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2025 Volume 3, Issue 4
Lecture Notes in Education, Arts, Management and Social Science
ISSN(Online): 2705-053X

Research on the Relationship between Corporate Governance and Financial Accounting Quality

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Abstract: This article focuses on the inherent correlation between corporate governance and the quality of financial accounting, analyzing the logic of how governance structures and mechanisms affect the generation of accounting information. It reveals the transmission path of power and responsibility allocation and decision-making processes on accounting recognition, measurement, and reporting. Additionally, it examines the practical contradictions between current governance practices and accounting quality requirements from four dimensions: the risks of equity concentration, the misalignment of independent directors' effectiveness, insufficient internal supervision and coordination, and the limitations of external constraints. Based on this analysis, the article proposes strategies such as constructing a balanced structure of diversified equity, improving the performance guarantee for independent directors, strengthening internal supervision and coordination mechanisms, and establishing an external governance and constraint system. This forms a complete research chain from theoretical analysis to problem diagnosis and then to countermeasure design, striving to provide a systematic solution for enterprises to improve the quality of financial accounting.

Keywords: corporate governance; financial accounting quality; equity checks and balances; independent directors

Online publication: May 26, 2025

1. Introduction

Improving corporate governance is an important foundation for enhancing the quality of corporate information disclosure and maintaining the order of the capital market. In recent years, regulatory authorities have continuously issued documents such as the "Governance Standards for Listed Companies" and "Basic Norms for Enterprise Internal Controls," emphasizing the optimization of governance mechanisms to ensure the authenticity of financial information. However, in practice, some enterprises still face issues such as distorted financial data and superficial supervision, reflecting that the synergistic effect of corporate governance and financial accounting quality has not been fully utilized. This article takes the core elements of corporate governance as the starting point, systematically analyzes its mechanism of action on financial accounting quality, identifies key contradictions in current governance practices, and proposes targeted optimization strategies. The aim is to provide theoretical support and practical reference for enterprises to improve their governance structure and enhance the reliability of accounting information.

2. Mechanism of Corporate Governance on Financial Accounting Quality

Corporate governance, as the institutional framework for enterprise operations, directly affects the generation process of financial accounting information through its core elements and institutional design. From the perspective of governance structure, the ownership structure determines the distribution of decision-making power. Decentralized equity facilitates multiple checks and balances, prompting management to focus more on objectivity in accounting recognition. On the other hand, concentrated equity may allow controlling shareholders to dominate decision-making, affecting measurement choices such as asset valuation and cost allocation. The board of directors, as the core decision-making body, directly influences the quality of financial report auditing through its independence and professional background. Independent directors with financial knowledge are more likely to demand strict compliance with accounting standards, enhancing information reliability [1]. The board of supervisors ensures sufficient accounting recognition basis and reasonable measurement methods through the entire process of supervising vouchers and accounts. From the perspective of governance mechanisms, incentive and restraint mechanisms link management compensation to financial performance. Although this can stimulate business motivation, it may also induce accounting manipulation and affect information authenticity. The information disclosure mechanism regulates the process of information generation and transmission, reduces information distortion, and improves the completeness and timeliness of reports. In summary, corporate governance constructs its basic logical chain of action on financial accounting quality by influencing accounting recognition, measurement, and reporting.

3. Real-world Contradictions Between Corporate Governance and Financial Accounting Quality

3.1. Risk of Financial Information Distortion Under Concentrated Ownership

In enterprises with highly concentrated ownership, controlling shareholders wield significant decision-making power due to their substantial shareholding advantages, while the voice of small and medium shareholders is greatly reduced. Differences in interest demands between the two gradually emerge. Controlling shareholders are more focused on short-term capital appreciation or financing needs. To maintain their interests with controlling shareholders, management often tends to influence financial data by adjusting accounting policies or transaction arrangements. Some enterprises may recognize income from unfinished contracts ahead of time, delay the accrual of bad debt losses that have already occurred, or transfer profits to other entities controlled by controlling shareholders through unfair connected transactions. These operations cause core indicators such as income and profits in financial statements to deviate from real business results, fundamentally questioning the reliability of accounting information.

3.2. Misalignment Between the Effectiveness of Independent Directors and the Need for Accounting Oversight

The misalignment between the effectiveness of independent directors and the need for accounting oversight first manifests in the insufficient independence of the selection mechanism. Currently, independent directors in some enterprises are recommended by controlling shareholders or management. This selection model creates potential interest connections between independent directors and the recommending party, making it difficult for their oversight position to completely transcend the will of the recommending party[2]. Secondly, there is the impact of compensation correlation. Some enterprises directly link independent directors' compensation to company performance. Although this incentive design intends to enhance participation, it may weaken their objective evaluation of financial information. When the company has motives to window-dress its financial statements, independent directors may reduce their oversight due to concerns about compensation losses. Additionally, the issue of professional competency matching is prominent. While some independent directors possess industry experience or legal knowledge, they may not have a deep understanding of professional areas such as accounting standards and financial analysis. When reviewing complex financial reports or identifying unfair connected transactions, they may find it difficult to accurately detect data anomalies or operational violations.

3.3. Insufficient Synergy Between Internal Oversight Mechanisms and Accounting Controls

The insufficient synergy between internal oversight mechanisms and accounting controls first manifests in the overlap of personnel allocation. To reduce management costs, some enterprises have cross-appointments between members of the board of supervisors and internal audit department personnel. Although this arrangement simplifies the organizational structure, it weakens the independence of oversight. When overseers simultaneously participate in the daily work of the objects being overseen, their evaluation of financial processes can be easily influenced by subjective tendencies. Secondly, there is ambiguity in authority division. The statutory oversight responsibilities of the board of supervisors and the professional verification scope of internal audits lack clear definition. This can lead to situations where duplicate inspections increase management costs or risk points are missed due to gaps in responsibilities during key processes such as financial revenue and expenditure audits and asset inventories. Finally, there is the issue of inefficient work coordination. The board of supervisors and the internal audit department lack a normalized communication mechanism in information transmission and problem feedback. Abnormal data or operational loopholes identified by internal audits may not be timely communicated to the board of supervisors, causing oversight actions to lag behind the execution of financial processes.

3.4. Constraints of External Governance Environment on Accounting Quality

The constraints of the external governance environment on accounting quality are primarily reflected in the inadequate effectiveness of market regulation. Some regulatory authorities' penalties for financial violations do not match the benefits obtained from such violations. The law enforcement cycle is relatively long, and the follow-up rectification and tracking mechanism is not perfect, making it difficult to form a continuous deterrent to enterprises. Secondly, the supervisory role of intermediaries has not been fully utilized. Some accounting firms have long-term business relationships with the audited enterprises. To maintain client resources, they may lower audit standards, and the verification of the authenticity of complex transactions only stays at the surface level, failing to deeply identify abnormal fluctuations in financial data. Finally, the participation of investor supervision is limited. Small and medium-sized investors are limited by information access channels and professional analysis capabilities. They often focus more on short-term stock price fluctuations rather than the quality of financial information. They have insufficient motivation to actively participate in corporate governance and supervise accounting behavior, making it difficult to form effective external pressure.

4. Strategies to Optimize Corporate Governance and Improve Financial Accounting Quality

4.1. Building a Diversified Equity Balance Structure to Suppress Motives for Financial Manipulation

The core of building a diversified equity balance structure lies in the introduction of external entities and optimization of internal mechanisms to form mutual checks and balances among multiple stakeholders. This fundamentally weakens the absolute control of a single controlling shareholder over financial decision-making, thereby suppressing motives for financial manipulation. Firstly, introducing strategic investors with business synergies is a key measure to diversify equity concentration. Enterprises should prioritize selecting institutional investors with high relevance to their main business, complementary industry resources, and no direct interest connections, such as leading enterprises in the upstream and downstream of the industry chain or funds focusing on long-term value investment. By introducing such investors through private placements or equity transfers, and maintaining their shareholding ratio within a reasonable range of 5%-15%, it can avoid excessive equity dispersion leading to inefficient decision-making while forming an effective check and balance on the controlling shareholder[3]. Secondly, improve the voting mechanism for small and medium-sized shareholders. Enterprises can promote the cumulative voting system, allowing small and medium-sized shareholders to concentrate their voting rights on one director candidate, increasing the probability of independent directors or financial professional directors nominated by them entering the board. At the same time, establish a convenient online voting platform to reduce the time and space costs for small and medium-sized shareholders to participate in general meetings of shareholders. Set up special voting rights for major issues involving financial statement preparation, approval of connected transactions, etc., requiring separate approval from small and medium-sized shareholders before implementation. Additionally, explore the establishment of a shareholder voting rights entrustment system to encourage small and medium-sized shareholders to entrust their voting rights to professional institutions for exercise, concentrating dispersed voting rights to enhance supervision over controlling shareholders. Establishing a dynamic equity adjustment mechanism can ensure the long-term effectiveness of the balance structure. Enterprises should adjust equity proportions based on their development stages. During the startup phase or rapid expansion phase, a higher degree of equity concentration can be maintained to improve decision-making efficiency. However, after entering a stable phase, it is necessary to gradually dilute the controlling shareholder's equity through share repurchases, private placements, etc. For controlling shareholders with a history of obvious financial manipulation, equity reduction restrictions can be set to prevent them from transferring benefits through rapid reductions.

4.2. Improving the Mechanism for Independent Directors to Perform Their Duties and Enhancing the Effectiveness of Accounting Oversight

Improving the mechanism for independent directors to perform their duties requires building a systematic support framework from three aspects: selection and appointment, incentives, and ability enhancement. This framework aims to reduce conflicts of interest, strengthen responsibility constraints, and enhance professional literacy, pushing independent directors to shift from formal participation to substantive oversight and effectively enhancing their auditing efficiency of financial reports. An independent selection and appointment process lays the foundation for the independence of their duties. Enterprises should establish a nomination committee consisting of the supervisory board, representatives of small and medium shareholders, and industry experts. The representatives of small and medium shareholders should be elected through a differential election process, accounting for no less than 30% of the committee. Candidates with related relationships to controlling shareholders should be explicitly excluded, and an independent director candidate pool should be established and made public. Members of this pool should have backgrounds in finance, law, and other relevant fields. The general meeting of shareholders should adopt a cumulative voting system to ensure fair selection and appointment. A compensation system linked to performance is the core of motivating oversight. Compensation should be divided into basic compensation and performance-based compensation, with the latter evaluated based on indicators such as meeting attendance rate and the number of objections to financial reports. Part of the performance-based compensation can be temporarily stored in a third-party account and released upon audit confirmation. Additionally, a liability recovery mechanism should be established, requiring those who fail to perform their duties and cause information distortion to bear corresponding compensation responsibilities. A professional training system is key to enhancing oversight capabilities. By collaborating with industry associations to conduct pre-job and continuous education and training, focusing on accounting standards, fraud identification, and connected transaction reviews, combined with case studies and simulated audits, practical abilities can be improved. Independent directors are encouraged to participate in professional committee work to enhance their judgment in practice.

4.3. Strengthening Internal Oversight Synergy Mechanisms to Improve Accounting Process Control

Strengthening internal oversight synergy mechanisms should be based on the complementary functions of the supervisory board and internal audits. By clarifying the division of responsibilities, establishing normalized communication channels, and designing collaborative oversight processes, a joint oversight force covering the entire financial process can be formed, effectively improving the level of accounting control[4]. Clarifying the boundary of responsibilities between the supervisory board and internal audits is the primary task of collaborative oversight. The supervisory board should focus on compliance oversight, responsible for reviewing whether financial activities comply with laws, regulations, company charters, and regulatory requirements, with a focus on the legitimacy of connected transaction approval procedures and major asset disposal decisions. Internal audits, on the other hand, should focus on process control oversight, evaluating the accuracy of accounting policy implementation and the effectiveness of internal controls around specific operational aspects such as financial revenue and expenditure records, asset measurement methods, and cost accounting standards. Establishing an information sharing mechanism is a key support for achieving collaborative oversight. Enterprises should establish a joint oversight meeting system, co-chaired by the chairman of the supervisory board and the head of internal audits, and hold monthly thematic meetings to report problems discovered during their respective oversight processes. The internal audit department needs to submit a monthly audit report before the meeting, highlighting abnormal financial data, process vulnerabilities, and potential risk points. The supervisory board provides feedback on institutional deficiencies or decision deviations discovered during compliance reviews. Designing a joint oversight process is an important guarantee for improving control effectiveness. For key links such as financial revenue and expenditure and asset measurement, enterprises should formulate collaborative oversight operation guidelines. In the financial revenue and expenditure audit stage, internal audits are involved in the verification of original documents ahead of time, identifying issues with document integrity and accuracy of amounts, and synchronizing suspicious information to the supervisory board. The supervisory board reviews the approval authority and connected relationships of revenue and expenditure items based on compliance requirements. Both parties must jointly sign the audit opinion before accounting treatment can be performed.

4.4. Improving the External Governance and Constraint System to Stimulate the Improvement of Accounting Quality

Improving the external governance and constraint system requires the establishment of a pressure transmission mechanism from three dimensions: regulation, intermediaries, and investors. By increasing the cost of violations, strengthening professional supervision, and protecting investors' rights and interests, an external force can be formed to compel enterprises to actively improve their accounting quality. Strengthening the financial fraud penalties of regulatory authorities is the foundation of building a constraint system [5]. Regulatory agencies should revise the penalties for financial violations, adjusting the fine amount from "1-5 times the illegal income" to "3-10 times the illegal income" and adding personal penalty clauses for directly responsible individuals, including market prohibition, revocation of professional qualifications, and personal fines up to 5 million yuan. At the same time, a blacklist system for financial fraud should be established, and enterprises with significant financial fraud behavior should be included in the key regulatory list, restricting their participation in mergers and acquisitions, refinancing, and other capital operations for three years. Additionally, the regulatory law enforcement process should be optimized, the case investigation cycle should be shortened, and a "rapid response channel" should be activated for serious fraud behaviors to ensure that penalty results are implemented within six months, enhancing the timeliness of regulatory deterrence. Standardizing the professional standards of intermediaries is key to improving the effectiveness of external supervision. Industry associations need to revise the quality evaluation system for accounting firms, incorporating substantive indicators such as the depth of audit procedure implementation and abnormal data tracking rates into the evaluation core, replacing the simple business income-oriented rating method. For firms with consecutive two-year "unqualified" evaluation results, their securities and futures audit business qualifications should be suspended. An audit project quality review mechanism should be established, requiring independent review by a third-party agency designated by the industry association for each listed company audit business. If significant procedural defects are found during the review, the project partner and quality control leader should be held jointly responsible. At the same time, accounting firms should be encouraged to adopt a "rotation system + mandatory disclosure" model, requiring enterprises to change their primary audit firms every five years and disclose detailed differences with their previous firms in annual reports to reduce independence impairment issues caused by long-term cooperation. Improving the investor litigation and compensation mechanism is an important support for stimulating external supervision.

5. Conclusion

The research results indicate that the structural design and mechanism operation of corporate governance directly affect the quality of financial and accounting information generation. Key influencing factors include equity concentration, the effectiveness of independent directors, internal supervision synergy, and the strength of external constraints. This conclusion reveals the fundamental role of governance mechanism improvement in ensuring the reliability of accounting information and provides a governance perspective interpretation framework for understanding corporate financial behavior. In practical applications, the strategies proposed in this article for equity balances, independent director protection, internal supervision synergy, and external constraint strengthening can provide specific path references for enterprises to optimize governance practices and for regulatory authorities to improve policies.

Disclosure statement

The author declares no conflict of interest.

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