

THE MODERATING EFFECT OF CORPORATE GOVERNANCE STRENGTH ON THE RELATIONSHIP BETWEEN FAIR VALUE REPORTING AND STOCK RETURN VOLATILITY

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Abstract

The purpose of this study is to investigate the connection between stock return volatility and fair value reporting and to evaluate the moderating effect of improved corporate governance. Due to its capacity to offer more pertinent information on the worth of a company's assets and liabilities, fair value reporting has grown in importance within the accounting and finance literature, but at the same time, it increases uncertainty related to market fluctuations. The strength of corporate governance is believed to influence the extent to which fair value information impacts investor behavior and volatility of stock prices. Using a literature review methodology, this study looks at numerous publications, journals, and empirical studies of stock volatility, corporate governance, and fair value reporting. The literature analysis indicates that companies with stronger governance tend to be able to reduce the uncertainty created by fair value reporting, thus more controlling stock return volatility. These findings provide a theoretical understanding of the moderating mechanism of corporate governance in the context of fair value disclosure and its implications for the capital market, and open opportunities for further empirical research to quantitatively test this relationship.

Keywords: Fair value reporting, Corporate governance strength, Stock return volatility, Moderating effect

INTRODUCTION

This research is motivated by the increasingly complex dynamics of capital markets, which demand a high level of transparency and accountability from

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public companies. In this context, fair value reporting has become an accounting practice that has received significant attention, primarily due to its ability to more realistically reflect the worth of a business's assets and liabilities in light of the state of the market. When evaluating a company's financial performance and future prospects, investors and other stakeholders are thought to receive more pertinent information via fair value reporting. But there are drawbacks to this approach as well, especially when it comes to the volatility of stock market values. Because fair value is heavily influenced by changes in market prices and managerial assumptions, fluctuations can reflect high volatility in stock returns, thereby increasing risk for investors (Abu Alia et al., 2022).

Stock return volatility itself is an important indicator in assessing market risk. High volatility indicates uncertainty in investors' assessment of a company's performance, which can impact investment decisions, the cost of capital, and market perceptions of the company's stability. In this regard, mark-to-market fair value reporting serves a dual role. On the one hand, it provides transparent and accurate information regarding the value of a company's assets and liabilities. On the other hand, due to its sensitivity to market fluctuations, fair value reporting can also increase stock return volatility if not accompanied by effective control mechanisms (Jati et al., 2023). Therefore, it is important to understand the factors that can moderate the impact of fair value reporting on stock return volatility, one of which is strong corporate governance.

Strong corporate governance encompasses various practices and mechanisms designed to ensure transparency, accountability, and protection of shareholder interests (Thesing & Velte, 2021). These mechanisms include board of directors structure, audit committee oversight, management remuneration policies, and effective internal control mechanisms. Strong corporate governance is believed to mitigate the risks arising from fair value reporting by ensuring that fair value estimates are conducted objectively, accurately, and responsibly. Therefore, companies with good governance tend to be able to suppress excessive stock return volatility, even when implementing fair value reporting.

Various previous studies have shown that the relationship between fair value reporting and stock return volatility is not always consistent. Some studies find increased volatility due to fair value sensitivity to market conditions, while others suggest that transparency resulting from fair value reporting can actually reduce volatility by increasing investor confidence. This

inconsistent finding opens up an opportunity to explore the role of corporate governance as a moderating variable that can explain these differences. By understanding the interaction between fair value reporting and corporate governance strength, this study aims to contribute to the accounting and finance literature, particularly in the context of mitigating market risk through effective governance practices.

Furthermore, this research has practical relevance, particularly for investors, company management, and regulators. Investors can use information about corporate governance strength as a consideration in making investment decisions, while company management can improve governance practices to mitigate the negative impact of fair value reporting on stock return volatility (Thesing & Velte, 2021). Regulators can also utilize this research's findings to strengthen financial reporting guidelines and corporate oversight mechanisms, thereby creating a more transparent and stable capital market (Mansour et al., 2022). Thus, this study offers specific consequences for corporate governance procedures and market risk management in addition to addressing the scholarly requirement to comprehend the effects of fair value reporting.

In light of this, the study's main objective is to investigate how corporate governance strength affects the correlation between fair value reporting and stock return volatility. It is anticipated that this method will offer a more thorough understanding of the ways in which intricate accounting procedures and corporate governance systems interact to impact stock market dynamics, thereby aiding in the advancement of risk management and financial accounting theories and practices.

RESEARCH METHOD

This research method uses a literature review approach to analyze the moderating effect of corporate governance strength on the relationship between fair value reporting and stock return volatility. This approach involves collecting, evaluating, and analyzing various secondary sources, including scientific articles, academic journals, financial reports, and previous research relevant to the topic. The selected literature focuses on research addressing fair value reporting, corporate governance, and stock return volatility, both theoretically and empirically, to build a comprehensive conceptual framework. The analysis is conducted systematically to identify relationships between variables and examine how corporate governance can strengthen or weaken the effect of fair value reporting on stock price fluctuations.

The literature review process involves identifying primary literature, synthesizing previous research findings, and assessing the quality and relevance of existing studies. The researcher emphasizes understanding the theoretical mechanisms underlying the connection between stock return volatility and fair value reporting, as well as the moderating effect of strong corporate governance. A conceptual analytical framework that explains the relationships between variables, serves as a foundation for additional research, and provides insights into efficient financial reporting procedures and the consequences of corporate governance for stock market stability is then developed using the findings of the literature review.

RESULT AND DISCUSSION

The Concept of Fair Value Reporting

The fair price that is, the amount that would be received to sell an asset or paid to transfer a liability in an arm's length transaction between market participants at the measurement date is the basis for measuring assets and liabilities in fair value reporting. International accounting regulations, particularly International Financial Reporting regulations (IFRS), provide specifics on this idea, such as IFRS 13 on "Fair Value Measurement." This standard establishes the basic principles of fair value measurement, including the use of market assumptions, risk adjustments, and a three-level measurement hierarchy that considers both directly observed data and model-based valuation techniques. The primary emphasis of fair value is on reflecting the current economic value of an asset or liability, rather than the historical cost incurred at acquisition. This aims to provide more relevant and up-to-date information for users of financial statements, particularly investors and creditors, in making rational economic decisions ("PRIMENA KONCEPTA FER VREDNOSTI U FINANSIJSKOM RAČUNOVODSTVU I IZVEŠTAVANJU U USLOVIMA KRIZE," 2023).

In practice, fair value differs fundamentally from historical cost accounting. In historical cost accounting, assets and liabilities are valued according to their initial purchase price, which is subsequently modified over time for depreciation or amortization. Because the recorded value doesn't change unless specific things happen, like a sale or impairment, this strategy is typically stable and cautious. Fair value reporting, on the other hand, adjusts the value of assets and liabilities on a regular basis in accordance with the state of the market. For instance, changes in market pricing, liquidity, and other risk variables may cause the fair value of a property or financial investment to vary

with each reporting period. This difference indicates that fair value is more dynamic and sensitive to external conditions, while historical cost focuses more on costs that have already been incurred and provides stability in financial reporting.

Fair value has many advantages in financial reporting, especially when it comes to making the information more relevant to stakeholders. Fair value enables management, investors, and analysts to more precisely evaluate a company's financial situation and make more accurate forecasts of future performance by reflecting the present worth of assets and liabilities (Elgabali, 2020). Furthermore, implementing fair value can increase transparency, particularly in liquid markets, as it reflects prices that can be exchanged in the open market. Fair value also facilitates comparisons between companies in the same industry, as measurement based on market value creates uniformity in reporting.

However, the use of fair value is not without risks and challenges. Fair value is highly dependent on available market data; for illiquid assets or inefficient markets, fair value assessments can be subjective and susceptible to manipulation. Uncertainty in estimates and valuation models can lead to high volatility in income statements, thus creating a perception of risk for investors. Furthermore, fair value can encourage companies to employ opportunistic accounting strategies, such as overvaluing assets during market upswings or overvaluing assets during market downturns (Luty et al., 2024). Therefore, international accounting standards emphasize the need for adequate disclosure regarding the valuation methodology, the assumptions used, and the impact of changes in fair value on the financial statements.

Stock Price Volatility

A key idea in finance and investing, stock price volatility represents the degree of changes in stock prices over a given time frame. To put it simply, volatility is a measure of the risk involved in stock price fluctuations; the higher the volatility, the more uncertain the stock's future value is. The standard deviation of stock returns over a specified time period is sometimes linked to the formal definition of volatility. Stock returns are typically calculated as the percentage change in stock prices from one period to the next, and volatility provides an indication of how much those returns fluctuate around their average. In practice, volatility can also be measured using other methods such as variance, beta versus a market index, or through econometric models that capture more complex stock price dynamics, such as the ARCH (Autoregressive

Conditional Heteroskedasticity) and GARCH (Generalized ARCH) models, which capture the clustering nature of volatility that often occurs in capital markets. Thus, volatility measurements serve not only as risk indicators but also as tools for investors and portfolio managers in making investment and risk management decisions (Hewamana et al., 2022).

Stock price volatility is influenced by various factors that can be categorized as internal and external. Internal factors stem from the company's own characteristics, including financial performance, capital structure, profitability, and operational strategy. Companies with stable performance and consistent cash flow tend to have lower volatility than companies with fluctuating performance or relying on high-risk projects (S. Liu et al., 2023). Furthermore, dividend policy, product innovation, and earnings announcements also play a role in influencing investors' perceptions of the company's stock risk. External factors, on the other hand, stem from market conditions and the broader economic environment. Macroeconomic conditions, interest rates, inflation, market liquidity, and political and regulatory turmoil significantly influence stock price volatility. Changes in commodity prices, global market sentiment, and unexpected events such as financial crises or pandemics can also increase sudden stock price fluctuations. The interaction between these internal and external factors makes volatility a dynamic variable that constantly changes according to the surrounding conditions.

The relationship between financial statement disclosure and stock price volatility lies in the role of information in shaping investors' risk perceptions (F. Liu et al., 2023). Complete, accurate, and transparent financial reports provide investors with a basis for assessing a company's performance, financial structure, and future prospects. Good disclosure can reduce uncertainty and limit market overreaction to rumors or partial information, thereby reducing stock price volatility. Conversely, minimal or misleading disclosure can increase uncertainty, fuel speculation, and lead to sharper price fluctuations (Shakil, 2022). Furthermore, the way information is presented, for example, using fair value versus historical cost measurements, can influence investors' risk perceptions of a company's assets. Investors, assessing risk based on available information, adjust their return expectations, and these changes in expectations are reflected in stock price volatility. Therefore, financial statement disclosure is not only a regulatory compliance instrument but also a strategic tool capable of influencing market stability and stock price efficiency.

Corporate Governance and Its Strengths

Corporate governance is a collection of connections, procedures, and systems used to guide and manage a business. This idea highlights how crucial it is to balance the interests of many stakeholders, such as shareholders, management, the board of directors, staff, clients, and outside parties like regulators. Good corporate governance focuses not only on regulatory compliance but also emphasizes the principles of transparency, accountability, and integrity in corporate decision-making. Theoretically, corporate governance can be explained through several theoretical frameworks. Agency theory, for example, highlights conflicts of interest between management and shareholders, which can be minimized through effective oversight mechanisms (Martínez-Ferrero & García-Meca, 2020). Meanwhile, stakeholder theory broadens the perspective by emphasizing that companies have responsibilities not only to shareholders but also to all stakeholders who may be affected by corporate decisions. Furthermore, financial theory and legitimacy theory are often used to understand how corporate governance practices affect a company's value and public perception of its credibility. In this context, the strength of corporate governance is a crucial factor in determining the extent to which corporate governance is able to maintain a balance between internal control and external accountability. The strength of corporate governance can be measured through several interrelated indicators. One key indicator is the structure of the board of directors, encompassing the composition of board members, the proportion of independent directors, and the existence of supporting committees such as the audit committee, remuneration committee, and nomination committee (Larcker & Tayan, 2020). An effective board structure can improve management oversight, minimize conflicts of interest, and strengthen rational decision-making mechanisms. Another indicator is share ownership, which reflects the extent to which shareholders can influence the company's direction. Concentrated ownership, for example by a major shareholder, can strengthen internal controls but also poses the risk of domination that disregards the interests of minority shareholders. Conversely, dispersed ownership can promote transparency and accountability but may reduce the effectiveness of strategic oversight. Other oversight mechanisms include the role of external auditors, risk management systems, and regulatory oversight. These systems act as extra safeguards to guarantee the accuracy of financial accounts and adherence to relevant laws. Lastly, information transparency is a crucial metric since a company's accountability to stakeholders is reflected in the caliber of its financial and non-financial

disclosures. A high degree of transparency boosts market trust by enabling stakeholders to evaluate a company's performance, risks, and strategy in an unbiased manner.

The impact of strong corporate governance on the quality of financial reporting and stock market stability is significant. Companies with strong corporate governance tend to produce more accurate, relevant, and reliable financial reports due to strict internal oversight mechanisms and transparent disclosure practices. High-quality financial reports, in turn, increase investor confidence and reduce the risk of information asymmetry, a key factor in market volatility (Primec & Belak, 2022). Furthermore, effective corporate governance can reduce the likelihood of financial statement manipulation or misuse of company resources, thereby strengthening financial stability and capital market credibility. From an investor perspective, companies with strong governance offer greater certainty regarding investment risks, which can encourage capital flows and strengthen market liquidity. Empirical studies also show that companies with better corporate governance indicators, such as strong independent boards and high information transparency, have lower stock price fluctuations and more stable returns. This confirms the role of corporate governance not only as an internal tool to improve company performance but also as an external instrument that can influence market perceptions and support overall financial system stability (Beck & Brødsgaard, 2022).

Overall, corporate governance and its strengths are a crucial foundation for building responsible, transparent, and sustainable companies. By addressing key indicators such as board structure, share ownership, oversight mechanisms, and information transparency, companies can improve the quality of financial reporting and strengthen stock market stability. Strong corporate governance creates synergy between internal control and external accountability, ultimately supporting the growth of company value and the long-term trust of all stakeholders. Understanding and applying this concept are increasingly crucial in the era of globalization and digitalization, where transparency and integrity are key criteria for assessing a company's reputation and sustainability.

The Relationship between Fair Value Reporting and Stock Return Volatility

In accounting and finance literature, fair value-based financial reporting has gained significant attention, especially in relation to its effect on stock price volatility. In order to give investors and other stakeholders more pertinent and

transparent information, the idea of fair value reporting refers to documenting assets and liabilities based on estimations of current market worth rather than historical cost. This approach makes reported asset values more responsive to changing market conditions, increasing the potential to reflect risks and opportunities in real time. However, this responsiveness also has the potential to lead to sharper price fluctuations, giving rise to debate regarding the effect of fair value on stock volatility (Bollerslev et al., 2020).

Theoretically, fair value reporting can influence stock price volatility through the information mechanism conveyed to the market. On the one hand, the use of fair value allows investors to assess a company's financial position more accurately and up-to-date, thus facilitating more informed investment decisions. With more complete and relevant information, the risk of information asymmetry can be reduced, and investors can assess company risk more rationally. Under these conditions, stock price volatility can decrease because market prices more consistently reflect investor expectations and valuations (Tasnja et al., 2020). On the other hand, because fair value is highly sensitive to market changes, financial statements can show sharp fluctuations in assets and liabilities, especially for financial instruments whose values are strongly influenced by macroeconomic conditions or market liquidity. This can increase investor risk perception and, consequently, increase stock price volatility.

Several empirical studies have explored the relationship between fair value reporting and market risk. Research by (Dai et al., 2020) shows that fair value-based financial statements tend to provide more relevant information to investors, but is also associated with increased stock price sensitivity to changes in asset values. Another study by (Just & Echaust, 2020) emphasizes that fair value can amplify market reactions to economic shocks, because fair value fluctuations are immediately reflected in financial statements. Empirically, several studies have found that stock price volatility increases in companies that widely adopt fair value reporting, particularly for complex financial instruments or illiquid markets. However, other research suggests that greater transparency in fair value reporting helps reduce long-term volatility by reducing information uncertainty and increasing investor confidence in financial reports.

Analysis of the positive and negative effects of fair value reporting on investor perceptions emphasizes the dual role of financial reporting. Positive effects are seen in increased transparency and relevance of information, which allows investors to more accurately assess company risk, thereby minimizing

investment decisions based on incomplete or outdated information. This can support long-term stock price stability and increase market liquidity. Negative effects arise when changes in fair value cause financial reports to display significant fluctuations in earnings or assets, thus increasing perceived market risk. Investors who overreact to changes in fair value can exacerbate short-term stock price volatility, especially in speculative or illiquid markets. Thus, fair value reporting has a dual effect: it improves information quality while potentially increasing stock price sensitivity to market changes (Joo & Park, 2021).

Furthermore, external factors such as macroeconomic conditions, market liquidity, and the complexity of financial instruments also moderate the relationship between fair value and volatility. Companies with complex asset structures or high exposure to derivative instruments tend to be more vulnerable to volatility due to changes in fair value. Meanwhile, in stable and liquid markets, the effect of fair value on volatility may be more manageable because investors can assess changes in fair value more rationally. Therefore, the relationship between fair value reporting and stock return volatility is contextual, influenced by company characteristics, the market, and investor behavior.

In general, investor views and stock price dynamics are significantly influenced by fair value reporting. Investors' capacity to evaluate risk and make investment decisions is improved by the transparency and applicability of the data produced by this method. However, there is a chance that stock price volatility will rise due to fair value's susceptibility to market changes, particularly in very uncertain times. In order to reconcile information quality with market stability, businesses, regulators, and investors must have a thorough grasp of how fair value affects volatility. To better understand how fair value reporting affects market risk and investor perceptions, more study is needed on variables that temper this relationship, such as the complexity of financial instruments and the effectiveness of corporate governance.

The Moderating Effect of Corporate Governance

One important topic in the accounting and finance literature is the moderating role of corporate governance in the relationship between fair value reporting and stock price volatility. The structures, procedures, and practices that guarantee business management operates in the best interests of shareholders and other stakeholders are conceptually referred to as corporate governance. In actuality, corporate governance includes share ownership, board composition, internal and external oversight mechanisms, and

transparency and quality of information disclosure. Agency theory serves as the primary basis for understanding the role of corporate governance as a moderating variable. This theory emphasizes the potential for conflicts of interest between management and shareholders, which can impact the quality of financial reports and investor risk perceptions (Buertey et al., 2020). When corporate governance is strong, effective oversight mechanisms can suppress opportunistic management behavior, improve the accuracy of fair value disclosures, and reduce investor uncertainty, which in turn has the potential to dampen stock price volatility.

In the context of fair value reporting, the practice of measuring assets and liabilities based on fair value can increase transparency but also creates uncertainty due to rapid changes in market values. Stock price volatility arises when investors interpret fair value-based financial reports as indicating higher or lower risk, depending on the quality and credibility of the information presented. Strong corporate governance can serve as a moderator by providing mechanisms that ensure fair value disclosures are consistent, accurate, and transparent. These mechanisms can include an independent audit board, a risk committee, or a robust internal control system. With strict oversight and high transparency, the effect of fair value fluctuations on investor risk perceptions can be minimized, preventing excessive stock price volatility. Theoretically, this moderating effect explains that the relationship between fair value reporting and stock volatility is not linear and absolute, but rather is influenced by the strength and quality of a company's corporate governance (Buertey et al., 2020).

Research models used to test the moderating effect of corporate governance typically involve regression analysis with interactions between independent and moderating variables. For example, stock price volatility can be the dependent variable, fair value reporting the independent variable, and corporate governance the moderating variable. A moderated regression model would include an interaction term between fair value reporting and corporate governance to determine whether the strength of corporate governance changes the direction or strength of the relationship between fair value disclosure and stock volatility. Several studies also use panel data models to control for firm heterogeneity and time changes, thus more accurately estimating the moderating effect. This approach allows researchers to capture the dynamics of corporate governance's influence in a capital market context sensitive to fair value information.

Previous empirical studies have shown mixed results regarding the moderating effect of corporate governance. Some studies found that strong corporate governance reduces the sensitivity of stock price volatility to changes in fair value, suggesting a positive moderating effect in enhancing market stability. Other studies found that certain governance mechanisms, such as independent audit committees or substantial institutional ownership, are more effective in buffering the negative impact of fair value fluctuations than simple board structures (Lu, 2021). This finding is consistent with the argument that not all aspects of corporate governance have the same influence, and therefore the effectiveness of moderation depends on the quality and comprehensiveness of the implemented oversight mechanisms. Furthermore, several cross-country studies have shown that the regulatory context and market culture also influence the strength of the moderating effect. In countries with strong legal systems and market regulations, corporate governance has been shown to be more effective in dampening stock price volatility caused by fair value fluctuations. While in developing countries, the moderating effect tends to be weaker due to weak oversight mechanisms and limited transparency (A.A. Zaid et al., 2020).

Overall, the moderating effect of corporate governance on the relationship between fair value reporting and stock volatility emphasizes the importance of quality corporate governance in creating stable and transparent capital markets. Agency theory, internal monitoring mechanisms, and empirical interaction regression models provide a robust analytical framework for evaluating how corporate governance can minimize uncertainty and information risk. Findings from various empirical studies demonstrate that corporate governance is not merely a regulatory formality, but a key factor moderating the influence of fair value disclosure on investor perceptions and stock price fluctuations in modern capital markets.

CONCLUSION

The conclusion of this study confirms that the implementation of fair value reporting has a significant impact on stock return volatility, with increased use of fair value tending to increase stock price fluctuations due to estimation uncertainty and sensitivity to market changes. This finding aligns with previous literature showing that fair value-based financial reporting can increase relevant information for investors, but also introduces volatility risk due to the subjectivity of the valuation of certain assets and liabilities.

Furthermore, this study demonstrates that strong corporate governance acts as a moderating variable, reducing the negative impact of fair value reporting on stock return volatility. Companies with stronger governance mechanisms, including board oversight, effective audit committees, and transparency in disclosure, are more likely to withstand stock price fluctuations arising from fair value uncertainty. These results emphasize the importance of integrating robust governance practices to enhance capital market stability and investor confidence in the financial information presented.

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