Northern Economic Review
ISSN: 0262-0383
Vol. 15, No. 1 (2024)
https://nerj.org/
DOI: https://doie.org/10.0924/Nerj.2024475313

EFFECT OF CORPORATE GOVERNANCE ON THE QUALITY OF FINANCIAL STATEMENT IN CASE OF COMMERCIAL BANK OF ETHIOPIA

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ABSTRACT: The purpose of the study was to investigate the influence that corporate governance has quality of financial statement, in Case of Commercial Bank of Ethiopia. The study was guided by specifically, focus on the board's independence, board's transparency, audit committee, board's diversity and board's expertise the primary data involved use of questionnaire, and interviews. Secondary data used publication and banks records. This study consists a total sample size of 92 respondents were assigned in different organs of the Head Office, were involved in the study. The research design used for this study was a cross-sectional research design. Among non-random sampling techniques, the study used judgmental techniques. SPSS and Stata computer programme was used to analyze data that was collected through questionnaires and the qualitative data were analyzed using explanation. Descriptive analysis techniques were used to produce frequencies, descriptive and inferential statistics. Specifically, ordinal regression modelling was used. The findings indicated there was an overall goodness of fit. An Analysis of Variance (Chi-square) results indicated that the overall model was significant. Ordinary Regression results indicate that there is a positive relationship between Quality of Financial Statement and Corporate Governance. Overall results indicate that a unit change in board's independence, board's transparency, and board's expertise audit committee led to a positive change in Quality of Financial Statement the other negative. The study thus concludes that the effect of corporate governance on Quality of Financial Statement depends on the variables. The study recommends that the National Bank of Ethiopia should encourage banks to implement good corporate governance practices through enacting rules and regulations.

Keywords: Corporate Governance, Financial Reporting, Independence, Transparency, Audit Committee, Gender diversity and Expertise

1. Introduction:

Corporate governance has been a central theme in business since the emergence of the corporate form of business organization in the 16th and 17th centuries. This inherent separation of ownership and control creates a potential conflict between investors and managers, highlighting the need for mechanisms to ensure alignment and accountability (European Corporate Governance Institute, 2012).

The recent global financial crisis underscored the importance of robust corporate governance frameworks. These frameworks establish how stakeholders exert influence and ensure proper utilization of their investments (Robert, 2004).

At its core, corporate governance refers to the processes and structures that guide and manage an organization to ensure its stability and enhance shareholder value. These frameworks promote transparency, efficiency, and adherence to the rule of law, while clearly defining the responsibilities of supervisory, regulatory, and enforcement bodies (OECD, 2004).

Corporate governance is synonymous with responsible business conduct and adherence to ethical standards. Transparency, accountability, and open disclosure of both operational and financial information are internationally recognized as pillars of good corporate governance. Effective financial reporting, both internally and externally, fosters public trust and encourages open dialogue on financial matters (Fourier, 2006).

Governance, in general, pertains to the structures and processes that govern decision-making, accountability, control, and behavior at the highest levels of organizations. Corporate governance practices encompass the organization, management, and control of companies. It dictates how organizations are directed, controlled, and held accountable. Broadly, it refers to the processes by which organizations are steered, controlled, and held accountable (Brown, 2001).

Corporate governance encompasses the interactions between various stakeholders who contribute to a company's performance. These stakeholders include shareholders, employees, creditors, long-term suppliers, and subcontractors (Brown, 2001).

Banks play a critical role in any economy, providing essential financing to businesses. Their role becomes even more crucial for new and existing ventures. Financial resources are considered a critical input for a country's development endeavors. Sound corporate governance is fundamental for healthy banking operations and the integrity of financial markets (Jonathan and Maureen, 2003). The financial sector, particularly banking, is highly vulnerable to governance issues. Strong corporate governance systems and high-quality disclosures are paramount, as stakeholders increasingly scrutinize reported information (Okpala, 2012).

2. Statement of the Problem:

The relationship between corporate governance and the quality of financial information has been extensively explored in developed countries. Emerging economies present a distinct context for corporate governance due to unique features in corporate control, capital allocation, and regulations (Dimitropoulos and Asteriou, 2010). While research on corporate governance and financial reporting in developed countries is extensive, there's a scarcity of studies focusing on these aspects in less developed countries, particularly Ethiopia (Vafeas, 2005).

This research gap is problematic for several reasons. The quality of financial information is crucial for stakeholders to assess a company's performance and make informed decisions. High-quality financial reporting can mitigate this information asymmetry and promote trust (Beasley, 1996).

Considering the limited research on corporate governance and financial reporting in Ethiopia, and the critical role of high-quality financial information, this study aims to investigate the impact of corporate governance mechanisms on the quality of financial statements in Commercial Bank of Ethiopia. By addressing this gap, the study seeks to contribute to the existing body of knowledge and potentially improve corporate governance practices, leading to more transparent and reliable financial reporting in the Ethiopian banking sector.

3. Theoretical Overview and Hypothesis Development:

A bank's success relies heavily on its ability to generate income and the accuracy of its financial data (Fentaw and Thakkar, 2022). In other words, healthy profits depend on good income generation and reliable financial information. Corporate governance plays a vital role in ensuring the quality of financial reporting. Strong corporate governance mechanisms can mitigate the risk of financial reporting problems and improve overall quality (Cohen et al., 2004).

Several tools are used to assess financial reporting quality. These include fundamental and qualitative characteristics such as relevance, faithful representation, comparability, verifiability, understandability, and timeliness. These characteristics all contribute to the usefulness of financial information for decision-making (IASB, 2008).

The wave of accounting scandals in recent years, like Enron and Worldcom, eroded trust in financial reporting. Establishing effective corporate governance mechanisms is crucial to restore trust by ensuring companies provide stakeholders with reliable and accurate information (Akeju & Babatunde, 2017).

Transparency and accountability, core principles of corporate governance, lead to more trustworthy and accurate financial reports. These high-quality reports benefit all stakeholders who rely on financial information to make informed decisions. In essence, strong corporate governance strengthens financial reporting quality (Cohen et al., 2004).

Board Transparency and Financial Reporting Quality:

Transparency is a cornerstone of good corporate governance. Insufficient transparency hinders stakeholders' ability to monitor and hold boards accountable. For banking organizations, transparency and information disclosure are crucial to ensure stakeholders can assess whether their interests are being protected (Anameje, 2007). Disclosure rules help address the information asymmetry between managers and shareholders, while legal responsibilities of boards include managing the business for shareholder benefit and complying with financial reporting and disclosure requirements (Keasey, 2005). Based on this research, this study proposes a hypothesis:

H1: Board transparency significantly and positively affects the quality of financial statements.

Board Independence and Financial Reporting Quality:

The relationship between board independence and financial reporting quality is complex. On one hand, strong monitoring by an independent board is believed to improve the quality of financial information (Hamid, 2008). A higher proportion of independent directors is seen as a key factor in achieving board independence (Beasley, 1996). These independent directors, free from management influence, can ensure transparency, proper accounting methods, and the timeliness and accuracy of financial information (Kantudu & Samaila, 2015). Studies support this view, suggesting a positive association between board independence and the quality of financial reporting, including better fraud detection and adherence to accounting principles (Dabor & Adeyemi, 2009).

However, some research presents a contrasting viewpoint. Critics argue that independent directors may lack the necessary expertise to effectively monitor managers, potentially leading to no impact on financial reporting quality (Petra, 2007). Similarly, studies have found no significant link between the proportion of independent directors and the quality of information disclosure (Ho & Wong, 2001). Therefore, the relationship between board independence and financial reporting quality remains a topic of ongoing discussion. Based on this research, this study proposes a hypothesis:

H2: Board independence significantly and positively affects the quality of financial statements.

Audit Committee and Financial Reporting Quality:

Audit committees play a critical role in ensuring reliable financial reporting. Their activities include reviewing financial statements, assessing the quality of earnings, and overseeing the internal control system. They are typically composed of independent board members with expertise in accounting and auditing. Their responsibilities encompass supervising the financial

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reporting process, interacting with internal and external auditors, and approving the appointment and scope of external audits (Basel Committee on Banking Supervision, 2015). Based on this research, this study proposes a hypothesis:

H3: Audit committee significantly and positively affects the quality of financial statements.

Board gender diversity and Financial Reporting Quality:

Boardroom diversity, particularly gender diversity, is receiving increasing attention as a key aspect of corporate governance. Research is now exploring whether diverse boards, with a mix of genders, are more effective in managing and monitoring companies (Eulerich, 2014).

Traditionally, boards were homogenous, lacking diversity in gender, age, and background. However, the focus is shifting towards the potential benefits of a more diverse board composition (Akpan, 2015).

Studies suggest that companies with a higher proportion of female directors may outperform those with fewer women on the board (Farrell & Hersch, 2005). These findings point to potential advantages of boardroom gender diversity, such as a broader perspective on complex issues, increased attendance at meetings, and a greater emphasis on transparency (Catalyst, 2004). Based on this research, this study proposes a hypothesis:

H4: Board gender diversity significantly and positively affects the quality of financial statements.

Board Educational Qualification and Financial Reporting Quality:

Some studies suggest that boards with better educational qualification, particularly those with expertise in finance, accounting, and auditing, inspire greater confidence in the financial statements (Onourah & Imene, 2016). Experience often comes with age, leading some researchers to believe that qualified directors contribute to higher quality financial reporting (Kang et al., 2007). Based on this research, this study proposes a hypothesis:

H5: Board educational qualification significantly and positively affects the quality of financial statements.

4. Conceptual Framework:

Based on a comprehensive review of related literature, the following conceptual framework was developed to guide this specific study. In this framework, the quality of financial statements is considered the dependent variable, while the independent variables include board independence, board transparency, audit committees, board gender diversity, and board expertise. The relationships between these variables are depicted as follows.

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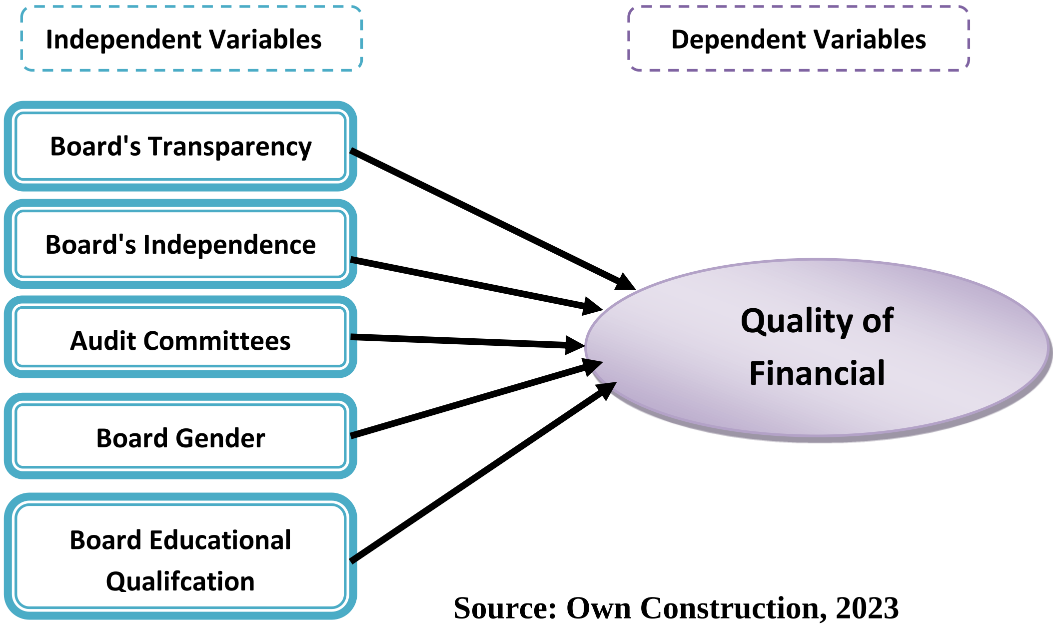
Figure 1: Conceptual Framework



Source: Own Construction, 2023

5. Methodology:

The study employs a quantitative research approach to examine the relationship between board gender diversity and financial reporting quality in organizations. Quantitative research involves generating numerical data subjected to rigorous statistical analysis, offering a formal and structured method to infer population characteristics or relationships (Kothari, 2004). This inferential approach uses survey research to study a sample population, enabling the researcher to generalize findings to the entire population.

A well-planned research design is crucial for obtaining valid and reliable results. According to Kumar (2011), a research design is a structured strategy that answers the study's questions or problems. This study employs a descriptive quantitative research design, allowing the collection, analysis, and description of numerical data to address the research questions or test hypotheses (Cooper & Schindler, 2011).

The explanatory research design used in this research addresses the research problems based on respondents' views and literature reviews. Both qualitative and quantitative methods are utilized to neutralize biases inherent in single-method studies (Creswell, 2009). The target population includes supervisory staff from the Commercial Bank of Ethiopia, categorized into top, middle, and lower-level managers. Due to practicality and resource constraints, the study focuses on a sample size of 97 out of 128 managers, determined using Yamane's formula (1967) with a 5% sampling error.

Primary data is collected through structured questionnaires with close-ended questions, adapted from previous relevant studies and modified to fit the research objectives. The questionnaire comprises three sections: demographic information, corporate governance (including board independence, transparency, experience, and audit committee qualifications), and financial statement quality. five-point Likert scale measures responses, allowing for comprehensive statistical analysis, including averages, frequencies, and correlations.

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This study employs ordered logistic regression (OLR) due to its flexibility in interacting between theory and data, estimating multiple and interrelated dependence relationships, and representing unobserved concepts (Chin and Newsted, 1999).

By applying OLR, the study effectively models the impact of board gender diversity on financial reporting quality, addressing the complexities inherent in categorical data with natural orderings. This method ensures a robust analysis, capturing the intricate dynamics between gender diversity and the quality of financial reports.

The ordered logit equation for predicting the dependent variable (Y) can be expressed as follows:

$$Y = \beta 0 + \beta 1\ X1 + \beta 2\ X2 + \beta 3\ X3 + \beta 4\ X4 + \beta 5\ X5 + \text{€}$$

$$QFS = \beta 0 + \beta 1(BOTR) + \beta 2(BOIN) + \beta 3(AC) + \beta 4(BODI) + \beta 5(BOEDQ) + \text{€}$$

Where:

QFS= Quality Financial Statement
BOTR=Board's Transparency
BOIN=Board's Independence
AC=Audit Committees
BODI = Board Gender Diversity
BOEDQ = Board Educational Qualification

Where Y stands for the Quality Financial Statement, whereas, β0, X1, X2, X3, X4, X5 and € denote the intercept of the equation board’s independence, board's transparency, audit committees, board expertise, board educational qualification and error term of the equation respectively.

The variables were measured according to the following table;

Table 1: Variables and their Description:

Variables	Symbol	Expected result	Proxy or Measurement
dependent variable Quality Financial Statement	QFS		Ordinal scale
independent variables Board's Transparency	BOTR	+	Measured in Likertscale
Board’s Independent	BOIN	+	Measured in Likertscale
Audit Committees	AC	+	Measured in Likertscale
Board Gender Diversity	BODI	-	Measured in Likertscale
Board Educational Qualification	BOEDQ	+	Measured in Likertscale

+, Positive effect; -, Negative effect.
Source: Own construct (2023)

6. Result and Discussions:

6.1. Results of Regression Analysis:

The regression estimate associated with the corporate governance and quality of financial statement is presented in the following tables.

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Table 2: Model Fitting Information:

Model	-2 Log Likelihood	Chi-Square	df	Sig.
Intercept Only	185.614			
Final	119.324	66.289	5	.000

Link function: Logit.

Table 3: Pseudo R-Square

Cox and Snell	.514
Nagelkerke	.592
McFadden	.357

Link function: Logit.

Source: SPSS version 23 outputs

Table 4: Parameter Estimates

		Estimate	Std. Error	Wald	df	Sig.
Threshold	[QFS = 1]	-1.638	3.910	.175	1	.675
	[QFS = 2]	2.712	3.934	.475	1	.491
Location	BOTR	3.897	.950	16.815	1	.000
	BOIN	1.527	.555	7.560	1	.006
	AC	4.215	1.030	16.754	1	.000
	BODI	3.841	.974	15.546	1	.000
	BOEDQ	2.726	.702	15.086	1	.000

Link function: Logit.

Source: Questionnaires and SPSS version 23 outputs, 2023

The likelihood ratio chi-square statistic of 66.29, with a p-value of 0.000, indicates that the model is statistically significant at the 1% level, demonstrating its reliability and validity. In ordinal regression models, the standard R-square statistic from linear regression cannot be used, so alternative approximations are computed. The pseudo R-square value, such as Nagelkerke's R-square of 59.2%, shows that the independent variables explain 59.2% of the variance in the quality of financial statements. This leaves 40.8% of the variance to be explained by other factors not included in this study, suggesting the need for further research on the quality of financial statements.

The analysis reveals a strong association between the studied factors and the quality of financial statements, with all variables showing statistical significance (p-values less than the alpha level). The parameters estimates table presents the coefficients, standard errors, Wald test p-values, 95% confidence intervals, and odds ratios. Significant p-values indicate the importance of the variables. The thresholds at the top of the parameter estimates output represent the intercepts, indicating the points where the latent variable is divided into the three observed categories of financial statement quality.

6.2. Hypothesis Testing:

Board's Transparency and Quality Financial Statements (H1):

The study found that board transparency significantly and positively affects the quality of financial statements, with a coefficient (ß) of 3.897 and a p-value of 0.000, indicating statistical significance at the 5% level. The Z critical value (Z = 0.67) surpasses the Z table value of 1.96 at a 95% confidence level. This result underscores the importance of timely and accurate disclosure in corporate governance, ensuring that all material matters regarding the corporation, including financial performance and governance, are communicated effectively. High transparency reduces information asymmetry between management and stakeholders, mitigating agency problems (Barbu, 2005). An independent audit further enhances transparency, providing assurance that financial statements fairly represent the company's financial position and performance. Therefore, H1 is accepted, affirming that increased transparency leads to higher quality financial statements.

Board Independence and Quality Financial Statements (H2):

The study reveals a positive relationship between board independence and the quality of financial statements, with a coefficient (ß) of 1.527 and a p-value of 0.006, showing significance at the 5% level. This suggests that an increase in board independence improves financial reporting quality by 1.527 units. Independent boards are less likely to be influenced by the CEO, promoting better financial oversight and reporting. Prior research supports this finding, indicating that outside directors enhance information quality (Bushman et al., 2004). Beekes et al. (2004) also noted that independent boards tend to disclose higher quality information. Therefore, H2 is accepted, indicating that greater board independence positively impacts financial statement quality.

Audit Committees and Quality Financial Statements (H3):

Contrary to expectations, the study found a positive relationship between audit committees and the quality of financial statements, with a coefficient of 4.215 and a p-value of 0.000, indicating significance at the 5% level. This suggests that the presence of an audit committee positively impacts financial reporting quality in this context. This result is consistent with the finding of Carcello and Neal (2000) which stated a positive relationship between audit committee and report quality. Therefore, H3 is accepted, indicating a significant and positive impact of audit committees on financial statement quality.

Board Gender Diversity and Quality Financial Statements (H4):

The study found that board gender diversity positively impacts the quality of financial statements, with a coefficient (ß) of 3.841 and a p-value of 0.000, indicating significance at the 5% level. This result is supported by theories suggesting that women bring valuable oversight and monitoring capabilities. This finding aligns with research by Belhaj and Mateus (2016), who found a positive impact of gender diversity on financial reporting quality. Therefore, H4 is accepted, indicating that increased gender diversity on boards positively affects financial statement quality in this context.

Board Members' Educational Qualifications and Quality of Financial Statements (H5):

The study found that the educational qualifications of board members positively influence the quality of financial statements, with a coefficient (ß) of 2.726 and a p-value of 0.000, indicating significance at the 5% level. Directors with higher education levels are better equipped to manage business operations and control agency problems, thereby improving financial

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reporting quality. This finding is supported by Amran (2011) and Yasser (2011), who argue that higher educational qualifications enhance directors' ability to oversee management effectively. Thus, H5 is accepted, affirming that higher educational qualifications among board members lead to better quality financial statements.

7. Conclusions:

This study investigated the relationship between corporate governance practices and the quality of financial statements. The findings provide strong evidence that all five examined corporate governance factors significantly influence financial reporting quality.

- **Board Transparency (H1):** Increased transparency, through timely and accurate disclosure, reduces information asymmetry and strengthens oversight, leading to higher quality financial statements.
- **Board Independence (H2):** Independent boards are less susceptible to management influence and promote better financial reporting practices.
- **Audit Committees (H3):** The presence of an active audit committee plays a crucial role in ensuring the quality of financial reporting.
- **Board Gender Diversity (H4):** Boards with greater gender diversity benefit from a wider range of perspectives, potentially leading to improved financial oversight and reporting practices.
- **Board Members' Educational Qualifications (H5):** Directors with higher education possess a stronger understanding of financial concepts and are better equipped to monitor management, leading to more reliable financial statements.

These findings highlight the importance of effective corporate governance practices for fostering high-quality financial reporting. Companies should strive to implement strong governance structures with transparent communication, independent boards, active audit committees, diverse board composition, and well-educated directors. By doing so, they can enhance stakeholder confidence and improve the credibility of their financial statements.

However, it is important to acknowledge that the study explains 59.2% of the variance in financial statement quality, suggesting other influential factors not considered here. Further research is needed to explore the remaining unexplained factors and their impact on financial reporting quality.

8. Implications:

The study's findings link strong corporate governance to high-quality financial statements. Here's a breakdown of the implications for different stakeholders:

Implications for the Commercial Bank:

Enhance Transparency - The study has shown that transparency is crucial for effective corporate governance. Without transparency, stakeholders cannot adequately monitor the activities of the board of directors and management. To address this, bank management should arrange for the resolution of conflicts of interest without hindrance and regularly improve the system by taking recommendations and suggestions from stakeholders when necessary.

Encourage Education and Training - Boards should promote management participation in education programs that align with corporate governance standards. These programs are vital for shaping management integrity, creating effective management, and providing advice on enhancing corporate governance quality within the company. Additionally, these programs should address potential obstacles to corporate governance implementation.

Promote Gender Diversity - The study found a positive relationship between gender diversity and the quality of financial statements. Therefore, the Commercial Bank of Ethiopia should implement policies to increase gender diversity. To encourage this, the bank should create flexible working policies that help female employees manage their work and personal life (work-life balance) without conflicts. The management should also monitor gender metrics by periodically checking the male-to-female ratio and promotion rates. This ensures that policies support diversity in hiring, promotion, and retention.
Conduct Annual Evaluations - The board and management of the bank should undergo annual evaluations, including assessments of the quality of board committees. These self-evaluations are important to ensure that the board and its committees are following necessary procedures to function effectively. This helps determine if the organization is moving in the right direction and measure the quality of its financial statements.

Implications for Governments (National Bank of Ethiopia):
Implement Regulatory Support - The National Bank of Ethiopia should encourage banks to adopt good corporate governance practices by enacting appropriate rules and regulations. This regulatory support will help reinforce the importance of corporate governance and ensure its consistent implementation across the banking sector.

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ISSN: 0262-0383
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DOI: https://doie.org/10.0924/Nerj.2024475313

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