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Corporate Governance Score and the Quality of Financial Disclosures: Evidence from the French Context

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Abstract

This research paper examines how corporate governance is related to the quality of financial disclosures for a sample of French listed firms during the period 2003-2009. We find that the level of financial reporting is positively influenced by corporate governance score. Managers and block-holders are more likely to disclose less information. These results are consistent with the belief that effective corporate governance is associated with higher financial disclosure quality while entrenched insiders do not improve this effect.

Keywords: Corporate governance score, Financial information disclosures, Entrenchment, Ownership structure

1. Introduction

Governance of the company itself is not a problem; however improving financial corporate governance is a matter of concern when analyzing financial scandals (WorldCom and Enron crises) that have recently hit some businesses which have revived interest in studying the quality and transparency of financial information contained in financial statements. Previous studies have also found an association between good corporate governance and financial reporting quality. Berbar and Boufares (1998) defined information as a system, which enables us to improve our knowledge on any subject. It is represented by the implementation of languages or symbols with which communication is ensured. Therefore, information is a set of messages that would provide useful knowledge to the recipient. It is supposed necessary for decision-making and have been subject to many studies. Given its historical importance for stakeholders, the concept of the disclosure of financial and accounting information have become increasingly important. According to Jensen and Meckling (1976), information asymmetry is a mechanism that results from the fact that a group of market participants has information not shared by other agents involved in transactions of the same goods or services. According to these authors, information asymmetry is especially present in the financial market. It generally results from a situation where professionals in the field of investment are better informed than individuals who wish to use their services.

Generally speaking, shareholders like to receive information that helps determine whether managers are maximizing firm value rather than self-interest. According to Brown et al,(2001), the concept of information quality in decision making depends on the type of decision to be taken by the user. The state intervenes through the Financial Security Act to require companies have an auditor to validate its financial statements. This obligation is considered as the way to solve the problem of information symmetry and subsequently increases the level of financial disclosure and market transparency. The "Sarbanes- Oxley Act" has been implemented since 2002 to change the conditions of financial disclosure in the United States. Indeed, the establishment of the Financial Security Act (FLSA) in France on the 1st of August 2003 came to emphasize the important role of environmental information (transparency, statutory auditor and company governance) to ensure a high level of disclosure. In order to obtain a high level of reliable and relevant disclosure, the Financial Security Act strengthens some aspects of the business and its environment, such as the auditor, transparency of financial reporting and governance mechanisms.

According to John and Senbet (1998) and Fama (1980), there are features that may affect the exercise of control and therefore improve financial disclosure level. Loukil and Triki (2008) found also a positive and a significant relationship between board size and level of voluntary disclosure in the annual reports of Tunisian firms. Ginglinger (2002) adds that large boards allow creating links with the environment and reduce uncertainty (Resource-based theory) at the expense of efficiency due to coordination problems and increase agency problems. Gul and Leung (2004) reported similar results with a sample of 385 companies listed on the Hong Kong Stock Exchange. These authors observed that the proportion of independent directors in addition to the fact that they are experienced, both, encourage managers to disclose more voluntary information.

According to Beneish (2001), managers who possess inside information tend to take advantage of their position by either selling or buying securities at the right moment. Jiang and Habib(2009) show that when capital is concentrated, controlling shareholders may pose a threat of expropriation of minority shareholders and are reluctant to publish financial information. Wallace (1989) and Cormier (1991) defined audit quality as the auditor's probability of discovering fraud or irregularities in the customers' financial statements. Gonthier and Schatt (2005) show that disclosure after having been audited by firms is likely to enhance the vision of shareholders and promote their trust towards the auditor and hence improve the transparency of information. Keasey and Wright (1993) define external audit as a means of the monitoring, evaluation and supervision of organizational agents to ensure that they act in the interests of shareholders. DeAngelo (1981) finds that external audit intervenes as an independent and competent supervision to reduce costs and subsequently increases credibility of the information produced.

In this context our study examines the impact of different governance mechanisms on the quality of financial reporting in a French context. The remainder of the paper is structured as follows: section two analyzes the research methodology, the measurement of the variables, hypotheses and model to be tested. Results are presented in the section three; concluding remarks are presented in the final section.

2. Research Methodology

The objective of this paper is to examine whether good corporate governance has a positive influence on the level of corporate information disclosure for French firms after the financial security law (known as LSF 2003).

2.1. Measurements of Variables and Hypotheses

The dependent variable: information disclosure measured by Information Score (INFSCORE). Many studies have constructed scores to estimate disclosure content. The simple score is to assign each type of financial reporting the value of 1 if information exists in the company's financial statements and 0 otherwise. Consequently, the total of these values is subsequently considered as the measure of the company information score. This value is used to measure the quality the disclosed information. Some researchers have chosen to quantify financial disclosure on Internet. This variable will hold the value 0 in the absence of information in the financial statements, the value 1 if a summary of the information is present, the value 2 for complete reporting of financial information and value 3 for a full reporting of financial information. We used the Standard & Poor's (2002) rating as a notation specific tothe field of financial disclosure. "Corporate Information Score" assesses the transparency of information published by a company and its readability and comparability (Table 1). This score consists of 40financial reporting items (De LaBruslerie H, and H.Gabteni (2011), Cook (1989), Which describe good information disclosure.

$$INFSCORE = Log(\sum_{i}^{40} FR_i) \qquad (1)$$

Where FR_i is financial reporting which equal 1 if it exists in the company's financial statements and 0 otherwise. 40 is the total of items as proposed by the Standard & Poor's (2002). We suppose the quality of information disclosure increases with the level of information score.

Explanatory variables

Governance Score(GOVSCORE): this measure is based on items proposed by Standard and Poor investigations (Standard & Poor's (2001) and (2002)). Govscore is an index consisting of 28 internal and external attributes that individually measure governance mechanisms. We use a Score as a variable to measure the characteristics of governance unlike previous studies which used different individual substitutes for measuring corporate governance.

$$GOVSCORE = Log(\sum_{i}^{29} GA_i) \quad (2)$$

Where GA_i is Governance attribute i(i=1…29) as proposed by Standard & Poor's (2001) and (2002). Larcker and Richardson (2004) argue that the use of different individual variables is insufficient to measure corporate governance, since this concept includes several other variables that influence the quality of information that researchers cannot examine. For this reason, Standard & Poor's (2001) devised a particular rating of corporate governance. The "Corporate Governance Score" gives the Agency an idea on the governance mechanisms used by the company, and more specifically, on how they are applied. It is a combination of international politics, current procedures and governance. The Standard & Poor's (2002)' governance quality can be examined through the following: ownership structure, the nature of relationships between the various actors, transparency and the characteristics of internal and external audit and the structure of the Board and its functioning. According to previous studies, we suppose that there is a positive correlation between governance score and financial disclosure quality.

Management ownership (MOW) : represents the percentage of the manager's participation in the capital of the company. This variable is measured by the number of shares held by the manager/ the total number of shares of the company. We suppose a positive relationship between management ownership and information disclosure. In other words, the greater is the manager's percentage in the capital, the greater is the reliability of financial reporting.

Large Shareholders (BLOC): This variable represents the percentage of majority shareholders in the company, it measures capital concentration. We measure the existence of block-holders by the number of shares held by the controlling shareholders to the total number of shares of the company. We suppose that Capital concentration improves level of financial disclosure.

Board Independence (BIND): this variable is measured by the number of outside directors to the total number of directors. Fama and Jensen (1983) give a fundamental role to outside directors who are in charge of controlling managers and consequently ensure performance. Then we suppose there is a positive correlation between independent members of the board of

directors and level of financial disclosure.

CEO Dual functions(DUAL): There is duality when the CEO of a company is himself the president of the board. This variable is measured as = 1 if the CEO is not himself the president of the board, 0 otherwise. We suppose separation between manager and chairman of the board functions improves the level of financial disclosure.

Expert committee(EXPCOM): this variable is measured as = 1 if there is a financial expert committee of auditors, 0 otherwise. Bedard et al (2004) found that the presence of at least one expert in finance or accounting improves the quality of reports. We suppose that the existence of an financial expert committee of auditors improves level of financial disclosure.

Meeting: Charreaux and Pitol-Belin (1987) find the number of meetings of the board of directors as an independent variable that measures the effectiveness of governance mechanisms. This variable is measured by a logarithm of the number of annual meetings of the Board. We suppose that an Increased number of board meetings improves the effectiveness of the board and then level of financial disclosure.

The Big 4 Accounting Firms This variable is a binary variable, it takes 1 if the account belongs to a Commissioner big4; 0 otherwise.

Control variables: **Return on equity:** ROE: Return on capital invested = net income / equity. **stock market capitalization:** Log capitalization: this variable is measured by the logarithm of stock market capitalization (company's shares outstanding multiplied by the current market price). **Loss:** 1 if the firm is losing, 0 if not.

2.2. Sample Description

In order to validate our hypothesis, we choose companies listed on the French stock market and in particular their governance mechanisms and their respective impact on the reliability of financial information. The study sample includes 80 companies listed in the French financial market (AMF), however because of lack of data on stock prices; we reduced the sample to 51 listed French companies observed over five years (2003 and 2009). The study data were collected manually from the following sources: Information documents, stock price indices and "YAHOO, finance. "Financial statements published in the official gazettes of the AMF and the AMF website.

2.3. Model to be Tested

We examine the relationship between governance mechanisms and level of disclosure.

$$INFSCORE_{it} = \lambda_0 + \lambda_1 GOVSCORE_{it} + \lambda_2 CV_{it} + \varepsilon_{it} \qquad (3)$$

Where control variables (CV) are measured by : Management ownership **MOW**, Large shareholders **BLOC**, Board Independence **(BIND),** CEO Dual functions **DUAL**, Expert committee Meeting **EXPCOM**, The Big 4 Accounting Firms**BIG4**, Return on equity market **ROE,** the stock market capitalization **Capitalization**, losing **LOSS**.

3. Empirical Results

In the first regression, we estimate the data and the variables using a panel method to study the impact of governance mechanisms on level of financial disclosures (Table 3). Through this estimation method, we reached the following results: AdjustedR^2 of this model is equal to 0.896954 and the statistical probability of F is equal to 0 % , then overall this model is significant. The coefficient of the intercept is positive (0.751070) and statistically significant at 1%. This result indicates that there are several other variables that positively influence level of disclosure of financial information. The governance Score is positive (0.475729) and statistically significant at 1%. In other words, governance mechanisms have a global impact on level of disclosure of financial information. Our result is consistent with that obtained by Brown and Caylor (2006), who developed a corporate governance score and found a positive relationship between governance score and the quality of financial reporting.

The coefficient on the percentage of majority shareholders is negative (-9.73) and not statistically significant. This result indicates that the percentage of majority has no effect on level of financial disclosure and therefore information transparency is not related to the firm's capital characterized by the presence of blockholders. Furthermore, the coefficient of an independent member in the board of directors is positive (0.012469) and is not statistically significant. Therefore, independence of the Board of Directors has no effect on the quality of information. As for the duality variable, tests indicate that this variable has an effect on information transparency. Indeed, the coefficient on this variable is negative (-0.009760) and statistically significant at 10%. Then, if the manager himself is presiding the board of directors, he will be the sole owner of the information and will disclose the required information. The presence of financial expert committee of auditors has a negative coefficient (-0.012753) and statistically significant at a 5%level.This indicates that the presence of committee of auditors has a negative effect on financial information quality. This result can be explained by the fact that committee gives managers-owners a greater guarantee and trust in the management of the company, which decreases level of financial disclosures.

The coefficient on the number of meetings of the board of directors is positive (0.111472) and statistically significant at the 1% level, indicating that an increasing number of meetings of the Board of Directors enhances the level of financial disclosures and subsequently transparency of financial information. Furthermore, the variable that measures the audit quality "BIG4" has a positive coefficient (0.039748) and is statistically significant at a 5% level. This means that if the company is audited by an auditor belonging to the "BIG FOUR" it produces more transparent information than other financial report, since the auditor is able to detect any abnormalities in the financial statements and should increase the level of financial disclosure to protect their reputation.

The relationship between financial reporting and management ownership is negative with a coefficient equals (-0.047411) and statistically significant at a 1%level . Then, the presence of manager as the owner of the firm tends to increase transparency of information. Management ownership is benefic for shareholders and constitutes an opportunity to better serve theirs interests.

Table3: Empirical analysis of the relationship between corporate governance and the quality of information disclosure

Variable	Regression 1		Regression 2		Regression 3	
	Coefficient	Prob.	Coefficient	Prob.	Coefficient	Prob.
Intercept	**0.751070**	**0.0000**	**0.767109**	**0.0000**	**-1.531111**	**0.0000**
GOVSCORE	**0.475729**	**0.0000**	**0.482278**	**0.0000**	**-0.599324**	**0.0000**
MOW	**-0.047411**	**0.0041**	**-0.050873**	**0.0016**	**-**	**-**
BLOC	-9.73	0.8132	-	-	-0.000102	0.8065
BIND	0.012469	0.2439	0.012432	0.2436	0.009339	0.3849
DUAL	**-0.009760**	**0.0714**	**-0.011192**	**0.0301**	**-**	**-**
EXPCOM	**-0.012753**	**0.0322**	**-0.011804**	**0.0419**	-0.009269	0.1150
Meeting	**0.111472**	**0.0000**	**0.113603**	**0.0000**	**0.116104**	**0.0000**
BIG4	**0.018633**	**0.0171**	**0.018833**	**0.0157**	**0.020925**	**0.0082**
ROE	4.35E-05	0.9134	-	-	-	-
Capitalization	0.002809	0.3203	-	-	-	-
LOSS	-0.008952	0.1288	**-0.010610**	**0.0045**	-	-
Adjusted R-squared	0.896954		0.897469		0.893466	
Prob (F-statistic)	0.000000		0.000000		0	

In the second regression, we estimated only governance-specific variables (Table 3). This estimation produced the following results: Adjusted $R^2$is 0.897469, therefore the overall estimation is significant. The coefficient of governance score remains positive (0.482278), and statistically significant. Governance mechanisms affect the whole level of financial information disclosures. The coefficient on the management ownership remains negative (-0.050873), and statistically significant at the 1% level (0.0016). The management ownership influences negatively the transparency of information. The coefficient on the dual function of managers remains negative (-0.011192) and statistically significant at the 5% level (0.0301).

Then, if the manager himself is presiding the board of directors, this will negatively affect the level of financial information disclosures. The coefficient on the number of meetings of the Board remains positive (0.116104) and statistically significant at the 1 %.In other words, the increased number of meetings of the board of directors has a positive effect level of financial disclosures.

Similarly, the estimation of the third regression produced the following results (Table 3) : the overall model is significant with an adjusted R^2 equal (0.893466). The coefficient on governance score became negative (-0.599324) and statistically significant at the 1% level (0), indicating that the quality the information disclosures is not better with the presence of the governance monitoring devices. Furthermore, the presence of outside directors in the board negatively influences level of financial information disclosure. This result is explained by the fact that governance mechanism is efficient to ameliorate information quality. Independent directors cannot play any function to have a better information disclosure. The coefficient on the presence of financial expert committee of auditors is negative (-0.009269) and statistically not significant.

4. Conclusion

In this study we assume that governance mechanism is associated with higher quality of financial information. Corporate governance used as to motivate management to maximize shareholders wealth and ensure that large shareholders do not use reliable for their own wealth at the expense of the minority shareholders. Financial information is the result of corporate accounting and external reporting systems that quantify data concerning the financial characteristics of the firm. The previous studies mainly investigated on developed countries has found that the quality of information disclosures is associated with certain firm characteristics. These factors are specific to the company, on its structure or performance and corporate governance. The disclosure quality is appreciated through the quantity and also through the nature (type) of information disclosed. Giving high quality financial information is essential because it will positively persuade investors, and other stakeholders in making investment, and similar source allowance decisions enhancing overall market effectiveness. In this article, we tested the impact of global governance on level of financial disclosure by a Governance Score "GOV SCORE". The results of this study indicate that governance has a positive impact on the transparency of financial information (level of disclosure). Our results are coherent with those found by Chau and Gray, 2002; Gelb, 2000, Labelle and Schatt, 2005; Bushee and Noe, 2000).

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Table 1: Summary of the governance score

The characteristics of the Board		
1	the Board Size	1 if 10 < number of Directors < 15, 0 if not
2	The independence of the members of the Board of Directors	1 if independence > 1/3; 0 if not
3	The number of Board meeting	1 if the number of meeting > 4; 0 if not
4	The Dual role of CEO and chairman	1 if there is separation of function; 0 if not
5	The presence of administrators	1 if the > 85% attendance rate; 0 if not
6	Age of the president of the Council	1If 40 < age < 65; 0 if not

7	The existence of the woman within the Council	1 if exists; 0 if non
8	The existence of the Nominating Committee	1 if there is the Committee. 0 if not
9	The size of Nominating Committee	1 if number of Committee > 3; 0 if not
10	The independence of the Nominating Committee	1 if independence > 1/3; 0 if not
Audit		
11	The existence of the audit committee	1 if the Committee exists; 0 if not
12	The size of the audit committee	1 if number of Committee > 3; 0 if not
13	The independence of the audit committee	1 if independence > 1/3; 0 if not
14	The existence of an expert within the audit committee	1 if there is an expert to the Committee; 0 if not
15	The reputation of the auditor	1 belongs to the BIG4. 0 if not
16	The publication of remuneration of the auditor	1If the remuneration is published; 0 if not
Compensation		
17	The existence of the remuneration Committee	1 if the Committee exists; 0 if not
18	The size of the Compensation Committee	1 if number of Committee > 3; 0 if not
19	The independence of the remuneration Committee	1 if the independence of Committee > 2/3;0 if not
20	The remuneration is variable	1 if exists; 0If non
21	Compensation per stock option	1 if exists; 0If non

22	Remuneration indexed on the accounting profit	1 if exists; 0If non
23	Attendance	1 if exists; 0If non
Ownership structure		
24	The institutional ownership	1 if exists; 0 if non
25	The management ownership	1 if exists; 0 if non
26	Administrators	1 if exists; 0 if non
27	The employee ownership	1 if exists; 0 if non
28	Concentration of ownership	1 if one shareholder holds more than 20% of the capital; 0 if non
29	Dispersion of ownership	1 if the share of the first shareholder ownership ＜20%; 0 if non
Total of the GOV Score = 29		

	Table2 Items of information score
1	Description of principal products / services -Market share
2	Forecast of profit year n +1 (qualitative)
3	Forecast of profit year n+1 (quantitative)
4	Future cash at horizon 2 to 5 years
5	Description of the major factories, warehouses and properties
6	Biographical Profile of Directors and Officers (responsibilities, experience, courses)
7	Capital expenditures (past and futures), Investments
8	Directors' biography

9	General objectives of the firm – Goals
10	Description of marketing network for final goods and services
11	Main activity or affiliation of directors with other organizations
12	Information on the social responsibility of the firm
13	Structure of ownership, investors' types and names
14	Historical share price – Trend
15	Cost of sales
16	Advertising expenditures: information and amount
17	Human Resources: Cost of training operations
18	Information on depreciation
19	Value added statement
20	Return on capital employed
21	Return on shareholders' securities
22	Cash Ratio - Current Ratio
23	Other financial ratios 344 X X
24	Economic factors influencing future activity
25	Political and social factors influencing future activity
26	Technological factors influencing future activity
27	Discussion on past industry tendencies
28	Discussion on future industry tendencies
29	Position and competitive environment

30	Policy and financial objectives
31	Description of activities and transactions linked with government and state entities
32	Firm history
33	Description of the organizational structure
34	Market capitalization and financial operations
35	Information on fixed assets variations
36	Information on secured and non-secured debts
37	Information on R&D projects
38	Development of new products / services
39	Number of employees
40	Special report on employees and social activities

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