

Ownership Structure, External Audit 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 managerial ownership, ownership concentration (block ownership, local institutional ownership, and foreign institutional ownership), and external audit on firm performance. The study utilized data extracted from the annual report of public listed companies on the Iraqi Stock Exchange over the period 2012 – 2015. The result revealed a positive and significant relationship between managerial ownership and firm performance. While it was found that block ownership does not have any relationship with firm performance. Local institutional ownership, foreign institutional ownership, and external audit have a negative and significant relationship with firm performance. This implies that managerial ownership improves firms performance while block ownership, local institutional ownership, and foreign institutional ownership and likewise external audit are not effective tools in improving firm performance. The findings of this study have implications on the policy-making that are meant to reconcile the difference between agent and principal.*

Keywords: *Firm performance, Iraq, ownership structure, and external audit.*

1. Introduction

The collapse of several companies such as WorldCom and Enron in 2002, the 1998 Asian financial crisis and the 2008 global financial crisis reignite regulators and researchers interest in corporate governance as the need to strengthen corporate governance mechanisms across the globe become more imperative (Kirkpatrick, 2009; Altaie, Flayyih, Talab, & Hussein, 2017). For instance, the 2002 Enron saga led to the promulgation of the Sarbanes Oxley Act in the year 2002, Higgs 2003 report in the UK, and the OECD Principles of Corporate Governance in Europe. The promulgation of all the corporate governance policy across is connected to the fact that effective and efficient corporate governance mechanisms could

resolve agency conflicts as propounded in corporate governance literature (Haniffa & Hudaib, 2006).

Among the important governance mechanisms identified in prior literature (see for example: Haniffa & Hudaib, 2006; Martinez & De Jesus Moraes, 2014) which the shareholders can employed to resolve agency conflict are those imposed by market forces such as the managerial ownership, the individual block shareholders, the local institutional shareholders, foreign institutional shareholders and the external auditing. Managerial share ownership leads to the convergence of interest between shareholders and managers of the organization since managers owning similar shares in the same organization will face the same consequence as shareholders in the event of poor performance record (Davies, Hillier & McColgan,

2005). Therefore, investment in viable projects that will enhance shareholder's wealth will be of priority and hence there will be an improvement in firm performance.

Block shareholding that owns of large unit of shares by individuals is another type of ownership structure (Habbash, 2010). Previous studies provide evidence suggesting that block shareholders are effective monitoring mechanisms. This type of shareholders has the ability to supervise and influence board structure through voting rights (Persons, 2006). Zhong et al. (2007) classified block shareholders to larger and small block shareholders with explanation of the various influence wielded by each class. According to the study, the small block shareholders might decide to dispose their shares when the company's performance is no longer favorable. However, the shareholders may face some difficulties at the point of selling their shares due to poor performance of the company and therefore might rather decide to employ some monitoring strategy to improve managerial performance. By doing so, large block shareholders create pressure on the managers more in order to improve financial performance (Shleifer & Vishny, 1997).

Local institutional ownership refers to the ownership stake in a firm that is held by large institutions such as banks, pension funds, insurance companies and mutual funds (Davis & Steil, 2004). Due to the growing volume of corporate equity that institutional investors control and own, they are considered as a major governance mechanism that have a direct influence on firm performance. In addition, given the high cost of monitoring, only large shareholders such as institutional investors can effectively monitor managers and reduce agency problems (Shleifer & Vishny, 1986).

From the view of agency theory, foreign ownership can be considered a source of good managerial and monitoring skills in corporate governance (Choi et al., 2012; Khanna & Palepu, 1999). According to this view, foreign investors may act as a monitoring force to mitigate the decisions of managers or insider owners that may be costly to other

shareowners. They can improve corporate governance by becoming board members or outside large shareholders (Choi et al., 2012). Foreign investors require high levels of information disclosure and accounting practices, which may enhance firm performance (Ghahroudi, 2011; Kimura & Kiyota, 2007). Foreign investors in the emerging markets may have more highly developed skills than domestic investors, so that firms with high foreign ownership may have few agency problems (Koo & Maeng, 2006).

An important external corporate governance mechanism is the external auditing. Theoretically, an independent examination of the books of account of a company by an auditor reduce agency problem by preventing the insider (controlling shareholders or managers) from engaging in discretionary accounting practices and estimates (Jensen & Meckling 1976). Extant studies (Afza & Bazir, 2014; Hay, Knechel, & Wong, 2006; Stanley, 2011) showed that market participant react positively to companies audited by reputable audit firms. This is because reputable audit firms deploy more time, skill and resources during audit engagement. A few studies like Fan and Wong (2005) and Lennox (2005) examined the role of quality external monitoring mechanism in reducing the agency problems that emerges from the separation of ownership from control. These studies argued that external monitoring by high quality auditor improves the credibility of financial reporting.

While research on corporate governance and firm performance is abundant, further investigation on its relationship with ownership structure and external audit to the best of our knowledge is yet to receive sufficient empirical attention most especially in Iraqi context (Rafiee & Sarabdeen, 2012). Iraq is an interesting setting to study ownership structure and external audit quality because of the absence of a sound corporate governance framework. (Talab, Abdul Manaf, and Abdul Malak, 2017a, Talab, Abdul Manaf, and Abdul Malak, 2017b; Talab, 2015; Mashhadani and Talab, 2013; Talab, 2009; Hussein, 2018; Talab, Flayyih, and Ali, 2018; Tamimi and Flayyih, 2017). The legal and

institutional environment in Iraq is different from those of the developed economy such as the USA, UK and Australia that has a large market. The small size of the Iraqi market, its international reliance, geographical isolation and less regulated market suggest that empirical findings emanating from larger market might not be generalizable to the Iraqi environment. Similarly, the Iraqi market is characterized by less highly ownership concentrated and the less presence of the big 4 auditing firms. In Iraq, block shareholding (individual and family) and concentrated shareholding (institution and government) is prevalent. Since, severity of agency problem varies with the ownership structure, findings from other regulatory settings are less applicable in the Iraqi context (Doski, 2015).

Therefore, it will be interesting to investigate how the selected corporate governance mechanism (ownership structure and external auditing) affect firm performance in the Iraqi context. The remainder of this paper is organised as follows. Section 2 provides literature review and hypotheses for the study. Data and method of sampling as well as research design are discussed in section 3. The results are discussed in section 4. Finally, in section 5, summary of our findings and conclusion.

2. Literature Review and Hypotheses Development

2.1 Managerial ownership and firm performance

A form of ownership structure that can align management and shareholders' incentive is director shareholding also called managerial ownership. Managerial shareholding is viewed as a potent incentive mechanism that aligns the interest of shareholders and management (Jensen & Meckling, 1976). According to Farhat (2014), when manager owns significant portion of firm shares they act differently. Consistent with convergence of interest hypothesis, managerial ownership aligns the interest of shareholders and management and prevent management from engaging in any opportunistic behaviour because managers bear the same loss with shareholders if their wealth suffers. As a result, directors have the incentive to monitor the

behaviour of managers and thus reduce agency cost and improve financial performance of firm. Contrarily, management entrenchment hypothesis which states that when managerial ownership is substantial to make managers possess voting power, managers are immune against the action of market forces to remove them in case of poor performance (Denis & Denis, 1994). Therefore, managers act opportunistically by increasing personal gains at the expense of maximising the overall welfare of the shareholders. The expectation under the entrenchment hypothesis is that the association between managerial ownership and performance will be negative.

Due to the conflicting theoretical postulation empirical studies have produced inconsistent results. For instance, Daraghma & Alsinawi (2000) found a positive relationship between the proportion of shares held by managers and firm performance. Fauzi & Locke, (2012) documented a positive relationship between managerial ownership and financial performance in New Zealand. Singh and Davidson (2003) reported that in large publicly traded corporation managerial ownership significantly alleviate principal-agent conflict. Similarly, Davies, Hillier and McColgan (2005) investigated the relationship between managerial shareholding and firm value proxy by Tobin's Q for a sample of industrial listed firm between the years 1996 and 1997 in UK. Their finding reveals that firm performance increase at managerial level of 7% and then decrease at director ownership at 26%. Cheng, Su & Zhu (2011) find that managerial ownership mitigates the agency problem between managers and shareholders.

Bhagat and Bolton (2008) opined that the present value of shares owned by managers increase companies' performance. Mandaci and Gumus (2010) using Turkey data found that managerial ownership has a significant negative relationship on firm values. Likewise, Florackis et al. (2009) found a negative relationship between managerial ownership and firm performance when ownership is high. The negative relationship reported by these studies confirms the entrenchment theory. Research

on managerial ownership is very scarce, as a result it is not easy to predict an exact relationship. However, owing to the ineffectiveness of other corporate governance mechanism in Iraq it could be argued that managerial ownership in Iraq would provide managers with the incentive to act in the interest of shareholders. Therefore, it is hypothesized that:

H1: There is a positive relationship between managerial ownership and firm performance.

2.2 Concentrated ownership and firm performance

Another mechanism use in reconciling management and ownership conflict is concentrated ownership by outside shareholders for example institution and block holders (Haniffa & Hudaib, 2006). This is because shareholders with large investment have sufficient resources and incentive to monitor the activities of management when compared to small investors. Because, this class of investors suffers much investment loss arising from managers destroying activities, thus they have the incentive to monitor firm performance (Ferreira & Matos, 2008). Therefore, consistent with the efficient monitoring hypothesis, concentrated ownership structure can improve firm performance. On the other hand, the activities of concentrated shareholders could lead to minority shareholders' expropriation (Haniffa & Hudaib, 2006). Accordingly, the influence of concentrated shareholders in firms could negatively affect firm performance due to the magnitude of firm risk exposure.

Empirical relationship between ownership concentrations and firm performance is mixed. In a cross country study conducted by Ferreira and Matos, (2008) aimed at investigating the role of institutional investors in firm monitoring. He reports that foreign and independent intuitions improve firm value. In the US, Charitou et al., (2007) report that tendency to manage earning by board of directors of firms with high institutional is low. In Korea, Joh (2003) found that Korean firms with high ownership concentration performs better

than those with low ownership concentration. The largest shareholders and the five largest shareholders in Iraq is about 30% and 60% according to the annual report for listed companies in Iraqi stock exchange for 2014. This shows that the ownership structure of many of the companies listed on the Iraqi stock exchange is highly concentrated which suggest better managerial monitoring. Because, block shareholders and institutional investors with substantial investment are financially buoyant to monitor the activities of the managers as they tend to lose more in the event of corporate collapse. Accordingly, this study hypothesizes that:

H2: There is a positive relationship between concentrated ownership and firm performance.

2.3 External auditing and firm performance

The agency theory suggests several corporate governance mechanisms and these mechanisms are made provision for in the code of corporate governance to mitigate the agency problem associated with the separation between ownership and control (Jensen & Meckling 1976; Fama, 1980). The import of these mechanisms is to align the interest of shareholders and management interest. An important external corporate governance mechanism is the external auditing. Few studies like Fan and Wong (2005); Lennox (2005) examined the role of quality external monitoring mechanism to help in reducing the agency problems that emerges from the separation of ownership from control. These studies argued that external monitoring by high quality auditor improves the credibility of financial reporting. Theoretically, an independent examination of the books of account of a company by an auditor reduce agency problem by preventing the insider (controlling shareholders or managers) from engaging in discretionary accounting practises and estimates (Jensen & Meckling, 1976). In the model of DeAngelo (1981), high quality auditors are said to be conscious of their reputation capital and this makes them to supply high quality audit than other auditors.

Afza and Nazir (2014), reported that audit quality has a strong positive relationship with ROA and Tobin's Q. Ghosh (2007) documented that quality external monitoring (external audit) will increase the incentive of the manager to engage in internal monitoring which will simultaneously improve firm value. Fooladi and Shukor (2012) as well showed that audit quality has a significant positive relationship with firm performance (ROA and Tobin Q). Griffiin et al., (2008), found that the amount paid as audit fees improves corporate governance quality. Thus, an increase in corporate governance mechanisms will improve the quality of financial statements which will in turn improve financial perform of the firms. The effect of external audit measured by audit tenure, brand name audit firm and unqualified audit opinion on the value of company was as well investigated by Ardiana (2014). It was documented that mandatory audit rotation improves audit quality hence increase firm value and brand name auditors provide good audit quality which subsequently improve firm value. Francis (2004) in his case reported that firms affiliated with big four audit firm hence the value of their client because investors prefer reliable and credible financial information. Beatty (1986) found that high quality auditors that have high reputation reduce the extent of ex ante uncertainty in the firm going public which suggest that Big4 auditors reduce agency conflict. Some other studies examined the relationship between audit fees and firm performance and high quality audit. Therefore, this study hypothesis that:

H3: There is a positive relationship between audit quality and firm performance.

3. Methodology

3.1 Sample Selection

The sample of this study comprises all listed companies on the Iraqi Stock Exchange from 2012 to 2015. It comprises 69 firms over 4-years period (2012-2015) resulting into 276 observations (balanced panel). As shown in Table 1 below, the majority of the sampled companies comes from the banking sector (84%), followed by Industry (60%); Tourism & Hotel (32%); Services (28%); Agricultural (24%); Investment (24%); Insurance (20%) and communication (4%).

3.2 Regression model and specification

We estimate the following regression model to examine the relationship between the dependent and the independent variables:

$$FP_{it} = \alpha_{it} + \beta_1 MGROWN_{it} + \beta_2 BLOCKSHR_{it} + \beta_3 LOCAL_INSTIT_{it} + \beta_4 FOREIGN_{it} + \beta_5 EX_AUDIT_{it} + \beta_6 COYSIZE_{it} + \beta_7 COYGROW_{it} + \beta_8 COYLEV_{it} + \beta_9 COYAGE_{it} + \varepsilon_{it}$$

Where:

α = Intercept term

β = Regression slope coefficient

FP= Firm performance

MGROWN= Managerial ownership

BLOCKSHR= Block ownership

LOCAL_INSTIT= Local institutional ownership

FOREIGN= Local institutional ownership

EX_AUDIT= External audit quality

COYSIZE = Company size

COYGROW = Company growth

COYLEV = Company Leverage

COYAGE = Company Age

ε - Error term

Table 1:- Sample based on sector classification

Sector	Freq.	Percent
Agricultural	24	8.7
Bank	84	30.43
Communication	4	1.45
Industry	60	21.74
Insurance	20	7.25
Investment	24	8.7
Services	28	10.14
Tourism &Hotels	32	11.59
Total number of observation	276	100

Table 2:- Variable description and measurement

Variable	Description	Measurement
A		An intercept term, a constant
β		A regression slope coefficient
FIRM PERFORMANCE		
FP	Return on Asset (ROA)	Measured by net income divided total asset.
OWNERSHIP:		
MGROWN	Managerial ownership	The percentage of companies' shares held by executive directors.
BLOCKSHR	Block shareholders	Block shareholders is the percentage shares by largest shareholder .
LOCAL_INSTIT	Local institutional ownership.	Percentage of company shares held by local institutional shareholders .
FOREIGN	Foreign institutional ownership.	Percentage of company shares held by foreign institutional shareholders.
EX_AUDIT	Audit quality	The log percentage of the amount paid as audit fees.
CONTROL VARIABLE		
COYSIZE	Company size	Measured by the log of total asset.
COYGROW	Company growth	Growth in sales.
COYLEV	Company Leverage	Shareholders fund divided by total liabilities.
COYAGE	Company Age	The years the company was listed on the stock exchange.

4. Result and discussion

4.1 Descriptive Statistic

Table 3 presents the descriptive statistics. The financial performance (FP) measured by Return on Asset (ROA) ranges between -1.10 to 0.34 with a standard deviation value of 0.17. On average 35.72% of the firms have managers whom possess firm shares (MGROWN). The means proportion of Block share ownership (BLOCKSHR), local institutional shares (LOCAL_INSTIT) and foreign institutional shares (FOREIGN) are 7.52, 22.94 and

6.71 respectively. The natural logarithms of EX_AUDIT measured by log of audit fees averages 7.07 and ranges from 6 to 8.3 (in millions) while the average size (COY_SIZE) of the sampled company in log form stands at 10.34 and ranges from 8.36 to 12.56. The mean (standard deviation) of company growth (COY_GROW) stands at 27.90 (123.95) while the company leverage (COY_LEV) averages 1.20. Finally, on the average the company age (COY_AGE) averages 22.38 and ranges from 5 to 69.

Table 3:- Descriptive statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
FP	276	- 0.001	0.17	-1.10	0.34
MGROWN	276	35.72	22.23	0.01792	114.6432
BLOCKSHR	276	7.52	13.35	0	57.76091
LOCAL_INSTIT	276	22.94	24.09	0	79.33356
FOREIGN	276	6.71	18.90	0	91
EX_AUDIT	276	7.07	0.52	6	8.30103
COYSIZE	276	10.34	1.09	8.36	12.56
COYGROW	276	27.90	123.95	-99.96	1179.17
COYLEV	276	1.20	3.44	-5.85	29.61
COYAGE	276	22.38	13.21	5	69

4.2 Result of regression analysis

Table 4 shows the regression result. A linear fit was achieved with an adjusted R square of 33%. The regression coefficient for managerial ownership (MGROWN) is positive and significant (Coefficient 0.0004934; t value 2.87). The finding is consistent

with managerial interest convergence theory which states that significant managerial ownership aligns the interest of the shareholders and management, and thus it prevents management opportunistic behaviour. The findings support the findings of Cheng, Su and Xhu (2011) that documented that managerial ownership reduces agency conflict.

Table 4:- Regression Table

ROA	Coef.	Panel Corrected Std. Err.	t	P>t
MGROWN	0.0004934	0.000172	2.87	0.004
BLOCKSHR	0.0006485	0.000514	1.26	0.207
LOCAL_INSTIT	-0.00261	0.000237	-11.04	0.000
FOREIGN	-0.000632	0.000108	-5.83	0.000
EX_AUD	-0.043876	0.010474	-4.19	0.000
COYSIZE	0.0343381	0.014857	2.31	0.021
COYGROW	0.0000564	5.39E-05	1.05	0.296
COYLEV	-0.000235	0.001089	-0.22	0.829
COYAGE	-0.005527	0.000967	-5.72	0.000
_CONS	0.1641143	0.227092	0.72	0.47
PROB > CHI2	0.000			
R-Square	0.33			

Further, the result of the concentrated ownership measured by block shareholdings (BLOCKSHR), local institutional ownership (LOCAL_INSTIT), and foreign institutional ownership (FOREIGN) are reported in table 4. BLOCKSHR revealed a positive but an insignificant relation with firm performance (coefficient =0.0006485; t value= - 1.26) which suggests that block shareholdings does not significantly improve firm performance in Iraq. The findings is consistent with those of Mat, Nor and Sulong (1999) who reported that an insignificant

relationship suggests that managers have less incentive to maximise organisation value.

Both LOCAL_INSTIT and FOREIGN institutional ownership showed a negative but significant relationship (coefficient-0.00261, t-value -11.04; - 0.000632, t value -5.83. The result is consistent with Haniffa and Hudaib (2006) who documented that the activities of concentrated shareholders could lead to minority shareholder’s appropriation.

External audit quality measured by the log of audit fees revealed a negative and significant relationship

with firm performance (coefficient = -0.043876, t value=-4.19). The implication of this finding is that, external audit quality negatively affects firm performance. This validates the assertion that the intervention of the external auditor is likely being compromised. Also, in a poor economic state, the clients are perceived as riskier and as such attribute more audit effort, resulting in higher audit fee, thus it can say that higher fees for auditors are related to weak firm performance. This result is consistent with previous studies (Alali, 2011; MoutinhoCerqueira, and Brandao, 2012; Stanley, 2011).

5. Summary and Conclusion

In the current study, the relationship between corporate governance and firm performance in Iraq was examined. Specifically, the study examines the effectiveness of ownership structure and external audit quality on firm performance measured by ROA. Using a sample of 296 public listed Iraqi companies, the findings of the study indicate that managerial ownership improves firm performance while both local and foreign institutional ownership as well as external audit quality negatively affect firm performance. Similarly, block ownership has no significant effect on firm performance. The findings of the study have implication for corporate governance studies from the Middle East countries. In relation to the type-two agency problem, this study reveals that minority shareholder expropriation is likely to be present in Iraq due to the nature of the country's ownership structure. Likewise, the quality of external audit is as well in question. Therefore, future regulatory reforms in Iraq could look in this regard to further improve corporate governance practice by incorporating the outcomes of this study into a regulatory code of governance.

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