Examining the effect of corporate governance on the relationship between firm value of Firms Listed on the Tehran Stock Exchange

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A R T I C L E   I N F O

A B S T R A C T

The purpose of this paper is to examine the effect of corporate governance on the relationship between the firm value for the listed companies in Tehran Stock Exchange during period 2013-2018. The corporate governance mechanisms include board size, board composition, institutional ownership, financial knowledge of the board, CEO duality, state-ownership and managerial ownership. The population is composed of the firms listed on the Tehran Stock Exchange. Filtering technique is used to select the sample. Furthermore, multivariate regression method, Analysis of Variance (ANOVA) and tree regression methods are used to test the hypotheses. The findings reveal that firm's value prediction is influenced by the two variables of managerial ownership and the non-executive members of the board. The findings of this research show that investors conceive earnings management negatively and earnings management has a negative effect on firm value. But in corporations with high quality corporate governance this effect is reduced. In other words, corporate governance mechanisms has a positive effect on the relationship between firm value and earnings management and firms with a higher corporate governance score face a less negative effect from earnings management..

1- Introduction

Undoubtedly, the industrial revolution, the emergence of corporations and separation of ownership and management were the most important changes over the eighteenth century. Before these changes, economic and business operations were accomplished by individuals. As a result, various stakeholders including shareholders, managers, creditors and employees gathered in corporations and formed organized financial markets in many countries. The managers held the responsibility of handling corporations because the whole stakeholders could not participate in the corporations. The shareholders and stakeholders aim to maximize the corporate benefits which is not necessarily aligned with the interests of the directors. This is the beginning point of conflict of interests (Esmaeilzadeh et al., 2010).

By communicating general policies of the Article 44 of the Constitution of the Islamic Republic of Iran, the corporations are trying to promote an economic situation focused on private ownership and economic growth. Clearly, the business owners play an essential role in making strategic decisions. The decisions which could whether increase or decrease the firms' value. The present

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gathered in corporations and formed organized financial markets in many countries. The managers held the responsibility of handling corporations because the whole

stakeholders could not participate in the corporations study bridges the gap between corporate governance literature on financial and accounting fields. Governing corporations based on market values will provide the chance to achieve added value resulted from corporate governance approaches. As a consequence, integration analysis is used which fits the evaluation model. In other words, changes in corporate governance mechanisms of a firm are consistent with the changes in the firm value for a long time. Therefore, the present study seeks to identify and rank the corporate governance factors impacting firm's value.

2- Theoretical Framework

The model shows the relationship of variables with each other. this model assumes that corporate governance is affected by ownership concentration can affect corporate governance which would have impact on to firm's value. The good corporate governance mechanism is expected to increase firm's value. There is ample evidence in the literature, that the more the ownership concentration the less would be the effective corporate governance. The relationship between the CEO duality i.e. the holding of both the top offices of the chairman and the CEO by the same person and corporate governance has also been shown. Moreover, the firm's value has been determined by Institutional Ownership, namely, Institutional investors have come to play an important part in the debate about shareholder value creation and the corporategovernance of public companies (Hellman, 2005). The impact on another variable that would be seen on corporate governance is board independence.The fraction of Board's Independence is expected to maximizefirmvalue .Weisbach(1988) provides evidence that the greater the number of outside directors on the board, the stronger the corporate governance of the firm. Helland and Sykuta (2005) suggest that boards with higher

proportions of independent (outside) directors do a better job of monitoring management. Fama and Jensen(1983) argue that manager-monitoring activities of the board will be more effective when they are dominated by independent-outside directors. The positive relationship is expected because of the positive effect of monitoring function of the independent directors.The literature also supports the proposition that presence of more independent directors on the board leads to better corporate governance, which in turn would positively impact the firm's value. It has been shown in the model that firm's value would be measured through Tobin's Q

Figure (1) conceptual Framewok of the research
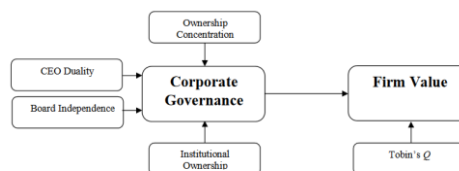
3- Theoretical bases

Firm size, credit, solvency and growth rate are the measures of firm value which have been used in the prior literature; however, governance quality is a new measure introduced in the recent studies (Yeganeh and Dadashi, 2010). Corporate governance system is a set of guidelines, structures, processes and cultural norms by which the firms will achieve their objectives in terms of transparency in working processes and accountability to the stakeholders. The firms with more growth opportunities have higher enterprise values. Growth opportunity and capital structure are the effective factors of decision making at both micro and macro levels.

That is, the profit is considered as a source of finance by the firms with higher growth opportunity (Sinayi et al., 2011). Ownership structure of the firms plays a significant role in determining firm's value. There is a non-linear relationship between managerial ownership (shares held by the managers) and firm value. Monitoring managers' operations will be more difficult when the managers hold the majority of the

shares. This is because holding the majority of shares helps managers resist external pressures. Those managers who are not monitored by the others hold more cash to pursue their personal interests. The net impacts of the prior items will determine the relationship between managerial ownership and cash holdings (a non-linear relationship) (Ozkan and Ozkan, 2004).

4- Literature review

Andreou et al. (2014) investigated the relationship between corporate governance and financial managementdecisions such as earnings management and sub-optimal investment in maritime industries. They have also considered factors related to firm performance in their study. Finally, it was determined that their used corporate governance measures, such as insider ownership, board size, presence of corporate governance committees, the percentage of directors serving on the boards of other firms and CEO duality, are associated with financial management decisions and firm performance.Gupta and Sharma (2014) investigated the effect of corporate governance practices on the performance of Indian and South Korean companies. They tried to show that better corporate governance leads to better performance of the company. The results showed that the practices of corporate governance impose effective limitations on both the share prices of companies and their financial performance.Koerniadi et al. (2014) analyzed practices of corporate governance and variability of stock returns. Their findings showed that in the case of thestability of other factors, various aspects of corporate governance such as board composition, shareholder rights, and disclosure practices are associated with lower levels of risk. Mousavi et al. (2010) studied the effect of some of the regulatory mechanisms of corporate governance such as ownership concentration on the rate of return on assets, return on equity and the ratio of market value to book value. Their results showed that there is a significant relationship between the concentration of owner shipand return on assets, but there is no relationship between concentration of ownership and return on equity and the ratio of market value to book value. Lee (2008) investigated the effect of ownership structure on financial performance of the companies. Heconsidered the two criteria of ownership concentration and the nature of shareholders as the criteria of ownership structure and investigated companies listed in South Korean stock exchange in the period of 2000 to 2006 using panel data. The results showed that the performance can be improved by increasing the concentration of ownership of companies, but the effect of institutional ownership and foreign ownership is negligible.

Connelly et al. (2012) studied the effect of ownership structure and corporate governance measures on the value of Thailand firms. Based on their findings, those firms which have not achieved optimum corporate governance measures have lower Tobin's Q.

Chen suggested that the managers decrease their ownership percentage when the firms deviate from the optimal level. However, when the ownership percentage of the managers increases, the firm value moves toward the optimal level. Leung and Cheng (2013) examined the relationship between corporate governance mechanisms and the value of the firms listed on Chinese Stock Exchange. The results show that the accumulated ownership of large shareholders and the CEO compensation have different impacts on the firms controlled by central and local government.

5- MATERIALS AND METHODS

This is an empirical study using inductive method. The findings of this study add to the literature about corporate governance and firm value in Iran. The results of the present paper can be used in solving investment problems. The cross-section and multivariate regressions are employed to analyze the data. The required data is gathered from the related software and Tehran Stock Exchange website and compact discs of the stock exchange. The collected data are classified in computerized spreadsheets and finally processed by SPSS.

Population and sample: The population of the study is composed of the firms listed on the Tehran Stock Exchange from the beginning of 2013 to the end of 2018. The sample firms should have the following characteristics:

To be comparable, the end of the fiscal year should be consistent with the calendar year

There should be no changes in the fiscal year over the sample period (2013-2018)

There should be no changes in the operations over the sample period (2013-2018)

The financial institutions (including mutual funds, financial intermediaries, holdings and leasing) and banks are excluded from the sample

The firms should be listed on the Tehran Stock Exchange The information related to the firms should be available

As shown in Table 1, the final sample is composed of 115 firms selected by filtering technique.

Hypotheses development: The following hypotheses are developed:

Table 1: Sample and population

Number of listed firms until the end of 2018	Non-listed before 2013	Inconsistent with the calendar year	Banks and financial institutions	Ceased transaction for >70 days	The remaining firms
584	179	171	60	111	115

- Board size impacts firm value
- The non-executive members on the board (board independence) impacts firm value
- Institutional ownership impacts firm value
- Board structure impacts firm value
- CEO duality impacts firm value
- State ownership impacts firm value
- Managerial ownership impacts firm value

Variables: The variables of this study are defined below:

- Dependent variable
- firm value at the end of year t(CA)
- Independent variables
- independent variables include Corporate Governance (CG) elements at the end of year (t)
- Board Size
- Non-executive members on the board
- Institutional ownership
- Board structure
- CEO duality
- State ownership
- Managerial ownership
- Control variables:

- Ox^2_t Earnings before extraordinary items at the end of year (t)
- Oat: Net assets at the end of year (t)

6- RESULTS AND DISCUSSION

Findings: Kolmogorov-Smironov test (K-S): The variable of company interests is known by CA and is not normally distributed. As a result, a normal variable is defined for CA by using the equation below:

$LNST_{ca} = In (Z_E + Z_x + Z_{NA})$

Where in it:

$$Z_E = \frac{E - \mu_E}{E \ \sigma_E \mu_M} - N(0,1)$$
$$Z_M = \frac{}{(NA\sigma_M \mu_{NA})} - N(0,1)$$
$$Z_{NA} = \frac{}{\sigma_{NA}} - N(0,1)$$

Where:

E = Earnings before extraordinary items

M = The market value of the equity

NA = The net assets of the firm

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Table 2: Goodness of fit of LN for the sum of the standardized variables of M,E,NA

Variables	LNSTCO
Observations	134
Parameters of normal distribution Mean	
Mean	**0.55**
SD	
The greatest distance	
Absolute value	1.876
Positive	0.065
Negative	-0.108
Z-statistic of Kolmogorov-Smironov test	1.276
Two tailed Sig. level	0.121

Table 3: Parameters of regression model

Models	Correlation coefficient	R^2	Adj. R^2
1	a0.232	0.055	.048

Table 4: Regression coefficients

Models	B	SD	β	t-statistics	Sig. level
Constant value	1.223	0.323		3.928	0.000
Non-executive	0.278	0.124		3.367	0.015
members of the board Managerial ownership	0.188	0.213		1.878	0.022

Based on K-S test, the normality of LNSTCA is confirmed (Table 2). Two tailed Sig. level.

Modelling linear regression: Results of stepwise multivariate linear regression model reveal that nonexecutive board members and managerial ownership are significant for firm value. Based on Table 3, the correlation coefficient is 0.232, R^2 is 0.055 and adjusted R' is 0.048. Regardless of the low level of these coefficients, the model is significant.

Table 4 represents the coefficients of the regression model. As shown in Table 4, the non-executive board members and managerial ownership are the independent variables which significantly influence the dependent variable. The significance level is >98%. The adjusted regression model is defined below: +0.188M LNSTCA = 1.223 -0.287NO1.

NO1 is the number of the non-executive members on the board and M is the managerial ownership. As it seems, the firm value grows by increasing the number of non-executive members on the board.

Managerial ownership is the first factor affecting firm value. On average, when the managerial ownership is <75%, the interests of the firm will increase by 8 million Rials with the point estimation of 8138352 which is 1.61 times more than the average interests of the studied firms (5.42843). However, when the managerial ownership is higher than 75%, firm's interests will be <3798257 (million rials). Therefore, group A is the group with <75 ownership percentage and group B is the group with >75 ownership percentage.

In group A, when the managerial ownership percentage is <66%, the firm's interests are estimated 2734077 (million rials); however, when the managerial ownership is 66%-75%, the firm's interests are estimated 18541571 million rials. CART model predicts firm's interests based on the managerial ownership percentage in three formats shown on Table 6.

For group B, the tree model is classified into two categories based on the number of non-executive members: when the non-executive members are <2 individuals (one or none) and the managerial ownership is >75%, the firm's interests are estimated 7110436 (million rials); however, this amounts to 2689131 (million rials) for two or more non-executive members on the board.

Based on the model, it seems that the managerial ownership of group B is less coordinated with those shareholders who are only the major shareholders of the firm. Managerial coordination with the firms with one non-executive member on the board could increase firm value by 164%.

Table 6: Output of layer one for model CART

Groups	Relative to average (%)	Firm value (%)	Managerial ownership (%)
A2	59	2837890	<66
A1	354	1965363	66%>-75
B	73	3878677	>75

In this successful group which is called B1 by increasing managerial ownership to >89%, the firm's interests are estimated 14539834 (million rials) which is 276% of the average financial interests. When the managerial ownership is 74-87%, the firm's interests of group Bl are 19367743 which is 369% of the average financial interests.

Generally, predicting firm value is affected by two variables of managerial ownership level and the number of non-executive members on the board. Table 7 represents the final output of CART Model. Tree regression model of CART is described in details.

Node O includes all firms' data bout CA. The average of CA in these firms is equal to 5042843 rials. The information is gathered from 816 firm-year observations; that is 100% of the studied firms. Therefore, our prediction about CA is 5042843 million rials.

Node 1 includes all CA data among the firms with the managerial ownership <74%. In these firms, the average CA is 8138352 rials. The information is collected from 234 firm-year observations that is 29% of the studied firms. Generally, we predict that CA is 8138352 rials and this is 1.61 times more than the general mean in node 0.

The second node (Node 2) includes all CA data for the firms with managerial ownership percentage >74%. In these firms, the average CA is 3798256 rials. The

information is collected from 582 firm-year observations which is 71% of the studied firms. Generally, our prediction about CA is 3798256 rials which is 0.69 times more than the general mean in Node 0.

The third node (Node 3) includes all CA data for the firms with the managerial ownership <68%. In these firms, the average CA is 2734077 rials. The information is collected from 154 firm-year observations that is 19% of the studied firms. Generally, we predict that CA is 2734077 rials and this is 0.54 times more than the general mean in node 0.

The fourth node (Node 4) includes all CA data for the firms with the managerial ownership <74%. In these firms, the average CA is 18541581 rials. The information is collected from 80 firm-year observations that is 10% of the studied firms. Generally, we predict that CA is 18541581 rials and this is 3.67 times of general mean in node 0.

The fifth node (Node 5) includes all CA data for the firms with the managerial ownership >74% and with the maximum one non-executive member. In these firms, the average CA is 7119437 rials. The information is collected from 164 firm-year observations that is 18% of the studied firms. Generally, we predict that CA is 7110437 rials and this is 1.41 times of general mean in node 0.

Table 7: Final output of CART Model

Managerial ownership	Firn value	Relative to total (%)	Firn value	Relative to total (%)	Firn value	Relative to total (%)
<69	2899078	55	2737087	55	26098372	55
69-75%	19009838	389	19783387	389	19767367	387
75-89%	3809899	75	19367743	40	2508889	54
>89	3698963	75	14539834	276	2786778	54

Table 8: Results of hypotheses testing

Hypotheses	Sig. level	Results	Descriptions
Board size impacts firm value	286/0	Rejected	alpha =5%
The number of non-executive members on the board impacts firm value	018/0	Confirmed	alpha =5%
Institutional ownership impacts firm value	643/0	Rejected	alpha =5%
Board structure impacts firm value	189/0	Rejected	alpha =5%
CEO duality impacts firm value	289/0	Rejected	alpha =5%

State-ownership impacts firm value	302/0	Rejected	alpha =5%
Managerial ownership impacts firm value	078/0	Confirmed	alpha =5%

The sixth node (Node 6) includes all CA data for the firms with the managerial ownership >74% and with the minimum two non-executive members. In these firms, the average CA is 2689132 rials. The information is collected from 436 firm-year observations that is 53% of the studied firms. Generally, we predict that CA is 2689132 and this is 53% of the general mean in node 0.

The seventh node (Node 7) includes all CA data for the firms with the managerial ownership between 74-87 % and with the maximum one non-executive member. In these firms, the average CA is 1810138 rials. The information is collected from 79 firm-year observations that is 10% of the studied firms. Generally, we predict that CA is 1810138 rials and this is 36% of general mean in node 0.

The seventh node (Node 7) includes all CA data for the firms with the managerial ownership between 74-87 % and with the maximum one non-executive member. In these firms, the average CA is 1810138 rials. The information is collected from 79 firm-year observations that is 10% of the studied firms. Generally, we predict that CA is 1810138 rials and this is 36% of general mean obtained in node 0.

The eighth node (Node 8) includes all CA data for the firms with the managerial ownership >87% and with the maximum one non-executive member. In these firms, the average CA is 13360043 rials. The information is collected from 79 firm-year observations that is 10% of the studied firms. Generally, we predict that CA is 13360043 rials and this is 2.65 times of general mean in node 0.

Testing hypotheses: The results of testing hypotheses are summarized in Table 8.

Model selection: As mentioned before, two regression models are used to test the hypotheses. These two models are different in terms of analysis structure and variable selection and implications. So that the linear

multivariate regression is categorized into inferential statistics and tree regression model is classified as a data mining technique. The objective is

to select the best model; however, it is not expected that the selected variables by two models are the same.

The accuracy rate of the models determines the priority of them. However, for the discrete variables, some other measures such as sensitivity and diagnosis are also taken into account.

In this study, the accuracy rate is considered for the dependent variable. This is achieved by the errors or residuals. Accordingly, accuracy rate of the regression model is 0.05 and 0.0072 for the linear regression.

Managerial ownership is the first factor affecting firm value. On average, when the managerial ownership is <74%, the interests of the firm will increase by 8 million Rials with the point estimation of 8138352 which is 1.61 times more than the average interests of the studied firms (5.42843). However, when the managerial ownership is >74%, firm's interests will be <3798257 (million rials). Therefore, group A is the group with <74 ownership percentage and group B is the group with >74 ownership percentage.

In group A, when the managerial ownership percentage is <68%, the firm's interests are estimated 2734077 (million rials); however, when the managerial ownership is 68%-74%, the firm's interests are estimated 18541571 million rials.

According to the above mentioned points, it is concluded that firm value is affected by managerial ownership level and the number of non-executive members on the board.

7- CONCLUSION

The findings reveal that managerial ownership has a significant positive impact on firm value. This is consistent with the findings of Valipour. In this study, it is concluded that the managerial ownership is positively associated with firm value and economic value added. This is consistent with the findings of Zadeh et al. (2012).

The results of the study show that among five corporate governance elements (including ownership

percentage of institutional investors, ownership percentage of major shareholders, ownership percentage of controlling shareholders, CEO duality and the number of non-executive members on the board), only ownership percentage of institutional investors has a significant positive impact on economic added value. In other words, the number of non-executive members on the board has a significant impact on firm value. This finding is not consistent with Abbasi and Rastegari Niya. However, this is consistent with the results of Gupta and Fakhari.

The findings about the effect of ownership percentage of institutional shareholders and state-ownership on firm value are not consistent with the findings of Izadi niya and Resayian and Zadeh et al. (2012). However, Ahmadi and Abbasi (2011), Diyanati Deylami et al. (2013) found the same results. These researchers concluded that there is no significant relationship between CEO duality and firm value. Moloudi confirmed this result but Chung and Son (2008) found different results.

Given the fact that the number of non-executive members on the board will increase firm value, the investors are suggested to select the firms with more non-executive members on the board (maximum one or >1 member or the managerial ownership percentage between 67-74%).

8- SUGGESTIONS

Tehran Stock Exchange is also suggested to establish instruments to increase the non-executive members of the board or separate the responsibility of CEO and chairman of the board. The following suggestions are presented for future studies:

9- Further Research

A further study may be carried out including more factors in corporate governance mechanisms and byexpanding its scope to other industriesof Iranfor better understanding and generalizing of the findings.We focusedon corporate governance and firm'svale. We recognizedthat better corporate governance is advocated for reasons aside from

enhancing firm'svalue. It is plausible that governance factors unrelated to firm value are important for other purposes. Future research should examine corporate governance in these and in other contexts

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