

## Factor Influencing and Financial Reporting Quality among Private Sector in Yemen

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### Abstract

This study has been conducted to investigate the impact of corporate governance mechanisms (audit committee and internal audit) and dependent variable is financial reporting quality. To obtain relevant information the financial reporting quality in Yemen, the researcher conducted a survey and distributed by application. In addition, this study has been 290 respondents in the private sector of Yemen. TO purpose of analyzing, Structural Equation Modelling (SEM) has been employed through Smart PLS software prior to using of SPSS. Audit committee is measured by (size, independence, expertise) and internal audit. The study results reveal that audit committee and internal audit have a significant effect on financial reporting quality. Overall, the results of corporate governance (Audit committee and internal audit) and enhance quality of financial reporting. The expected results for the recent conceptual paper would support the hypotheses that audit committee and internal audit have a positive impact on financial reporting quality. Agency theory was used to underlie the conceptual framework.

**Keywords:** Audit committee, financial reporting quality, internal audit

### 1. Introduction

Poor corporate governance practice misunderstanding vital role importance of them in financial reporting lead to financial scandals pointed to weaknesses of the financial reporting quality (FRQ). Many bankruptcies and failures of business happened in 2002 in famous and big companies. There are huge corporate scandals such as (Enron, WorldCom, and Tyco) also in United Kingdom such as (Bank of Credit and Commerce International and Barings Bank) in Italy (Parmalat) and Australia (HIH). Hence, this explains many organizations attracted attention to establish corporate governance mechanisms in recent times. One of the factors that might lead to the failure of the company is the expropriation of the stakeholders by senior manages like Enron, which is an example for the inability of the stakeholders to protect their interests due to conflict of interests and the asymmetrical information (Zerban, 2017)

According to (Agyei-mensah & Agyei-mensah, 2018) corporate governance practice CGP has an important role in the administration in the organizations. It refers to the means of governing companies. It helps to grow the benefits of shareholders and stakeholders, and it promotes transparency and accountability in the firm. (Zerban, 2017). Besides, CG is of great importance in the studies related to the business field. Generally, companies use CG strategies to develop the effectiveness and efficiency of FRQ through reforming the weak points in the organization (Alrshah, 2016). Corporate governance practice provides a platform to ensure the financial reports quality. Corporate governance has come to be an issue of great concern in the corporate world (Aifuwa & Embele, 2019).

Institutions in Yemen do not function well, and this is considered the driving force of corruption such as fraud, nepotism and bribe. The percentage of poverty and unemployment is increased every year (Moghran,

2007). In 2008, an agreement between Businessmen Club of Yemen and Centre of International Private Enterprise was signed to start implementing corporate governance project in Yemen funded by Middle Eastern Partnership Initiative which that improve the quality of financial reporting (Alobaidi, Aloqab, & Raweh, 2017) .

Generally speaking, combating corruption and having better work transparency are not limited to the work policies of the western countries, and such elements are important for developing countries such as Yemen. Although Yemen has carried out many efforts to combat corruption, the problem is still there, and corruption in Yemen has escalated to a great extent between the years 2008 and 2021. The existing of corruption in the public sector has many forms in all the government departments, and Yemen has been ranked as 176 of 180 worldwide in terms of fraud and corruption (Organization Transparency International, 2020). It is clear that Yemen is still suffering from management fraud, so the Central Bank of Yemen (YCB) has intervened in the National Bank issue in 2005, and it accused the members of the Yemeni Central BOD of the National Bank for defrauding more than \$9 million U.S(Moghram, 2007). This led to bankruptcy, but the financial reporting has never pointed out to the risk of administrative fraud (YCB, 2005). This study purpose to examine the direct relationships between the corporate governance (AUC and INA), and the financial reports quality.

## **2. Literature Review**

### **Financial Reporting Quality (FRQ)**

Verdi, (2006), defined that the FRQ is considered same way to display information for any business activity along with its expected cash flows, and the main aim is to inform the other parties, especially the shareholders, of the operations carried out by the company. The term financial report quality also refers the ability of the financial reporting to give correct and truthful information about the company in terms of its financial status and performance (Chen, Tang, Jiang, & Lin, 2010). In terms of the any firm's financial reporting, they must have the qualitative traits that are required by International financial reporting standards, including relevancy, comparability, understand ability, timeliness, faithful representation and verifiability. In order to provide high quality information, the financial reporting should provide extensive details about the company economic performance as well as its reporting of financial position, equity, cash flows (Barth, Landsman, & Lang, 2008) .

The financial reporting quality is an important for stakeholders, (Internal -external) users. Internal users including Investors or potential investors, Suppliers and creditors, Employees and management, and external users including Financial advisors and analysts, Stock markets or exchanges, Regulatory authorities and others. This is because high quality financial reporting has a positive effect on capital providers and stakeholders to decide on making investments, allocating existing resources, making credit and increasing the overall market efficiency (IASB, 2008). Moreover, financial reporting aims to produce authentic and useful information so that decision-makers can build their decisions based on qualitative and quantitative information. In a broader perspective, this will be of great advantage for the users of these financial reports to evaluate, predict, compare and utilize resources effectively, and this is to achieve the goals of their organizations. Bribesh, 2006 (pp. 57–62), stated that corporate reports can be effective if they have specific qualities such as relevance, comparability, reliability, timeliness, completeness, and understand ability. Hence, the focus of this study is on financial reporting quality in order to help investors and other consumers, who get true financial reporting, make right and rational financial decisions in their organizations.

### **3. Corporate Governance (CG)**

There are many researchers who showed that the effect of CG on FRQ. The variables considered in this study (audit committee and internal audit) have been found to have some impact on FRQ.

#### **Audit Committee (AUC)**

One of definitions of AUC is that it is “a standing committee of board of directors established to work directly with the auditors, both independent and internal, as well as with the representatives of other accounting-related activities as seems appropriate” (Mautz & Neumann, 1970). The main duty of AC is to monitor the process of FR in the company, which includes different aspects such as FR integrity, IC effectiveness, and monitoring (internal – external) auditors. Committee improves the capability of the board to perform better monitoring for the management through providing better understanding and in-depth knowledge of the financial reporting of the company (Kusnadi & Sin, 2015). So, one of the main responsibilities of the AC is to supervise the FR process so that the managers submit ethical reports to their firms.

The term corporate governance has different meaning; however, this current study focuses on role of the AC in the firms. Therefore, the current research investigates the effect of the roles of AUC and INA on FRQ. In the current research, CG is considered monitoring mechanism that safeguard interests of the shareholders, which is in line with the agency theory. Besides, the current study focuses on the financial reporting quality as it has an

effect on decisions and the interests of the stakeholders just like the potential investors. To achieve this aim, stakeholder theory is presented in this study. Hence, it is not surprising that there is a constant call to raise the role of auditing to include firms control for the advantage of both the stakeholders and the society.

Accordingly, main role of the AUC is to make guarantee the independency of the audit process. The AC also has the authority to recommend potential external auditors and present such recommendation to the board, and it receives, reviews and forwards the annual financial reports to the board. Besides, (Gebrayel, Jarrar, Salloum, & Lefebvre, 2018) .

Other researchers highlighted that the primary role of AUC is to verify and protect the FR of the company and its IC processes in order to reduce unmoral accruals and fraud (Asiedu & Deffor, 2017). Moreover, the audit committee is important for corporate governance to raise the efficiency and reliability of FRQ (Gebrayel et al., 2018).

Other studies stated that the AUC has an important role in reviewing FR processes such as contacting auditors and reviewing the systems of internal control. In addition, effective audit committees help to improve the FRQ through different tasks such as reviewing the policies of accounting policies and the financial reporting. In addition, AUC has an important role to improve the auditors' skills in FRQ by appointing and remunerating external auditors (Dhaliwalz, Naiker, & Navissi, 2010). A closer investigation showed that the development of audit committee is many countries was based on worries regarding the FRQ because of the failures of different corporations(Huang & Thiruvadi, 2010) . The audit committee is also an essential mechanism in corporate governance because it makes sure that the controlling systems and internal control is more effective in the companies. This study has focused on Audit committee size, independence and Expertise.

### Internal Audit (INA)

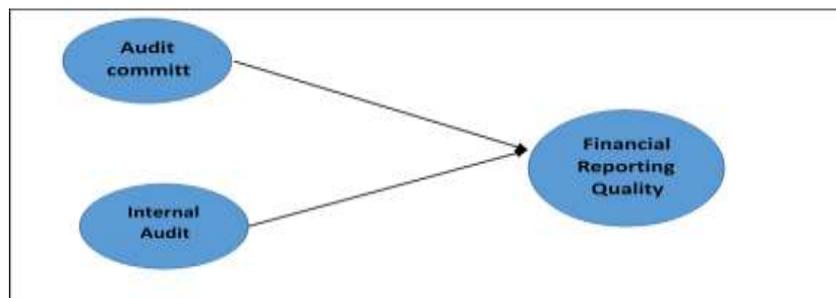
Recently, internal auditing (INA) has passed through essential changes which have widen its area to be more effective in the company. The traditional role of the IA was limited to compliance assurance, assets safeguarding, and financial control. There are many reforms that have taken place after the scandals that happened in 2000 in the financial aspects of many companies, which have resulted in the reinforcement of the duties of the INA (Sarbanes-Oxley, 2002).

According Arens, Elder, & Mark (2012)and Boynton & Johnson (2006) , auditing is considered a process that involves collecting and evaluating evidence concerning information through measurements, and it is usually a part of an economic body which is carried out by independent and skilful members to check the correctness of reporting and information.

(Kewo & Afiah, 2017), stated that the independent auditor has some aspects, including (a) he must have high level of honesty; (b) he must be independent through having a distance with all the others to ensure independency and objectivity; and (c) he must have independent competency so that he can carry out his tasks. According to the study of Al-Shetwi, Ramadili, Chowdury, and Sori (2011) , there might be weak relationship between FR and the function of the IA , and this has a negative effect on the entity. However, other scholars stated that the Internal Audit Function helps to improving the work environment, leading to FRQ in terms of increasing the investors' confidence and reduces errors in reporting errors (Agyei-Mensah, 2014; Holt & DeZoort, 2009; Influencing, Quality, Financial, On, & Government, 2014; Kewo & Afiah, 2017).

### 4. Conceptual Framework

This model, independence CG is broadly divided into parts: 1) audit committee). (Audit committee size, Audit committee and Audit Committee Expertise.). and 2) internal audit and dependent variable is the financial reporting quality. Hence, hypotheses stated for this study result from the reviews of extant literature (Al-thuneibat, 2016).



**Fig1:** Research conceptual model.

Based on the above literature review and past studies findings, the following hypothesis were established :

H1 AUC has positively relationship with FRQ in Yemen.

H2: INA has positively relationship with FRQ in Yemen.

## 5. Research Methodology

This study utilises primary data. Notably, in this study, primary data is generated via the survey method. According to Sekaran & Bougie (2016), have cited a table ,which is developed by considering factors and supports the size decision developed by (Krejcie & Morgan, 1970). A research population consist of data collection and information which properties are to be analysed in a specified research (Hair Jr, Black, Babin, & Anderson, 2014) . Population defined as the total collection of the topic of benefit to be studied in a research. The target population should be clearly defined concerning its elements, geographical boundaries, and time (Sekaran & Bougie, 2016) .The target population of the current study consists of Yemen private sectors. According to them, for population of 1400 element or more the sample size should be 290. All measures included in these questionnaire were adopted from Published literature. In this study, the respondents were individuals from financial and services sector in Yemen. The results of the frequency descriptive analysis.

## 6. Data Analysis and Results

This part illustrates the findings of data analysis such as descriptive statistics, measurement model, structural model, and hypotheses testing.

### Descriptive Statistics

Table 1 illustrates the result for respondents

**Table 1:** Profile of respondents demographic result

<b>Gender</b>	<b>Frequency</b>	<b>Percentage</b>
<b>Male</b>	264	91%
<b>Female</b>	26	9%
<b>Total</b>	290	100 %

<b>Educational level</b>	<b>Number of respondents</b>	<b>Percentage</b>
<b>Diploma</b>	6	2.1%
<b>Bachelor</b>	154	53.1%
<b>Master</b>	115	39.7%
<b>PhD</b>	15	5.1%
<b>Total</b>	290	100%

<b>Experience Years</b>	<b>Number of respondents</b>	<b>Percentage</b>
<b>Less than 5 years</b>	18	6.2%
<b>5-10 years</b>	64	22.1%
<b>11-15 years</b>	102	35.2%
<b>More than 15</b>	106	36%
<b>Total Number</b>	290	100%

<b>Sector Type</b>	<b>of respondents</b>	<b>Percentage</b>
<b>Commercial Sector</b>	102	35.2%
<b>Sevieces Sector</b>	68	23.4%
<b>Finaincial Sector</b>	120	41.4%
<b>Total</b>	290	100%

According to the table above, out of 290 respondents, 91% of them are male, or 264 out of 290. Females had only 26 respondents, which made up 9 percent of the total. Additionally, the majority of educational level respondents (53%) were from Bachelor's degree, which accounted for 154 of the respondents in the survey. But there were 15 PhD-holders (representing 5.1 percent of the total respondents). 115 (39.7%) of the respondents

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had a master's degree, and 2.1% had a diploma. With respect to experience more than 15 years with 106 respondents of the total number of respondents making up 36%. The survey found that, of the 102 respondents who replied, 35.2 percent had five to fifteen years of experience. Moreover, 64 of the 290 respondents or 22.1 percent had between five and ten years of experience. Only about 18% of respondents, however, have experience of fewer than five years. Over 40% of the respondents in the financial sector (representing 120 companies) came from 41.4% of firms. It is, however, evident from the fact that services sector is represented by 23.4 percent (68) and 102 firms out of 290 firms are Commercial Sector businesses. Yemen has a shortage of consumption goods due to its reliance on imports and exports.

### Data Screening

This research made use of data screening procedures including missing data, outlier, normality, linearity, and homoscedasticity assessments, as well as multicollinearity detection.

### Outliers

It was discovered in this investigation that the sample population included 12 cases of outliers because their z-scores were more than  $\pm 3$ . The final data set of 302-12 cases was created by excluding these cases. Variables outlier data are in Table 4.2.

### Normality

Tabachnick and Fidell (2007) show that skewness and kurtosis are both equal to zero when the distribution of values is normal. Hair et al. (2013) contend, however, that critical values do not exceed  $\pm 2.58$ .

### Linearity

The notion of homoscedasticity is "that the dependent variable exhibits equal variance across several independent variables," says the textbook (Hair et al., 2006: p. 83). A scatter plot shows how two variables are related. A scatter plot seeks to depict a dotted line that is less dense.

**Table 4.3** Skewness and Kurtosis for Variables.

Variables	Code	Skewness	Kurtosis
<b>Audit Committee</b>	AUC	-1.061	2.217
<b>Internal Audit</b>	INA	-2.173	2.175
<b>Financial Reporting Quality</b>	FRQ	-2.431	1.328

### Test of Multicollinearity

Table 4.4 shows that multicollinearity diagnostics indicate that the research predictor variables don't exhibit a significant level of multicollinearity because all of the tolerance values are above 0.10, ranging from 0.561 to 0.367, and all of the VIF values are below 10, with values of 2.726 and 1.783. (Sekaran, 2003).

**Table 4.4** the Tolerance and VIF for Variables

Variables	Collinearity Statistics		
	Co de	Toleranc e	VIF
Audit Committee	AU C	.376	2.658
Internal Audit	IN A	.367	2.726

### Measurement Model

This model shows the relationship between the variables observed and the constructs. Convergent validity was confirmed by Hair, Risher, Sarstedt, and Ringle (2019) in Smart PLS when items loaded highly (greater than 0.70 or 0.60 in exploratory research). To be on the safe side, however, the removal of the items with the lowest outer loadings (below 0.60) should be done, and that should be followed by removing items that would lead to a reduction in the average variance extracted (AVE) value.

**Table 2 :** Cronbach's alpha, Composite Reliability (CR) and AVE

Variables	Cronbach's alpha	CR	AVE
Audit Committee	0.843	0.871	0.459
Internal Audit	0.955	0.963	0.766
Financial Reporting Quality	0.897	0.928	0.764

Because the AVE values were greater than the squared correlations for each set of constructs, discriminant validity was proven. The research found that the root mean square variance (RMSV) of all the extracted variance was greater than the correlation among the latent constructs, thus suggesting that the discriminant validity is adequate.

**Table 2:** Discriminant validity -Fornell and Lacker Criterion

Variables	AUC	FRQ	INA
AUC	0.678		
FRQ	0.642	0.781	
INA	0.631	0.663	0.875

### Structural Model

The model was able to adequately reflect the data as evidenced by the R<sup>2</sup> values for the dependent variables. Moreover, the International Accounting and Financial Reporting Standards explain a significant 71.3% of the variance in Financial Reporting Quality (FRQ).

**Table 4: Coefficient of determination result R<sup>2</sup>**

Exogenous Construct	Endogenous Construct	R <sup>2</sup>	Cohen, (1988b)	Chin (1998)
AUC, IA, IFRS	FRQ	0.713	Substantial	Substantial

The results show that the board of Directors had a large effect of 0,429 on the international financial reporting standard of the predictive variable (more than 0.35). In addition, the predictive variable's medium effect size on International Financial Reporting Standard (IFRS) was 0.246. (more than 0.15). However, the size of the audit committee in the International Financial Reporting Standard was 0.059. Furthermore, audit committee and internal audit showed a smaller effect on Financial Reporting Quality, with respective improvements of 0.062 and 0.074. It is shown in Table 5.

**Table 5: Effect Size of predictive Variables**

Variable		
	Financial Reporting Quality	Rating
Audit Committee	0.062	Small
Internal Audit	0.074	Small

### 7. Conclusion

This research aimed to find out if CGM (AUC and INA) and FRQ are connected. This study indicates that CGM and the FRQ are highly related. Agency theory states that CGM are necessary for improved and enhanced FRQ, and the results of this study bear this out. This study has provided valuable insights for further research on the country's role in the complementarity effect of other factors, such as oil and land, which must be investigated further in Yemen and other developing countries and throughout the world

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