheet entities allowed Enron to mask its financial condition, highlighting the need for clear, transparent financial disclosures.

3.2 Case Study: Wirecard AG (2020)

Wirecard, a German payment processor, was embroiled in one of Europe's largest accounting frauds. The company falsely reported that it held €1.9 billion in cash, which did not exist. This scandal exposed major weaknesses in Wirecard's governance, including inadequate checks by the company's supervisory board and a lack of rigorous audits by its external auditors. Wirecard's collapse raised questions about the effectiveness of European corporate governance frameworks and led to increased scrutiny of accounting practices across the region, (Hornuf, et al 2020)

Key Lessons from Wirecard:

- **Weak Governance Mechanisms:** Wirecard's supervisory board failed to detect or address the irregularities in its financial statements.
- **Importance of External Auditors:** The scandal underscored the need for stronger, independent audits, as the company's auditors overlooked clear red flags

3.3 The Regulatory Response to Corporate Failures:

The collapse of companies like Enron and Wirecard has prompted regulatory bodies to implement stricter corporate governance and financial reporting standards. The Sarbanes-Oxley Act (SOX) in the U.S. and the European Union's Corporate Governance Directives are examples of frameworks designed to prevent fraud by enhancing transparency, accountability, and independence in financial reporting. These regulations require greater oversight from boards of directors, stronger internal controls, and increased accountability for auditors.

4.0 Challenges in Implementing Ethical Practices and Corporate Governance

Despite the clear importance of ethics and corporate governance, several challenges impede their full implementation. One challenge is the potential conflict of interest between management and auditors, where auditors may be incentivized to overlook financial misstatements to maintain client relationships (Bhasin, 2013). Additionally, the complexity of global business operations and regulatory environments can make it difficult to enforce uniform ethical standards and governance practices (Choi & Pae, 2011).

Another challenge is the lack of ethical training and awareness among employees at all levels. As Duska, et al (2011) emphasize, promoting a culture of ethical awareness requires continuous education and reinforcement of ethical standards, yet many organizations fail to provide adequate resources for such initiatives.

The increasing complexity of financial products and services has made it more difficult for boards and auditors to fully understand the risks associated with financial reporting. This complexity can lead to oversight failures, as seen in the global financial crisis of 2008, where opaque financial instruments obscured the true financial health of many organizations (Tricker, 2015).

Several ethical challenges arise in the context of financial reporting, including:

Creative Accounting: This involves manipulating accounting methods to present a more favorable financial position than is accurate.

Earnings Management: Companies may artificially inflate or deflate earnings to meet market expectations, which misleads investors and other stakeholders.

Misrepresentation of Financial Information: Providing false or incomplete information can deceive stakeholders about the true state of an organization's financial health.

Conflicts of Interest: When auditors, directors, or executives have conflicts of interest, they may prioritize personal or organizational gain over transparency and integrity in financial reporting.

The consequences of ethical failures in financial reporting can be disastrous, ranging from legal penalties to reputational damage and loss of investor confidence. These challenges make it imperative for organizations to adopt strong governance frameworks that prioritize ethical conduct.

4.1 Best Practices for Upholding Ethics and Corporate Governance in Financial Reporting

To address these challenges and prevent ethical failures and governance breakdowns, companies should implement best practices. Organizations should consider the following key practices

Leadership Commitment to Ethics: The tone at the top matters. Senior management must demonstrate a commitment to ethical practices by fostering a culture of integrity. Establishing a strong ethical and governance culture within the organization can mitigate risks and promote integrity in financial reporting. This includes providing ethics and governance training and fostering an environment where employees feel empowered to report unethical behaviour. Also, Continuous education on ethical standards and corporate governance practices ensures that employees at all levels understand their responsibilities in upholding financial integrity (Kaptein, 2015).

Regular Audits and Assessments: Periodic reviews of financial statements and governance processes can help detect and prevent ethical breaches. **Transparency and Open Communication:** Transparent communication with stakeholders' fosters trust and minimizes the risk of ethical misconduct. Companies should prioritize transparency in financial reporting by providing clear and comprehensive disclosures that accurately reflect their financial position and performance (Barth, 2008).

5.0 Conclusion

The relationship between ethics and corporate governance is central to ensuring the credibility of financial reporting. Organizations must prioritize both to protect the interests of stakeholders and maintain public confidence in financial markets. Cases like Enron and Wirecard demonstrate how the breakdown of these pillars can lead to devastating consequences for companies and stakeholders alike. Ethical lapses and governance failures in financial reporting can have far-reaching consequences, making it essential for companies to adopt strong governance frameworks, enforce ethical standards, and comply with regulatory requirements. As the business landscape evolves, continued vigilance and proactive governance will be crucial in addressing emerging challenges and safeguarding the integrity of financial disclosures.

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