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Research Paper

Investigating Corporate Governance And Its Effect on Firm Performance with Assets Return index

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ABSTRACT: *Corporate governance and its effect on firm performance are investigated in this research. Research independent variables include non-bound members of board of directors, board of directors' independence, institutional shareholders, and dependent variable includes assets return which is the index of firm's performance. Accordingly, data of 125 accepted firms in Tehran securities exchange during 2009 to 2013 was extracted and panel data regression model was applied to test the hypotheses. Results indicate an inverse significant relationship between non-bound members of board of directors and assets return and a positive significant relationship between board of directors' independence and firm's performance. Also, there is a positive relationship between institutional shareholders and firm's performance. In general, results showed that appropriate corporate governance improves firms' performance.*

Keywords: *non-bound members of board of directors, institutional shareholders, firm performance, board of directors independence.*

I. INTRODUCTION

Large firms' emergence and great investments in communities have led to the separation of ownership from management and conflict of interests between managers and business units' owners was gradually created. In the meantime, a system called corporate governance was created to establish the balance between owners and managers and firm's policies in order to monitor the performance and improve the firm's condition. As a result of developments of ownership separation from management, corporate governance caused the accumulation of stakeholders' interests in firms including shareholders, managers, creditors, employees, other stakeholders and more organized financial market consequently. Nonetheless, the interests' conflict between stakeholders in firms has had numerous problems such as agency problems and caused several arguments among which the corporate governance is the most important one. Appropriate establishment of corporate governance mechanisms is a basic action for optimal usage, accountability promotion, transparency, fairness, and rights of all stakeholders of firms. Corporate governance affects financial markets' development and progress and also has a remarkable effect on sources allocation. Also, through increasing capital dynamism and globalization it presents a valuable framework which can increase industrial competition in the organization of economic development cooperation.

Corporate governance includes various types of organizational agreements and mechanisms as well as procedures to create balance between power and responsibility of firm's shareholders, managers, board of directors, and employees (Lin & Liu, 2009). Appropriate corporate governance can contribute to trust building in investors and encouraging them to invest and implement these principles in firm, according to experimental research, leads to financial performance improving and increasing the value of firm (Black et al, 2006).

II. THEORETICAL FOUNDATIONS

The issue of management and stock ownership separation in recent years caused interest conflict creation between these two groups and there is this possibility that management takes some actions to its advantage and at the expense of owners and such actions certainly affect firm's performance. Investigating the reasons and pathology of some large firms' breakdown having large losses, especially for shareholders, shows

that these problems were resulted from corporate governance systems weakness. Corporate governance can promote business standards of firms, encourage, supply, and equip capitals and investors along with improving their executive affairs and is one of the main elements of firms' economic efficiency and performance because it monitors the relationships of shareholders, board of directors, managers, and other stakeholders. Drabters et al (2003) believe that achieving the accountable, responsive, value creator managers, and finally firms' controlling are the goals of corporate governance. Corporate governance system is different in different countries which is determined in a country with a number of internal factors including firms' ownership structure, legal system economic condition, governmental and cultural policies. Ownership structure and legal frameworks are the most important and determinant factors of corporate governance system. Also, external factors including the capital flow from outside into inside, global economic situations, stocks ceding in other countries market and trans-boundary institutional investment affect a country's corporate governance system (Hassas Yeganeh, 2006). On the other hand, corporate governance can be viewed as a network of relationships that not only are existed among firms and their owners (shareholders), but between the firm and a lot of stakeholders including employees, customers, sellers, creditors, owners, buyers of bonds, insurers, buyers of life insurance and so forth. Such a view is seen in form of stakeholders' theory (Blau & Fuller, 2008, p. 133).

III. LITERATURE REVIEW

In their research, with investigating the corporate governance and its relationship with firm's value Ditmar and Smith (2006) concluded that changing the firms' cash flow having weak governance changes market value and it is two times in firms with stronger governance. In his research, Black (2001) noticed the relationship between corporate governance and firms' performance using time series and regression.

In a research about the effect of ownership structure on firm's performance Demsetz and Lehn (1985) found that there is an important and positive between ownership structure and firm's performance. Nandelstadh and Rosenberg (2003) found that firms with weak and undesirable governance have lower stocks return and firm value compared to firms with appropriate governance. In their studies about the effect of institutional investment on firm's value McConnell and Servaes (1990) found that there is a positive and significant relationship between them. In some research implemented by Navissi and Naiker (2006), they showed that institutional investors have a high motivation to monitor the management and their existence increases the firm value. Jensen and Mackling (1976) believed that firm stocks' managers' ownership contributes to aligning shareholders and managers interests and decreases the conflict between shareholders and managers and it makes managers try hard to protect shareholders' interests and firm's performance improvement. In their research Bai et al (2009) investigated the effect of corporate governance on firm's performance. They investigated this effect in two ways. Firstly, they investigated each feature of corporate governance and its effect on the firm performance and then all features and their effect on firm performance. They concluded that firms with more governance had better performance and higher value. In a research about the effect of board of directors' size and profitability, Yermack (1996) found a negative relationship between them and showed that chief executive officer separation from the chairman of the board firm value increases. In a study, Yammesiri and Kanthi Herath (2010) investigated the effect of corporate governance on firms' value. They investigated the effect of board of directors and performance of 245 non-financial firms. Results of their study showed the lack of significant effect of board of directors on firms' value improvement.

IV. RESEARCH HYPOTHESES

1- There is a significant relationship between the ratio of non-bound members of board of directors and firm performance.
2- There is a significant relationship between board of directors' independence and the firm performance.
3- There is a significant relationship between the ratio of institutional shareholders and firm's performance.

Statistical population

Statistical population includes the accepted firms in Tehran securities exchange during 2009 to 2013 having the following features. Accordingly, 125 firms compose the selected sample of this study.

1- For information to be comparable, firms' fiscal year should be the end of the last month.
2- Firms should not have any changes during the investigation period.
3- Financial information required for firms should be available during the investigation.
4- Sample should not include types of financial supporters, investment, and insurance firms.

V. METHODOLOGY

To test the hypothestes the multi-variable regression model is applied as following:

$$ROA_{it} = \alpha_0 + \alpha_1 \text{ out-ratio}_{it} + \alpha_2 \text{ independent}_{it} + \alpha_3 OWN_{it} + \alpha_4 SIZE_{it} + \alpha_5 LEV_{it} + \alpha_6 CFO_{it} + \varepsilon_{it}$$

Research dependent variable is return of assets (ROA) which is the firm performance index and independent variables include the ratio of institutional shareholders, board of directors' independence, and type of ownership. Controlling variables are size, financial leverage, and operational cash flow that have been applied. General profile of variables is illustrated in table1.

Table-1. variables descriptive statistics

	Variable	Calculating
ROA	Firm performance	Return of assets
out-ratio	Non-bound members' of board of directors ratio	Dividing the number of non-bound members of board of directors by all members of board of directors
independent	Board of directors independence	Ratio of independent managers and supervisors
OWN	Institutional shareholders	Number of shares belonged to institutional investors over the shares at the beginning of period
SIZE	Firm size	Natural logarithm of total assets
LEV	Financial leverage	Ratio of debts to assets
CFO	Operational cash flow	Total cash sum obtained from firm's operation during year t

Descriptive statistics: to present a general profile of calculated variables important features some descriptive statistics concepts of these variables including mean, mode, standard deviation, minimum, and maximum observations are presented.

Table-2. descriptive statistics

Variable	Mean	Mode	Max	Min	STD
ROA	0.0987	0.0856	0.7324	0.0021	0.1458
out-ratio	0.3902	0.4732	0.8864	0.3256	0.1445
independent	0.5451	0.6822	1.0532	0.4578	0.2319
OWN	215.0164	192.1258	248	11.4561	14.7294
SIZE	0.5784	0.4188	1.0295	-0.2257	0.1246
LEV	0.8033	0.7914	11.0132	-0.1782	0.2536
CFO	0.7316	0.6807	0.2563	0.0068	0.1044

Appropriate panel data model choosing

In this research the number of each section observations is 125 and including a time period of 5 years. The relationship between independent and dependent variables among 125 different firms on the one hand, and during 2009 to 2013 on the other hand is tested. Thus, to obtain better results panel data method was used and to estimate regression models relevant data of 125 firms and five-year period were combined and estimations were done accordingly (625 year-firm). Chow test results for research model have not confirmed this test's null hypothesis indicating the similarity of intercept in all periods. Accordingly, panel model (fixed or random effects) should be applied and Haussmann test results for research model show that the null hypothesis of this test has not been confirmed. Therefore, random effects method is a more appropriate option to estimate this model.

VI. HYPOTHESES RESULTS

In three hypotheses F statistics is significant with certainty level of 99%., because p-value obtained from model testing is lower than 1%. Thus, research model is significant in general, and independent variables can explain the dependent variable.

Table 3. hypotheses testing results

Explanation	Hypotheses		
	Ratio	t-static	p-value
out-ratio	-0.3571	5.2418	0.0000
independent	0.0215	3.1106	0.0041
OWN	0.4514	4.3013	0.0002
SIZE	5.1840	6.3245	0.0032
LEV	0.8413	8.5621	0.0041
CFO	0.1223	2.8723	0.0599
R-squared	0.3866		
Adjusted R-squared	0.3721		
F-static	5.0248		

F(p-value)	0.0021
D-W	1.8941

Results obtained from hypotheses are presented in table 3 in which adjusted determination coefficient (Adjusted R2) obtained from model testing has been 0.37. This number shows that about 37% of changes of assets return in selected firms are explained by independent and control variables in model. To investigate the lack of auto-correlation of errors results from model Durbin-Watson test has been applied. Its desirable value for lack of auto-correlation is 2. If the value of this statistics is between 1.5 and 2.5, auto-correlation is rejected in model error values. Regarding this fact that Durbin-Watson value obtained from research model is 1.8941, auto-correlation is rejected in model error values.

With respect to presented results in table 3, the significance amount (p-value) for the first hypothesis variable is 0.0000 which is less than 1%. Thus, non-bound members' variable has had a significant effecton return of assets in the model. Independent variable coefficient is negative; accordingly, the relationship type is an inverse one. So, the first hypothesis is confirmed with certainty of 99%. The second hypothesis is confirmed because the significance level (p-value) is less than 1% with certainty level of 99%. The type of relationship between dependent and independent variable of this hypothesis is positive. Also, in the third hypothesis because the significance level (p-value) is less than 1%, it is confirmed with certainty of 99% and the type of relationship between dependent and independent variables in this hypothesis is positive

VII. CONCLUSION

Corporate governance and return of assets were investigated as firm performance index in this study. Variables of number of non-bound members of board of directors, board of directors' independence, and institutional shareholders are as indexes of corporate governance measurement and return of assets variable as the index of measuring firm's performance. Results indicate that there is an inverse relationship between return of assets and non-bound members of board of directors and with decreasing the non-bound members the return of assets can be increased which is consistent with Yermack (1996) research. There was a positive relationship between board of directors' independence and return of assets, i.e. with increasing the independence of board of directors firm's performance increases. Also, there is a positive relationship between institutional shareholders and firm's performance. Thus, institutional shareholders presence in each firm increases the return and improves firm's performance. Generally, results showed that observing the corporate governance principles and valuing institutional shareholders and giving more independence to board of directors the firm's performance will be better.

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