

# The Role of Governance Mechanisms in Improving the Performance of Economic Entities

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**Abstract-** *The present research aims to review the legal and regulatory frameworks related to governance and compare them with the way local economic units are manage. The deficiencies are then identify and should be consider arriving at a set of conclusions and recommendations that seek to improve the performance of these units. The research problem is a key question, to what extent the application of governance mechanisms contributes to protecting shareholders from conflicts of interest, It is the misconduct of the Unit's officials, the owners of the majority of the shares, As well as enhancing the delivery of information to owners regarding decisions affecting their investments. In order to achieve the objective of the research, descriptive analysis and quantitative analysis were use. In the quantitative analysis, the application of data through a questionnaire was use as a research tool and the Statistical Package for Social Sciences (SPSS) was use to analyze the research data and to reach the results. The most important conclusions were deficiencies in the legal and regulatory environment related to the legislation, laws and instructions of the units, especially with regard to the application of governance and its mechanisms. The most important recommendations were the need to issue a guide for the governance of local economic units as practiced in the rest of the world and to benefit from their experiences in this regard. In particular, the experiences of Arab countries and the attempt to unify the accounting policies followed in the Iraqi units in order to facilitate the task of applying governance on the one hand and keep abreast of global and international developments in this regard on the other.*

**Keywords:** *Governance Mechanisms, Economic Entities, Financial Managers, Audit Committees, Disclosure of Accounting.*

## I INTRODUCTION

The economic units suffer from many problems, the most important of which is weak management effectiveness, and neglect of the rights of minority shareholders, and lack of adequate protection, In addition to the lack of information and lack of transparency in those units.

The performance of economic units can be improved through the application of governance and its mechanisms, particularly with regard to the formation of boards of directors of independent members and the formation of independent audit committees among the independent directors, As well as the rotation of external auditors between economic units from time to time.

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Governance focuses on transparency in economic unit transactions, accounting operations, financial statements as well as financial audit to prevent corruption and adopt fair methods of bankruptcy proceedings and in case of failure of the unit (Lutfi, 2010: 130-131).

It is also define as the procedures and structures through which the business and affairs of the Unit was managed in order to maximize the long-term benefit of shareholders by enhancing the performance and issue of the Unit taking into account the interests of different parties (Von, 2003: 3).

The Basel Committee defined it as a set of relationships between management, shareholders and stakeholders through which the objectives of the unit are achieved and helps to identify authority, provide requirements for achieving objectives and oversee economic unity (basel, 2014: 1).

The importance of research stems from the fact that the absence or weakness of the application of governance and its mechanisms, especially with regard to disclosure and transparency, non-separation of ownership from management and the failure of the Board of Directors to fulfill its responsibilities. This led to weak control of executives and consequently the collapse of economic units, which led to damage to all the parties involved, including shareholders, employees, financial institutions, suppliers, and consumers and other beneficiaries.

## **II HISTORICAL DEVELOPMENT OF THE CONCEPT OF GOVERNANCE**

The first claims of separation of ownership from management in general and censorship by economists were in 1932, the first spark of the concept of governance. In 1977, the Anti-Corruption Act was draft after the Water Gate scandal in the United States. In addition to the collapse of a large number of economic units that were working in the field of loans and savings. In 1985, a tread way commission was establish to reform and reduce violations (Taleb and Mashhadani, 2011: 27-28).

In 1997, the Asian financial crisis emerged, and in 1999, a report was issue containing the principles of governance by the Organization for Economic Cooperation and Development, which included the separation of the functions and terms of reference of the supervisory board from the executive board in the management of units (Beauty, 2014: 489). The economic meltdown and financial crises in the early twenty-first century, most notably the collapse of Enron Energy (Enron) and Arthur Anderson.

## **III NEED FOR GOVERNANCE**

There are several reasons or motives for the emergence and adoption of governance, as the need for foreign investment was a major reason for the need to develop concepts of governance, Good governance attracts domestic and foreign investment and helps reduce capital flight. In other words, the more good governance has led to the flow of funds to push development forward and at a lower cost, these drivers can be summarized as follows (El Gammal, 2011: 495):

- a- Separate ownership and management and increase performance control.
- b- The need for financial and non-financial information on performance.
- c- The need for reliable accounting disclosure.
- d- To seek to establish rules for financial transparency.

- e- The need for solutions to problems.
- f- Avoid the exposure of economic units to default and financial failure.
- g- Attracting investment.
- h- Improving the reputation of the economic unit and enabling it to access external financing.

#### **IV PRINCIPLES OF GOVERNANCE**

Many organizations seek to establish or develop principles of governance, perhaps the principles established by the Organization for Economic Co-operation and Development (OECD) (Wikipedia, OECD):

**First principle:** The rights of shareholders and the functions of owners means the establishment of a general framework capable of protecting shareholders and facilitating the exercise of their rights.

**Second principle:** Equal treatment for shareholders, which all shareholders of the same class should be treated in one or equal treatment, including small investors and foreign shareholders.

**Third principle:** The role of stakeholders in the governance of economic units, recognition of the rights of stakeholders and workers in the units and work to encourage cooperation between units and stakeholders in the field of wealth creation and employment and achieving sustainability for existing projects.

**Fourth principle:** Disclosure and transparency. The governance framework should provide the achievement of accurate and timely disclosure on all matters relating to the establishment of economic unity, financial position, performance, ownership, and the exercise of power.

**Fifth principle:** The responsibilities of the Board of Directors, the framework of governance of economic units should provide strategic guiding steps for guiding the units, it should also ensure effective follow-up to executive management by the Board of Directors and include accountability of the Board of Directors by shareholders.

**Sixth principle:** An effective framework for the governance of economic units is available; the governance structure should be develop taking into consideration the impact of this development on the overall economy and market integrity.

In addition to applying the rules and laws formulated with transparency, as well as the distribution of powers, and that the supervisory bodies perform their work with integrity.

#### **V GOVERNANCE LEGISLATION AND INSTRUCTIONS**

The financial collapses and scandals in the global economic units, especially the American ones, included a long list of them (Paramalat, WorldCom, Enron, health south, vivent, ahold), which indicated that there is a weakness in the governance of economic units and specifically in the control systems of the various activities. As it became common in the United States when referring to Enron for example, it is used for every economic unit that does not have sound management practice and indicates that this unit is free from error, excesses, fraud and manipulation. It is necessary to see the extent of the damage caused by these collapses, as well as to see the reaction of the legislative and regulatory bodies responsible for regulating financial markets and accounting bodies. In fact, these and other scandals were behind accountants, who created a wave of discontent with the entire profession, Accountants who fail in England have a negative impact on the trust accorded to accountants.

The same can be said regarding the work of the external auditors and their role in cases of failure. The criticisms were fair and called for scrutiny of what happened in order to see what could be learned from these events. The protection of the investor is the main objective of governance, the study of the history of investor protection must pass through a study of financial collapses, and the laws issued to respond to those collapses. As according to the report restoring confidence in financial reports, the main responsibility for the integrity of financial reports lies with the Board of Directors ([www.ifac.org/credibility](http://www.ifac.org/credibility)).

This is consistent with the position of the Organization for Economic Cooperation and Development, as the Board of Directors is primarily responsible for the integrity of the financial disclosure of the economic unit and is the cornerstone of the governance of the unit, which corresponds to the position of many countries on this issue ([www.hawkama.net](http://www.hawkama.net)).

While the American position bears responsibility from the CEO and CFO instead of fully uploading it to the Board of Directors.

In addition, this position is based on the idea that OECD principles emphasize strategic planning, information technology, financing, and the relationship with the investor at a time when financial control has weakened accordingly, the reaction in the Sarbanes Oxley Act focused on the following topics ([www.sec.gov](http://www.sec.gov)):

- 1- Certificates of executive and financial managers.
- 2- The independence of the auditor for the purposes of governance.
- 3- Audit committees and their role in governance.
- 4- Disclosure of accounting procedures for governance purposes.

#### ***A- Certificates of Executive and Financial Managers:***

Sarbanes Oxley act has focused on the necessity of obtaining a clear certificate by the CEO and CFO regarding internal control, the Securities Commission (SEC) with a number of points has clarified it, and the following are the most important:

- Review the report.
- The report should not contain any incorrect recognition of a material fact or refrain from mentioning any material fact necessary in order to give the financial statements presented clearly the circumstances in which these lists were given and make them not misleading.
- The financial statements and any other financial information present in the report should show all the material aspects related to the financial situation and the results of operations related to the economic unit of the paragraphs covered in the report.
- The responsibility of the managers in disclosing the establishment and maintenance of the internal control system and designing the internal control systems to ensure that this material information related to the economic unit and its subordinate units is known to the managers by others. As well as assessing the effectiveness of internal control and reporting on the effectiveness of internal control.

### ***B- The independence of the auditor for the purposes of governance***

The independence of the external audit, represented by the auditor, is the second aspect in the framework of addressing weaknesses in financial control. Therefore, audit firms played a large role in obtaining these scandals, which necessitated highlighting the relationship between companies and their customers, for example, "Anderson, Enron".

This means that there is no objection that prevents the accounting company from providing consulting and other non-auditing services to its clients who are auditing their accounts; in addition to that, there is no limit to the number of years of dealing with the accounting company. As it can undertake auditing of customer records for more than a year and has reached Enron, for example, 16 years old ([www.eippo.arabia.org](http://www.eippo.arabia.org)).

While Sarbanes-Oxley Act came to address the weaknesses mentioned above related to non-auditing services, as it focused on the auditor not performing non-auditing services (except in exceptional cases). and it is necessary to support the rotation of auditors after five years and note whether one of the members of the Board of Directors for economic units The subject of the audit was working within the audit team or company within a period of one year from the date of the start of the audit procedures, in addition to requiring the auditor to report critical matters and policies used by the economic unit to the audit committee. Moreover, to report alternative accounting treatments and results the religion to use those alternatives.

### ***C- Audit Committees and Their Role in Governance.***

The audit committee is concerned with the supervision and control of financial reports. It supervises and reviews independent financial reporting, internal control, and external auditors. Accordingly, the function of the audit committee is considered the most dangerous job in the economic unit because this committee represents the guarantee in the operations carried out by the administration. internal control employees and independent external auditors, and in this field Sarbanes-Oxley law referred to the work of the audit committees and what they should enjoy, the most important of which are ([www .sec.gov](http://www.sec.gov)) :

- Each member of the Audit Committee is independent according to the specified criteria.
- The audit Committee should have the authority to appoint an independent consultant or independent consultants and take all necessary measures to perform its duty.
- Providing the necessary funding for the audit committee in each economic unit.
- The audit committee is directly responsible for setting and fixing wages and supervising the work of the external auditors.
- The audit committee is responsible for the procedures for communicating and handling complaints regarding accounting, internal control, and audit fees.

### ***D- Disclosure of Accounting Procedures for Governance Purposes.***

The Sarbanes-Oxley Act is required to disclose in periodic reports all off-budget transactions, arrangements, and obligations, including potential liabilities or any other relationships of economic unity, with non-unified entities and other persons who have a material or future influence on the financial position, results of operations, liquidity, capital expenditures, capital sources, or important components For expenses and revenues.

## VI RESEARCH METHODOLOGY

For the purpose of achieving the objectives of the research, a questionnaire was included that included a main axis to clarify the extent to which the application of governance and its mechanisms contribute to protecting shareholders from one side and enhance the delivery of information and transparency to investors for the purpose of assisting them in the decision-making process. As well as an axis that includes the personal data of the 60 respondents, most of whom are investors in the Iraq Stock Exchange and university professors at local universities.

Likert scale has been used in the questionnaire form, which allows greater flexibility for the respondent to express an opinion. The scale consists of five levels starting from strongly agree to not agree strongly and gives weight for each answer starting from (5) and ending with (1).

### a. Questionnaire analysis:

**Table 1:** Arithmetic mean and standard deviation to implement governance and its mechanisms:

NO	Paragraph	Arithmetic mean	Standard deviation	Coefficient of Variance	Materiality
1	Governance is one of the mechanisms through which shareholders in economic units are protected.	4.20	1.002	1.044	4
2	The application of governance further enhances the delivery of information on the one hand and increases transparency in providing information to users on the other hand.	4.38	0.846	0.715	2
3	There is a lack of local instructions and legislation that compel local units to implement governance and its mechanisms	4.32	0.930	0.864	3
4	The application of governance and its mechanisms contributes to attracting local and foreign investments.	4.25	0.836	0.669	1
5	The necessity of issuing instructions and legislations that obligate the units to implement governance in order to benefit from the advantages obtained from their application.	4.15	1.005	1.113	5

NO	Paragraph	Arithmetic mean	Standard deviation	Coefficient of Variance	Materiality
6	Total indicator of governance application and mechanisms	21.30	3.126	9.773	
Source: Prepared by researchers using SPSS outputs					

It is clear that the second question (the application of governance increases the enhancement of information delivery on the one hand and increases transparency in providing information to users on the other hand) He got the highest arithmetic mean, as it reached 4.38, which qualified to be the second most important question. While the fourth question, which stipulated (that the application of governance and its mechanisms contributes to attracting local and foreign investments), occurred on the least standard deviation, it reached (0.836) and the lowest difference coefficient of (0.669), which qualified it to be the first question in terms of relative importance.

**b. Correlation coefficient for the application of governance and its mechanisms:**

**Table 2:** Correlation coefficient for the application of governance and its mechanisms

NO	Paragraph	Correlation coefficient
1	Governance is one of the mechanisms through which shareholders in economic units are protected.	** 0.618
2	The application of governance further enhances the delivery of information on the one hand and increases transparency in providing information to users on the other hand.	** 0.597
3	There is a lack of local instructions and legislation that compel local units to implement governance and its mechanisms	** 0.655
4	The application of governance and its mechanisms contributes to attracting local and foreign investments.	** 0.671
5	The necessity of issuing instructions and legislations that obligate the units to implement governance in order to benefit from the advantages obtained from their application.	** 0.778
Source: Prepared by the researcher, using SPSS		
** Significant at the significance level 0.01		

**c. Measuring the stability of the governance application axis and mechanisms:**

**Table 3:** Measuring the stability of the governance application axis and mechanisms

NO	Alpha Kornbach to the axis of application of governance and its mechanisms	Alpha Kornbach
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1	Governance is one of the mechanisms through which shareholders in economic units are protected.	0.675
2	The application of governance further enhances the delivery of information on the one hand and increases transparency in providing information to users on the other hand.	0.657
3	There is a lack of local instructions and legislation that compel local units to implement governance and its mechanisms	0.636
4	The application of governance and its mechanisms contributes to attracting local and foreign investments.	0.618
5	The necessity of issuing instructions and legislations that obligate the units to implement governance in order to benefit from the advantages obtained from their application.	0.564
Stability coefficient of the axis of application of governance and its mechanisms		0.683
Source: Prepared by the researcher, using SPSS		

The stability coefficient of the governance axis and application of mechanisms, as illustrated in the table, is reached (0.683) it is greater than the standard stability factor of (0.600). In addition, question number five contributed more than others to the stability of the axis questions, and if this question is canceled, the stability factor of the axis will decrease to reach (0.564).

This confirms the research hypothesis, which confirms that the proper application of the governance of economic units and their mechanisms lies in the integrity of legal and regulatory frameworks and requirements. Which work to arrange the relationship between the responsible parties within the unit on the one hand and in providing information in a fair and transparent manner on the other hand.

## VII CONCLUSIONS AND RECOMMENDATIONS

### *First: Conclusions:*

A- Governance is a way to protect investors, as it requires structures and processes that allow economic unity to survive and grow on the one hand and attract investors on the other hand.

B- There is a deficiency in the legal and regulatory environment related to the legislation, laws and instructions of the units, especially with regard to the application of governance and its mechanisms.

C- An independent board of directors must be formed from those who are not working in the economic unit in order to be able to take independent decisions, especially in cases where conflicts of interest exist.

### *Second: Recommendations:*

A- Make efforts to achieve a change in the thinking and convictions of all actors affecting this issue, whether they are or units or even individuals, and spread awareness among shareholders and financial institutions and assist economic units in applying governance methods.



B- Issuing a guide for the governance of local economic units as it is in place in the rest of the world and benefiting from their experiences in this regard. Especially the experiences of Arab countries and trying to unify the accounting policies used in Iraqi units in order to facilitate the task of applying governance on the one hand and keeping pace with global and international developments in this regard on the other hand.

C- Developing local theoretical and applied policies and research in this field as well as the importance of this in keeping pace with new environmental developments in the field of governance and accounting auditing. In addition, how to apply them locally and contribute to solving problems resulting from practical application in many economic units.

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