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# *Does Corporate Governance Increase Financial Reporting Quality?*

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***Abstract*—This study aims to theoretically explain the relationship between corporate governance and financial reporting quality. The implementation of Corporate Governance conducted by companies can reduce agency conflict that occurs in companies between investors and managers. This research uses study literature. The data collection method is a literature study. The data obtained are compiled, analyzed, and concluded to obtain conclusions regarding the study of literature. The results of the study indicate that the application of Corporate Governance is one form to minimize agency conflicts that occur between investors and management so that information produced by companies shows quality information. This raises agency problems in the form of asymmetry information between managers and owners can provide managers with opportunities to manage earnings to maximize their utility. one strategy in limiting earnings management activities is by implementing corporate governance.**

***Keywords—Agency Conflict; Corporate Governance; Financial Reporting Quality***

## I. INTRODUCTION

Moral Hazard occurs between company managers who often have different goals that may conflict with the main goals between the principal, it causes problems. Problems arising from conflicts of interest between managers and shareholders are called agency problems. Agency problems are caused by conflicts of interest and asymmetric information. Conflicts of interest between the owner and agent occur because the possibility of the agent does not always act by the interests of the principal, thereby triggering agency costs. Therefore as a manager, the manager is obliged to give a signal about the condition of the company to the owner. However, the information submitted is sometimes received not by the actual condition of the company. This condition is known as asymmetric information or asymmetric information (information asymmetric) [1].

When GCG is implemented well in a company, this can minimize the manager's opportunity to do moral hazard, so that decisions that harm the company will be reduced and ultimately the decisions made by the company will improve the company's financial performance. The global financial crisis in 2008 was one of the sub-optimal impacts of GCG. This opinion is reinforced by reference [2] who concluded that the current global financial crisis can be associated with failures and weaknesses in corporate governance arrangements in financial service companies. The success of GCG is inseparable from the effectiveness of the GCG mechanism. Reference [3] divide the GCG mechanism into two parts, namely internal control consisting of concentration of ownership & board structure and external supervision consisting of institutional ownership and security analysts. Internal supervision is a supervisor who comes from within the company, while external supervision is a supervisor who comes from within the company. According to reference [3] internal and external supervision is very important for companies to have to make the level of supervision of managers higher. If this continues, then the information imbalance will be reduced and the performance of the organs in the company increasingly integrated.

The mechanism of GCG used in various studies varies greatly. For example, research conducted by reference [4], [5], [6], [3] use different proxies in measuring the implementation of GCG. used in this study are the board of commissioners, independent commissioners, audit committees, managerial ownership, and institutional ownership [7], [8]. The difference in the use of these mechanisms is because researchers want to see the effectiveness of monitoring of GCG implementation [8] Besides, the difference in the mechanism is greatly influenced by the legal system in force in the country. The legal system in Indonesia is a Continental European legal system that adopts a two-tier system. The two-tier system is a legal system in Indonesia that requires companies to have two bodies separate within a company, namely the supervisory board (board of commissioners) and the management board n (board of directors).

Board of commissioners and independent commissioners are some of the GCG mechanisms that must be owned by companies in Indonesia. The board of commissioners as a corporate organ is a mechanism that is collectively responsible for supervising and giving advice to company managers or management and ensuring that the company implements GCG [9]. The existence of this board of commissioners makes decisions made by management to be as objective as possible and can minimize moral hazard by management.

In addition to the board of commissioners, an independent commissioner is also one of the mechanisms for the success of GCG. Independent commissioners are very important to be

owned by the company because the existence of independent commissioners will put pressure on the board of commissioners to act as objectively as possible without conflicting interests between management and shareholders. Reference [3], [7], [5], [6],[10] found that if independent commissioners were increasingly dominant they could put pressure on the board of commissioners to improve the quality of disclosure corporate social responsibility.

The next GCG mechanism is the audit committee. The audit committee is an additional organ of the company whose function is to carry out checks or research deemed necessary for the implementation of the directors' functions. The existence of an audit committee in a company can have a major influence on disclosure in the company [11].

The mechanism that is part of the implementation of Corporate Governance has an important role in minimizing conflicts of interest between investors and management so that it has an important role in producing good financial reports [12].

Reference [1] argues that agency relations will arise when the delegation of authority by shareholders as the owner of the company to management. The agency relationship has the potential to cause conflicts of interest between the two parties, namely the shareholders representing the principals and management representing the agents. This conflict of interest occurs because of differences in the goals and interests of each party to the company. The principal hopes that the agent will manage the company that he owns works well so that later the dividends that will be received by the shareholders will be greater. But on the other hand, managers as agents in charge of managing the company often act not as the principal wishes, in fact managers often do things that are deviant (moral hazard) so that there needs to be a form of supervision carried out by the company to oversee management actions to act as expected by the shareholders. This is based on the assumption that both principals and agents are considered as economic people who can do things that deviate and act in their interests.

Various steps have been put forward by reference [1] to minimize agency problems including monitoring the expenditures by the principle, the bonding expenditures by the agent, and the residual loss. Besides these three steps, one way to minimize agency problems is by GCG [13]. GCG is used as a form of company monitoring to minimize agency problems that occur between agents and principals because without adequate supervision and control by the company it will make management have the opportunity to take actions that only benefit themselves without regard to the interests of shareholders.

In addition to GCG, the agency theory developed by reference [1] aims to explain social information or voluntary reports that companies should disclose. When based on agency theory, management as the recipient of a delegation from shareholders will try to cover up the information they have, including information that is social [1]. This is because if the information is disclosed by management will make the costs incurred by the company will be large and will reduce the income earned by management. Even though the information could be information that is needed by the shareholders as decision-makers. Therefore, there is a need for agency costs to minimize agency problems, one of which is by implementing GCG [13].

When GCG is implemented well in a company, especially to minimize asymmetry information that occurs mainly in disclosing social information, it causes the agency cost to be incurred by the company to decrease. Unlike when companies have to spend agency costs to minimize agency problems, the costs must be greater than if the company implements GCG [13]. Therefore, implementing GCG in a company is very important in addition to being able to minimize the asymmetry of information that occurs, GCG can also improve the company's financial performance.

## II. METHOD

This article is carried out using a literature study that discusses an issue using the literature available. The focus of this research is to explain the theoretical relationship between the implementation of Corporate Governance and Financial Reporting Quality. This article also explains in-depth the relationship between the implementation of Corporate Governance and financial reporting quality. So that his hope with the form of literature study formulation can provide development of the research study.

## III. RESULT AND DISCUSSION

The literature review on the relationship of GCG implementation with financial reporting quality (FRQ) is very close. This is important because FRQ becomes the basis for shareholders in decision making. But in producing good quality information as a basis for decision making, for that, we need a system that is used to be able to minimize the information asymmetry that occurs between management and investors. Reference [1] states that the information asymmetry that occurs between the principal and agent is represented by investors and management so companies need to issue agency costs to minimize the gap that occurs between investors and management. The relationship between the application of GCG and Financial Reporting Quality can be explained by agency theory. If you can draw on Figure 1 the conceptual framework related to the relationship between GCG and Financial Reporting Quality:

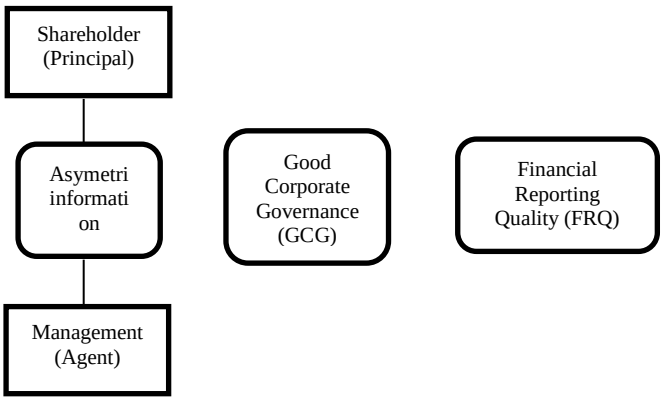


*Fig. 1. Conceptual Framework*

In its application, GCG is a system built by the company so that the company can run the company by adhering to the principles of Transparency, Accountability, Responsibility, Independence, and Justice. The implementation of GCG is proxied by the board of commissioners, independent commissioners, audit committees, managerial ownership, and institutional as well as reducing agency problems by bridging the interests between agents and principals. The implementation of GCG will make the level of supervision of management behavior higher so that the decisions made are more objective and ultimately will improve the Financial Reporting Quality for the company. The board of commissioners has a very large share for the implementation of corporate GCG. A large number of board of commissioners can make a company to reduce environmental uncertainty [14]. When the board of commissioners can reduce environmental uncertainty, managers can be more stable in running the company so this makes financial performance improved. Besides, if the board of commissioners functions as it should, it makes the supervision system in the company better and guarantees the success of GCG implementation and ultimately if the level of supervision goes well then this can have an impact on financial performance.

Not unlike the board of commissioners, an independent commissioner is one of the GCG mechanisms that have a very large share in supporting the successful performance of the board of commissioners. Independent commissioners are commissioners who are not affiliated with the company, so it is expected that independent commissioners can help the board of commissioners to be independent and ultimately the decisions made can improve financial performance. Reference [15] suggested that independent commissioners have a very important role to reduce agency problems and make the role of the board of commissioners more effective in decision making. So when the agency problem decreases, it can improve the quality of financial information for the company.

Necessary for the implementation of the directors' functions in carrying out the management of the company as well as carrying out important tasks related to the financial reporting system. When the audit committee performs its functions properly it is expected that the company's financial statements will be more credible. This is reinforced by the opinions expressed by reference [16] argue that it is important to increase the number of audit committee members to ensure more effective control of accounting and financial processes. Reference [17] also found that large-sized audit committees can protect and control the accounting and financial processes to make the financial reporting system more transparent. This will give a good image to shareholders and creditors so that shareholders and creditors trust the financial statements produced by the company and ultimately this can have an impact on the company's financial reporting quality.

The next GCG mechanism is the ownership structure which is divided into managerial and institutional ownership. Giving shares given to management makes managers will be careful in carrying out and making decisions, especially when related to financial performance. Financial performance is one of the important things to be considered by management because financial performance is a reflection of the company's performance in that period so that the greater ownership of management in a company can make the company's financial performance increase. If managers already have significant equity in the company then managers are more likely to make decisions maximizing shareholder value [18], [19].

Not only managerial ownership but also the large institutional ownership also plays a role in improving financial performance. Bathala argues that with the presence of large shareholders this will make the monitoring or the level of supervision also occur which will also be greater so that it can directly increase the value of the company including financial reporting quality of the company. Institutional ownership in a company can improve the process of supervision of management and ultimately can improve financial reporting quality

## IV. Conclusion

The relationship between Good Corporate Governance and financial reporting quality is very important for the company. Financial Reporting Quality is a means or basis for shareholders in decision making. With the basis for decision making obtained from financial statements, shareholders can make decisions appropriately. However, to produce the right decision the financial statements must have a quality information imbalance that occurs between investors and management, to minimize to produce quality financial reports agency costs incurred by the company is to implement Good Corporate Governance. Good Corporate Governance is a form of corporate monitoring to minimize agency problems that occur between agents and principals because without adequate supervision and control by the company it will make management have the opportunity to take actions that only benefit themselves without regard to the interests of shareholders.

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