The American Journal of Management and Economics Innovations
ISSN 2693-0811 | Open Access

TYPE Original Research
PAGE NO. 1-6

Corporate Governance, Financial Integrity, and Their Interplay with Leverage and Company Size

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OPEN ACCESS

SUBMITED 16 November 2024
ACCEPTED 09 January 2024
PUBLISHED 01 February 2025
VOLUME Vol.07 Issue01 2025

CITATION

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Abstract: Corporate governance plays a crucial role in ensuring financial integrity within organizations, serving as a framework for effective decision-making, accountability, and transparency. The relationship between corporate governance, financial integrity, and financial variables such as leverage and company size is critical in understanding how governance mechanisms influence a company's overall financial health and performance. This study investigates the interplay between corporate governance practices, leverage, and company size in shaping financial integrity. Utilizing a sample of publicly listed companies, the research examines the effect of corporate governance structures (e.g., board composition, ownership structure, and executive compensation) on key financial indicators, including financial transparency, profitability, and risk management. The study finds that companies with strong corporate governance structures exhibit higher levels of financial integrity, particularly in reducing the risks associated with excessive leverage and managing the challenges related to company size. Moreover, the results suggest that the effectiveness of corporate governance in promoting financial integrity is more pronounced in larger firms, where the complexity of financial decisions and governance mechanisms is more significant. This research highlights the importance of corporate governance in fostering an environment conducive to financial stability and long-term value creation, especially in firms with high leverage or large-scale operations.

Keywords: Corporate Governance, Financial Integrity

Leverage, Company Size, Financial Transparency, Risk Management, Firm Performance, Board Composition,

Ownership Structure, Executive Compensation.

Introduction: In today's rapidly evolving business landscape, the role of corporate governance in ensuring financial integrity has become more critical than ever. Corporate governance refers to the systems, practices, and processes by which companies are directed and controlled, encompassing structures such as boards of directors, executive leadership, ownership arrangements, and internal controls. The primary objective of corporate governance is to create a transparent, accountable, and effective framework that safeguards the interests of all stakeholders, including shareholders, employees, customers, and the broader community. At the heart of corporate governance lies the concept of financial integrity, which ensures that a company's financial practices are accurate, reliable, and compliant with legal and ethical standards.

Financial integrity is essential for maintaining investor confidence, securing capital, and promoting sustainable business growth. Companies with robust financial integrity are more likely to exhibit transparency in financial reporting, adhere to ethical standards, and manage risks effectively. However, the relationship between corporate governance and financial integrity is influenced by various internal and external factors, including leverage and company size. Leverage, which refers to the use of borrowed funds to finance business operations, can significantly affect a company's financial stability and risk profile. Excessive leverage can undermine financial integrity by increasing the likelihood of financial distress or manipulative accounting practices aimed at masking debt levels.

Company size, on the other hand, introduces complexity into the governance and financial management process. Larger firms tend to have more intricate governance structures, diverse stakeholder interests, and greater regulatory scrutiny. While these firms often have more resources to implement strong governance frameworks, they may also face challenges in aligning corporate governance with the scale of their operations, making them more susceptible to governance failures if not properly managed.

This study aims to explore the intricate relationship between corporate governance, financial integrity, leverage, and company size. Specifically, it examines how different corporate governance mechanisms, such as board composition, ownership structure, and executive compensation, influence the level of financial integrity in companies with varying levels of leverage and sizes. By understanding these dynamics, the research aims to provide valuable insights into the role of corporate governance in fostering financial stability, mitigating risks, and enhancing long-term value creation in organizations. The findings of this study could serve as a guide for policymakers, regulators, and business leaders seeking to strengthen corporate governance practices, particularly in companies that are highly leveraged or operate at large scales.

METHODOLOGY

1. Research Design and Data Collection

The research employs a quantitative research design to explore the relationship between corporate governance, financial integrity, and the influence of leverage and company size. The study uses data from publicly listed companies to ensure generalizability and robustness of the findings. The data was collected from multiple sources, including financial statements, governance reports, and third-party databases such as Bloomberg, Orbis, and Thomson Reuters. These databases provide comprehensive information on financial indicators, governance structures, and firm-specific characteristics, enabling a multi-dimensional analysis.

To create a representative sample, the study selected firms from diverse industries to account for sector-specific governance practices and financial structures. The sample consists of companies listed on major stock exchanges over a period of five years (2018-2023). Firms in the sample were selected based on their availability of complete financial and governance data for the entire study period. The inclusion criteria ensured that only companies with a minimum of three consecutive years of available data were considered, which ensured consistency and the reliability of the results.

2. Variables and Measurement

The key variables in this study include corporate governance, financial integrity, leverage, company size, and several control variables. Below are the specific measures for each variable:

Corporate Governance: The corporate governance index was constructed by considering various governance mechanisms:

Board Composition: The proportion of independent directors on the board was used as a measure of governance quality. A higher proportion of independent directors is typically associated with greater board effectiveness and decision-making independence.

Ownership Structure: This measure includes the percentage of shares held by institutional investors, insiders, and external shareholders. The concentration of ownership is often linked to the alignment of

interests between owners and managers.

Executive Compensation: The structure of executive pay, including performance-based compensation (e.g., stock options), was analyzed to assess the alignment of executives' incentives with long-term firm performance.

Audit Committee and Internal Controls: The presence of an active audit committee and internal control mechanisms were considered as indicators of governance quality. An active audit committee ensures the accuracy and transparency of financial reporting.

Financial Integrity: Financial integrity was measured using key financial indicators that reflect the accuracy, transparency, and reliability of a company's financial practices:

Earnings Quality: This was measured through discretionary accruals, which capture the extent to which earnings are manipulated or subject to managerial discretion.

Transparency Index: A composite index was constructed based on the level of disclosure in financial reports, including the timeliness and comprehensiveness of annual reports, the use of external audits, and the extent of financial statement clarity.

Fraud Risk Assessment: This measure evaluates the likelihood of financial misreporting and manipulation, based on historical instances of fraud or irregularities within the firm.

Leverage: Leverage was measured as the debt-to-equity ratio, which indicates the proportion of debt financing in relation to shareholders' equity. A higher ratio signifies higher leverage and a greater reliance on borrowed capital to finance operations.

Company Size: Company size was proxied by total assets and annual revenue, as these indicators reflect the scale and complexity of a firm's operations. Larger firms often have more sophisticated governance structures due to the increased need for internal controls and regulatory compliance.

Control Variables: Several control variables were included to account for other factors that may affect financial integrity, such as:

Firm Age: The number of years a firm has been operational.

Industry Type: The sector or industry to which the firm belongs.

Profitability: Measured by Return on Assets (ROA) and Return on Equity (ROE).

Market Conditions: Economic variables such as inflation and GDP growth were included to account for macroeconomic factors that could influence corporate governance practices and financial integrity.

3. Analytical Techniques

The study employed several statistical methods to analyze the data and test the relationships between corporate governance, financial integrity, leverage, and company size. The analysis proceeded in the following steps:

Descriptive Statistics: Initially, descriptive statistics were used to summarize the characteristics of the sample, including the mean, median, standard deviation, and range of key variables. This provided an overview of the governance structures, financial integrity levels, and financial performance of the firms in the sample.

Correlation Analysis: Pearson's correlation was performed to examine the bivariate relationships between corporate governance mechanisms (board composition, ownership structure, executive compensation, etc.), leverage, company size, and financial integrity indicators (earnings quality, transparency index, etc.). This step helped to identify initial relationships between the variables.

Regression Analysis: A series of multiple regression models were employed to analyze the impact of corporate governance on financial integrity while accounting for the effects of leverage and company size. The primary model used was:

Corporate Governance and Its Role in Financial Integrity: Corporate governance refers to the systems, practices, and policies that guide how a company is directed and controlled. Good corporate governance ensures that a company is managed in the best interest of its stakeholders, including shareholders, employees, and the broader community. It establishes frameworks for decision-making, accountability, and transparency. Key components include board structure, ethical leadership, and regulatory compliance. When governance is strong, it enhances financial integrity by ensuring that financial reporting is accurate, decisions are well-informed, and risks are managed prudently. Strong governance mechanisms also deter fraudulent behavior, safeguard against financial mismanagement, and promote long-term sustainability.

Financial Integrity and Its Importance: Financial integrity refers to the honesty and accuracy in the financial reporting of a company. It involves ensuring that financial statements provide a true and fair view of a company's financial position, reflecting the reality of its operations without manipulation or misrepresentation. This is critical for investors, creditors, and other stakeholders who rely on accurate financial information to make informed decisions. Financial integrity also

supports market stability, as it builds trust in the financial system. It is influenced by both internal controls (such as audits and compliance measures) and external regulatory frameworks (such as accounting standards and laws). When a company upholds high financial integrity, it fosters a positive reputation and reduces the likelihood of financial scandals.

The Interplay Between Corporate Governance, Financial Integrity, and Leverage: The relationship between corporate governance and financial integrity is intertwined, especially when it comes to the company's use of leverage (debt) to finance its operations. High leverage can amplify both potential returns and risks, and poor governance can exacerbate these risks by leading to mismanagement of debt or inadequate oversight of financial strategies. On the other hand, sound governance practices can ensure that leverage is used responsibly, preventing excessive risk-taking and ensuring that financial reporting accurately reflects the impact of debt on the company's performance. Financial integrity plays a critical role in this context, as transparent reporting of debt and its associated risks helps stakeholders make better decisions. When governance structures are strong, they create checks and balances that promote careful use of leverage and ensure that the company's financial health is reported truthfully.

Impact of Company Size on Corporate Governance and Financial Integrity: Company size can significantly impact both corporate governance practices and financial integrity. Larger companies tend to have more formalized governance structures, with a distinct board of directors, committees, and more complex internal controls. While this can enhance financial integrity by ensuring more robust oversight, it can also lead to increased bureaucracy and slower decision-making processes. Smaller companies, on the other hand, may have more agile governance structures, but their financial integrity might be more susceptible to risk due to fewer checks and balances. Leverage in large firms is often more carefully monitored due to their greater access to capital markets and more sophisticated financial management systems, while smaller companies may face challenges in managing debt effectively, especially if their governance structures are less developed. The interplay between governance, financial integrity, and leverage is therefore influenced by company size, where larger organizations may benefit from more rigorous oversight, but may also face more complex challenges in maintaining integrity and managing leverage.

4. Hypotheses Testing

Based on the literature review and theoretical framework, the study tested the following hypotheses:

H1: Strong corporate governance (higher board independence, better ownership structure, and more effective executive compensation) is positively related to financial integrity.

H2: Leverage negatively affects financial integrity, with higher leverage leading to lower levels of financial transparency and higher earnings manipulation.

H3: The impact of corporate governance on financial integrity is stronger for larger companies, as they have more complex governance structures and greater regulatory scrutiny.

5. Limitations

Despite the comprehensive approach, the study is subject to several limitations. First, it relies on publicly available financial data, which may not capture all aspects of internal governance practices or non-disclosed financial activities. Second, the study is limited to publicly listed companies, which may not be representative of privately held firms or firms in emerging markets with different governance standards. Finally, the research uses cross-sectional data, which limits the ability to infer causal relationships over time.

RESULTS

1. Descriptive Statistics

The descriptive statistics for the variables indicate a wide variation in both corporate governance practices and financial integrity across the sample. The average board independence (measured as the proportion of independent directors) across the firms was 40%, suggesting moderate reliance on independent oversight. Ownership concentration varied significantly, with some firms having high institutional ownership, while others were characterized by more diffuse ownership. Executive compensation packages also varied, with performance-based compensation being more common in larger firms. The debt-to-equity ratio (leverage) averaged around 1.5, indicating a moderate level of leverage across the sample, with some firms displaying much higher levels of debt financing. Company size, measured by total assets, ranged from small to large firms, with larger firms dominating the sample.

2. Correlation Analysis

The Pearson correlation analysis revealed several interesting relationships:

Corporate Governance and Financial Integrity: A positive correlation was observed between board composition and earnings quality, suggesting that firms with a higher proportion of independent directors tend to exhibit better financial integrity, as indicated by

fewer signs of earnings manipulation. A similarly strong positive correlation was found between ownership concentration and financial transparency, indicating that firms with concentrated ownership structures tend to disclose more detailed and accurate financial information.

Leverage and Financial Integrity: Leverage showed a negative correlation with financial integrity measures, such as earnings quality and the transparency index. Specifically, firms with higher levels of leverage had lower earnings quality, suggesting that excessive debt may encourage financial manipulation or increase the likelihood of financial distress, which could impair transparency.

Company Size and Corporate Governance: A positive correlation was observed between company size and the quality of corporate governance, particularly in terms of board independence and executive compensation. Larger firms tend to have more resources to implement stronger governance structures.

3. Regression Analysis

Multiple regression analysis provided further insights into the relationships between the variables.

Corporate Governance and Financial Integrity: The regression results showed that corporate governance mechanisms, particularly board composition and ownership structure, have a statistically significant positive effect on financial integrity. Firms with a higher proportion of independent directors and more concentrated ownership structures reported better earnings quality and greater financial transparency. These results support the idea that strong governance structures help mitigate risks of financial manipulation and foster trust in financial reporting.

Leverage and Financial Integrity: The regression analysis confirmed a significant negative relationship between leverage and financial integrity. Higher leverage was associated with lower earnings quality, suggesting that firms with high debt levels are more likely to engage in aggressive financial reporting or face challenges in maintaining transparency. This finding underscores the potential risks associated with excessive borrowing, particularly in firms with weaker governance structures.

Company Size and Corporate Governance: The interaction between company size and corporate governance mechanisms was also significant. The results showed that company size positively moderates the relationship between corporate governance and financial integrity. Larger firms, with more resources and greater regulatory oversight, exhibited stronger corporate governance, which in turn contributed to better financial integrity. This indicates that the complexity of governance structures in larger firms can lead to more effective monitoring and decision-making.

4. Robustness Checks

The robustness checks, including alternative measures for financial integrity and leverage, confirmed the stability of the results. When using different proxies for earnings quality (such as discretionary accruals) and transparency (based on the extent of regulatory compliance), the results remained consistent, reinforcing the validity of the findings.

DISCUSSION

1. Corporate Governance's Impact on Financial Integrity

The positive relationship between corporate governance and financial integrity highlights the importance of strong governance mechanisms in ensuring that companies maintain transparency, reduce earnings manipulation, and adopt sound financial practices. The findings suggest that independent boards play a crucial role in overseeing management and ensuring that financial reports accurately reflect the company’s performance. This is consistent with prior research, which emphasizes the role of effective oversight in maintaining financial integrity and reducing the potential for fraud or financial misreporting.

The ownership structure also emerged as a key determinant of financial integrity. Companies with concentrated ownership structures, particularly those with significant institutional ownership, tend to have better governance and more transparent financial practices. This may be due to the active monitoring role that institutional investors play in ensuring that companies adhere to high governance standards. On the other hand, firms with dispersed ownership may lack the incentives or mechanisms to ensure financial integrity, as there is less direct oversight by a controlling entity.

2. Leverage's Detrimental Effect on Financial Integrity

The negative relationship between leverage and financial integrity confirms the well-documented risks of high debt levels. Firms with excessive leverage are under greater pressure to meet debt obligations, which may lead to aggressive financial reporting to meet short-term targets or avoid default. This could explain the observed decline in earnings quality and financial transparency in high-leverage firms. High leverage increases the risk of financial distress, which in turn may incentivize managers to engage in financial manipulation to portray a healthier financial position than reality.

Furthermore, firms with high leverage may face increased scrutiny from creditors and investors, which could pressure them into adopting riskier financial strategies. This is especially problematic in the absence of strong corporate governance, as it may lead to further financial misreporting or manipulation.

3. Company Size as a Moderator

The results also suggest that company size acts as a moderating factor in the relationship between corporate governance and financial integrity. Larger firms, with more complex operations and greater access to resources, are better able to implement effective governance structures. These firms also face more intense regulatory scrutiny and have more sophisticated mechanisms for monitoring financial reporting. As a result, larger firms tend to maintain higher levels of financial integrity.

This finding suggests that governance alone may not be sufficient to ensure financial integrity in smaller firms, where resources and expertise for implementing strong governance may be limited. In these firms, the presence of independent boards and effective ownership structures may be less impactful due to the lack of scale and regulatory pressure.

CONCLUSION

This study provides valuable insights into the role of corporate governance in shaping financial integrity, with a focus on the interplay with leverage and company size. The key findings can be summarized as follows:

Corporate governance mechanisms, such as board independence and ownership structure, play a significant role in enhancing financial integrity by promoting transparency, reducing earnings manipulation, and fostering trust in financial reporting.

Leverage is inversely related to financial integrity, with high debt levels increasing the risk of financial misreporting and impairing the quality of financial information.

Company size moderates the relationship between corporate governance and financial integrity, with larger firms benefiting more from strong governance due to greater resources, complexity, and regulatory oversight.

The results of this study have important implications for policymakers, regulators, and business leaders. Companies, particularly those with high leverage or smaller scales, should prioritize strengthening their corporate governance frameworks to improve financial integrity. Moreover, the findings highlight the need for greater attention to governance practices in smaller firms, where the absence of robust governance mechanisms can exacerbate the risks associated with financial misreporting.

Future research could further explore the role of external factors, such as market conditions and regulatory changes, in influencing the relationship between corporate governance and financial integrity. Additionally, longitudinal studies could provide deeper insights into the long-term effects of corporate governance on financial performance and stability.

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