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FACTOR INFLUENCING INTERNATIONAL FINANCIAL REPORTING STANDARDS 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). The mediating variable is international financial reporting standards, and the dependent variable is the financial reporting quality. To obtain relevant information on the financial reporting quality in Yemen, the researcher conducted a survey and distributed it by application. In addition, the respondents of this research are 290 of private sectors in Yemen. To analyze, Structural Equation Modelling (SEM) has been employed through Smart PLS software before using SPSS. The audit committee is measured by (size, independence, expertise) and internal audit. The study results reveal that audit committee and internal audit, and international financial reporting standards significantly affect financial reporting quality. Overall, the results of corporate governance (Audit committee and internal audit) and international financial reporting standards enhance the quality of financial reporting.

1. Introduction

Poor corporate governance practice and not applying international financial reporting standards (IFRS) misunderstanding the vital role the importance of them in financial reporting led to financial scandals pointed to weaknesses of the financial reporting quality (FRQ). Many bankruptcies and failures of business happened in 2002 infamous and big companies. There are substantial corporate scandals such as (Enron, WorldCom, and Tyco) also in the 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 company's failure is the expropriation of stakeholders by senior management. For example, Enron has been an instance of the inability of the stakeholders to protect their interests due to conflict of interests and asymmetrical information (Zerban, 2017).

According to Agyei-mensah & Agyei-mensah (2018), corporate governance practice CGP has an essential 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, promoting transparency and accountability in the firm. (Zerban, 2017). Besides, C.G. is of great importance in the studies related to the business field. Generally, companies use C.G. 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 quality of the financial reports. Corporate governance has become 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 (Moghram, 2007). In 2008, an agreement between the Businessmen Club of Yemen and the Centre of International Private Enterprise was signed to start implementing a corporate governance project in Yemen funded by the Middle Eastern Partnership Initiative, improving the quality of financial reporting (Alobaidi, Aloqab, & Raweh, 2017). In addition, International Financial Reporting Standards has been adopted in Jan-2020 Yemeni Association of Certified Public Accountants (YACPA 2020).

Combating corruption and having better work transparency are not limited to the work policies of western countries, and such elements are essential 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 dramatically between 2008 and 2020. The existence of corruption in the public sector has many forms in all government departments. Yemen has been ranked as 176 of 180 worldwide in terms of fraud and corruption (Organization Transparency International, 2020). The country is still suffering from management fraud, and the Central Bank of Yemen (YCB) has intervened in the National Bank issue in 2005. It accused the Yemeni Central BOD members of the National Bank of defrauding more than $9 million U.S(Moghram, 2007). This led to bankruptcy, but the financial reporting has never pointed out the risk of administrative fraud (YCB, 2005). The purpose of this research is to examine the direct relationships between corporate governance (AUC and INA), International financial reporting standards and the quality of the financial reports. Furthermore, to

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investigate the mediating effect of IFRS on the association between C.G. (AUC and INA) and financial reports quality in Yemen.

2. Literature Review

2.1 Financial Reporting Quality (FRQ)

Verdi (2006) defined that the FRQ is considered the same way to display information for any business activity and its expected cash flows. 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 to 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 any firm's financial reporting, they must have the qualitative traits required by International financial reporting standards. This includes relevancy, comparability, understandability, timeliness, faithful representation, and verifiability. Furthermore, to provide high-quality information, the financial reporting should provide extensive details about its economic performance and its reporting of financial position, equity, cash flows (Barth, Landsman, & Lang, 2008).

The financial reporting quality is essential for stakeholders (Internal -external) users. Internal users, including Investors or potential investors, suppliers, 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 positively affects capital providers and stakeholders to decide on making investments, allocating existing resources, making credit, and increasing overall market efficiency (IASB, 2008). Moreover, financial reporting aims to produce authentic and helpful information to build their decisions based on qualitative and quantitative data. 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, which is to achieve the goals of their organizations. Bribesh, 2006, pp. 57–62) stated that corporate reports could be effective if they have specific qualities such as relevance, comparability, reliability, timeliness, completeness, and ability to understand. Hence, the focus of this study is on financial reporting quality to help investors and other consumers, who get accurate financial reporting, make right and rational economic decisions in their organizations.

2.2 International Financial Reporting Standards (IFRS)

The International Accounting Standards BOD (IASB) has focused on developing a single set of high-quality financial reporting standards to meet the increasing need for high-quality, transparent, and comparable financial information in international markets. The IASB has focused since it was founded in 2001 as the successor body to the International Accounting Standards Committee (IASC). According to Ball, Robin, & Wu (2003), accounting standards are different, which can be noticed in common law countries with market orientations. On the other side, the code law countries have directions towards planning. Countries with common law, such as the U.K. and the U.S., tend to have high-quality financial reporting, and they tend to have more disclosure to help serve the public and the stakeholders.

IASB stated that IFRS had been developed to ensure a better presentation of entities' economic position and performance by disclosing relevant, understandable, comparable, and timely financial information. Therefore, it is expected to increase financial reporting transparency and quality of financial reporting by adopting IFRS. Accounting standards setters, business communities, and regulatory bodies worldwide have proposed some potential economic benefits by adopting IFRS worldwide (Bodle et al., 2016). According to the Yemeni Association of Certified Public Accountants, IFRS has been adopted in Jan-2020.

2.3 Corporate Governance (C.G.)

Many researchers showed that the effect of C.G. on FRQ. The variables considered in this study (audit committee and internal audit) have been found to have some impact on FRQ.

2.3.1 Audit Committee (AUC)

One of the definitions of AUC is that it is "a standing committee of the 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 primary duty of A.C. is to monitor the process of F.R. in the company, which includes different aspects such as F.R. integrity, I.C. effectiveness, and monitoring (internal and external) auditors. The committee improves the capability of the board to perform better monitoring for the management by providing a better understanding and in-depth knowledge of the company's financial reporting (Kusnadi & Sin, 2015). So, one of the primary responsibilities of the A.C. is to supervise the F.R. process so that the managers submit ethical reports to their firms. The term corporate governance has a different meaning; however, this current study focuses on the role of the A.C. in the firms. Therefore, the present research investigates the effect of the functionalities of AUC and INA on FRQ. In the current investigation, C.G. is considered a monitoring mechanism that safeguards the interests of the shareholders, consistent with the agency theory. Besides, the present study focuses on the financial reporting quality as it

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affects decisions and the stakeholders' interests, 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 auditing to include firms' control for both the stakeholders and society.

Accordingly, the central role of the AUC is to make guarantee the independence of the audit process. The A.C. also has the authority to recommend potential external auditors and present such recommendations to the board. In addition, it receives reviews and forwards the annual financial reports to the board. Besides, Gebrayel et al. (2018) stated that the AUC has important mechanisms for C.G., particularly after the financial frauds and scandals of many companies in 2002. Its role included improving the FRQ. Other researchers highlighted that the primary function of AUC is to verify and protect the F.R. of the company and its I.C. processes to reduce immoral accruals and fraud (Asiedu & Deffor, 2017). Moreover, the audit committee is essential for corporate governance to raise the efficiency and reliability of FRQ (Gebrayel et al., 2018).

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

2.3.2 Internal Audit (INA)

Internal auditing (INA) has recently passed through essential changes that have widened its area to be more effective. The traditional role of the I.A. was limited to compliance assurance, assets safeguarding, and financial control. However, many reforms had taken place after the scandals in 2000 in the financial aspects of many companies resulting in reinforcement of the duties of the INA (Sarbanes-Oxley, 2002). According to Arens, Elder, & Mark (2012) and Boynton & Johnson (2006), auditing is considered a process that involves collecting and evaluating evidence concerning information through measurements. It is usually a part of an economic body that independent and skillful members carry out to check the correctness of reporting and communication.

Kewo & Afiah (2017) stated that the independent auditor has some aspects, including (a) he must have a high level of honesty; (b) he must be independent through having a distance from all the others to ensure independence and objectivity, and (c) he must have independent competency so that he can carry out his tasks. According to Al-Shetwi, et al. (2011), there might be a weak relationship between F.R. and the I.A. function, which harms the entity. However, other scholars stated that the Internal Audit Function helps to improve 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).

3. Conceptual Framework

A conceptual model has been proposed to elucidate the relationships and interrelationships among various components of C.G., IFRS, and FRQ. In the model, independence C.G. has broadly divided into three parts: 1) audit committee). (Audit committee size, Audit Committee, and Audit Committee Expertise.). and 2) internal audit, the mediating variable which IFRS and the dependent variable is the financial reporting quality. Hence, the hypotheses stated for this study result from the reviews of extant literature. (Al-thuneibat, 2016)

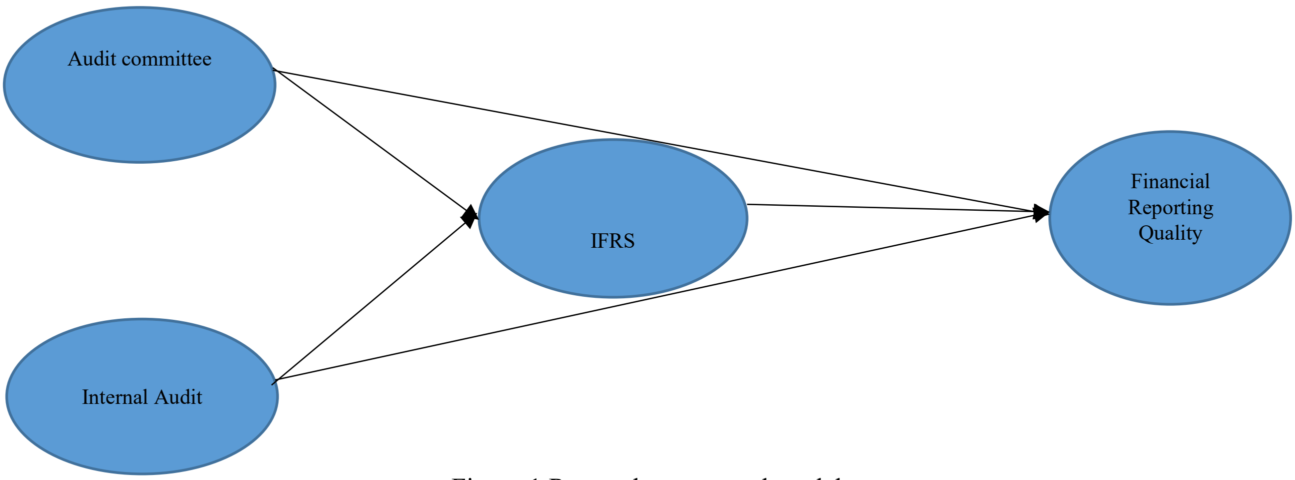

Figure:1 Research conceptual model

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H1: AUC has a positive relationship with FRQ in Yemen.
H2: INA has a positive relationship with FRQ in Yemen.
H3: IFRS has positively mediated the relationship between AUC and FRQ in Yemen.
H4: INA and FRQ have a positive relationship through IFRS in Yemen.
H5: IFRS has a positive relationship with FRQ in Yemen.

4. Methodology

This study utilizes primary data. Notably, in this study, primary data is generated via the survey method following (Saeed and Bekhet 2018), who studied the influencing factors of mobile marketing using survey. Sekaran & Bougie (2016) have cited a table developed by considering factors and supports the size decision developed by Krejcie & Morgan (1970). A research population consists of data collection and information on which properties will be analyzed in specified research (Hair Jr et al. 2014). The population is defined as the total collection of the topic of benefit to be studied in 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's private sectors. According to them, for the population of 1400 elements or more, the sample size should be 290. All measures included in these questionnaires were adopted from Published literature. In this study, the respondents were individuals from the financial and services sector in Yemen. The results of the frequency descriptive analysis.

5. Data Analysis and Results

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

5.1 Descriptive Statistics

The Tables below illustrate the result for respondents of the demographic factors.

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Table 1: illustrates respondents results of their gender

Gender	Frequency	Percentage
Male	264	91%
Female	26	9%
Total	290	100 %

Table: 2 shows respondents result of their experiences

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

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

Table: 3 illustrates the educational level of respondents

Sector Type	Number of respondents	Presentage
Commercial Sector	102	35.2%
Services Sector	68	23.4%
Financial Sector	120	41.4%
Total	290	100%

Table: 4 demonstrates the respondent's results for industry types

According to the above table 1, most respondents (264) are males out of 290, which equals 91%. However, females only had 26 respondents, which equals 9%. Furthermore, most respondents for the educational level were from bachelor's degrees, which is 53%1 or 154 respondents. However, there were 15 respondents from PhDs making up 5.1%. In addition, the table show 115 (39.7%) of the respondents had a master's degree, and 6 out of a maximum of 290 respondents, or 2.1%, had a diploma degree. Concerning experiences of more than 15 years with 106 respondents, the total number of respondents makes up 36%. They were followed by 102 respondents who have experience years from 5 to 15 years, making up 35.2%. In addition, 64 respondents out of 290 or 22.1% have experience from 5 to 10 experience years. However, only just 18% (6.2) of respondents have experienced less than five years. Most of the respondents involved in the financial sector represented 41.4% or 120 firms. However, the services sector was represented by 23.4% (68), and this clearly shows that out of 290 firms, 102 firms were Commercial Sector related businesses. One possible explanation for the services sector is the lowest sector is that Yemen depends on imports and exports to meet its consumption needs.

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5.2 Measurement Model

To measure the relationship between the observed variables, constructing a model to explore the influence is very important (Saeed et al., 2017). This model is showing the relations between the observed variables and the constructs. According to Hair, et al. (2019), convergent Validity is confirmed in Smart PLS when items load highly (greater than 0.70 or 0.60 in exploratory research). Nevertheless, items with the lowest outer loadings (below 0.60) should be removed from the scale with the condition the removed item does not decrease the average variance extracted (AVE) value.

Table 5: Cronbach's alpha, Composite Reliability (C.R.), and AVE

Variables	Cronbach's alpha	CR	AVE
International Financial Reporting Standard	0.914	0.933	0.700
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

Discriminant validity was indicated, as the AVE values are more than the squared correlations for each set of constructs. However, the study's findings demonstrated that the square root of the average variances extracted were all greater than the correlation among latent constructs, suggesting adequate discriminant validity.

Table 6: Discriminant validity -Fornell and Lacker Criterion

Variables	AUC	FRQ	IFRS	INA
AUC	0.678			
FRQ	0.642	0.781		
IFRS	0.567	0.771	0.837	
INA	0.631	0.663	0.568	0.875

5.3 Structural Model

This part presents the results of the structural model and test of hypotheses. Specifically, it is concerned with the testing of hypotheses related to moderating and mediating effects. The essential criteria used were path coefficient (β), effect size (f 2), coefficient of determination (R2) for endogenous variable, prediction relevance (Q2), and multicollinearity (inner VIF). The path coefficients showed the strengths and direction of the relations, and t –statistics and standard errors showed the importance of the effect. In contrast, the R2 value, known as the coefficient of determination Araya (2015), showed the variance explained. In this study, the model showed an excellent fit to the data as evidenced by the squared multiple correlations (R2) values for the dependent variables: International Financial Reporting Standard (IFRS) (R2=0.577) as shown in Table 4. Thus, the three latent variables (audit committee and internal audit) explain a substantial 57.7% of the International Financial Reporting Standard (IFRS). Furthermore, A.C. and I.A., and international financial reporting standards explain a substantial 71.3% of the variance for Financial Reporting Quality (FRQ).

Table 7: Coefficient of determination result R^2

Exogenous Construct	Endogenous Construct	R^2	Cohen, (1988b)	Chin (1998)
AUC, IA	IFRS	0.577	Mediate	Substantial
AUC, IA, IFRS	FRQ	0.713	Substantial	Substantial

The findings show Board of Directors had a significant effect size of the predictive variable on the International Financial Reporting Standard, at 0.429 (more than 0.35). Furthermore, Internal Audit had the medium effect size of the predictive variable on International Financial Reporting Standard at 0.246 (more than 0.15). However, Audit Committee had a small effect size on International Financial Reporting Standard at 0.059. The findings also show International Financial Reporting Standard had a significant effect size of the predictive variable on Financial Reporting Quality at 0.527. Still, the board of directors did not affect Financial Reporting Quality at 0.009 (less than 0.02). In addition, the audit committee and internal audit had a small size effect on Financial Reporting Quality with 0.062 and 0.074, respectively. Table 5 shows the results.

Table 8: Effect Size of predictive Variables

Variable	Effect size (f^2)			
	International Financial Reporting Standard	Rating	Financial Reporting Quality	Rating
Audit Committee	0.059	Small	0.062	Small
Internal Audit	0.246	Medium	0.074	Small
International Financial Reporting Standard			0.527	Large

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Table 9: Summary of Structural Model Assessment Direct and Indirect Hypotheses

H. No	Exog.		Endo.	Estimated	S. E	t-value (C.R)	P-Value	Status	Result
H1	AUC	⟹	FRQ	0.182	0.050	3.654	0.000	Sig	Supported
H2	INA	⟹	FRQ	0.211	0.061	3.471	0.001	Sig	Supported
H3	AUC	⟹	IFRS	0.210	0.049	4.261	0.001	Sig.	Supported
H4	INA	⟹	IFRS	0.420	0.130	3.229	0.000	Sig.	Supported
H5	IFRS	⟹	FRQ	0.598	0.064	9.274	0.000	Sig	Supported

As shown in Table 6, the T-statistics and p-value of IFRS in prediction the financial reporting quality were (9.274) and (0.000) respectively. In other words, the regression weight of the international financial reporting standard in predicting financial reporting quality is strongly positive significant. Therefore, hypothesis H5 is accepted. In addition, the regression wright was 0.598, revealing a positive relationship. Thus, when the international financial reporting standard goes up by one standard deviation, financial reporting quality goes up by 0.598 standard deviations.

6. Conclusion

This research investigated the relationship between CGM (AUC and INA), IFRS, and FRQ. The findings of this study support the significant relationship between CGM and the FRQ. It was also found that there is a direct positive relationship between C.G. and IFRS and between IFRS and FRQ. In terms of the mediating effect, the results suggest that International Financial Reporting Standards partially mediates the relationship between CGM and FRQ. Overall, the results of this study coincide with agency theory, which states that CGM is an essential monitoring device that improves International Financial Reporting Standards, which in turn helps to enhance FRQ. Crucially, this study has opened up possibilities for further research into the complementarity effect of other factors that need further probing in the Republic of Yemen and other developing countries worldwide.

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