

Internal Audit Function, Ownership Structure and Firm Performance in Iraq

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Abstract: This study investigated the influence of corporate governance mechanisms on firm performance of public listed companies in Iraq. Specifically, the study examined the effect of internal audit function, government share ownership and private share ownership on firm performance. The study utilized data extracted from the annual report of public listed companies on the Iraqi Stock Exchange between the period of 2012-2015. The result obtained from the regression revealed a positive and significant relationship between internal audit department establishments, government share ownership and firm performance while it was found that private shareholding does not have any relationship with firm performance. This implies that listed companies that established internal audit department and whose shares are substantially held by the government perform very well due to strong monitoring mechanism. The findings of this study create a case for both policy makers and management of listed companies in Iraq on the significant of sound corporate governance.

Key words: Firm performance, Iraq, internal and external corporate mechanisms, ownership, structure, sound

INTRODUCTION

The present study is motivated by the recorded poor performance of public listed companies in Iraq that is occasioned by the absence of code of corporate governance in Iraq as well as the ongoing effort of the Iraqi government to attract Foreign direct investment into the country. The occurrence of high profile corporate collapse (for example, Iraqi North Bank, Basra Bank and Iraqi Warka Bank) caused by unethical management conduct as well as exacerbated weak corporate governance practise and its antecedent cost to the economy leaves much to worry about across the global. Moreover, technological advancement and the trade liberalization policy in the recent time which permits the free flow of capital across countries make firms monitoring through sound corporate governance more imperative.

Despite the importance of corporate governance, little research has been conducted on the role of internal audit function in improving firm performance. Notably, Sarens and Abdolmohammadi (2011) observed that in the last two decades only a limited number of studies have explained the existence of internal audit function. The current study is the first research to the best of the researcher's knowledge to include internal audit function along with other corporate governance variables. Talab (2009, 2015), Mashhadani and Talab (2013) investigated the importance of corporate governance in

Iraq. Rashid (2009) examined impact of corporate governance on firm performance for Iraq banking sectors. All of the mentioned studies established a relationship between corporate governance and firm performance, although, the findings are mixed and might not be generalizable beyond the sample. This is because past studies only employed the data of companies in one sector of the economy and also the peculiar nature of corporate governance.

For instance, result on the effect of board size, proportion of independent director's firm performance are conflicting. Larcker *et al.* (2007) noted that the effectiveness of internal corporate governance mechanisms and external corporate governance mechanisms enhanced monitoring which consequential effect will lead to an improvement in firm performance. On the other hand, Hsu and Wu (2014) found that the proportion of independent director on corporate board is attributable to firm. Therefore, further investigation on the role of corporate governance, i.e., internal control establishment using a less studied environment is very important.

Likewise, majority of corporate governance studies were mostly conducted in developed countries consistent with the agency problem (i.e., principal-agent problem) and few studies are so far conducted on developing countries most, especially, country like Iraq (Larcker *et al.*, 2007). Similarly, most of the developed countries where the corporate governance studies have

been conducted have established code of corporate governance guidelines that are either mandatory or voluntary, thus, influencing the variations in the findings of extant studies.

Therefore, the main objective of this study is to examine the relationship between internal control establishment, government shares ownership and private shares ownership and firm performance.

Internal audit establishment is an important monitoring tool in corporate governance. According to Mercer (2004), Archambeault *et al.* (2008), Holt and DeZoort (2009) the existence of internal audit function enhances stakeholder confidence when its complement governance disclosure. Kaplan and Schultz Jr. (2007) explained that Internal Audit Function (IAF) help expose fraudulent activities. While Coram *et al.* (2008) documented that firms that establish internal audit department have the advantage of detecting fraudulent reporting arising from misappropriation of assets. The management of organisations are saddled with the responsibility of instituting an effective internal control over financial reporting procedures and ensuring the efficient operation of such controls and procedure (Lin *et al.*, 2011). The internal audit department provides an independent assessment of the internal control mechanisms in the organisation (Lenz *et al.*, 2014).

Again, agency problem has been suggested to vary with different form of ownership. Of interest to this study is government and private concentrated ownership shareholding in public listed companies. Ghazali (2010) reported that the degree of government shares ownership has significant influence on firm value. Government equity ownership could positively improve firm performance because government officials could give favourable regulatory policies to favour those firms where the government owns shares (Bushman and Smith, 2003). Similarly, private concentrated ownership which could otherwise be called blockownership is the concentration of firm outstanding share in the hand of individuals. This form of ownership structure just like the government ownership could positively or negatively influence firm performance.

By analysing the data extracted from the annual report of public listed companies on the Iraqi Stock Exchange between the year period 2012-2015 using Generalized Least Square (GLS), the regression revealed a positive and significant relationship between internal audit department establishments, government share ownership and firm performance while it was found that private shareholding does not have any relationship with firm performance. Consequently, it is expected that the study will provide insight to corporate organization to be conscious of the importance of corporate governance mechanisms in promoting good corporate culture. In addition, the study is of immense benefit to the regulators

and policy in developing a corporate governance framework that align with global standard. As a result, the finding of this study will enable the managements the expectations and the objective of the study.

Literature review: Corporate governance issues continue to dominate accounting literature due to its significant contribution to economic growth and development. Several studies examined the relationship between corporate governance mechanisms and firm performance in both developed and developing countries. Callen *et al.* (2013) demonstrated that sound corporate governance ensures that firms have access to capital at a lower cost, improves firm's valuation, ensures sound operational performance and enhance the relation between the firm and all stakeholders. Likewise, Maher and Andersson (2000) showed that sound corporate governance improves firm performance, preserve shareholder's right, improve the country investment climate and stimulate economic growth and development. Sound corporate governance improves transparency and accordingly reduces corruption in the country because fraudulent financial reporting is easily detected (Watson and Hirsch, 2010). Several attempts were made in developing countries to conceptualise the issue of corporate governance from the perspective of agency theory, however, it have been faced with challenges. Some studies like Solomon *et al.* (2003) focused are on the impact on board structure on firm performance, Tsamenyi *et al.* (2007) conducted compliance studies while studies like Siddiqui (2010) concentrated on the state of corporate governance implementation in emerging market. Findings from many of the studies corporate governance studies from emerging market revealed that corporate governance practise is weak.

Hypothesis development

Internal audit establishment and firm performance: Of recent, internal audit establishment is seen as an important monitoring mechanism in corporate governance. Through an effective internal control, an internal audit function could be established which reviews and tests the effectiveness of existing control and reports back to the management (Wan-Hussin and Bamahros, 2013). The Institute of Internal Auditor defines internal audit function as a value added assurance and consulting service which preserves firm assets and ensures that financial information emanating from the accounting information system reflects the true state of affairs in the company. This is because the establishment of an effective internal control is one of the methods adopt by managers to bond themselves (Sarens and Abdolmohammadi, 2011). According to DeFond (1992), internal audit function establishment is a deliberate effort

of the managers embarked upon to convince the owners and signal to them that they are acting consistently with their (owners) incentive.

In Iraq, internal audit establishment is not mandatory in the company law, however, few companies create their own internal audit department responsible for establishing the company's internal control system. Accordingly, this study expects that those companies that established internal control department have strong corporate governance mechanisms which will subsequently improve firm performance. Therefore, this study hypothesizes that:

- H₁: there is a positive relationship between internal audit function establishment and firm performance

Ownership structure and firm performance: Under the concentrated ownership structure, the agency focus is between the minority shareholders and controlling shareholders who possess voting right above their cash flow right. At this instance, conflict of interest exists between the controlling shareholders and minority shareholders. The conflicting of interest is further compounded in environment where there is weak protection for the minority shareholders. As the majority shareholders could influence board decision for self-serving purpose. On the contrary, however, majority shareholders could also be more inclined to monitoring, since, they possess more information at lower cost.

The government or private individuals or private organisation could hold substantial shares in companies. The effects of institutional investors on firm performance have been studied in past studies. This class of investors could either be institutional investors in short terms or institutional investors in long term who invest with the intention to hold the shares for a long term:

- H₂: there is a positive significant relationship between the proportion of government share ownership and firm performance
- H₃: there is a positive relationship between private ownership and firm performance

MATERIALS AND METHODS

Research design

Sample and data: Under the Iraqi Stock Exchange law all firms are to submit their audited annual reports at the end of each fiscal year. Therefore, the annual reports were retrieved from the stock exchange and both financial and non-financial information were manually collected from the annual reports. our final sample consist of 276 firm-year observations over the sample period of 2012, 2013-2015, respectively. The 276 firm year observation comprises of 69 companies across 8 different sectors.

Regression model specification: The model takes the following structural form:

$$\begin{aligned}
 FP_{it} &= \alpha_{it} + \beta_1 INT_EXIST_{it} + \beta_2 GOVERN_OWN_{it} + \\
 &= \beta_3 PRIV_OWN_{it} + \beta_4 LOGAF_{it} + \beta_5 LOGCOY_SIZE_{it} + \\
 &= \beta_6 COY_GROWN_{it} + \beta_7 COY_LEV_{it} + \beta_8 COY_AGE_{it} + \\
 &= \beta_9 INDUSTRYDUM_{it} + \beta_{10} YEARDUM_{it} + \epsilon_{it}
 \end{aligned}$$

Where:

- FP = The Financial Performance of firm i in year t using tobin q
- INT_EXIST = To hypothesis 1 related to the Existence of Internal audit function in firm i in year t taking a dummy variable 1 and 0 if otherwise
- GOVERN_OWN = To hypothesis 2 related to Government Ownership variable is the proportion of issued equity held by government (>5%) as at the year-end
- PRIV_OWN = Hypothesis 3 related to the proportion of issued equity held by Private Ownership (>5%) as at the year-end
- LOGAF = Log of Audit Fees
- COY_SIZE = Company Size is measured as the natural logarithms of the total book value of asset as at the firm year end
- COY_GROWN = Change in sales
- COY_LEV = The gearing variable is the ratio of total debt to total equity as at the end of the year
- COY_AGE = Number of years the company has been in existence
- INDUSTRYDUM = Control industry and year variation and YEARDUM
- ε_{it} = Error term

The control variables, i.e., company size, company growth, leverage, audit fees, year dummy and sector dummy were drawn from previous literatures (Howton, 2006; Hsu and Wu, 2014).

RESULTS AND DISCUSSION

Result of regression analysis: Table 1 showed the result of the GLS Model used to examine the relationship between the hypothesised variables and firm performance. Firstly, the model examined the effect of internal audit department establishment (INT_EXIST) and firm performance and the result demonstrates that the establishment of internal audit department is positively related to firm performance consistent with agency theory.

Table 1: Regression

FP	COEF.	z-values	p-values
INT_EXIST	1.905	2.040	0.041
GOVERN_OWN	0.038	2.120	0.034
PRIV_OWN	0.020	0.820	0.412
LOGAF	0.000	2.500	0.012
COY_SIZE	-4.316	-6.180	0.000
COY_GROW	-0.001	-0.560	0.574
COY_LEV	0.325	3.740	0.000
COY_AGE	-0.052	-1.630	0.103
N = 276 cons	51.630		8.170

The coefficient of INT_EXIST is 1.905 with a z = 2.040. Secondly, the model examined the effect of Government Ownership (GOVERN_OWN) on firm performance. The coefficient for GOVERN_OWN was significant and positive 0.038 (z = 2.120). Lastly, the model examine the relationship between private ownership and firm performance and the result shows that Private Ownership (PRIV_OWN) does not have any significant effect on firm performance. The coefficient for PRIV_OWN was positive, however, not significant 0.020 (z = 0.820).

In this study, we examined whether internal audit establishment, government shares ownership and private shares ownership improve firm performance in Iraq. In doing, so, we employed the GLS regression model. The empirical results suggest that internal audit establishment and government shares ownership significantly improve firm performance while private shares ownership does not improve firm performance in Iraq. The findings of the current study are consistent with the theoretical postulation of previous studies. For instance, the positive relationship between internal audit establishment and firm performance reinforce the argument that internal audit function plays an important role in reducing information asymmetries between the owners and the managers (Sarens and Abdolmohammadi, 2011). Hence, internal audit is a monitoring mechanism that reduces agency cost and improve firm performance (Carey *et al.*, 2000). Similarly, the significant positive relationship between government share ownership and firm performance reported in the current study is consistent with the argument that the increment in concentrated shareholders cash flow right reduces concentrated shareholders incentive to exploit minority shareholders because they are more affected by the cost of any misused fund (Holderness, 2003).

CONCLUSION

Therefore, this explains the reason why they are important monitoring mechanisms which reconcile the difference between the shareholders and managers. The findings of this study have important implication for

policy making and existing corporate governance studies. This study theoreticized the role of corporate mechanisms in enhancing firm's performance and hence, stimulating economic growth in Iraq. A major contribution of this study is role of internal audit function.

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