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The Effect of Corporate Governance on Information Content of Operations (Unprofitable Compared Profitable Companies)

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ABSTRACT: The purpose of this study is to investigate the effect of corporate governance mechanism on information content of operating results in unprofitable companies, compared to that of profitable companies to do so, the impact of variables such as Institutional Investors, The Non-duty Managers in the Board of Directors, Free Float Stock and The Use of Debt in Financing on Stock returns of both unprofitable and profitable companies was studied. Statistical sample includes 13 companies, between the years of 2007 to 2012 this study "combinational data" method was used in order to test considered theories. Study results shows that there is a meaningful relation between nominative stockholders percent of property and stock yield in both unprofitable and profitable companies , but its effect is more obvious in bad companies . In addition, there is also a positive relation between unbound managers in board of directors and Stock returns, which its impact is more in bad companies. Moreover, there is a meaningful relevance between floating stock and stock returns in both profitable and bad companies but it has a stronger effect on the former one. Finally, there is a negative and adverse relation between using debt to financial feasibility and stock yield in bad companies. However, no relation was found in profitable companies.

Key words: Corporate Governance, Debt Financing, Institutional Investors, Non-duty Managers, Stock returns.

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INTRODUCTION

Recently, significant improvements have been made in establishment of corporate governance through legislation and regulation as well as voluntary measures of developed and developing companies. Investors and stakeholders became more informed about the importance of corporate governance. They also became interested in establishment of this system within companies. Furthermore, establishment of internal control systems and how to engage and involve all stakeholders, or in other words, including the rights of all interest groups has been the subject of world economic and financial circles. Undoubtedly, corporate governance is a small part of goodgovernance in the whole country. In recent years, many studies have been carried out on corporate governance system and its relationships with financial performance, stock prices and the firm value. These studies examined the effects of various factors of corporate governance on the profitability of companies and achieved some vague and conflicting results.

The concept of corporate governance monitoring regime that applies to a public company accountable to shareholders in accordance with their organizational stakeholders and various other is the way.

For this reason, and also function as important to society as a whole, and in recent years has attracted much attention (Imam et al., 2007).

Corporate Governance: The definitions of corporate governance include a broad range of limited to extensive perspectives. The limited views limit the corporate governance to the relationship between corporate and shareholders. On the other hand, the corporate governance can be considered as a network of relationships, not only between the company and shareholders, but also between the company and a large number of beneficiaries including employees, customers, vendors, the company's bondholders and all stakeholders.

Information Content: According to Hendrikson and Breda (1992), data that can make a dramatic impact on the recipient is informative. They believed that information must be able to reduce uncertainty and to send a message to the decision-maker which its value shall be higher than the costs for obtaining information. On the other hand, it could potentially affect the decisions that people make.

Stock Returns: The most important criterion for evaluating the performance of enterprises is stock returns rate. This measure alone contains information for investors and is used for performance evaluation. When this criterion is reduced, it shows improper performance of the company, thus it could be an alarm for the company.

Corporate Governance Mechanisms

Institutional Investors: What needs to be examined carefully when investigating the relationship between ownership structure and performance is strengthening a large group of owners called institutional investors. They directly influence on the managerial decisions of invested companies through the high right to vote at meetings of the companies. The

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balance between the institutional investors and other owners can affect the performance.

The Non-duty Managers in the Board of Directors: The non-duty members of the Board of Directors have control over the decisions of responsible managers by monitoring them. As a result, the composition of the Board of Directors could affect the company's financial performance. If a majority of the Board members consisted of the independent non-duty directors, then the Board of Directors will have better performance.

Free Float Stock: Free float stock is a limited stock, also called fixed stock (strategic) and includes items such as stock in main company maintained to control subsidiaries, shares held by the government and shares held by cross-ownership of the company (Shingo, 2001).

The Use of Debt in Financing: Financial leverages have substantial impact on stock returns, thus they have always been considered in economic decisions. This is why researchers have paid much attention to the relationship between financial leverage and other financial variables such as stock returns.

Background

Chekili (2012) examined the impact of corporate governance mechanisms on earnings management in the Tunisian market. He concluded that there is a significant relationship between the size of the Board of Directors, the separation of chairman and CEO and earnings management.

Khodadadi , and Takor (2012) concluded that there is a significant positive relationship between the concentration of ownership of state-owned companies with performance and value of firms. Major institutional investors have a significant positive relationship with firm value, while there is a significant negative relationship between the major institutional investors and the firm performance.

Modarres et al (2009) found that although the level of institutional ownership in companies listed in Tehran Stock Exchange is very high, there is no significant relationship between institutional shareholders and efficiency.

Dimitropolos and Asterious (2010) found that the composition of the Board of Directors has a positive impact on information content.

Omran (2009) concluded that the high proportion of non-duty board members and changes in the composition of the board of directors after the privatization impact on firm performance.

Feali (2008) showed that there is significant relationship between the number of non-duty managers and firm value. The results showed that there is a significant relationship between corporate governance and firm value.

Hoseini (2007) examined the impact of institutional shareholders on shareholder returns to calculate the excess returns of shareholders in companies with good corporate governance. The results showed that there is no significant relationship between institutional shareholders and stakeholders returns in Iran.

Chiyachantana et al. (2005) showed that the leverage is negatively related to the quality of corporate governance until certain points, then this relationship became reversed and the relationship become positive with increasing the quality of corporate governance.

Greenwood (2005) found that: A) When the floating stock is limited, the prices increase and when the float stock increases, the prices decrease and B) the efficiency is periodically depend on the reduced free float stock.

Rosenstein and White (1990) found that if a majority of the Board members are non-duty members, this directly impact on shareholders wealth. Consequently, there is no relationship between the number of non-duty members and firm value.

Hypotheses

1 – There is a significant relationship between the ownership of institutional investors (concentration rank) and information content of the operation of unprofitable companies compared to profitable firms.

2 – There is a significant relationship between the number of non-duty members of the Board of Directors and information content of the operation of unprofitable companies compared to profitable firms.

3 – There is a significant relationship between the free float stock and information content of the operation of unprofitable companies compared to profitable firms.

4 – There is a significant relationship between the use of debts in financing and information content of the operation of unprofitable companies compared to profitable firms.

MATERIALS AND METHODS

The independent variables include institutional investors, non-duty members of the board of directors, the percentage of free float stock, the amount of debt financing. The stock returns, as a measure for the information content of corporate operations is used as the dependent variable.

According to Firth et al. model, the following model can be proposed:

$$RET_{it} = a_0 + a_1 EPS_{it} / P_{it-1} + a_2 EPS_{it} / P_{it-1} * INS_{it} + a_3 EPS_{it} / P_{it-1} * BDIND_{it} + a_4 EPS_{it} / P_{it-1} * FLOAT_{it} + a_5 EPS_{it} / P_{it-1} * DEB_{it} + a_6 EPS_{it} / P_{it-1} * SIZE_{it} + a_7 EPS_{it} / P_{it} * GROWTH_{it} + e_{it}$$

EPS_{it}: Earnings per share

Dependent variable:

RET_{it} : Return on equity

Independent variables:

INS_{it}: Institutional ownership, Herfindahl-Hirschman index is used for calculating the concentration rank.

Herfindahl-Hirschman Index

This index is defined as the number of firms and its relation to the competitiveness among the firms

It gives a greater weight to larger firms in calculating the concentration rate. The Herfindahl index is generally equal to reduced competitiveness.

$$HHI = \sum_{i=1}^{n} (\frac{p_i}{p} \times 100)^2$$

HHI : Level of ownership concentration

P_i : The total number of treasury shares

P : Number of Shareholders

$BDIND_{it}$: The ratio of non-duty members of the board will be calculated by dividing the number of non-duty members on the total number of members

$FLOAT_{it}$: The percentage of free float stock is calculated by multiplying the floating factor by the total non-managerial shareholders' equity at the end of fiscal period for which the free float stock is calculated.

Floating coefficient:

$$Z = \frac{T}{\frac{t}{2}}$$

T: The number of days in publisher's fiscal period during which the trading of shares in common market is over a ten-thousandth of shares of publisher.

t: the number of trading days of the period with a maximum value of 1.

DEB_{it}: The amount of debt financing; the total long-term debt divided by total assets.

$BDAC_{it}$: The ratio of non-duty members of the Board of Directors in the Audit Committee

Moderating Variables and Parameters:

$SIZE_{it}$: Firm size; the natural log of average total assets

$GROWTH_{it}$: Growth opportunities, the market value of equity divided by its book value

e_{it}: Residual error of the company i in year t

Population and Sample: The firms with following conditions were considered in the sample:

1 - Banks, investment and insurance firms will be eliminated from the population.

2 – The financial year should be ended at 21 March with no change in the fiscal year during the aforesaid period.

3 – The trading symbol must not stop more than four months per year.

4 - The data for the years 2007 to 2012 should be available.

Since this is a comparative study between the profitable and unprofitable companies, the samples are divided into profitable and unprofitable groups during the period of investigation with regard to the above conditions. The companies must show at least one obvious financial period of profit or loss during the 5-year period of the study.

Data Collection: This is an applied study in terms of objectives. It is a post-event research in terms of the time examining the correlation between variables.

RESULTS

The results of the table 1 indicate that at confidence level of 95%, the number of non-duty members of board of directors, percentage of free float shares, firm size and growth opportunities have a positive (direct) significant correlation with earnings returns in profitable and unprofitable companies. On the other hand, the ownership of institutional shareholders and long-term debt financing is negatively (reversed) correlated with earnings per share.

Hypotheses Test

The First hypothesis: There is a significant relationship between the ownership of institutional investors (concentration rank) and information content of the operation of unprofitable companies compared to profitable firms. The ownership of institutional ownership is significant in both unprofitable and profitable companies. However, since the absolute value of the variable in unprofitable companies is higher than profitable companies, the first hypothesis is approved. Therefore, there is a significant relationship between the ownership of institutional investors (concentration rank) and information content of the operation of unprofitable companies compared to profitable firms.

The Second Hypothesis: There is a significant relationship between the number of non-duty members of the Board of Directors and information content of the operation of unprofitable companies compared to profitable firms. The number of non-duty members of the board of directors is significant in both unprofitable and profitable companies. However, since the absolute value of the variable in unprofitable companies is higher than profitable companies, the second hypothesis is approved. Therefore, there is a significant relationship between the number of non-duty members of the Board of Directors and information content of the operation of unprofitable companies compared to profitable firms.

The Third Hypothesis: There is a significant relationship between the free float stock and information content of the operation of unprofitable companies compared to profitable firms. The percentage of free float shares is significant in both unprofitable and profitable companies. However, since the absolute value of the variable in profitable companies is higher than unprofitable companies, the third hypothesis is not approved. Therefore, there is no significant relationship between the free float stock and information content of the operation of unprofitable companies compared to profitable firms.

The Fourth Hypothesis: There is a significant relationship between the use of debts in financing and information content of the operation of unprofitable companies compared to profitable firms. The amount of long-term debt financing is significant in unprofitable, while it is not significant in profitable companies. Therefore, the fourth hypothesis is confirmed. In other words, there is a significant relationship between the use of debts in financing and information content of the operation of unprofitable companies compared to profitable firms.

Table 1. Descriptive statistics for study data

Parameters	Max. Unp. Co.	Max p. Co.	Min Unp.	Min p. Co.	SD unp. Co.	SD p. Co.	Middle Unp. Co.	Middle P. Co.	Average Unp. Co.	Average P. Co.
Stock Returns	0.5306	-0.31376	-0.4420	2.535937	0./1554	0.080784	0.0718	0.095979	0.0769	-0.18
Earnings per	-70.00	200.000	-	1.180	1112.04	1450.000	-	1598.124	-1376.47	2856.503
Non-duty Managers in the Board of Directors	0.6000	0.2	0.2000	-1.31243	0.1645	0.4	0.4000	0.374599	0.4385	0.6
Free Float	0.9901	0	0	-1.4357	0.3323	0.6025	0.4757	0.514711	0.4736	0.54
Institutional Investors	0.8550	0.235582	0.2458	-1.20861	0.1812	0.555621	0.5443	0.55049	0.5517	0.84
Use of Debt in Financing	0.9828	0.000103	0.0022	6.814719	0.1424	0.118604	0.1627	0.136022	0.1723	0.25
Firm size	16.4082	9.879553	9.8602	1.258505	1.3375	13.03148	12.4762	13.17033	12.7867	13.07
Growth opportunities	11.5458	3.683322	3.7241	-1.17467	2.4560	7.682836	7.5671	7.600146	7.7300	6.00

Table2. Comparison of information content of the operation of profitable and unprofitable companies

Company	Variable	Coefficient	Coefficient value	T Value	Sig.
Profitable	Ownership of institutional stakeholders	a_2	-4.706	-2.002	0.046
Unprofitable			-6.753	-2.141	0.003

Table 3. Comparison of information content of the operation of profitable and unprofitable companies

Company	Variable	Coefficient	Coefficient	t	Sig.
Profitable	The ratio of non-duty members of board of directors	a_3	5.421	2.381	0.018
Unprofitable			7.081	3.838	0.000

Table 4. Comparison of information content of the operation of profitable and unprofitable companies

Company	Variable	Coefficient	Coefficient value	t	Sig.
Profitable	The percentage of free float stock	a_4	6.527	2.619	0.009
Unprofitable			3.631	2.388	0.002

Table 5. Comparison of information content of the operation of profitable and unprofitable companies

Company	Variable	Coefficient	Coefficient value	t	Sig.
Profitable	The use of debts in financing	a_5	-3.651	-0.223	0.823
Unprofitable			-2.894	-2.601	0.0037

DISCUSSION

First Hypothesis: Since the absolute coefficient of the ownership of institutional shareholders is higher in unprofitable companies, there is a more significant relationship between stock returns and ownership of institutional shareholders in unprofitable companies compared to profitable companies.

According to self-interest hypothesis, institutional shareholders are more likely to have access to confidential information for their commercial purposes. In such circumstances, these investors are less willing to monitor the actions of the company and disclose information of the company. Consequently, this leads to increased information asymmetry and thereby increased agency cost. In such circumstances, investors and capital market participants consider a negative value for ownership of institutional shareholders due to increased information asymmetry. Due to the risk aversion of investors, this negative value is higher in unprofitable companies compared to profitable companies due to the high risk of these companies.

Second Hypothesis: Since the ratio of non-duty members of the board of directors in unprofitable companies is higher, the relationship between stock returns and the ratio of non-duty members of the board in unprofitable companies is more significant compared to profitable companies.

According to active monitoring hypothesis, the presence of non-duty members in the board of directors increase the performance of their regulatory function due to continuous monitoring and control, independence and having no direct financial interest in the company. This in turn reduces the information asymmetry and consequently reduces the agency cost. In such circumstances, investors and capital market participants consider a positive value for ownership of institutional shareholders due to increased information asymmetry. Due to the risk aversion of investors, this positive value is higher in unprofitable companies compared to profitable companies.

The Third Hypothesis: Since the coefficient of the free float shares is higher in profitable companies, the relationship between stock returns and the ratio of non-duty members of the board is more significant in profitable companies compared to unprofitable companies. It can be concluded that due to uncertainty in future profitability and performance of the unprofitable companies as well as higher risk of investing in these companies, investors consider a lower value for the free float shares of such companies compared to profitable companies with good prospect and lower risk.

The Fourth Hypothesis: Since the coefficient of debt financing is not significant in profitable companies, the relationship between stock returns and the use of debts in financing is mores significant in unprofitable companies compared to profitable companies. Accordingly, investors consider a higher value for the use of debts in financing (financial leverage) as a measure of corporate risk, due to the high risk investment. The statistical results show a significant negative value of the use of debts in financing from the perspective of investors and the market participants.

Suggestions: Investors are recommended to consider nonfinancial variables such as institutional shareholders in evaluating the quality of financial statement information. Furthermore, they are recommended to use the notice of free float stock change to improve their economic decisions. The officials of Tehran Stock Exchange (TSE) are recommended to provide requisites for better implementation of governance regulations in companies listed on TSE to increase the effectiveness of the Board of Directors.

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