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Research paper



Value Engineering for the Role of Internal Audit Quality in Activating the Principles of Corporate Governance: A Case of Non-financial Firms on Iraqi Stock Exchange

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Abstract

The main purpose of this study is to investigate the impact of the quality of internal audit on the effectiveness of corporate governance in Iraqi listed firms. The frequency of audit committee meeting and board size are in a negative and significant relationship of the audit committee and firm size are only variables which in negative relation with corporate governance index. Whereas all the other variables which independence of audit committee are, qualification if independent director in audit committee and audit committee to board independence are in positive relation to corporate governance. The results indicate that along with independence its mandatory to have qualified person on a board committee. Similarly, the frequency of audit committee also appears in positive relation to corporate governance practices for the sample of Iraqi firm. The results of the study provide support with agency theory. This study will be helpful for policy-makers and corporate heads in formulating policies related to development and implementation of corporate governance.

Keywords: *Iraq, Internal Audit, Corporate Governance, Value Engineering, Industrial Engineering.*

1. Introduction

The recent episodes of Asian financial crisis and subsequent event of subprime crisis have raised certain questions on the ways organizations are being governed and control. The world has observed a wave of corporate reforms in its different parts. The prime objective of these reforms was to strengthen the internal and external governance mechanisms of corporations. In an effort of doing so, they have introduced codes of corporate governance. According to [1-3], the corporate governance is a mechanism which not only ensures the health of the relationship between different stakeholders but also ensures the transparency among these relationships. Transparency is at heart of any effective corporate governance mechanism. The codes of corporate governances around the world are devising different mechanisms to ensure the transparency in corporate governance. Internal audit is one of those devices. The corporate governance is playing key role in reducing agency cost.

Transparency is a precondition for any effective code of corporate governance. The Dawn of the twenty-first century has witnessed series of corporate scandals such as Enron and World.com. The inquiry reports of these scandals highlighted the weak internal governance and misreporting of financial record as a major reason behind these reforms. The weak, ineffective or in some cases absent internal audit department helped the executives to pursue their self-interest at the cost of shareholders wealth.

As discussed earlier than around the world aftermath of the crisis. It is observed that the development of a code of corporate governance in developed countries is in pace with developing countries. However, in terms of implementation, the developing counties are far behind the developed countries. The current study is being carried out in Iraqi context. Till to date, Iraq has no formal code of corporate governance. Along with that, it is evident from the literature that Iraq is among most corrupt counties of the world and ranked 5 among most corrupt countries and stands at 171 out of 175 countries. The corruption is deeply rooted in every segment of society. The corporate sector is also badly corrupted. An effective internal audit is a solution to corporate corruption scandals. The effectiveness of internal audit department is a key for transparency in governance. Many prior researchers [4] has argued in the wake of corporate scandals and financial crisis the internal audit has emerged as a solution to wake internal control.

2. Literature Review

The agency theory argues that manage in any firm are agents which are hired by owners or shareholders to maximize their wealth. Agency theory view, ownership concentration, efficient board and effective audit committees as a proxy of internal governance. Following [5, 6] argued that corporate governance is a mechanism which helps the regulatory authorities and stakeholders in eliminating agency issue and promoting accountability by preventing corruption and fraud. The code of corporate governance around the world are increasingly imposing restrictions to improve internal governance mechanism. Human resource and internal audit committee to scrutinize the affairs of internal audit and recruitment functions are being formed in financial and non-financial corporations [7, 8].

An audit committee is a subcommittee among few major committees formed by companies under the supervision of the board of directors. The prime duty of this committee is to make sure that the financial matters of the company are being carried out in most effective and efficient way. The board of company usually direct and controls the company, and it's their duty to assign competent and qualified director as head of the committee. The concept of

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the audit committee is a new concept and has emerged in the last decade of last century. In [9] argued that the efficient audit committee is at heart of an effective code of corporate governance. However, he was the first to broach the issue that only the existence of audit committee is not sufficient to ensure the transparency, rather it will be efficient it must be led by an independent and qualified director.

According to [10-12] the audit committee is a platform which helps the board to comply with accounting standards and code of corporate governance. They continued and argued that effective audit committee helps the organization to install an effective control mechanism which reduces agency cost and encourage best practices. The audit committee is a pivotal pillar of a sound and effective code of corporate governance. They continued and argued that the performance of audit committee is dependent upon the independence and competency of the audit committee. They continued that audit committee by bringing transparency and reducing agency cost makes the code of corporate governance more effective. Researchers indicate that there is a significant difference in recommended structure and the role of audit committees. The establishment of an audit committee within a company is a core component of corporate governance. Therefore, from the above discussion, we can hypothesize the following relation.

3. Results and Discussion

The size of the audit committee and firm size are only variables which in negative relation to corporate governance. Whereas all the other variables are in positive relation to corporate governance. The results are discussed in table 2.

Table 1:. Logit Regression

Dependent Variable: GI	Coef	Robust Std. Error	Z	VIF
ACS	0.7860	0.345	-2.75*	1.09
NEDAC	0.3240	0.246	1.87**	1.07
FENXEDAC	0.2220	0.547	3.31	1.12
ACM	-0.775	0.658	-2.71**	1.26
ACSTOBS	-0.975	0.754	-1.77**	1.43
ACITBI	0.775	0.858	-2.75**	1.52
FIRMSIZE	-0.223	0.421	1.28***	1.39
PROF	0.234	0.342	2.12	1.21
LEV	-0.029	0.008	2.45*	1.09
Cons	-0.769	-0.786	-0.534	
Number of Obs	605			
Prob>Chi2	0.000			
Pseudo R2	0.8321			
Mean Vf	1.30			

This type of management needs a lot of information such as the cost of products and services, the amount of production, the cost of various components of production, the price of sales of products and services, and the capacity of various sources, such as the production capacity of machinery and analysis of this information. This flow of information has increased the need for information, especially financial information. Increasing the use of financial information by managers has led to improvements in the cost-effectiveness of products, services and activities and to provide more detailed information on the various aspects of the financial activities. As such, management accounting became a special field at the beginning of this century.

The negative relation between audit frequency of audit committee meeting and corporate governance is consistent with predictions of agency theory that frequent meetings of the audit committee will increase the time and resource cost and decrease the efficiency. Therefore, it can be argued that for an effective code of corporate governance Iraqi firms should have fewer audit committee meetings. Meanwhile, the relationship between the size of the audit committee and the effectiveness of corporate governance is also negative which indicates that board with more members lead to an effective audit. The ratio of non-executive directors in audit committee, which basically measures the independence of audit committee is in positive relation. The results indicate that an independent audit committee strengthening the code of corporate governance. The results are again consistent with the proposition of agency theory that independent board by applying proper check and balance reduces agency cost.

The independence of audit committee to board is in significant positive relation with the effectiveness of audit committee which shows consistency with the prediction of agency theory. The financial qualification of the independent director is another most important factor which affects the corporate governance practices of any firm. In current analysis the relationship between the financial expertise of independent directors and corporate governance practices and principal of Iraqi firms is positive. The results indicate that along with independence it's mandatory to have qualified person on a board committee. Similarly, the frequency of audit committee also appears in positive relation with corporate governance practices for the sample of Iraqi firms. Again, these findings are consistent with the propositions of agency theory. Meanwhile, they also provide support with a resource-based view which argued that committee with competent independent directors which held meeting frequently strengthen the corporate governance mechanisms of any firm.

4. Conclusion

The purpose of current study is to investigate the impact of internal audit on the effectiveness of corporate governance. The size of the committee, independence of committee member, the financial knowledge of independent members and the meeting frequency committee are used as proxies of internal audit quality. Whereas corporate governance is measured by corporate governance index used by Al-Najjar (2017). The results of the study have provided support with the proposition of agency theory. The size of the audit committee and firm size are only variables which in negative relation to corporate governance. Whereas all the other variables which the independence of audit committee are, qualification if independent director in audit committee and frequency of audit committee meetings are in positive relation to corporate governance. The results indicate that along with independence its mandatory to have qualified person on a board committee. Similarly, the frequency of audit committee also appears in negative relation with corporate governance practices for the sample of Iraqi firms. Again, these findings are consistent with the propositions of agency theory. Meanwhile, they also provide support with a resource-based view which argued that committee with competent independent directors which held meeting frequently strengthen the corporate governance mechanisms of any firm.

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