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Enhancing Financial Reporting Quality through Corporate Ethics Commitment

Noorul Azwin Md Nasir[1*], Hafiza Aishah Hashim[2], Noorshella Che Nawi[1], Mohd Nor Hakimin Yusoff[1] and Nur Athirah Mohd Aluwi[1]

[1]Faculty of Entrepreneurship and Business, Universiti Malaysia Kelantan, Malaysia
[2]Faculty of Business Economics and Social Development, Universiti Malaysia Terengganu, Malaysia

ABSTRACT

Objective - A rising number of cases involving ethical misconduct within firms have of late received considerable attention in Malaysia. Despite the country's declaring having a strong corporate governance policy, strengthened through the Code of Ethics for Company Directors and Malaysia Code of Corporate Governance, unethical practices, and lack of integrity within firms remain an issue. This paper aims to review the current implementation of corporate ethical conducts among corporate governance practitioners as well as factors that influence corporate ethics commitment in a firm.
Methodology/Technique – This paper is developed from extensive readings of previous literature on corporate governance practices and their effect on the quality of financial reports.
Findings - This paper discloses collective approaches of corporate ethics practiced in Malaysian firms and how the implementation has enhanced the firms' overall financial reporting quality. It demonstrates current issues and the importance of corporate ethics commitment to enhance financial reporting quality. Firms that emphasize ethical commitments, reduce the risk of financial statement fraud and firms will naturally gain trust from their stakeholders.
Novelty - This paper stresses the importance of sound ethical conduct above other factors that influence the financial reporting quality of firms in Malaysia. This paper is the result of extensive research on corporate ethics commitment and financial reporting quality.
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1. Introduction

Commitment to ethics appears to be important for any firm in today's complex markets. A rising number of cases involving ethical misconduct within firms have of late received considerable global attention following the collapse of several long-established firms worldwide.

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* Corresponding author: Noorul Azwin Md Nasir
E-mail: azwin@umk.edu.my
Affiliation: Faculty of Entrepreneurship and Business, Universiti Malaysia Kelantan, Malaysia

Incidents of ethical misconduct, such as the widely publicized Enron and Parmalat cases, were met with legislative remedies, including corporate governance-related legislation. Gula Perak, MEMS Technology, PuncakNiaga, Golden Land and Actacorp, Megan Media, Transmile, and Welli Multi have all been found guilty of ethical violations in Malaysia. Furthermore, recently, the Malaysian corporate environment was shocked by the news of Government-related corporations (GLCs) scandals such as 1Malaysia Development Berhad (1MDB), Lembaga Tabung Haji, Felda Global Ventures, and Khazanah Nasional Berhad with poor performance. Despite the loud declarations of having a robust corporate governance system in place, which has been further strengthened by the Malaysian Code of Corporate Governance (MCCG), unethical activities and a lack of transparency continue to be serious issues among Malaysian businesses. The ubiquitous nature of the problem has subsequently jeopardized the overall financial reporting quality of firms in Malaysia.

Through a survey report conducted by PricewaterhouseCoopers (PwC) Malaysia in 2018, it was found that 41 percent of Malaysian registered companies were guilty of committing some forms of economic crimes, specifically business misconduct, asset misappropriation, bribery, and corruption. However, PwC Malaysia indicated that the actual number may be higher due to many cases of ethical misconduct that typically go unreported. To add to the concern, crimes of ethical misconduct in Malaysia have also increased by 28 percent in the last two years. According to the same survey by PwC in 2018, corporate culture was revealed to be the most influential element in helping detect early warning signs of ethical misconduct within a firm. Many of the unethical activities found, according to a KPMG 2019 report issued the following year, are motivated by an irrational desire for a prosperous lifestyle. As a result, in light of the worsening condition of ethical misbehavior in Malaysian corporations, the necessity to research these corporate ethical concerns has never been more important or relevant.

Mat Norwani, Mohammad and TambyChek (2011) emphasize the significance and impact of corporate governance and financial reporting issues. In Malaysia itself, many scandals and financial issues arise as a result of a failure of corporate governance, which is connected with ethical issues and may have an impact on financial reporting. Kermis and Kermis (2013) said that accountants should have a strong relationship between professional ethics, personal ethics, and financial reporting regulations as it important aspect of dealing with financial reporting is responsibility and integrity. Adjusting the amount of revenue and expenses, window dressing, concealing any fraudulent activities, and so on are examples of poor corporate governance. This shows that ethics in financial reporting is important in producing a high-quality financial report. That is the purpose of the MCCG as it provides guidelines to corporate boards of directors on how to be independent and free of bias.

Indeed, the Malaysian government has always played a supportive and proactive role in combatting ethical misconduct in firms by ensuring that MCCG is properly revised and well-abreast of current development. In addition, the Securities Commissions of Malaysia (SCM) has developed the Corporate Governance Strategic Priorities 2017-2020, which focuses on five priorities: improving the regulatory framework for corporate governance, strengthening the corporate governance ecosystem, promoting greater gender diversity on boards, embedding corporate governance culture early in the life cycle of companies, and enhancing the corporate governance regulatory framework. By emphasizing on the relation between financial reporting quality and corporate commitment to business ethics, the public expects that firms will eventually result in being exceptionally virtuous with regards to their ethical commitment.

The purpose of this paper is to highlight the importance of corporate ethics commitment to enhance the financial reporting quality of a firm. The remaining sections begin with the literature review section, which includes corporate governance practice in Malaysia, the present setting of financial reporting quality in Malaysia as well as the theoretical consideration on the topic. Section for methodology later highlights the approach used in gathering the information included in this paper. Further, the discussion section emphasized the current issues in financial reporting quality and the importance of having a high corporate ethics commitment. Lastly, the conclusion summarizes the significance of the paper and potential ways to enhance corporate ethics commitment that can be applied by corporate governance practitioners.

2. Literature Reviews

Early studies on financial reporting quality in Malaysia focused on corporate governance, including the role of the board of directors and audit committee in leading corporate reporting. The increased demand for high-quality financial information has prompted policymakers to look for ways to encourage businesses to establish and disclose high-quality financial data. The Malaysian government has always played a supportive and proactive role in combatting ethical misconduct in firms by ensuring that corporate governance codes are properly revised and well-abreast of current development. The following section highlights corporate governance and financial reporting practices in Malaysia.

2.1 Corporate Governance in Malaysia

The High-Level Finance Committee on Corporate Governance in Malaysia provides the following definition of corporate governance:

The process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long-term shareholder value, whilst taking into account the interest of other stakeholders. (2003, p. 41)

Najmuddin (2008) contended that well-implemented corporate governance enhances and delivers universal human values of honesty, integrity, responsibility, and love. These principles can be attained by leading and managing a company's activities in the direction of corporate accountability, to maximize long-term shareholder value while also taking into account the interests of other stakeholders. Malaysia's Companies Commissions (CCM), Bursa Malaysia, SCM, and the Malaysia Institute of Accountants (MIA) are dedicated regulatory agencies that ensure good corporate governance. Other independent institutes were also established to promote a highly transparent corporate governance constitution in Malaysian public firms. The Malaysian Institute of Corporate Governance (MICG) is the most well-known organisation in Malaysia that focuses on corporate governance issues. The MICG is an independent corporate governance institute that was founded in March 1998 with the mission of raising awareness and ensuring good corporate governance in Malaysian businesses. MICG operates as an independent body in giving corporate governance ratings, in addition to being an authoritative facilitator and delivering continual education programmes for senior executives, investors, and interested parties MICG also deals with corporate governance concerns in addition to CCM, Bursa Malaysia, SCM, and MIA. MICG supports MCCG's presence by requiring that every public company's board of directors follow the corporate code of conduct outlined in their financial reports.

The Malaysian government is determined to produce a high-quality corporate financial reporting system as evident in Chapter 15: Corporate Governance by Bursa Malaysia and MCCG issued by SCM, which sets out the requirements that firms and their directors must comply with regards to corporate governance attributes and conducts. Important codes and requirements enable stakeholders to conveniently assess and evaluate the standards of a corporate governance structure being practiced in a firm. Generally, a corporate governance structure consists of two interdependent mechanisms: the board of directors and the audit committees. Both mechanisms are responsible for ensuring transparent and high-quality financial reports are produced (Rezaee, 2004). An effective corporate governance structure is essential to prevent fraudulent financial reporting (Beasley, 1996; García Lara et al., 2009; Perols and Lougee, 2011, MdNasir&Hashim, 2020) and earnings management (Dechow et al., 1996;Xu& Hong, 2016, Muda et al., 2018, Abdullah et al., 2018). A study by MdNasir, Ali and Ahmed (2019) also emphasized that firms convicted with financial reporting fraud issues subsequently improved their corporate governance practices after their conviction.

SCM has identified several criteria of excellent corporate governance practices for enterprises through MCCG to offer effective corporate governance conducts. According to MCCG, a good board will ensure that its responsibilities include planning, analyzing, and implementing the best practices that will help their companies operate better. In addition, a competent board will ensure that the company follows all laws, policies, and standards imposed by regulators and policymakers. The MCCG also underlines the audit committees' responsibility to conduct an in-depth analysis of quarterly and year-end financial reports and to provide confidence that the firm is adhering to all accounting standards and regulatory requirements. In addition, audit committees are in charge of ongoing problems, changes or adjustments in audit and accounting policies and practices in financial reporting. The ISA 240 on The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements highlights the accountability of an auditor to prevent and detect any financial statement frauds in a firm. Furthermore, according to ISA 240, the auditor must always be on the lookout for any prospective profits management actions that could result in improper accounting changes. Audit committees are significant because they aid in the strengthening of a company's corporate governance framework, particularly in spotting threats to financial reporting. Malaysian businesses have reaped significant benefits from altering their corporate governance systems by adopting policymakers' recommendations (MdNasir, Hashim&Mohd Said, 2020).

2.2 Financial Reporting Quality in Malaysia

According to Salleh, Stewart, and Manson (2006), high-quality financial reporting is free from misstatements, omissions, and biases. Equipped with high-quality financial reporting, Khan and Ibrahim (2015) posited that investors can then make better investment decisions. Transparent disclosure and reliable accounting information may help current and potential shareholders minimize their investment risks. In Malaysia, the complex interactions between managerial motivation, financial reporting standards, and legal enforcement create powerful incentives to change the financial records of a firm (Ho & Sia, 2009).

Previous studies have proxied financial reporting quality using the earnings management level. Definitions by Schipper (1986), and Healy and Wahlen (1999) are widely accepted where earnings management are divided into accrual and real based earnings management. Meanwhile, Yasser, Al Mamun, and Hook (2016) discovered mixed findings on the impact of a firm’s ownership structure on the financial reporting of East Asian countries, including Malaysia. The study revealed that firms convicted in fraudulent financial reporting in Malaysia are vulnerable to corporate governance ineffectiveness especially in controlling and monitoring earnings management practices of their firms. This argument is supported by an example made by Abdullah and Nasir (2004) who indicated that a firm with a higher proportion of independent directors on its board and audit committees is more likely to reduce its earnings management. Similarly, Saleh, Iskandar, and Rahmat (2005) contended that earnings management of a firm may decline if fully independent audit committees are on the board. Moreover, the authors also discovered that an increase in number of audit committees comprising of accounting experts and more frequent meetings can minimize a firm’s overall earnings management. On top of that, Saleh, Iskandar and Rahmat (2007) also provided evidence that earnings management is positively associated with a practice known as duality.

Bhattacharya, Daouk, and Welker (2003) stated that Malaysia’s firms are more likely to manipulate their financial records to provide more optimistic accounting reports and deceive financial statement users. With these circumstances in place, Leuz, Nanda, and Wysocki (2003) suggested that Malaysia is among several East Asian countries with a poor financial performance system and is involved in earnings management.

Bukit and Iskandar (2009) explained that earnings manipulation in Malaysia's firms ranges from financial statement fraud to earnings management. Therefore, to prevent fraudulent financial reporting, firms must start with minimizing their existing earnings management. Over the years, the Malaysian government has gradually improved its regulatory and enforcement measures with the purpose to increase the confidence of foreign investors in Malaysia's firms.

A study by Enomoto et al. (2012) on earnings management activities in 38 countries provided evidence that real earnings management activities are preferred over accruals earnings management in countries with a stronger investor protection system. The result of the study also indicated that Malaysia has an above-average investor protection system but weak legal enforcement activities. Consistent with their argument, the report stated that firms in Malaysia regularly engage in higher real earnings management compared to accruals earnings management. This is confirmed by MdNasir et al. (2018) which asserted that real earnings management was found to be more aggressive in firms with financial statement fraud in comparison to non-fraudulent firms in the four years before the committal of those frauds.

2.3 Theoretical Considerations

This paper incorporates corporate governance attributes of ethics commitment using stakeholder theory. The stakeholders of an entity can include managers, shareholders, investors, employees, customers, suppliers or other users of financial reports who are affected by the corporate actions, either directly or indirectly. Kaler (2006) proposed that stakeholder happiness should be considered as a level of stakeholder satisfaction when engaging with firms. This theory has been widely used in previous studies relating to corporate governance and ethics. In the opinion of Quattrociocchi, Sergiacomi and Mercuri (2020), stakeholder theory is a powerful way to explain, justify, and understand financial reports. A firm's corporate ethics commitment can be used by management to manage the information needs of its most powerful stakeholders and manipulate them to gain the support they need for survival. As stated by Mat Norwani et al. (2011), poor corporate governance can harm financial reporting quality due to a lack of transparency in financial reporting. Hence, effective corporate governance structures are important to prevent financial statement fraud and earnings management, which can also lead to low quality of financial reporting (MdNasir, Ali and Kamran, 2018). By having good corporate governance, firms managed to improve the quality of financial statement reporting through better policies, standards, and enforcement. This perspective suggests that corporate governance should aim to increase stakeholder engagement and organizational legitimacy

3. Methodology

This paper is drawn by examining previous academic literature in corporate governance, corporate ethics and financial reporting quality. It focuses on corporate governance and financial reporting practices in Malaysia. The article review process aims at strengthening existing literature by identifying the issues in financial reporting quality among public listed companies in Malaysia and indicating the importance of corporate ethics commitment to enhance financial reporting quality.

4. Discussions

4.1 Issues in Financial Reporting Quality Among Public Listed Companies in Malaysia

Several well-known Malaysian frauds, such as Transmile Group Berhad, Southern Bank Berhad, Megan Media Holdings Berhad, and 1MDB, have been linked to financial reporting manipulation. These firms defrauded their investors by providing deceiving financial reports resulting in massive losses for investors as a result of poor investment decisions based on misleading information. These financial reporting frauds not only reduced investors' trust in financial reporting but also raised concerns about Malaysia's low-quality financial reporting. To prevent these issues, Malaysia converged its accounting standards with the International Financial Reporting Standards on January 1, 2012, by enforcing the Malaysian Financial Reporting Standards. This adoption of global accounting standards aims to improve the quality of financial reporting in the long run. Investors can make better investment decisions if they have access to high-quality financial reporting (Khan and Ibrahim, 2015). Transparent disclosure and reliable accounting information may assist current and prospective shareholders in reducing investment risks.

Past literature shows that the authors have used earnings management levels to measure financial reporting quality. Kuo, Ning and Song (2014) and Darmawan and Mardiati (2019) classified earnings management as accrual or real based. Yasser, Mamun and Hook (2017) discovered the impact of a firm's ownership structure on the financial reporting of East Asian countries, including Malaysia. The study found that firms convicted of fraudulent financial reporting in Malaysia are vulnerable to corporate governance ineffectiveness, particularly in controlling and monitoring their firms' earnings management practices. Arieftiara and Utama (2018) reported that previous studies have shown that corporate governance influences the quality of financial reporting, earnings management activities as well as firm performance. Susanto and Siregar (2017) studied the effect of corporate governance mechanisms on financial reporting quality and discovered that corporate governance has a positive effect on financial reporting disclosure. Furthermore, neither the effectiveness of the board nor the size of the auditor has a significant impact on earnings quality.

Ghafoor, Zaunudin and Mahdzan (2019) highlighted that Malaysian firms tend to manipulate their financial records to provide more optimistic accounting reports and deceive financial statement users. This statement had been supported by Nasiri and Ramakrishnan (2020) as they reveal that managers in poorly managed companies have high potencies to abuse accounting powers, resulting in a decline in corporate performance compared to managers in well-managed companies. Moreover, the possibility of fraud proxies, multiple directorships, and audit quality are all associated with fraudulent financial reporting in a positive and significant way. Hasnan, Rahman and Mahenthiran (2013) discovered evidence of earnings management in the years preceding financial fraud reporting. Bukit and Iskandar (2009) explained that earnings manipulation in Malaysia’s firms ranges from financial statement fraud to earnings management. Therefore, to prevent fraudulent financial reporting, firms must start with minimizing their existing earnings management. A study by Enomoto et al. (2012) on earnings management activities in 38 countries provided evidence that real earnings management activities are preferred over accruals earnings management in countries with a stronger investor protection system. They also discovered that Malaysia has a high aggregate accrual earnings management score. This is confirmed by Md Nasir et al. (2018) which asserted that real earnings management was found to be more aggressive in firms with financial statement fraud in comparison to non-fraudulent firms in the four years before the committal of those frauds. Over the years, the Malaysian government has improved its regulatory and enforcement measures including corporate governance best practices with the purpose to increase the confidence of foreign investors in Malaysia’s firms.

4.2 The Need for Corporate Ethics Commitment to Enhance Financial Reporting Quality

It is a universally known fact that financial information is essential for various reasons. Firms continuously strive to enhance the quality of their financial disclosure and deliver financial reports that can reflect their positive achievement to their respective stakeholders. The financial reporting of a firm can be demonstrated through the publication of various documents of financial reporting including financial statements. According to Ham, Lang, Seybert, and Wang (2017), high-quality financial reporting is free from misstatements, omissions, and biases. Past studies have mainly focused on examining the mechanisms in improving financial reporting quality including obligating the presence of auditors.

Nevertheless, only a few studies were found to place considerable emphasis on the ethical and moral principles practiced by corporate governance practitioners of firms. In the context of Malaysia, the Malaysian Code of Corporate Governance directly emphasizes the role of the corporate board of directors and management in promoting ethical corporate conduct. This is reaffirmed by Abidin, Hashim, and Ariff, (2017) arguing that a board’s commitment towards business ethics is positively related to the firm’s financial performance. A study by Salin, Ismail, Smith, and Nawawi (2019a) posited that corporate governance practitioners need to provide a good example of ethical leadership and be consistently committed to building a good ethical work culture in their firms. A code of ethics established within a firm also needs to be consistently promoted, embedded, and enforced in the firm’s daily operations. In another study performed by the same authors (Salin, Ismail, Smith, and Nawawi, 2019b), it was found that a board’s ethical commitment strengthens the relationship between corporate governance and the firm’s overall performance. Examining the Korean Stock Market, Pae and Choi (2011) incorporated 636 firms from 2004 to 2008. Their results indicated that firms with a higher commitment to business ethics demonstrate better corporate governance practices and reflect the lower cost of equity capital.

Indeed, companies are required to have clear standards relating to corporate ethical obligations, and their executives are expected to keep a high level of discipline to avoid engaging in any unethical behavior in their commercial operations. Although a corporation's primary goal is to increase profits and maximize shareholder wealth, stakeholders' interests should also be considered because they play a significant influence in determining a company's overall performance. Stakeholders regard corporate ethics of a firm as a form of their social responsibility since they are closely associated to their professional commitment (Shafer, Simmons & Yip, 2016). The findings of the authors also exhibited a crucial stakeholders’ view of how a strong corporate ethics value is negatively associated with an intention to commit a financial fraud. The firm's agenda in raising stakeholder interest and maintaining a constructive social interaction between the firm and its stakeholders can be stated as the firm's commitment to business ethics. Furthermore, stakeholders are more drawn to organisations that have a high ethical commitment, as this commitment reflects one of the firms' obligations in maintaining their long-term success (Abidin, Hashim and Ariff, 2017).

Mitonga-Monga and Hoole (2018) investigated employees’ perception of corporate ethical commitment and their studies provided evidence that corporate ethical values significantly encourage employees to extend and continue to discharge their organizational commitment as they are equipped with perceived higher organizational justice. Furthermore, Alleyne (2016) examined the influence of corporate ethical values on the whistleblowing intention found in corporate firms. The study found that both organizational commitment and corporate ethical values are positively significant towards the whistleblowing intention of employees of a firm.

In Malaysia, the implementation of a whistleblowing policy in firms presents several challenges. These include a differential sense of loyalty among employees at different levels of power - between top management and other employees - fear of punishment, and a policy of not interfering in other people's personal lives (Nawawi&Salin, 2019; Rachagan&Kuppusamy, 2013). Such difficulties are one of the main reasons why many Malaysian companies' whistleblower policies are ineffective. As a result, numerous programs should be explored to ensure that a whistle-blowing policy can be implemented effectively in organizations, including encouraging the increased engagement of corporate governance practitioners in being more devoted in their practice of practical behavior. Furthermore, companies must constantly communicate their code of ethics to their employees to provide understanding (Merchant and White, 2017; Whyatt et al., 2012), affect their morale (Whyatt et al., 2012), build a strong ethical culture, and prevent unethical behavior (Whyatt et al., 2012). (Merchant & White 2017; Garegnani, Merlotti& Russo, 2015).

In 2014, Abidin et al. (2017) conducted a study on business ethical commitment and its impact on return on assets and return on equity across 243 publicly traded companies on Bursa Malaysia's Main Board in 2014. Based on the Ethical Commitment Assessment Items by Pae and Choi (2011), the study measured business ethics commitment using a total of six themes incorporating corporate ethical values, action to promote ethics, a whistle-blowing policy, a code of ethics, sustainability practices, and ethics committees as the modified Ethics Commitment Assessment Index. With a modified index that incorporated MCCG, their findings confirmed that commitment towards ethics is positively related to a firm’s overall financial performance.

Integrity, courage, compassion, loyalty, honesty, forgiveness, trust, optimism, and resilience are examples of ethical principles held by a firm (Laouisset, 2009). As a company strategy, disclosing information about ethics can provide value for shareholders (Ho& Taylor, 2013). Malaysian corporations are well aware of the value of corporate strategy disclosures (Zaini, Sharma, Samkin& Davey, 2019). Management must therefore be extremely devoted to and supportive of ethical ideals to instill an ethical culture within their organizations (Driskill, Chatham-Carpenter, &Mcintyre, 2019) and produce value for their companies. According to Schwartz (2013), the implementation of ethics programs is critical for firms to build an ethical culture. He went on to say that organizations may effectively create an ethical culture by promoting their core values among their employees through relevant programs and demonstrating the company's leadership commitment to ethics in general. Ethics programs, according to Abidin et al. (2017), should be part of a bigger system to foster an ethical culture in businesses. Managers are still primarily responsible for ensuring that ethical behavior is widely practiced throughout the organization and that unethical activity is strongly forbidden and condemned, both in principle and in reality.

In Malaysia, the rapid growth of the capital market naturally demands a higher corporate ethical commitment from firms. Based on previous literature discussed, it is found that only a limited number of studies have explored the importance of corporate ethics for firms’ financial reporting quality, possible factors that influence ethical decision-making in financial reporting issues as well as the tools of detecting early-warning signals for possible corporate misconducts.

5. Conclusion

This paper highlights the studies on corporate ethics commitment practiced by corporate governance practitioners in Malaysia. It explains the benefits of ethically committed governance on a firm’s overall value. Apart from external stakeholders, internal stakeholders can also benefit from a firm’s good ethical conduct. This paper demonstrates that a full understanding of the practice can further contribute to improving and maximizing the financial reporting quality of a firm. Companies that prioritize ethical obligations, whether within or outside their operations, frequently see an increase in their corporate values. Indeed, when businesses demonstrate their commitment to ethics in areas other than their core operations, such as environmental ethics, will gain stakeholders’ trust. In Malaysia, the escalating examples of corporate ethical misconduct have gotten a lot of attention. This study broadens practitioners of corporate governance in Malaysia's understanding of ethical practices. It also improves the moral awareness, intent, judgment, and behavior of ethical practices in public companies. Despite the statement of strong corporate governance, which has been strengthened by the Code of Ethics for Company Directors and the MCCG, unethical behaviors and a lack of integrity continue to distress Malaysian corporations. The government's demonstrations of commitment and effort will attract potential shareholders who are constantly looking for assurance and security in their investments. The rapid growth of Malaysia's capital market necessitates a higher level of corporate ethical commitment from firms. Based on the previous literatures reviewed, it is discovered that only a small number of studies have investigated the importance of corporate ethics for firms' financial reporting quality, possible factors that influence ethical decision-making in financial reporting issues as well as tools for detecting early-warning signals for potential corporate misconducts. To conclude, corporate ethics commitment is beneficial in enhancing a firm's financial reporting quality, resulting in a positive return in the firm's overall values.

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