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The Relationship Between Financial Reporting and the Forces Affecting Corporate Governance

SUMMARY

The article examines the relationship between financial reporting and corporate governance and its impact on corporate performance, highlighting the fundamental effects that have a significant impact on the functioning of modern companies. The research aims to explore how different stakeholders, such as shareholders, creditors and regulators, influence the quality of financial reporting and the evolution of corporate governance. The paper highlights the importance of the fact that the often divergent interests of managers and owners can generate agency costs, the extent of which owners seek to minimise by demanding reliable and timely financial information from management.

In addition, the research also addresses the role of creditors, who also contribute to ensuring greater transparency for companies, as they require detailed financial statements when competing for finance. This situation also has a significant impact on corporate governance practices, as in many cases lenders want to control the financial decisions of companies and therefore require regular financial and management information.

The article also highlights the growing role of CSR (corporate social responsibility) and ESG (environmental, social and governance) expectations in the evolution of financial reporting as companies respond to social, environmental and ethical expectations. These expectations impact not only on companies' reputations but also on their long-term financial performance, as investors and other stakeholders increasingly look for responsible companies that transparently communicate their long-term management objectives. Ultimately, the article also highlights the need for companies to not only comply with legal obligations through the development of their financial reporting, but also to consider the needs and expectations of various stakeholders, thereby contributing to the increasing level of corporate responsibility in the modern business environment.

Keywords: financial statement, corporate governance, CSR, ESG, stakeholders

JEL-codes : M41,G34,Q56,M14

INTRODUCTION

Disclosure of financial and business reporting is an important means of effectively communicating information to key users outside the organization. According to the literature, hypotheses and theories on information disclosure point to the impor-

tance of the positive economic consequences of appropriate disclosure. Butasan (1997) argues that extensive disclosure of corporate information can reduce the cost of capital and risk and increase the value of the firm.

Berle and Means introduced the concept of independent management in 1932. It also made two important points:

- company managers and owners may have different objectives
- the company is an organizational unit of society, where members of society spend a major and active part of their time, and therefore the company is not only responsible to its owners

In Jensen and Meckling (1986) and Leftwich, Watts and Zimmerman (1981), the different interest systems of management and owners were taken further and the agency relationship between the two was shown. He showed that the maintenance of this relationship is not based on mutual trust and therefore has additional costs of owner control. The more complex the company is, the more the agency costs increase because it costs more resources to ensure transparency.

According to the agent theory, because of differences of interest between managers and owners, owners seek contracts that minimize the differences of interest. The cost of agency contracts can be reduced by managers seeking reliable and timely accounting information that allows for greater transparency. Therefore, the role of financial reporting is significant in Jensen's model.

Glass-Steagall (1933) and the Investment Company Holding Company Act (1940) effectively prevented investment funds from exerting excessive influence and control over operating companies. This significantly increased the latitude of corporate managers from the 1940s to the 1970s. Meanwhile, small individual investors are increasingly putting their financial assets into various mutual funds, so that the share index traded in mutual funds is approaching 50% of household financial assets in the US market.

As Berle and Means point out, loss of investor control occurs when owners are dispersed. This process has prompted regulators to give investment funds greater scope, both in terms of access to information and in terms of increasing their ability to control and influence. Thus, Berle and Means' two-actor model has become a three-actor model with a role for investment funds in corporate governance.

Investors are usually interested in long-term success, while management often seeks short-term profits, which can sometimes conflict with long-term corporate interests. This dual perspective can raise several financial reporting issues, for example between reports to investment funds and investors and

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Table 1. Háztartások befektetéseinek részaránya az alapokban (%)

	Biztosító-társaságok	Befektetési alapok	Nyugdíj-pénztárak	Egyéb alapok	Összesen
1990	7,40	6,30	18,00	6,20	37,90
1991	7,40	6,60	18,20	6,80	39,00
1992	7,80	7,00	19,10	7,10	41,00
1993	8,30	8,00	19,50	7,50	43,30
1994	8,40	8,10	19,60	7,10	43,20
1995	8,50	8,70	20,20	7,90	45,30

source: OECD data 1997

more general corporate reporting. Interoperability between the two reporting processes should be ensured by finance and accounting processes.

The role of creditors should also be considered, namely what additional information they will request from the company's management and how the information they need to represent their interests with the owners will be provided. A further question is how much influence creditors can exert on dividend policy through the financial information they obtain. Besides the influence of creditors on financial statements, regulators also play an important role.

Here it is important to mention the public side, not as a public authority, but as a source of market incentives. In particular, the COVID19 period has seen an increase in public incentives to help the economy cushion the impact of the crisis. Significant public subsidies have required reporting obligations from market actors. These ongoing reporting requirements have had a significant impact on changes in financial statements.

The consumer side has also emerged, setting requirements as a societal expectation to comply with sustainability standards. CSR requirements for their ongoing disclosure and ESG requirements in reporting (Ogachi-Zeman, 2020) are a significant and strong influence on the themes of companies' financial reporting.

Considering the internal division of labor within the company, the fact that the company's business segmentation is also measured in financial terms due to the complexity of its business operations has a significant impact on the company's financial statements. In addition to objectively considering internal interests, it is important to interpret the financial statements at the segment or business unit level.

Taking into account the company's internal division of labor, the fact that the company's business segmentation is measured financially due to the complexity of business operations has an important impact on the company's financial statements. An important aspect here is the interpretation of financial statements at the level of segments or business units, in addition to considering internal interests objectively.

Finally, the company should also consider Big Data-driven analytics, where a significant amount of financial, business and other information about the company can be made available to market analysts. Understanding this can be an important consideration in the development of financial statements.

The importance of the role of financial statements was pointed out by Jensen and Meckling in providing a clear platform for reconciliation and disclosure between the divergent interests of the owner and the corporate management. Since then, financial statements have had to satisfy many more dimensions

and expectations simultaneously. This is due to the fact that the corporate environment is no longer a two-player, but the needs of all these stakeholders are reflected in the financial information. However, this does not deviate from the basic thesis of Berle and Means, where they argued that the corporation operates embedded in society. In our analysis, we try to find a link between ownership structure and corporate governance characteristics by explaining the evolution of financial statements. Our hypothesis is that the imprint of corporate strategic management practices is reflected in the form and content of financial statements. The inclusion in financial statements of the requirements of key users (owners, creditors, government, etc.) may be a legal requirement, may be a result of corporate measurement, and may be a result of both ownership and creditor structure

LITERATURE REVIEW

Ownership and creditor structure

Impact of ownership structure

The differences of interest between corporate managers and shareholders, as shown by Fama and Jensen (1983), are explained by the fragmentation of the ownership structure of the firm. If the fragmentation of capital ownership is greater, there is a greater risk of conflicts of interest between owners and the management that controls the firm. For this reason, some shareholders demand more information from managers to assess the true performance of the company (Lakhal, 2004). Accordingly, the provision of voluntary financial and management detail statements may become even more important in the presence of a higher degree of capital ownership fragmentation (Chau and Gray, 2002). Ho and Wong (2001), however, argue that in the case of firms with high ownership concentration, conflicts of interest arise mainly between majority and minority shareholders, and that in some cases the concealment of information serves the interests of managers to avoid fully satisfying the interests of minority shareholders.

However, Chau and Gray (2002) provide statistical evidence that for Hong Kong and Singapore companies, the wider the fragmentation of the equity ownership, the more voluntary financial detail statements are used. And Lakhal (2004) provided empirical evidence of a positive association between ownership fragmentation and forecast disclosure. However, the results of Raffournier (1995) and Naser et al. (2006) contradict this: they could not demonstrate a positive association between broad fragmentation of capital ownership and the level of mandatory disclosure.

Impact of leverage

Jensen and Meckling's (1976) agency theory suggests that there is an information asymmetry between creditors and the firm. Consequently, creditors introduce controls, the costs of which are borne by the firm. For the firm to reduce these costs and reassure creditors, managers need to disclose more information about the firm (Ahmed and Courtis, 1999).

According to Ahmed (1994), the disclosure of significantly more financial information is necessary for companies planning to raise capital and debt, as investors and creditors expect

this information to be made available. The debt risk estimated by creditors is minimized by the availability of information on the financial position of the business and on its “going concern”. The disclosure of financial and business information is intended to reduce the cost of debt financing and thereby ensure better control for creditors. Naser and colleagues (2006) and Barako (2007) have shown that there is a positive and significant relationship between disclosed financial and business information and the amount of debt raised, while Chow and Wong-Boren (1987) and Raffournier (1995) found no such relationship.

Ownership fragmentation and the amount of debt in the company are factors that influence the motivation and disclosure of voluntary financial and accounting information. However, the phenomenon of information asymmetry in the relationship between companies and creditors remains widespread.

Lender behaviors on dividend policy

A study by Julie Byrne and Thomas O'Connor (2017) examined how creditors influence corporate dividend policy in the context of different regulatory requirements for financial statements. The results showed that the relationship between dividends and creditor rights is strongly dependent on the regulatory environment, i.e., the environment of financial transparency of debtors. In environments with strong creditor rights the relationship is positive, while in environments with weak creditor rights the relationship is negative. In a transitional environment, weakly protected creditor restrictions lead to low corporate dividend payout acceptance by creditors, while in a strongly protected creditor rights environment, dividend payout acceptance is high.

However, the study does not examine how the culture of a particular country or region may affect the practice of accepting dividend payouts by creditors or the practice of declaring and reporting dividend payments. Previous research by Byrne and O'Connor (2017) has shown that culture has a strong influence on the relationship between willingness to pay dividends and creditor veto rights: environments with strong creditor rights have a higher willingness to allow dividend payments. The results suggest that further research on the interaction between the culture of a country or region and the willingness to pay dividends and creditor vetoes is worthwhile.

Overall, the results of the study can be seen as important implications for business practice, particularly in the area of dividend policy and creditor enforcement practices.

Debtor-shareholder conflict on investments

Several studies point out that debtors and equity holders have different investment preferences because of their different return structures in time and form, which can create conflicts of interest (Fama and Miller, 1972, Jensen and Meckling, 1976, Myers, 1977, Smith and Warner, 1979). Jensen and Meckling (1976) and Eisdorfer (2008) argue that shareholders and debtors face risk-taking conflicts when the firm is in financial difficulty, which can lead to potential risk-mitigating transactions such as asset swaps.

Analyses in this area focus on conflicts arising from investment preferences between shareholders and debtors. Creditors and shareholders often have different risk-taking interests due

to their different return structures in time and form. Managers may discourage risky acquisitions encouraged by shareholders by more quickly and emphatically factoring potential losses into financial statements and planning (Kravet, 2014). However, from the shareholders' perspective, this may also mean foregoing projects with positive NPV. Nevertheless, results show that a prudent loss recognition approach mitigates crises in corporate finance, which avoids asset swap-type transactions. This consciousness allows for better access to both credit and capital markets (Garcia-Lara, 2016). The structure and quality of financial statements can also further accentuate shareholder-debtor conflicts by allowing managers to base their investment decisions on them just below risk-taking thresholds by overemphasizing the need to take into account the ability to pay debt on a sustainable basis (Franz, 2014). Shroff (2017) also outlines a management-induced effect when accounting rules (goodwill or IFRS valuations) may be taken into account behind the modification of their investment decisions in order to avoid negative financial effects interpreted in the short term.

Specificities of the company, size - internal characteristics

Effects related to the age of the company

Studies on the mandatory declaration and the age of the company rely heavily on logical reasoning. Courtis (2004) argues that a long-established firm has certainly developed its own habits of financial information disclosure, with a well-developed information system and sophisticated communication strategies. These companies presumably use expert staff to provide clearer, more understandable and more detailed reports than newly established companies.

In his study, Akhtaruddin (2005) argues that larger firms are more experienced and therefore more likely to include in their annual reports economic and financial information that enhances their market image and reputation. Older companies have gained a competitive advantage in the market by establishing their position in the market and in the industry. Mature companies are therefore not afraid of market reactions when they disclose financial and business information because they have learned over time how to react to it. Older companies can gain a competitive advantage even at the level of the information disclosed.

Little research has looked at the age of the firm, which Camferman and Cooke (2002) mention as a new variable. Akhtaruddin (2005) examined the relationship between firm age and the level of voluntary financial and accounting statements and declarations. He was unable to provide statistical evidence of a positive relationship between the level of disclosure of financial and accounting information and the age of the firm. However, in his study, Alsaeed (2006) showed that there is a positive and significant relationship between the age of Saudi companies and the level of voluntary financial and accounting statements.

Company size

The relationship between voluntarily disclosed financial and accounting statements and the size of the firm is essentially explained by agency theory. According to Chow and Wong-Boren (1987), accounting practices and voluntary financial statement disclosure are used to manage conflicts of interest among shareholders, creditors and managers. This conflict of inter-

est depends on the characteristics of some firms. Depending on the amount of outside capital, Jensen and Meckling (1986) and Leftwich, Watts and Zimmerman (1981) argue that agency costs increase because outside capital increases the size of the firm, which also increases the need for transparency. However, this increases the importance of the contract between shareholders, creditors and managers.

In addition to the theory of agency, the theory of political costs was also examined. Indeed, large corporations face high visibility requirements and, as a consequence, the need for government intervention. In order to reduce political costs, larger corporations seek greater voluntary publicity to appease social and government groups (Watts and Zimmerman, 1978). It is also important to note that large corporations seek to maintain or increase their market share. For this reason, disclosure of positive financial and management information does not threaten their competitive advantage. According to Ahmed and Courtis (1999), larger companies disclose more information from their corporate portfolio and due to the presence of owners with different information needs. Most studies have been able to demonstrate a positive and significant relationship (with different levels of significance) between firm size and levels of voluntary financial and business disclosure (Raffournier, 1995 for Switzerland, Chow and Wong-Boren, 1987 for Mexico, Cooke, 1992 for Japan, and Zeghal et al., 2007 for Canada).

Multisegmented effect

In addition to shareholder-debtor conflicts, some studies have also examined how financial reporting affects investment within multi-segment companies. Stein (2003) reviews the literature on incentives within multi-segment companies and emphasizes that conflicts can arise when a (benevolent) CEO is faced with the additional costs of overseeing the management of divisions whose particular interests are often not necessarily aligned with those of central management, owners or creditors. Inadequate oversight can result in inefficient capital allocation across divisions, and it appears that accounting and controlling information can play a significant role in mitigating or resolving such conflicts.

Cho (2015) has investigated the effect of segmentation information on the allocation of capital within multi-segment firms. In his paper, he finds that the effect of an increase in segmentation information is to improve capital allocation within multi-segment firms. One of Cho's (2015) findings is that the introduction of segmentation potentially improved the information base of top managers. In a study of multinational firms, Shroff and colleagues (2014) find that financial and managerial information in foreign subsidiaries is more transparent where disclosures by competing firms also provide a significantly better information base for external users. This in turn reduces information asymmetry between parent and foreign subsidiaries. Shroff and colleagues (2014) argue that foreign affiliates' investment decisions are more sensitive to local growth opportunities when they operate in a more transparent information environment.

External industrial environment - competitive environment

Size of the audited company

According to Raffournier (1995), auditors generally play an important role in determining the financial communication

policy of their clients. Large audit firms encourage companies to disclose more audited information and to be more transparent. Smaller firms, on the other hand, do not influence their clients but try to adapt to their needs in order not to lose clients (Alsaeed, 2006). Large and internationally recognised audit firms have had a positive impact on the level of disclosure of their clients. But the empirical results are not clear at this level either. Camfferman and Cooke (2002) and Nasser (2002) find a positive and significant relationship between the size of the audit firm and the quality of the audited firm's disclosed financial and business information. Raffournier (1995) confirms this positive relationship while pointing out that the size of the audited firm may also influence the relationship. Ahmed and Courtis (1999), Ansah (1998) and Alsaeed (2006) find no relationship between firm size and the level of voluntary disclosure of financial and accounting information. However, Wallace and Naser (1995) found a negative relationship between audit firm size and the level of voluntary disclosure of financial information.

Type of industrial branch

The industry also needs to consider certain characteristics such as the degree of competition within the industry, product differentiation, industry structure (monopoly or oligopoly) and industry growth. All of these can cause differences in communication policies (Leventis and Weetman, 2004). Cooke (1992) argues that the manufacturing sector is internationally prominent, which has implications (Mallinguh-Wasike-Bilanzeman, 2022) for communication practices in this sector. Zeghal (2007) suggests a number of reasons why disclosure levels of financial information may differ across industries. Several previous studies use political cost theory here to derive how the type of industry may influence a company's voluntary disclosure level. Raffournier (1995) failed to confirm the relationship between industry type and voluntary disclosure levels of financial information. De Ho and Wong (2001) and Cooke (1992) have shown that manufacturing firms disclose more voluntarily than those in other industries. Zeghal (2007) argues that firms in the biotechnology industry disclose more about their research and development activities. According to Lakhal (2004), companies that belong to the high technology sector declare more about their earnings forecasts. He adds that companies in sectors exposed to significant price risk also declare more (Meriem Jouirou, Mohamed Bechir Chenguel, 2014)

Social expectations

Some studies have investigated how the relationship between EID (environmental reporting) and corporate financial performance changes over time and how it modulates corporate factors. The positive impact of public attention requires companies to proactively disclose their environmental information. This can help companies gain more market share. The researchers suggest that the monitoring system should be improved on social and environmental issues to minimise user uncertainty. The government should develop regulatory and support mechanisms. Polluting companies should disclose more environmental information and introduce quality environmental audits. Research should focus on highly polluting companies and future research should focus on companies in different sectors.

The impact of information exposure on firm performance is multi-faceted, but the relationship between them is not explicit. According to the principle of disclosure, the more information is disclosed, the more liquid securities become, which further reduces transaction and capital costs and improves firm performance (Bidhari, 2013). In addition, according to the theory of signaling, if information asymmetry between the firm and external stakeholders is reduced, the firm's reputation improves. Thus, investors are more willing to invest in securities that communicate credible information, even if the return is lower. And in the long run, most companies are willing to cooperate with environmentally responsible companies (Wang, 2020). As a result, the number of financing opportunities increases and financing costs decrease, which contributes to the increase in company profits. At the same time, as the content and extent of environmental reporting increases, the reputational value of the company improves and the liquidity of securities increases, further improving the financial performance of the company.

However, researchers relying on legitimacy theory take the opposite view (Aragon-Correa et al., 2015; Rassier and Earnhart et al., 2010). These studies indicate that corporate environmental disclosure is only a response to pressure to meet stakeholder requirements. In order to disclose beneficial information and meet stakeholder expectations, companies need to improve their environmental performance, which can lead to increasing costs and decreasing business performance (Liu and Zhang, 2016; Lynch, 2018). In addition, there is growing evidence that EID does not have a significant impact on corporate firm performance (Qiu, 2016).

Government expectations

Mandatory control and publicity requirements apply to the monitoring of aid. In the US, the United Auditing Act of 1984 and OMB Circular A-133 ("Audits of Municipalities, Local Governments and Non-Profit Organizations") require audits of grants made by state governments to corporations. At the federal level, several legislative initiatives, including the Administrative Procedure Act of 1946, the Access to Public Information Act, and the Spokesman's Protection Act of 1989, have sought to achieve greater transparency regarding public spending, including government grant funds.

In 2010, the New York Times spent 10 months researching business grants awarded in hundreds of cities, counties and states. Public interest activists, such as the Cato Institute and GJF, examined the details of the various subsidy programs and provided critical assessments. In addition, political parties and interest groups have monitored the behavior of their political opponents (Downs, 1957; Ingram, 1984; Carpenter, 1991).

Self-interested politicians are empowered as agents of the taxpayer, similar to the classic agency framework in which self-interested managers are agents of shareholders. The agent problem arises because politicians can abuse their power and misuse taxpayers' money. Thus, taxpayers want tight control and oversight of the subsidy distribution process. As Piotrowski and Van Ryzin (2007, p. 307) argue, "government transparency is a means of achieving accountability". Politicians can also increase their accountability by increasing accountability through transparency (Evans and Patton, 1987).

The transparency of subsidised companies can be useful for politicians, because it can protect them from negative publicity. In exchange for helping politicians to take their public accountability, corporations can strengthen their relationships with politicians and later benefit from these relationships (e.g. Shleifer and Vishny, 1994; Bertrand, 2018; Faccio, 2006; Goldman, 2009).

The assisted companies also provide information related to several aid objectives, such as information on capital investment and job creation, which are among the most common objectives of aid.

TEST METHODOLOGY

The depth and quality of financial and business reporting will be shaped by a wide range of influences on the company in the country/region, based on the aspects described in the literature summary above. The following are prominent strands of the impacts presented:

- specificities of the ownership structure
- internal effects due to the structure and operational characteristics of the company
- externalities, which are basically due to market and sector specificities.

The analysis methodology focuses mainly on internal effects and essentially on ownership and corporate governance determinants. The study examines the evolution of external financial and accounting disclosures in comparison with the evolution of corporate governance processes. The study considers the following main aspects of published statements:

- how much more they disclose to the company than is required by law (IFRS disclosure standards)
 - how much more they contribute to the company than the stock market information would require. This should also be examined where the company is not listed.
 - Examining the depth of CSR and ESG information
- The study also examines corporate governance changes in companies as an explanation for changes in the statements.
- independent BOARD design
 - BOARD membership trends
 - Independence of CFO and control functions
 - Ownership concentration
 - The emergence of business lines as profit centres in their own right
 - Corporate performance evolution (ROE level)
 - Evolution of leverage

The study horizon covers the period from 2010 to 2019. The research methodology presented above complements the doctoral research. That is, the changes in the corporate governance focal points established with the information obtained during the interviews are also examined in the above disclosure focal points.

The following external factors are also considered:

- evolution of expectations for public incentives and related financial and accounting statements
- changes in sectors, focusing mainly on competition and changes in technology and development
- investor/lender expectations
- the existence of fusion processes

Hypotheses for the conclusions*First expectation: H1*

Corporate governance processes alone will not determine the level and quality of external financial and business reporting. Essentially, statements to the outside world are long-term in nature and therefore serve either the interests of owners or investors.

Second expectation: H2

Monitoring requirements create the possibility of external control. A company that can only meet this level of disclosure is not exposed to strong market competition and has no incentives to attract investors or creditors.

Third expectation: H3

Data-intensive business or corporate governance (Advanced analytics, Big Data) increases the quality and depth of financial and business reporting to gain a competitive advantage.

CONCLUSION

The level of sophistication of the financial and business statements published at the time of external disclosure can be a good reflection of the significant influence of ownership, investor and creditor interests on strategy and the expectations of regulators. External statements on a voluntary basis can give companies a significant positional advantage in financing issues. This allows companies to increase their financial flexibility and thus to obtain more favorable financing costs.

Companies interested in growth and development have an advanced external publishing practice. The size and market share of a company can also have a significant impact on the depth and quality of its external disclosures.

The role of the state is interesting, and it is basically twofold. On the one hand, they ensure the statutory monitoring requirements, and, on the other hand, they can formulate external reporting requirements in order to obtain state subsidies. However, the latter tends to be the result of a conjuncture and is therefore not embedded in a lasting corporate publication culture.

One indicator of the changes in the ownership structure of a company is the quality and depth of voluntary financial and accounting disclosures. Examining this can therefore lead to a number of conclusions about the “battles” between ownership, investor, creditor and management interests and the validity of the strategic path that has emerged.

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