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A Survey of the Relationship Between Corporate Governance and Corporate Created Value: Evidence from Iran

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Abstract: This study aims to examine the relationship between corporate governance mechanisms on two variables based on value, Created Shareholder Value (CSV) and Economic Value Added (EVA) of Iranian listed companies. Based on a sample of Iranian firms were selected using matched-sampling method during the years 2006-2014 and multiple liner regression was employed to test the relationship between among corporate governance mechanism with CSV and EVA. Corporate governance factors have a strong predicting power on company performance, mainly due to debt monitoring and Foreign ownership. However, the CSV has a positive relationship with institutional shareholder, ownership structure audit institution. It also has a negative relationship with the governmental ownership. The results showed that the EVA just has a positive relationship with audit institution. The results are very relevant to academicians and practitioners concerned with performance measurement. They basically underline the importance of including governance characteristics in any evaluation formula.

Key words: Corporate governance, shareholder value analysis, economic value added, empirical, ownership, government

INTRODUCTION

With the collapse of Enron and Arthur Andersen in the USA and similar disasters in the UK such as Marconi, corporate governance has received increased attention by the financial community. Consequently, international organizations have become very concerned about governance issues. For example, the International Monetary Fund has demanded that governance improvements be included in its debt relief program. In 1999, the Organization of Economic Cooperation and Development (OECD) issued its influential OECD principles of corporate governance, intended to assist member and non-member countries in their efforts to evaluate and improve the legal, institutional and regulatory framework for better corporate governance. The scandals clearly pointed to the need to improve corporate governance practices and accounting transparency. In the USA, the relevant context for this study, congress enacted new laws such as the Sarbanes-Oxley act and more stringent conditions for listing on the stock markets were introduced. New institutions such as the Public Company Accounting Oversight Board were created, audit committees were empowered and internal control systems were strengthened. The importance of better corporate governance practices in guaranteeing the quality of financial and accounting information, improving corporate performance and thereby, increasing market value, has been widely recognized (Albert and Jean-Luc, 1991).

Maximizing shareholder values, fulfilling moral duties and social responsibilities can be considered as the most important goals of corporations. One of the factors that are of significant impact in attaining the mentioned goals is the proper application of corporate governance rules. Since 300 years ago, when Adam Smith, in his nation's wealth suggested the separation of company runners (managers) from company ownership, some mechanisms have constantly been proposed for keeping a balance between the interests of the owners of the institutions (investors) and directors (Argenti, 1976).

The value creation by corporations is to some extent the result of the manager's performance. This issue gains greater importance with the expansion of corporations, the introduction of agency theory and the expansion of the responsibilities and powers of the directors' board. Ashbaugh-Skaife *et al*. (2006) suggested the theoretical framework for agency theory referring to the conflict of

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interests between the director and the owners. In other words, the two sides in the agreement have logical expectations and seek to maximize their own interests.

The unlimited transfer of duties to the board of directors and particularly the CEO by the owners has caused greater attention to corporate governance principles to a large extent. Baysinger and Hnskisson (1990). indicated that well-governed firms have higher equity returns, command higher values and their accounting statements show a better operating performance compared to their poorly governed counterparts. These findings are likely to encourage investors to consider corporate governance in their investment decisions.

The Created Shareholder Value (CSV) and Economic Value Added (EVA) for firm's owners may be attained by a variety of factors. In this study, the following question is posed: do the corporate governance mechanisms affect the two variables based on value, Created Shareholder Value (CSV) and Economic Value Added (EVA)?

Review of literature and the theoretical framework: Corporate governance includes a set of insider and outsider mechanisms that keep a proper balance between the shareholders' interests on the one hand and the power of board of directors, on the other hand. They provide a reliable guarantee for shareholders, the supporters of financial sources and the other groups who have an interest in the company giving assurance to them that their investment is retrievable along with its reasonable interest and the mechanism of creation of values would be observed (Beatty, 1989).

Corporate governance mechanisms

The board of director structure: The board of directors is an important component of internal governance that enables the solving of agency problems inherent in managing any organizations. The board has the power to hire, fire and compensate the top-level decision managers and to ratify and monitor vital decisions. Boards of directors are widely recognized as an important mechanism for monitoring the performance of managers and protecting shareholders' interests.

With regard to the independence of board of directors, it is argued by both agency theory and resource dependence theory that the larger the number of Non-Executive Directors (NEDs) on the board, the better they can fulfill their role in monitoring and controlling the actions of the Executive Directors (ED) as well as providing a window to the outside world. The premise of agency theory is that NEDs are needed on the boards to monitor and control the actions of ED due to their opportunistic behavior.

The effect of dual responsibility in the created value: From the point of view of agency theory, the efficacy and efficiency of the board can be compromised if the position of president and chairman of the board is held by the same person.

So, another aspect of corporate governance that has become a concern now a days is the "dominant personality" phenomenon. The issue revolves around role duality, that is, when the CEO is also the Chairman of the board. There are two views in this issue. Firstly, the proponents of agency theory argue for a separation of the two roles to provide essential check and balances over management's performance. On the other hand, the alternative argument based upon stewardship theory is that the separation of roles is not vital, since many companies are well run with combined roles and have strong boards fully capable of providing adequate checks. In addition, when the role is combined, the CEO may be able to shape the company to achieve stated objectives due to less interference. The basis of their arguments is stewardship theory which suggests that managers act in the best interests of the firms and shareholders and that role duality enhances the effectiveness of boards.

Several researchers have argued that CEO, chairman duality is detrimental to companies as the same person will be marking his "own examination papers". Separation of duties will lead to:

- The avoidance of CEO entrenchment
- An increase in board monitoring effectiveness
- The availability of a board chairman to advise the CEO
- The establishment of independence between the board of directors and corporate management

The role of non-executive directors in the created value: The degree of independence of the members of the board of directors is one of the factors promoting the effectiveness of the directors. Also another important aspect of corporate governance is about the issue of directors (regardless of executive or non-executive) who may sit on more than one board (cross-directorships). Brown and Caylor (2005) suggest that cross-directorships will help in making information more transparent as comparisons can be made based on knowledge of other organizations. Hence, decisions made at one board may become part of the information for decisions at other boards. In addition, the interlocking of CEOs is desirable because of their experience and credibility as peers. Serving on board is a way to see how somebody else is doing the same thing". In other words, CEOs join other boards and thereby create interlocking relationships specifically to "embed" what they are doing.

Empirical evidence on the association between outside independent directors and firm performance is mixed. Studies have found that having more outside independent directors on the board improves performance while other studies have not found a link between independent NEDs and improved firm performance (Black *et al*., 2006). The point that can be made from these studies is that there is no clear benefit to firm performance provided by independent NEDs.

Blackburn (1994) studied the relationship between corporate governance mechanisms and the performance in Iranian firms. The results of the mentioned study indicate that the number of non-executive members in the board of directors has no effect on the firms' performance.

The ownership structure: Shareholders can exercise their influence over the governance of individual corporations both formally, through the proxy system where they can initiate and vote on proposals and informally, through negotiations with corporate management.

Institutional ownership structure: High management ownership where managers obtain effective control of the firm will be negatively related to firm value because of management entrenchment. These researchers argue that managers entrench themselves by making manager-specific investments that make it costly for shareholders to replace them. According to Burkart *et al*. (1997), the possible reason is because managers with high levels of stock ownership, the potential for undiversified personal wealth portfolios and the potential for entrenchment may elicit management decisions inconsistent with a growth-oriented, risk-taking objective of enhancing shareholder value.

Studies investigating the relationship between firm performance and managerial stock ownership have come up with mixed evidence. In the USA, studies show that the effect of insider ownership to company performance is dependent upon the percentage of ownership. For example, Drobetz *et al*. (2004) find a positive relationship when the ownership is below 5% but shows a negative relationship when the range of ownership is between 5 and 25%.

The empirical ambiguity of the relationship is often cited as evidence of a complex role of institutional ownership. This is because, while it aligns the interests of managers and shareholders and thus enhances performance, it also facilitates managerial entrenchment and adversely affects performance.

Dahya *et al*. (1996) showed that Despite the concentrated ownership structure in the corporation's admitted listed in Tehran Stock Exchange (TSE), there is no significant relationship between the number of non-executive directors and the value of firms. Moreover, considering the fact that in the structure of all boards of directors of all sample firms, with at least one non-executive member, there was no significant relationship between the presence of non-executive members and the value of the firms. The overall results of the study indicate that there is significant relationship between corporate governance mechanisms and firms' value.

Concentrated ownership structure: The effects of ownership concentration on firm performance are theoretically complex and empirically ambiguous. Conceptually, concentrated ownership may improve performance by increasing monitoring and alleviating the free rider problem in takeovers but other mechanisms may work in the opposite direction. Most frequently discussed is the possibility that large shareholders exercise their control rights to create private benefits, sometimes expropriating smaller investors. Even the fear of expropriation may limit the ability of firms with high ownership concentration to raise fresh finance through borrowing or new share offerings. Other potential costs of concentration may result if managerial initiative is repressed by excessive monitoring or if a smaller fraction of liquid shares available to quietly establish a "toehold" raises a raider's costs of attempting a takeover. The reduced liquidity could also lower the informational value of the firm's share price as a measure of managerial performance.

In most of developing markets including I.R. Iran, the closely held firms (family or state controlled firms or firms held by widely corporations and by financial institutions) dominate the economic landscape. The main agency problem is not the manager-shareholder conflict but rather the risk of expropriation by the dominant or controlling shareholder at the expense of minority shareholders.

Free float stock: Free float shares are shares that are expected to be sold in the future. Morgan Stanley Institute defines free float shares as the proportion of the corporate shares that are exchangeable at the market and are not preserved by institutional shareholders for managerial reasons. To calculate free float shares, the strategic shareholders and the amount of their shares (The shareholders who do not aim to sell their shares in the short run) should be first identified. Having identified the mentioned group of shareholders, the free float share would equal the total number of distributed shares minus the number of shares held by strategic stockholders.

Audit institution: A major assumption in agency theory is the fact that the verification of the works of agent is hard and complex for an owner. Independent auditing is one of the most important and effective ways for unifying the interests of the shareholders and directors.

Audit is an important element of efficient equity markets because audits can enhance the credibility of financial information, directly support better corporate governance practices through transparent financial reporting and therefore ultimately influences the allocation of resources. Theoretically, a large public accounting firm with greater investment in reputational capital has more reason to minimize audit errors via “auditor-reputation effects”.

Created Shareholders Value (CSV): In the last three decades, the notion of “value” and created wealth for shareholders has been discussed along with the formation of corporate governance mechanisms in world economies and corporations. This is shown in governance principles delineated by Organization for Economic Co-operation Development (OECD). But what is mean by maximizing the value and the wealth of the shareholders? Is the mentioned issue one of the factors determining the delineation of the corporate governance principles in 21st century? Does the application of the mentioned principles promote the performance and efficiency of the corporations and the economic units?

Shareholders as the owners of business units, seek to increase their wealth that happens with desirable performance of the business entity. As such, the evaluation of the firm and the application of appropriate criterion are very important for owners.

Davis (1996) developed a new performance measure, CSV: “a company creates value for the shareholders when the shareholder return exceeds the share cost (the required return to equity)”. In other words, “a company creates value in one year when it outperforms expectations”.

If the rate of return of an investor is higher than his expected rate, the value of the invested property is higher and it creates more wealth. This increase in added value of the shareholder is termed as the CSV.

Economic Value Added (EVA): As explained earlier, the value of a corporation on the investors view has most importance since they are not willing to invest in corporations with high risks and if they do so, they would expect higher return for higher values. One of the criterion that can be used for the selection and evaluation of investment is the criterion of economic value added (3). EVA is a criterion based on Value Based Management (VBM) that controls the total created value in a business.

EVA is a trademark of Stern Stewart Management Services. It is based on the concept of economic profit which is measured by the residual of a firm’s income after the cost of capital and operating expenses have been deducted. EVA is rooted in the economists reasoning that for a firm to create wealth it must earn more than its cost of debt and equity capital.

Research hypotheses: The aim of this study is surveying of the relationship between some corporate governance mechanisms and the Created Shareholder Value (CSV) and the Economic Value Added (EVA). Therefore, the present research studied the following two main hypotheses:

- H_1: There is a relationship between the corporate governance mechanisms and the Created Shareholder Value (CSV)
- H_2: There is a relationship between the corporate governance mechanisms and the Economic Value Added (EVA)

MATERIALS AND METHODS

The goal of this research is application and the type of research methodology is correlation. In this study to test the hypotheses, we used basic multiple liner regression model.

Sample selection and variables measurement: The population of the study included all corporations listed Tehran Stock Exchange (TSE) from different industries. The information and the statistical data of the sample corporations for the study were collected from 2006-2014. For the purpose of selecting the sample, systematic elimination procedures were used. The following criteria were used for sampling procedures:

- The corporation ought to have been listed into the (TSE) before 2005 and it must have continued its membership up to 2014
- During the research period, the corporation shouldn’t have had a transaction gap of >6 month.
- The corporations must not be a bank or financial institution (investment companies, financial intermediary, holdings and leasing)
- Their information must be available enough so that the information about the corporate governance mechanisms, the Created Shareholder Value (CSV) and economic value added could be easily obtained

Imposing the above mentioned limitations, 172 accepted corporations in (TSE) from 13 different industries (1548 observation) were selected as the samples of the study (Table 1).

Table 1: List of governance variables and retained measure

Variables (Acronym)	Retained measure
No role Duality (DUAL)	Dichotomous 0 with role duality and 1 if no role duality
Board independence (BODS)	Ratio of non-executive directors to total members of board members
Institutional ownership (BHOLD)	Percentage of share owned by the biggest shareholder
Ownership Structure (OS)	percentage of the shares owned by shareholders with over 5% of shares
Parent (Parent)	Dichotomous: 0 whether the corporation is Subsidiary and 1 if corporation is a Parent
Governmental Ownership (GO)	Dichotomous: indicator variable with value 1 if biggest ownership is governmental and 0 for otherwise
Free Float (MFF)	Percentage of firms free float
Audit is a big (Audit)	Dichotomous: indicator variable with value 1 if corporation audit institute is a Public and 0 for otherwise

Table 2: Descriptive statistics of variables

Variables	Mean	Minimum	Maximum	SD
DUAL	0.76	1	0	0.43
BODS	59.60	10	100	21.11
BHOLD	75.61	0	100	19.29
OS	53.25	0	98.93	22.76
Parent	0.49	1	0	0.50
GO	0.80	1	0	0.40
MFF	22.85	5	75	13.64
Audit	0.37	1	0	0.48
CSV	-391.37	-17,531	11,399	2565.61
EVA	290.54	-2,987	13,820	1187.00

Measurement of CSV and EVA: We define CSV following Fernandez:

$$\text{Created shareholder value} = \text{Shareholder value added} - (\text{Equity market value} \times \text{Ke})$$

$$\begin{aligned}\text{Shareholder value added} &= \text{Increase of equity market value} - \text{Payments from shareholders} + \\ &\quad \text{dividends} + \text{repurchases} - \text{conversions}\end{aligned}$$

$$\text{Ke} = \frac{\text{DPS}}{\text{P}_0(1-\text{F})} + \text{g}$$

$$\text{g} = \text{ROE} \times \left(1 - \frac{\text{DPS}}{\text{EPS}}\right)$$

Economic value added measured by using following Stewart:

$$\text{EVA} = (\text{r} - \text{c}) \times \text{Capital}$$

$$\text{r} \times \text{Capital} = \text{NOPAT} \Rightarrow \text{r} = \frac{\text{NOPAT}}{\text{Capital}}$$

$$\text{EVA}_{i,t} = \text{NOPAT}_{i,t} - (\text{WACC}_{i,t} \times \text{Capital}_{t-1})$$

In this equation, NOPAT is the Net Operating Profit after tax and WACC is weighted average cost of capital.

Empirical results

Descriptive statistics: Table 2 provides the descriptive statistics of variables relative to governance variables and CSV, EVA for the 172 sample firms (1548 observation).

Table 3: Results of regression analysis for first statistic model

Variables	Coefficient	t-statistic	p-values
DUAL	0.086	0.212	0.832
BODS	0.012	1.359	0.175
BHOLD	0.028	2.709	0.007^{***}
OS	1.002	3.074	0.004^{***}
Parent	0.360	0.902	0.368
GO	-1.225	-2.378	0.018^{**}
MFF	0.004	0.181	0.856
Audit	1.128	3.008	0.003^{***}

R^2 = 0.285; F(SING) = $2.928(0.004)^{***}$; D-Watson statistic = 1.825; Dependent variable: Created Shareholder Value (CSV)

Table 4: Results of regression analysis for second statistic model

Variables	Coefficient	t-statistic	p-values
DUAL	0.091	0.219	0.831
BODS	-0.006	-0.737	0.462
BHOLD	0.007	0.688	0.490
OS	-0.014	-0.876	0.383
Parent	-0.074	-0.181	0.861
GO	-0.479	-0.908	0.377
MFF	0.021	0.999	0.324
Audit	0.914	2.378	0.021^{**}

R^2 = 0.083; F(SING) = $1.732(0.091)^{*}$; D-Watson statistic = 1.802; Dependent variable: Economic Value Added (EVA)

Regression analysis: We considered two multiple linear regression models to verify the hypotheses proposed above. Our basic estimating equation is the following:

$$\begin{aligned}\text{Attrib}_t^k &= \beta_0 + \beta_1(\text{DUAL}_{i,t}) + \beta_2(\text{BODS}_{i,t}) + \\ &\quad \beta_3(\text{B.Hold}_{i,t}) + \beta_4(\text{OS}_{i,t}) + \beta_5(\text{Parent}_{i,t}) + \\ &\quad \beta_6(\text{GI}_{i,t}) + \beta_7(\text{MFF}_{i,t}) + \beta_8(\text{Audit}_{i,t}) + \varepsilon_{i,t}\end{aligned}$$

In which Attrib_t^k is respectively in first and second hypothesis equal to the Created Shareholder Value (CSV) and Economic Value Added (EVA) in the year t. Table 3 and 4 present the results of the regression model for the two Hypotheses test.

According to the results of testing first statistical model given in Table 3, the level of significance for F(0.004) is lower than the acceptable percentage of 5 and the whole regression model is significant. The D-Watson statistic (1.825) is located between 1.5-2.5, therefore; there is no correlation between the elements of model error.

But according to the results of the tests of the second statistical model given in Table 4, p-value for F(0.091) is lower than the accepted level of 10% and the whole model of regression is significant. The D-Watson statistic of 1.802 is located between 1.5 and 2.5. So, there is no correlation between the elements of model errors.

RESULTS AND DISCUSSION

Interpretation of the results: In the theoretical bases for the study, the importance of separating the responsibilities of the chairman's and the CEO in corporations was highlighted. Due to the concentrated ownership structure and mainly governmental ownership in most of Tehran Stock Exchange (TSE), the dual responsibilities has not been influential in the performance and the increasing the wealth of the shareholders.

On the other hand, according to the theoretical bases of the research, the non-executive members of board of directors have a key role in solving the agency problems between the directors and the owners on one hand and the unification of the interests of shareholders and executive directors on the other hand. However, the results show that the presence of non-executive members in board of directors is not an important factor in creating value for shareholders and the economic value added.

The results of hypothesis testing indicate a positive relationship between institutional shareholders and the CSV. According to the theoretical bases, institutional investors, using their right to decide, can influence decision makings and the structure of board of directors and can serve as one of the most important sources for monitoring the performance of the director. Also regression result show there is no significant relationship between institutional shareholder and the EVA.

The results of the study indicate a positive relationship between the centralized structure and CSV. In contrast, the results of testing the second hypothesis show that there is no relationship between the ownership structure and EVA, most probably due to intense centralized ownership. In fact, the major shareholders interfere in market and the share value prices and affect the variable of the created value for shareholders which by itself depend on market rates.

Moreover, the results of the study indicate a negative relationship between the degree of governmental ownership and CSV. Today, after enforcing the 44th general policy of the constitution, the organization of privatization and the Tehran Stock Exchange (TSE) are obliged to enforce the law through selling the public corporations and lessening the governmental controls. As such, the country is in a process of transition from public economy to private economy. The degree of success in privatization necessitates the reliance of the investors on capital market. Therefore, adopting the appropriate strategies for promoting the culture of accountability and information transparency in the corporations involved seems inevitable.

The results of the study showed that there is a positive relationship between CSV and EVA with audit institution (whether it is public or private). Theoretically, the size of the accounting institution would affect the quality of accounting and would add to the reputation and validity of that institute. This research results also confirm this theory.

CONCLUSION

To create value and to increase wealth, corporations rely on the directors' economic decisions. One of the most important ways of controlling the directors and decreasing the agency problems and its costs is the use of desirable corporate governance mechanism. The present study, tried to study eight governance mechanisms and their effects on increasing firms' wealth and value. Testing the first hypothesis indicated that the CSV has a positive relationship with institutional shareholder, ownership structure audit institution. It also has a negative relationship with the governmental ownership. Also no relationship was observed between the CSV with the separation of the duties, the board of director's structure and parent. The results from the second hypothesis show that the EVA just has a positive relationship with audit institution.

SUGGESTIONS

The Tehran Stock Exchange(TSE): In delineating the governance mechanism, the corporation should carefully separate the CEO and chairman's duties and should pay proper attention to the monitoring role of the non-executive members of the firms as influential factors.

The boards of directors: Non-executive members should keep their independence and should appropriately fulfill their supervisory role on the performance of the corporation.

Creditors and investors: In their investment, they should always attend to the variables of creating wealth like the CSV and EVA.

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