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The Effect Of The Rules Of Corporate Governance On The Financial Performance In Iraq

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Abstract

The importance of corporate governance increased after the 2008 financial crisis that affected the United States and worldwide. Its importance stems from its contribution to achieving economic development and overcoming financial crises. It improves economic efficiency and economic growth. The research focuses on the corporate governance rules and demonstrates the impact on financial reporting in Iraq. The relationship between corporate governance and financial performance received wide attention from researchers in the last decade. However, several researchers have investigated the connection in the past. The mixed findings of the research cast doubt on the notion of a direct and universal relationship between corporate governance rules and financial reporting. The researcher examines the issue to address the effect of corporate governance's rules on financial reporting issues in Iraq. The researchers use the descriptive and analytical approach in conducting the study. They collect the primary and secondary data using a questionnaire by distributing it to one hundred and fifty Board of Directors and executives serving the joint-stock companies listed on the Iraq Stock Exchange. The statistical analysis program (SPSS) analyzes the data and tests the hypotheses in analyzing data and testing. The study found a range of crucial results relating to the governance rules. The rules significantly enhance the quality of financial reports.

Keywords: the rules of corporate governance, financial performance

JEL Classification: G34, G32

1.Introduction

The corporate governance (CG) term is familiar in the culture of companies and investors in Iraq. They used it a long time ago. The agency theory of CG belongs to the American scholars Beris and Means. Governance importance increased remarkably during the last three decades due to the transformation of the capitalist economic systems. The private companies adopted CG to a large extent to achieve high and continuous economic growth rates. The expansion of the enterprises' size led to separate ownership from management. The companies began searching for financing sources with less cost than the banking sources, so they moved to the capital markets. The world witnessed liberations of capital markets that supported the move, thus transferring the capital across the borders and increasing unprecedentedly (Nassar & Jreisat,2020).

Moreover, the companies' size expansion and separation of ownership from management led to the weakness of observation of managers' behaviors. Many companies in East Asia and the USA experienced financial crises. They witnessed the scandals of the audit committee and the lack of proper management in observation and supervision. Financial reporting quality was poor due to weak skill and experience, lack of transparency, and ignoring the application of accounting principles. Therefore, governance rules and controls aim to achieve justice and transparency and provide responsible company management. The shareholders obtain protection and provide attention to the interests of workers and laborers, limit the exploitation of power beyond public interests, and develop the financial reporting quality (Bhatt, P. R., & Bhatt, R. R.,2017).

Recently, due to fluctuations in the global markets and shareholders' companies, there has been a decline in profits because the investors' lost their confidence in the validity of financial reporting. Some companies manipulated the financial reports, and with the decline in stocks and profits, the owners found a quick solution to reduce and solve the problems. They introduce the governance rules to eliminate manipulation of financial reporting, maintain its quality and restore investor confidence by creating a supervisory, sophisticated and effective role (Al-Taie et al., 2017).

Therefore, due to the deterioration of confusion in the global economy, it is necessary to use the CG rules to rectify the problems in the joint-stock companies. It minimizes the risks and debts by detecting any attempt to manipulate the financial statements. The primary and micro firms seem particularly apprehensive after a decline in profits that hinder the significant companies from moving forward and displaying transparent and quality financial reports in the Iraqi market. Corporate governance is one of the practical tools to encourage investment in the stock market. It affects stock prices, as the stock markets need many elements to lift the degree of efficiency by promptly presenting the necessary information to investors (Al-Tamimia, 2020).

2. Literature Review

Firms' boardroom independence

The literature on the relation between board independence (as a corporate governance device) and firm performance indicates a significant growth, maintained by the studies conducted in developed and developing countries. The realization of CG motivates the growth in the literature since the market system cannot address the agency's problems. However, the literature suggests the principal techniques to alleviate the agency problem. Fama (1980) argues that the managerial labor market recognizes every manager's current and previous performance and cannot recognize reliable and unreliable managers. The market mechanism provides an incentive for managers to promote shareholder wealth and deter the pursuit of interests that jeopardize the firm's wellbeing. Another market mechanism for dealing with the agency problem is a corporate takeover. Managers of poorly performing firms risk losing their jobs once another firm takes over the office. Fearing such a prospect, managers act as a team, realizing that job security is dependent on every manager's performance in the team (Ahmadu et al.,2011).

The company provides incentives to each manager to monitor the behavior of the other managers in the team. Without pre-empting the outcome of the literature review, it is crucial to stress that in Iraq and other developing countries, weak institutional structures and the issue of corruption are prevalent, and it limits the ability of the market to discipline weak-performing managers. Umaah Alsmmarraie (2018) asserts that to ensure managers feel the ambiance of disciplining pressure of the capital market, the rights of the individual shareholder (particularly the voting rights), the country's legal system must enforce the law. However, the legal institutions in Iraq are weak. It limits the ability of the capital market to impose the necessary disciplinary mechanism (Ibrahem & Elshanawany,2021).

Generally, Iraq neglects the issue of board independence and corporate governance. In November 2003, Iraq developed a code of corporate governance. The following section discusses a specific set of recommendations on promoting board independence and corporate governance. The relative negligence of corporate governance in Iraq's public policy reflects the paucity of research in this area in the country (Al-Tamimia,2020).

Audit committee quality

The concept of corporate governance became prominent in the 1980s when the stock market crashed in different parts of the world, and corporations failed due to poor corporate governance. It forced the corporate governance codes to change according to the attitude change and the higher performance expectations placed on management boards. They are responsible for ensuring that firms perform effectively in the right direction. Mautz (1979) and Neary (1979) view the Audit Committee as a helpful device that provides security in corporate governance. In 1999, the Audit Committees gained significant acceptance by forming specialized committees such as the Blue-Ribbon Committee (BRC). Jonas (1999) and Young (1999) point out that concepts such as board accountability and Audit Committee effectiveness are essential topics of discussion in today’s corporate environment. They have become the subject of corporate governance studies and surveys.

Shankaraiah & Amiri (2017) opined that Audit Committees increase assurance against catastrophic failure and gross malfeasance, offering improvements on a broader front and raising the overall standard of corporate governance for all the companies that establish Audit Committees. Whereas Puri et al. (2010) point out that Audit Committees promote part of corporate governance reforms, audit committees’ mechanisms guide the board of directors to adopt better corporate governance practices. Furthermore, when presenting the importance of the Audit Committee as a mechanism for corporate governance, they point out that the US Securities and Exchange Commission's (SEC) initiation help in focusing on the financial reporting and structure of audit committees. It helps the movement towards progressive corporate governance, including regulatory and voluntary measures to improve overall board independence and oversight. It is, therefore, totally consistent that Good Corporate Governance practice points to the Audit Committee as the focal point for improvements in financial reporting (Namakavarani et al., 2021).

3. Application of Agency Model

In 1776, Adam Smith revealed the agency problem, noting that managers in-charged of other people's money were not trustworthy. Later in 1932, Berle and Means highlighted the existing separation between ownership and control of the company. It resulted in the consequences (diversification of investment, low concentration of ownership) and the divergent interests between directors, managers, and proprietary investors. In the same sense, Jensen and Meckling (1976) define an agency relationship and how the principal can limit the divergences concerning his interests by establishing appropriate incentives for the agent. The decision systems (decision processes) control the agency problems that different management decisions (implementation and application) and control decisions (ratification and monitoring) at all organizational levels (Fama and Jensen, 1983). The theory focuses on information asymmetry, adverse selection, pre-contractual opportunism, moral hazard, or post-contractual opportunism (Van-Slyke, 2007). Corporate governance research uses the theory and shows a continuous increase (Huang and Ho, 2011).

The theory explains the phenomena of corporate governance, particularly the agency-principle problems of conflicts between external investors and managers and the expropriation of minority shareholders by controlling shareholders (Eisenhard, 1989). The main contribution of agency theory is reforming corporate governance to handle the risks, uncertainty of results, incentives, and information systems. The study speculates that the agency theory assists corporate governance issues to grow because it tries to explain the actual events that occur globally.

4. Hypotheses development

A large body of academic research addresses the financial outcomes of different corporate board structures. Academicians such as Daily et al. (2003), Zubeltzu-Jaka, & Alvarez-Etxeberria (2019). They hypothesize the relationship between enhanced firms' boardroom independence and corporate financial performance (CFP). Several studies find a positive connection. Others argue about the negative influence of board independence on CFP (Horvath & Spirollari,2012; Mahadeo & Soobaroyen,2012). The situation reflects the existing narrative of reviews on board composition and performance. It describes the relationship as mixed, inconsistent, and puzzling. Under such controversy, some authors try to shed some light on that relationship through the development of meta-analytic studies. Two years later, Rhoades, Rechner, & Sundaramurthy (2003) revisited the relationship mentioned above and addressed that firms' boardroom composition only explained less than one percent of the variation in CFP.

Furthermore, they stated that one-third of the findings' variations across firms' boardroom composition studies resulted from sampling error. Thus, their results did not reflect the "true" differences in the relationship between board composition measures and financial performance (Rhoades et al.,2003). The preliminary evidence remained in the literature for twenty years.

Accordingly, the studies cannot encompass the significant changes in companies' boards that appear because of changes in the legal requirements in recent years. In 2006, the UK Combined Code declared that half of the board members should be non-executive independent directors. In 2010, the UK Corporate Governance Code recommended that firms' boards have the appropriate balance of skills, experience, independence, and knowledge (Terjesen et al.,2016).

There are several approaches to the relationships between the BoD chairman–CEO duality and the performance of an entity. The CEO provides the top management of an entity. Many researchers concluded that a combination of the BoD Chairman and CEO positions is not optimal for the leadership structure of an entity. The perspective shows limited independence and reduced efficiency in monitoring management through the concentration of the authority decision. (Zubeltzu-Jaka et al.,2019).

The board of directors is an essential corporate governance mechanism that aligns the managers' interests and shareholders' interests. The board of directors has the statutory responsibility of monitoring and advising the managers on behalf of the shareholders. Accordingly, the board structure is crucial concerning board size, composition, leadership structure, and internal control. Recently, corporate governance policymakers and scholars have emphasized the board's structural components. However, there are conflicting views regarding the effectiveness of each of these components of the board structure. The large board prevents CEO dominance. Board composition and leadership structure capture the significant factor of board effectiveness. Hence, it monitors the firm's performance. According to policymakers and scholars of corporate governance, a duly composed board proposed that the proportion of independent directors in the boardroom prevent management domination in Iraq (Kock et al.,2012). Based on these reasons, the researcher proposes to test the following hypothesis:

Hypothesis 1 (H1). The relationship between firms' boardroom independence and corporate performance in Iraq by an entity are positively correlated.

As a mechanism of governance, the US Financial Security Act (Sarbanes-Oxley) defines the audit committee (AC) as being "an independent advisory body established by and within the board of directors, primarily responsible for overseeing the accounting process, control the financial information and auditing the financial statements. Thus, it renders services to the board, the remuneration and the control of the auditors' works". Referring to the Sarbanes-Oxley Act (2002), the AC is responsible for appointing, remunerating, retaining, and supervising the work of internal and external auditors. It is responsible for strengthening the independence of the audit functions through the review of financial statements and the assessment of risks and vulnerabilities (Haddad et al., 2021).

Several studies consider the ACs' effectiveness as the subject in the literature. They highlight the impact of audit committee quality (ACQ) on governance quality (Moses et al., 2016; Zalata et al., 2018). The others indicate the empirical results agreed on the effect of ACs on financial performance (FP) (Surbakt et al., 2017; Chen & Komal, 2018; Amin et al., 2018). Given its role in monitoring and controlling management activities, the AC applies the necessary corrective actions in the case of fraud. However, Gul et al. (2019) indicate that the existence of an AC did not improve the auditor's perception of independence. Besides, Bouton (2002), Lin et al. (2006), and Baxter and Cotter (2009) criticized the presence of an AC within the companies and confirmed that the AC is not a practical activity within the company.

Several studies investigate the relationship between the presence of an AC, the financial reporting quality, and financial statement transparency (Mohammed 2018; Bouaine and Hrichi 2019; Oroud 2019). Nonetheless, AC research produces senior management financial information quality, and it reflects a positive impact on the governance quality before, during, and after the subprime crisis. Indeed, corporate oversight by a high-quality committee reduces the financial statement fabrication and earnings management. Other studies discuss the role of the AC in reducing agency costs between the chief executive officer and the chairman to solve conflicts of interest as a priority to achieve the objective of improving governance quality (Collier and Gregory 1999). The primary function of the AC is to monitor information related to FP (Xie et al., 2003). Consequently, Chen et al. (2015) reveal that companies that establish ACs without considering shareholders' primacy have more advantages to improve their benefits' quality. However, in favor of agency theory, many auditors show a poor FP.

Within banks, the air conditioner serves a dual purpose. On the one hand, members are in charge of overseeing the development of monetary value, safeguarding banks' assets, assuring the efficacy of governance systems, and controlling any conflicts of interest among banks. On the other hand, it also functions as a governance mechanism that aligns executive interests with shareholders'. A governance dilemma jeopardizes the efficiency of the AC in a volatile financial climate. As a result, the demand to establish such a body within banks has expanded considerably, particularly since the subprime crisis. Having an AC is required for publicly traded corporations and banks (Darmadi 2013).

On the other hand, audit quality is a necessary attribute for audit committee members to fulfill their responsibilities effectively. Not their statistics but their grasp of accounting and financial principles is the best indicator of an audit committee's competency. High-profile corporate frauds highlight the importance of a strong audit committee. As a result, firms hold frequent meetings and assure the audit committee's independence to ensure the reliability of corporate reports (Aggarwal, 2013). The audit committee's primary roles are to assist the board of directors in carrying out their duties, improve the credibility of financial statements and accounts, and strengthen audit independence (Ibrahem & Elshanawany, 2021). As a result, the research proposes the following hypothesis:

Hypothesis 2 (H2). The relationship between the audit committee quality and corporate performance in Iraq correlates positively by an entity.

The proposed framework for this research focuses on the link between corporate governance rules and financial reporting. Figure 1.0 indicates the Framework.

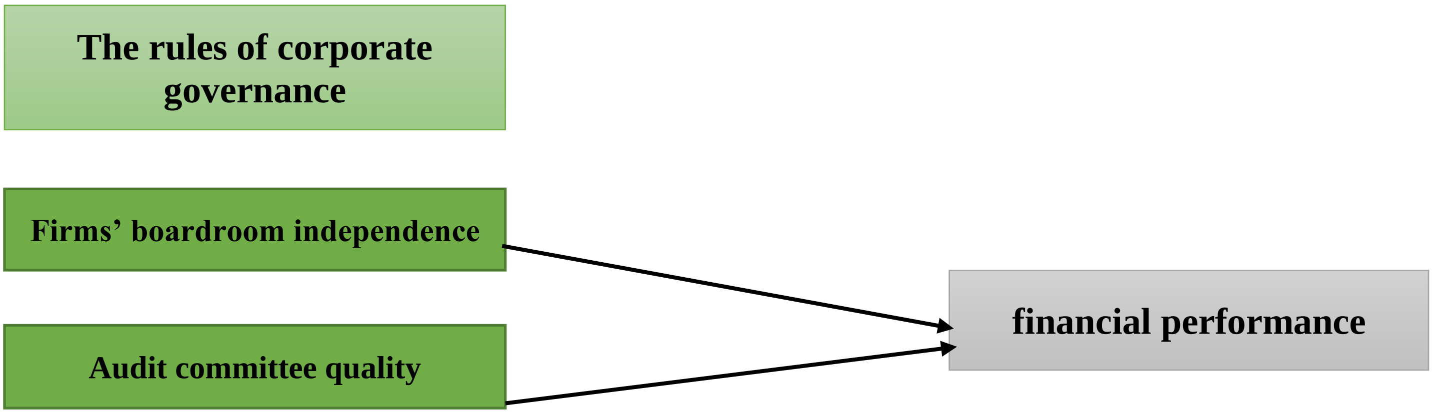

Figure 1. Conceptual Framework

5. Conclusion

The prime conclusion from the study indicates that the equity-based listed companies at the BSE understudy complied with legal formalities for the listing at a stock exchange in Iraq.
The formalities include independent directors, number of meetings, size of the audit committee, legal qualifications, and financial qualifications of the directors. Furthermore, the analyses and tests state that the audit committee quality characteristics are associated with corporate governance quality. The proportion of independent directors on the audit committee and the number of audit committee meetings show no impact on the meetings. Thus, the study suggests that companies should improve corporate governance by taking more independent directors and increasing the number of audit committee meetings. It contradicts the results of earlier studies, where the audit committee quality characteristics relate to corporate governance. It has a significant impact on the latter. Considering the study's limitations stated under the research methodology, the utility of the study improved the other characteristics of the audit committee meeting. The quality influences corporate governance, and the opinion survey shows the implications. One of the significant implications is that foreign investors, through the actions of foreign chief executives' resident in Iraq, contribute to the performance of Iraqi finance firms. Therefore, the country needs to strengthen policies to improve firm-level corporate governance, attract investors, and boost overall economic growth. The regulatory authorities in Iraq need to strengthen the board of directors' independence by ensuring that CEOs are not members of audit committees since there is evidence that such membership is detrimental to a firm's performance.

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