Examining the Impact of Managerial Narcissism on Earnings Quality Considering the Moderating Role of Corporate Governance in Companies Listed on the Iraq Stock Exchange

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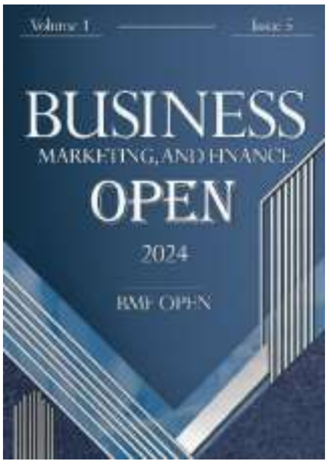

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Abstract: The primary objective of this study is to examine the moderating role of corporate governance in the impact of managerial narcissism on earnings quality in companies listed on the Iraq Stock Exchange. The study covers all companies listed on the Iraq Stock Exchange during the period from 2016 to 2021. This research is applied in nature, and to analyze the research hypotheses, a multivariate regression model has been employed using EViews software. The results of the research hypotheses indicate that managerial narcissism is associated with lower earnings quality. Furthermore, corporate governance moderates the negative relationship between managerial narcissism and earnings quality in a decreasing direction. Therefore, regulators should consider other institutional audit relationships, such as those formed between the audit firm and client personnel, when evaluating earnings quality.

Keywords: Managerial Narcissism, CEO Earnings Quality, Corporate Governance, Iraq Stock Exchange Companies.

1. Introduction

Investors and traders in the stock market are constantly seeking information about company stocks and their performance. Financial reports are the most critical output of a company's accounting system, containing extensive informational content, including data on corporate performance and capabilities. These reports are widely utilized by financial and economic decision-makers [1, 2]. One of the most essential components of financial reports within the accounting system is earnings, which significantly influences investors' and analysts' decisions. Earnings serve as a key performance evaluation metric used to determine corporate value and assess company performance. Deficiencies in the estimation and forecasting processes regarding future corporate performance and earnings have led to discrepancies between actual earnings and reported earnings in financial statements, making this issue a significant and noteworthy area of investigation. Consequently, the quality of financial reports, particularly earnings quality, is crucial for making informed and reliable investment decisions [3-6].

With the expansion of financial crises in recent years, there has been an increased emphasis on implementing corporate governance mechanisms worldwide. While, according to national laws, shareholders are considered company owners, and managers are expected to allocate resources and manage organizations to maximize shareholder returns, the expansion and development of corporations and the increasing dispersion of stock ownership make shareholder control more challenging. As a result, major responsibilities are transferred to corporate executives, including the board of directors and the CEO. It is evident that as long as companies do not face financial difficulties, they remain manageable. However, in times of crisis, shareholders often resort to leadership changes. Thus, designing internal and external control mechanisms is imperative, enabling shareholders to oversee corporate strategies and managerial activities, ensuring accountability, transparency, and greater corporate social responsibility [7, 8].

Corporate governance comprises a set of internal and external control mechanisms that establish a proper balance between shareholder rights and the board of directors' responsibilities. These mechanisms provide reasonable assurance to shareholders, financial resource providers, and other stakeholders that their investments will yield appropriate returns and that value creation mechanisms are in place [9].

Investors require relevant information to make economic decisions and allocate resources effectively to maximize returns. One of the most crucial factors in selecting optimal investments is earnings and earnings quality. Thus, recognizing the quality of accounting earnings is of significant importance. One key factor potentially influenced by earnings quality is stock liquidity risk, which has been widely acknowledged in various studies. Investors may need to liquidate their investments quickly, making stock liquidity an essential consideration. Stock liquidity is closely related to investor demand for trading in the stock market. According to Statement No. 1 of Financial Accounting Concepts, high-quality earnings provide more information about a company's financial performance characteristics, particularly in relation to specific decisions made by specific decision-makers. Earnings quality is a multidimensional concept that has been defined and evaluated in various ways. Some researchers define earnings quality as consistent, recurring, and cash-generating from operations, while others associate it with profitability, the likelihood of future earnings, and confidence in future earnings. Generally, investors and financial analysts consider earnings quality to accurately assess a company’s future performance and make informed investment decisions. When companies generate earnings, they distribute a portion of their net profit among shareholders based on legal requirements and their needs. The amount distributed as cash dividends to shareholders is known as the dividend payout [10, 11].

Narcissism is a personality trait characterized by excessive self-interest, a constant need for admiration, and cognitive biases. Among corporate executives, narcissism can impact organizational outcomes by influencing managerial choices in areas such as strategy, structure, and recruitment. Compared to other personality traits, narcissism drives managers toward actions that deviate from norms and seek admiration, ultimately affecting organizational performance. Narcissism, widely studied as a personality disorder, manifests in executives through traits such as a desire for power, self-aggrandizement, superiority, arrogance, exploitative behavior, entitlement, and self-sufficiency. In most cases, narcissistic managers pursue grand achievements within their companies, engaging in bold strategic actions and high-risk business ventures. Theoretically, in psychology, narcissism is classified as a personality disorder characterized by excessive self-entitlement, a tendency to exploit others for personal gain, dominance in decision-making, disregard for others' opinions, and an excessive desire for recognition and rewards. Consequently, organizations with narcissistic individuals may experience dysfunctional operations and impaired performance due to dominance-driven relationships, mistreatment of others, and emotionally driven decision-making [12-14].

The corporate governance system serves as a supervisory mechanism to regulate financial and managerial behaviors, aligning with the legal and cultural framework of each corporation (organization). The mechanisms within this system are tailored to these contextual conditions. The key components of corporate governance include the ratio of executive and non-executive board members, their independence from executive managers, the presence or absence of committees such as audit committees, and the involvement of institutional investors. When these elements and mechanisms are properly implemented, effective supervision and control can be achieved.

Following the emergence of agency problems, measures were introduced to safeguard public interests, align managerial and ownership interests, and protect information integrity. Various mechanisms have been employed to address these issues, including applying ethical theories in accounting, establishing theoretical frameworks and accounting standards, implementing internal controls, conducting internal and independent audits, incorporating non-executive directors on corporate boards, and adopting long-term incentive compensation strategies, even through government legislation. However, despite these efforts, agency problems have persisted and grown more complex [15-20].

Dividend payouts provide valuable insights not only into future profitability but also into earnings quality. Investors and financial analysts assess earnings quality and earnings sustainability through dividend distributions and distributable profits. Since dividend payments are backed by stable cash flows and reduce free cash flow availability, they convey important information to investors. This implies that dividend-paying companies generally exhibit higher earnings quality than non-dividend-paying firms. Additionally, companies that distribute dividends tend to have higher earnings quality and lower accruals than other firms. Given the significance of this topic, the present study examines the impact of managerial narcissism on earnings quality, considering the moderating role of corporate governance in companies listed on the Iraq Stock Exchange.

2. Methodology

The present study is applied in terms of its objective and semi-experimental in terms of research methodology. The reasoning method in this research follows a deductive-inductive approach. The study belongs to the category of positivist research from a theoretical perspective and is classified as descriptive and correlational from a statistical standpoint. Multivariate linear regression is employed to test the research hypotheses. For hypothesis testing, financial report data from companies have been extracted from the Iraq Stock Exchange website.

The statistical population of this study consists of companies listed on the Iraq Stock Exchange during the period from 2016 to 2021. The sample selection follows an exclusion-based approach, where selected companies are chosen from the total listed firms based on the following criteria:

- To ensure comparability, companies must have a fiscal year ending in December, with no fiscal year changes during the research period.
- To maintain homogeneity, companies engaged in banking, credit institutions, insurance, and other financial intermediation activities are excluded.
- Data related to the selected variables in this study must be accessible.
- Companies should not have experienced consecutive trading halts exceeding six months during the research period.
- Companies must have been listed on the Iraq Stock Exchange before 2016 and should not have been delisted during the study period.

The sample size determination process is presented in table below:

Table 1. Determining the Statistical Sample Size

Row	Description	Number of Companies
1	Total companies listed on the Iraq Stock Exchange at the end of 2021	134
2	Companies in financial intermediation industries, holdings, banks, and insurance	(68)
3	Companies with unavailable required data for the study	(32)
4	Companies with fiscal years not ending in December or with fiscal year changes during the study period	0
5	Companies newly listed during the research period	0

Final Sample Size	Selected sample of companies	34

Based on the above table, 34 companies have been selected as the research samples.

Research Models and Variables

This study employs the following regression model to test its hypotheses. The primary objective of the research is to examine the impact of corporate governance on the relationship between CEO narcissism and earnings quality. To test the hypotheses, the following regression models are used:

Model 1:

$Earnings\ Quality_{it} = a_0 + a_1\ CEO\_NAR_{it} + a_2\ PRICESTD_{it} + a_3\ Size_{it} + a_4\ LEV_{it} + a_5\ ROE_{it} + a_6\ M/B_{it} + a_7\ BOARDSize_{it} + a_8\ Age_{it} + \varepsilon_{it}$

Model 2:

$CG_{it} = a_0 + a_1\ CEO\_NAR_{it} + a_2\ PRICESTD_{it} + a_3\ Size_{it} + a_4\ LEV_{it} + a_5\ ROE_{it} + a_6\ M/B_{it} + a_7\ BOARDSize_{it} + a_8\ Age_{it} + \varepsilon_{it}$

Model 3:

$Earnings\ Quality_{it} = a_0 + a_1\ CEO\_NAR_{it} + a_1\ CEO\_NAR_{it} * CG_{it} + a_2\ PRICESTD_{it} + a_3\ Size_{it} + a_4\ LEV_{it} + a_5\ ROE_{it} + a_6\ M/B_{it} + a_7\ BOARDSize_{it} + a_8\ Age_{it} + \varepsilon_{it}$

Research Variables

Dependent Variable

Earnings Quality (Earnings Quality)

Earnings quality is assessed using various criteria. If only a single measure or a limited set of criteria is used, the test results may be unreliable. Therefore, this study employs the **accrual quality** measure to evaluate earnings quality.

Accrual Quality (Accrual Quality)

Earnings are recognized based on accrual accounting, meaning that revenues and expenses are reported when they are incurred, rather than when cash is received or paid. Given that the accrual basis incorporates estimates and forecasts in profit calculation, it serves as a useful metric for investors' decision-making regarding earnings quality.

This study utilizes the model proposed by Dechow and Dichev (2002) and McNichols (2002). This model is estimated as a time series for each company in each year. The residual term and the standard deviation of the residual over three consecutive years represent abnormal accruals for each firm annually.

The model is as follows:

$TACC_{it} = \alpha + \beta_1 (1/TA_{it-1}) + \beta_2 (CFO_{it-1} / TA_{it-1}) + \beta_3 (CFO_{it} / TA_{it-1}) + \beta_4 (CFO_{it+1} / TA_{it-1}) + \beta_5 (\Delta Sales_{it} / TA_{it-1}) + \beta_6 (PPE_{it} / TA_{it-1}) + \varepsilon_i$

Where:

$TACC_{it}$ = Total accruals of company i in year t

TA_{it-1} = Total assets of company i in year t-1

CFO = Operating cash flow of company i in years t-1, t, and t+1

PPE_{it} = Fixed assets of company i in year t

$\Delta Sales_{it}$ = Change in sales of company i in year t

From this model, two measures are obtained to evaluate abnormal accruals, which are used to assess earnings quality in the secondary hypothesis of this study:

- **AAQ:** Absolute value of the regression model’s residual for company i
- **AQ:** Standard deviation of the regression model’s residual over five years for company i

Independent Variable

CEO Narcissism (Narcissism)

CEO narcissism is measured based on the CEO's signature size. Following previous studies (e.g., Ham et al., 2017), a square or rectangular boundary is drawn around the CEO's signature, extending to the signature's outermost points. The area of this boundary is then measured. According to the Pareto rule, CEOs whose signature sizes fall within the top two deciles for each industry are assigned a value of one (indicating a narcissistic CEO), while all other CEOs are assigned a value of zero. To control for signature-related errors, the average signature size across all available signatures for each CEO is used. CEO signatures are collected from corporate reports available on the Codal website, specifically from board activity reports and financial statements of the studied companies.

Moderator Variable

Corporate Governance (CG): The corporate governance index (CG) is measured using a checklist comprising six components that align with the reporting environment in Iraq:

1. **Board Financial Expertise:** If at least one board member has an accounting or finance background, the firm is assigned a value of one; otherwise, it is assigned zero.
2. **Board Gender Diversity:** If at least one female board member is present, the firm is assigned a value of one; otherwise, it is assigned zero.
3. **Audit Committee:** If the company has an audit committee, it is assigned a value of one; otherwise, it is assigned zero.
4. **Audit Firm:** If the company is audited by Iraq's Supreme Audit Institution or other large audit firms (with above-median partner numbers), it is assigned a value of one; otherwise, it is assigned zero.
5. **Board Size:** If the board has more than the median number of members, the firm is assigned a value of one; otherwise, it is assigned zero.
6. **Institutional Ownership:** If the firm has institutional investors (such as banks or investment firms), it is assigned a value of one; otherwise, it is assigned zero.

The final **corporate governance score** is obtained by summing these values, with a minimum possible score of zero and a maximum of six.

Control Variables

- **Stock Price Volatility (PRICESTD):** Standard deviation of stock price relative to its mean
- σ = sqrt(1/N Σ (x_i - μ)^2)
- **Firm Size (Size):** Natural logarithm of total assets
- Size = LN(Asset)
- **Leverage (LEV):** Total debt divided by total assets
- **Return on Equity (ROE):** Net income divided by shareholder equity
- ROE = Net Income / Shareholder Equity
- **Book-to-Market Ratio (B/M):** Book value divided by market value
- B/M = Book Value / Market Value
- **Board Size (BOARDSize):** Number of directors on the board
- **Firm Age (AGE):** Difference between the research year and the firm's establishment year

3. Findings

Table 2 presents the descriptive statistics of the research variables. Based on the descriptive statistics table, earnings quality, which is the dependent variable of the study, has a median and mean that are very close to each other. The independent variable, CEO narcissism, is measured based on the top two deciles of CEOs in terms of narcissistic tendencies. The moderating variable, corporate governance, shows that more than half of the companies scored 3, with the highest score being 5 and the lowest score being 0. Among the control variables, the minimum firm age is 0.69 years, corresponding to Asia Cell Telecommunications in the telecommunications and internet industry, which is a newly listed company on the stock exchange. In terms of board size, more than half of the companies have a board consisting of seven members.

Table 2: Descriptive Statistics of Research Variables

Variable Type	Variable	Mean	Median	Minimum	Maximum
Dependent	Earnings Quality	-0.08	-0.06	-0.39	-0.001
Moderator	Corporate Governance	3.14	3	1	6
	Stock Price Volatility	0.19	0.16	0.01	0.82
Control	Board Size	6.46	7.00	5.00	9.00
	Firm Size	21.91	21.75	0.01	28.99
	Financial Leverage	0.32	0.25	0.01	0.93
	Firm Age	3.42	3.36	0.69	4.33
	Market-to-Book Ratio	3.35	2.50	0.27	13.65
	Return on Equity	0.17	0.06	-0.86	0.88
Number of Observations	232 firm-years				

Table 3. Descriptive Statistics of Control Variables

Variable Type	Variable	Count of Zero	Count of One	Percentage Zero	Percentage One
Control	CEO Narcissism	158	46	78%	22%
Number of Observations	204 firm-years				

Table 4. Regression Results for Hypothesis 1

Variable	Symbol	Coefficient	t-statistic	p-value	Variance Inflation Factor (VIF)
Intercept	β	-0.256	-0.66	0.508	-
CEO Narcissism	narcissism	-0.17	-8.18**	0.000	1.33
Stock Price Volatility	PRICESTD	0.03	0.61	0.53	1.39
Board Size	BOARDSize	-0.003	-0.41	0.67	1.97
Firm Size	Size	0.002	0.55	0.58	1.46
Financial Leverage	LEV	0.02	0.79	0.42	1.54
Firm Age	AGE	0.04	1.86	0.06	1.24
Market-to-Book Ratio	MTB	0.003	1.00	0.31	1.54
Return on Equity	ROE	0.02	0.69	0.48	1.24
F-statistic (p-value)	8.83 (0.000)	R-squared	0.25		
Durbin-Watson Statistic	1.97	Number of Observations	204		
Limer F-Test Significance	0.000	Hausman Test Significance	0.1448		

The first research model was estimated using panel data with a random effects approach. The Durbin-Watson statistic (1.97) indicates no serial correlation among the model's error terms.

The results for Hypothesis 1 show that CEO narcissism (independent variable) has a significant negative relationship with earnings quality (dependent variable). The p-value (0.000) is less than 0.05, and the coefficient of -0.17 indicates a negative and significant relationship. Thus, Hypothesis 1 is supported at a 95% confidence level.

The adjusted R-squared indicates that 25% of the variations in the dependent variable are explained by the independent variables in the model. Furthermore, the variance inflation factor (VIF < 5) confirms no multicollinearity among the independent variables.

Table 5. Regression Results for Hypothesis 2

Variable	Symbol	Coefficient	t-statistic	p-value	Variance Inflation Factor (VIF)
Intercept	β	-0.256	-0.66	0.508	-
CEO Narcissism	narcissism	-0.01	-0.08	0.93	1.33
Stock Price Volatility	PRICESTD	0.43	1.16	0.24	1.39

Board Size	BOARDSize	0.18	3.57**	0.000	1.97
Firm Size	Size	0.05	1.37	0.16	1.46
Financial Leverage	LEV	-0.32	-1.10	0.26	1.54
Firm Age	AGE	-0.74	-3.39**	0.000	1.24
Market-to-Book Ratio	MTB	-0.03	-1.62	0.10	1.54
Return on Equity	ROE	-0.37	-1.84**	0.06	1.24
F-statistic (p-value)	4.67 (0.000)	R-squared	0.12		
Durbin-Watson Statistic	1.51	Number of Observations	204		
Limer F-Test Significance	0.000	Hausman Test Significance	0.24589		

The results for Hypothesis 2 show no significant relationship between CEO narcissism and corporate governance at the 5% error level since the p-value (0.93) exceeds 0.05. Thus, Hypothesis 2 is rejected.

The adjusted R-squared indicates that only 12% of the variations in the dependent variable are explained by the independent variables. The VIF values (less than 5) indicate no multicollinearity.

Table 6. Regression Results for Hypothesis 3

Variable	Symbol	Coefficient	t-statistic	p-value	Variance Inflation Factor (VIF)
Intercept	β	-0.256	-0.66	0.508	-
CEO Narcissism	narcissism	-0.17	-8.45**	0.000	1.98
CEO Narcissism * Corporate Governance	Narcissism* CG	0.01	1.96	0.04	2.23
F-statistic (p-value)	8.39 (0.000)	R-squared	0.26		

The results for Hypothesis 3 show that the interaction term (CEO Narcissism * Corporate Governance) has a significant effect at the 5% level (p-value = 0.04 < 0.05). The sign of the interaction term is different from that of CEO narcissism, indicating that corporate governance weakens the negative relationship between CEO narcissism and earnings quality. Thus, Hypothesis 3 is supported.

4. Discussion and Conclusion

Business entities are led by managers who provide information about their companies, particularly financial data, through financial reports. These reports serve as essential tools for investors and shareholders, who rely on them for decision-making. The core of these financial reports consists of the company's financial statements, which reflect the financial status of the company from its inception to the end of the reporting period. Investors and other stakeholders seeking financial information about these companies can easily make optimal decisions based on such fundamental financial statements. These reports are always prepared by top executives within the company, including managers, and are published after being audited by independent auditors. The disclosed information includes future forecasts, as well as historical and current financial conditions of the company. Therefore, achieving corporate objectives requires reliable and efficient managers who can fulfill their responsibilities effectively.

Managers play a critical role in helping business entities achieve their goals and may adopt different decision-making approaches. For effective decision-making, they require high-quality information that enables them to make optimal and rational choices. The results of testing Hypothesis 1 confirm that CEO narcissism has a significant impact on earnings persistence. This finding aligns with prior studies [9, 21-26].

According to Fields et al. (2001) and Wallace & Zimmerman (1990), the quality of earnings may result from the application of different accounting methods under generally accepted accounting principles (GAAP) [27, 28]. These standards allow managers to legally adjust earnings (or losses) and other key financial statement components. Narcissistic managers may leverage this flexibility to improve the apparent profitability of the company, thereby enhancing their perceived performance.

The results of testing Hypothesis 2 indicate that CEO narcissism does not affect corporate governance. This result contradicts the prior findings which reported a significant positive relationship between CEO narcissism and corporate governance. Hence, the findings of this study do not align with those prior studies [9, 24].

The results of testing Hypothesis 3 indicate that corporate governance moderates the negative relationship between CEO narcissism and earnings quality by reducing its effect. Corporate governance serves as an independent assurance mechanism designed to enhance organizational value and improve operations and can act as a catalyst for corporate earnings quality. As an internal corporate process, governance influences earnings quality and mitigates the adverse impact of CEO narcissism on earnings quality.

In other words, narcissistic CEOs are subjected to stricter oversight under strong corporate governance mechanisms, compelling them to prioritize stakeholder interests and enhance earnings quality. The findings of Hypothesis 3 are consistent with prior studies [29, 30]which concluded that corporate governance plays a crucial role in determining earnings quality.

The present study has the following limitations:

1. Financial data in reports are not adjusted for inflation, which may lead to different results if adjusted.
2. The tools and methods used to measure CEO narcissism may lack complete accuracy, and different interpretations of narcissistic traits in management could affect the findings.
3. Organizational structures and management practices vary significantly across companies. For instance, larger companies often implement more complex and advanced corporate governance mechanisms, whereas smaller firms may lack such frameworks. These differences can influence research outcomes and create variations in earnings quality and its management.
4. Earnings quality is a multidimensional concept that can be affected by earnings manipulation, different accounting methods, and opportunistic managerial behaviors. These factors make precise earnings quality assessments challenging, requiring specific measurement approaches.
5. Due to data availability constraints, statistical analyses may lack sufficient power, and the sample size may not be large enough to represent all companies listed on the Iraq Stock Exchange.

Authors' Contributions

Authors equally contributed to this article.

Ethical Considerations

All procedures performed in this study were under the ethical standards.

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Conflict of Interest

The authors report no conflict of interest.

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