# Impact of Supply Chain Governance on Financial Reporting: Evidence from Iraq

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***Abstract*- The importance of supply chain governance mechanism has grabbed the attention of academia due to massive corporate scandals in 21st century. The following study is aimed to investigate the supply chain governance mechanism in Iraqi corporations at first stage and develop the relationship between supply chain governance with quality of financial reporting at second stage. The sample of this study is consists of listed Iraqi companies between the time period of 2009 to 2016. A panel regression technique is applied to investigate the proposed framework by fulfill the objective of this investigation. Results revealed that board independence has a significant and positive role on financial reporting quality. Whereas, board size and CEO duality have a negative association with financial reporting quality. Furthermore, firm size and age was considered as control variables which influence the relationship of supply chain governance and quality of financial reporting.**

**Keywords:** *Supply Chain governance, Financial Reporting, Board Size, Board Independence, CEO, Duality, Firm Size.*

## 1. Introduction

The role of supply chain governance in today's competitive and corporate world is gaining very positive reputation day by day. It is the identical reason that academicians and financial consultants around the globe are paying more attention in developing and testing the existing and new practices of supply chain governance. Similarly, in competitive world market, the performance of a firm is becoming an essential part. Many other factors may affect firm's financial reporting quality like, risk of competitor advancement in technologies and supply chain governance. In this study, it is planned to explore the association between features of supply chain governance and quality of financial reporting. For this purpose, it is scheduled to analyze all listed companies at Iraqi Stock Exchange.

Supply chain governance can be examined as both structure and relationship which identifies corporate direction and performance. Center of supply chain governance is board of directors that depends upon board characteristics. The critical participants of supply chain governance are mainly shareholders and management. It also includes employees, customers, suppliers, shareholders, consumers, government and tax authorities, etc. In last decades many mainstream corporate scandals are observed by poor financial reporting, shareholders demanded high quality reports. Now the researchers shows that the companies or firms adopt high quality external and internal governance tools and also adopt higher quality auditors (internal and external) to develop high quality financial report for shareholders. But, the supply chain governance mechanisms vary country to country, reflecting changes in the legal and business environments.

To understand the link between supply chain governance and financial reporting quality, little work has been done Iraqi context. In the case of Iraq the researchers have broadly studied and cited the conflict between managers and owners regarding the operations of the firm for developed and emerging markets. There is dearth of research studies to explain the governance phenomenon from the aspect of underdeveloped market. This study is focused to explore the relationship between supply chain governance structure and quality of financial reporting in context of Iraqi listed companies. This context of this study is unique and it is expected to find interesting results in the proposed framework.

## 2. Literature Review

The underlying purpose of financial reporting is to present financial and economic state of company. The information about financial health acquainted with cash flow information is center of interest for all stakeholders. Therefore, quality of financial reporting considered as a pivotal part of accounting procedures. Hence the quality of financial reporting is measured as the extent to which companies financial information are transparent and does not mislead the investors in particular and other

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stakeholders in general. Prior studies show that size of board of director affects the reporting mechanism by influencing the process of auditing. Therefore, quality of financial reporting suffers. [1] argued that low number of directors in boardroom can communicate and cooperate with higher manager in a better way. The study of Bradbury, [2] reveals that information contents of income and intensifies the earning management decrease with the large board in companies of developed world. However, certain authors find that big board can control the auditing process in a better way due to diversified experience of directors. In contrast some studies found no relationship between size of board and the quality of financial reporting. There is a view that bigger boards are better for corporate execution since they have a scope of skill to enable settle on to better choices, and are harder for a great CEO to overwhelm. In any case, late reasoning has inclined towards small sized boards. [3] contend that bigger boards are less powerful and are less demanding for the CEO to control. At the point when a board gets too enormous, it ends up hard to co-ordinate and process issues. Small sized boards likewise diminish the likelihood of free riding and increment the responsibility. For instance, [4] records that for majority of U.S. corporations that have smaller boards have higher market value.

According to [5] board characteristics can be arisen or improved due to agency problems that are the root problem of any organization. When the companies are small and medium-sized their basic corporate board role focuses on strategic advice, to extend management network and modifying and solving the conflicts of owners. According to [6] board of director's structure is the best mechanism of governance in inside control scheme. [7] express that effective tool for operating top managers and to deduct agency cost can be achieved by fixing the director of the board. There are lot of rules and regulations that are built newly in order to follow governance, but still there is a huge gap for the development of new rules and regulations for supply chain governance in under developed countries that also need to be fulfilled for the achievement of better performance of organization. [8] consider board of directors the key element of governance. It is also stressed that there is a need of effective participation of the board of directors to control the management. [10] further proved that board characteristics have significant influence in improving firm's financial reporting quality. Board activities can operate and control managers correctly in order to achieve higher reporting quality.

The argument about different boards and their structures has accumulated attention from both scholars and media during the last decade. Different authors have discussed widely about board size [11]. Board size affects different dimensions of firms either positively or negatively and also affects firm's financial reporting quality. According to [12] the large size of the board causes more difficulties to solve problems and decreases efficiency of the firms. It may also have difficulty in solving agency problems among the members. Similarly, According to the [13], agency problems increases due to large boards. [14] support the fact of the good performance of a small board and recommended that the board size should be limited to seven to eight members. Moreover, [15] suggests that the board size should not be more than 8 directors. [16] criticized on large board size with argument that it distributes the accountabilities and causes more liberty to management to manipulate financial performance. In the large size of board, there is more possibility of inefficiency, while the smaller board size is considered to be efficient in conveying messages and placing orders also to attain the interest of stakeholders. The independence of Boards is examined by diversity of board in terms of internal directors and external directors. Board of directors performs the duties to monitor the managerial functions of a firm and takes care of the rights of its people on the behalf of shareholders. The external directors play an important role to enforce accounting standards in true spirit. Therefore, independence of board of directors enforces the high level of accounting reporting by providing suitable circumstances for audit committee. In addition to this [17] found that US companies with low level of board independence were fined and forced to comply with accounting standards by the SEC.

The importance of separate positions of chief operating officer and chairman of board of directors has been discussed in previous studies. The objective of separate position is to give intendance for both domains and enforce transparency in the originations. The dual position of CEO increases the chances to manipulate financial information in financial reporting and mislead equity investors. In this way managers can prolong their benefits and current position in the organization [18]. However, it is important to explore this association in the context of Iraqi firms because contextual circumstances make a difference. Furthermore, [15] asserted that companies with autonomous board and independent manager found to be good in reporting quality and lower level of income variations.

## 3. Methods and Materials

In this investigation we consider all Iraqi companies listed in Iraqi stock exchange. Every company had an equal chance to be selected in sample by fulfilling the basic criteria. We exclude all the companies from sample those does not have financial information for the period of spanned over 2009 to 2016. Furthermore, financial companies were excluded from sample because of different nature and requirement of business. The financial data was calculated from annual reports of selected companies. Regression analysis was applied to measure the impact of governance variables on quality of financial reporting.

### 3.1. Econometric Model

This investigating considered accrual based model to measure quality of earning. Accrual based model assume that mangers use discretionary accruals to manage earnings hence earnings influence the quality of financial reporting in a negative way. The financial reporting quality is calculated by following the model of [16]. Econometric equation to measure financial reporting quality is given below:

$$\Delta \mathrm{WCt} = \beta 0 + \beta 1 CFOt - 1 + \beta 2 CFOt + \beta 3 CFOt + 1 + \beta 4 \Delta Salest + \beta 5 PPEt + \varepsilon t$$
(Eq.1)

Where; t represents current time period, t-1 represent lagged variable and t+1 represents next time period. ΔWC is explained as change in working capital. CFO is explained as cash flow and $\Delta Sales$ represents change in sales. PPE illustrates level of plant and equipment. In this research we used ΔWCt as a proxy of financial reporting quality.
Furthermore in second step each supply chain governance attribute were examined against financial reporting quality by following the equation below.

$$\mathrm{FRQ} = \beta 0 + \beta 1 BS + \beta 2 BI + \beta 3 DUL + \varepsilon$$
(Eq.2)
$$\mathrm{FRQ} = \beta 0 + \beta 1 BS + \beta 2 BI + \beta 3 DUL + \beta 4 SIZ + \beta 5 AGE + \varepsilon$$
(Eq. 3)

Where; BS= Board Size, BI=Board Independence, DUL= CEO Duality, SIZ= Firm Size, AGE= Firm Age. Firm size and age is being used as a control variable that affects the decision making power of organization (Arosa, Iturralde, & Maseda, 2013).
Results and Discussion

The statistical analysis was carried out by applying regression analysis on unbalanced panel data. In the first step hausman test was applied to select the regression model. The probability value of hausman test is 0.0134 which refers to apply fixed effect regression equation model. The result of hausman test is presented in table.1.

Table 1: Hausman Test Results

| Test Summery | Chi-Sq. Statistic | Chi Sq. D.F. | Prob. |
|---|---|---|---|
| | 10.89332 | 6 | 0.0134 |

The regression results presented in table 2 clearly mention the significance of supply chain governance characteristics for quality of financial reporting.

Table 2: Fixed Effect Regression Test Results

| Variables | Coefficients | Coefficients | Std. Error | t-statistics | P-Value |
|---|---|---|---|---|---|
| BS | -0.134756 | -0.15733 | 0.0076 | -2.45564 | 0.000 |
| BI | 0.0274 | 0.0935 | 0.0029 | 0.08364 | 0.000 |
| DUL | -0.1765 | -0.2094 | 0.0982 | -1.3942 | 0.0284 |
| SIZE | | -0.0474 | 0.0032 | -2.4765 | 0.0034 |
| AGE | | 0.0293 | 0.0087 | 0.3673 | 0.0427 |
| R2 | 0.3098 | 0.5782 | | | |
| Prob.(F-Statistic) | 0.000 | 0.000 | | | |

It is noted that board size is negatively associated with the quality of financial reporting. Whereas, board independence has a significant and positive influence on the quality of financial reporting. Furthermore, CEO duality has a negative relationship with financial reporting quality. The control variable were also found important in this model and noted that firm size has negative impact while firm age has a significant impact in this framework. The R square value is elevated while considering control variables in the fixed effect regression model. The results shows that size of corporate board may influence the quality of financial reporting. The large boards sizes are found in efficient to perform duties hence managers find ways to manipulate information in their own benefits. Further, an independent board is a better choice to improve the financial reporting quality. Hence the outsider directors play an important role for transparent information sharing. Similarly dual position of manager or CEO may influence the quality of financial reporting. As the CEO can use discretionary powers and influence the independent auditing process of business.

## 4. Conclusion

The quality of financial reporting has a vital position for the success and failure of business. The failure or success of business affects the economy as the business is considered backbone of economy. Therefore, the factors influence the financial reporting quality is very popular in business research. Previous researches focused on developed world hence a dearth of literature is found on developing countries perspective. This investigation is carried out with the focused to explore the link between supply chain governance structure and quality of financial reporting. Results show that governance characteristics has significant role on the quality of financial reporting. Board size, board independence and CEO duality were considered to measure the effect on financial reporting quality. This investigation provides guidelines for top management and policy maker to drw guidelines for supply chain governance mechanism for corporation to improve financial reporting quality. In addition to this the equity investors should review the governance structure of business before taking investment decisions.

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