The relationship between CEO duality and firm size whit over financial responsibility

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Abstract

Corporate governance is a set of functions, mechanisms and policies seeking for the better direction of the managers and achievement of responsiveness, transparency, justice and stakeholders' right (including government). They use various investments which require different finance methods to have close competition with the other firms. The population of this study is composed of the firms listed on the Tehran Stock Exchange, which has been initially listed on the stock exchange. The sample constitutes of the listed firms from 2007 to 2012. The collected data is analyzed by using the multivariate regression method. The findings reveal that there is no significant direct relationship between size and the over financial responsibility. It is further found that CEO duality and over financial responsibility are directly associated.

Keywords: Over financial responsibility, Board Members, CEO

Introduction

The over financial responsibility is a phenomenon in which the firms invest in various projects that are out of their financial ability and capacity. In terms of the relationship between corporate governance principles and the overinvestment strategy among firms, it is found that it is popular to use this method for financing the firms which results in over finance. Internal corporate governance mechanisms might significantly decrease the overinvestment. The IPO firms confront with significant problems associated with over finance. However, CEO duality results in over finance in order to the overinvestment of the firms. In addition, the top executives use the budgets of firms to compensate the monetary deficiencies and tend to overinvest. By improving the power balance between the shareholders, the overinvestment decreases significantly. Generally, this study examines the role and the effect of corporate governance mechanisms on using the over finance strategies in firms.

As a result, this study examines the effect of corporate governance principles on using the over finance strategies of the firms. The combination of shareholders of various firms is different. Part of firm's ownership is on the hand of minor shareholders and real parties. This group trusts on public information like released financial statements in order to supervise manager's performance. While the other part of firm's ownership is for major professional stakeholders who , in contrast to first group, access to internal valuable information about future perspectives, business strategies and long-time investment of firm through direct communication with firms' managers.

In recent years, managers are encouraged to profit under voluntary management. Also it is proceeded to manage profit when the managers use judgment in financial statement and transaction in order to change financial statements used to mislead some of the bankers about economical performance of firm or to affect contractual profits. The managers are flexible in selecting audit policies to maximize their use. In order words, it seems that potential investors play an important role in this regard. When the motivation is high to manipulate profit, irresponsible managers and major potential investors have a weak role in reducing the abnormality of unusual accruals. When potential investors, like banks and pension fund, are the owners of firm, the manager will be limited to manage profit (Modares and et al, 1999).

Theoretical Bases

Abor and Biekpe (2007) defined corporate governance as a process and structure used by the management to direct the affairs and to increase the welfare and responsiveness and finally increase the benefits of the shareholders to its maximum level.

Young Byun (2007) suggested that the successful corporate governance mitigates the information asymmetry. He also argued that the proper corporate governance impacts: (1) protection of the shareholders' rights, (2) protection of the management rights, (3) more appropriate disclosure and information asymmetry, (4) more auditing and handling of the affairs and (5) more appropriate dividend policy.

Corporate governance is one of the vital components of successful businesses which has been widely used by the public. Institutional shareholding and its impact on making financial and managerial decisions are the issues that the firms might be confronted with. (Rahanama Roudposhti and Aslani, 2008).

Appropriate establishment of the corporate governance mechanisms results in the optimum allocation of the resources, protection of the stakeholders' rights and growth of the sustainable development by attracting the investors. To achieve this objective, the officials and the policy makers should create the legal setting and monitoring agents and provide a secured environment for the economic and investment operations (Hosseini and Rahbari, 2008). Reducing the finance costs is one way to create value. As a result, the quality of the corporate governance seems necessary for the costs of the debts (Ahmad Pour et al, 2010).

Obviously, the investors aim to achieve the return which is determined to be appropriate for the investment goals. For the firms successful in creating value, the investors and the shareholders play a role and the stock price increases.

There are some optimal methods help managers to increase sale or decrease voluntary costs in economical crisis called the ways of manipulating real activities like price reduction of product sale. A fundamental factor to test profit management in firms is to estimate voluntary factor and managers' comment to determine profit (Roychowdhurg, 2006). Profit quality is not clear and observable. Various definitions are stated in past studies, and there is no agreement on it. In the majority of audit researches, accruals are used to measure profit quality with regard to this argument that accruals are direct criteria of profit management and it is a factor that helps profit quality (Moradzadeh Fard and et al, 1999).

Research Background

Perez and Timmermann (2007) studied fluctuations in stock return when business cycles were altering. They found considerable fluctuations in stock returns during business cycle alterations.

Antonio et al. (2007) addressed the question whether or not business cycles and biased profitability behavior account for trading speed in three major European markets. They reported that global trading conditions influenced the profitability of trading speed in European markets.

Corporate governance also provides a structure by which the objectives are determined and the ways to achieve the goals are clearly identified (Alnajjar, 2010). Different structures in the ownership system (including ownership and combination) have created diverse corporate governance systems affected by cultural, religious, legal, political and economic factors (Rahnama Roudposhti and Aslani, 2008).

In a study about the impact of free cash flows and the finance limitations on the over-and-under investment, Tehrani and Hesar Zadeh (2009) found that the free cash flows resulting from the information asymmetry among the managers and shareholders results in the overinvestment. On the other hand, the limitations in the finance lead to under-investment. The authors used the financial information of the Tehran listed firms over a period from 2000 to 2006 to empirically examine the relationship between the free cash flows and the overinvestment. The association between the finance limitation and the under-investment has been further investigated. The results of their study indicated that there is a significant relationship between free cash flows and overinvestment. In addition, no significant relationship is found between the financial limitations and under-investment.

Ghanbari (2007) tested the relationship between the non-executive board members, internal auditors, information transparency and institutional investment with the firm performance over a period from 2003 to 2005. They concluded that the non-executive board members have no effect on the performance. However, the internal auditing is found to have a direct relationship with the performance. This relationship, however, does not hold for the information transparency.

Vakili Fard and Bavand Pour (2010) examined the relationship between corporate governance measures and the performance. They used institutional shareholders, blockholders, non-executive board members and the quality of the financial information as the mechanisms of the corporate governance. Using a sample composed of 94 firms for a five-year period from 2004 to 2008, it was found that the non-executive members have significant and inverse relationship with the firm performance.

Aghayi et al (2009) considered the corporate governance attributes and information content of the earnings of the Tehran listed firms. They examined the relationship between corporate governance attributes and information content of the earnings over a period from 2001 to 2007 for the firms listed on the Tehran Stock Exchange. Verdi (2006) showed that there is a stronger relationship between the quality of the financial reporting and under-investment of the financially distressed firms. The association between the reporting quality and overinvestment for the firms with huge amounts of cash is also found to be stronger. For the firms intending to have overinvestment in business fields, the investment quality is found to be negatively associated with the investment.

Exo et exia (2012) investigated the measures of the internal corporate governance and their relationship with the financial issues of IPO firms over a period from 2006 to 2010. They selected 372 firms as the sample. The overinvestment of IPO firms in the Chinese capital market is considered as one of the significant issues. They concluded that overinvestment has a negative effect on the firm performance and negatively impacts the long-term return on investment. In addition, the measures of the internal governance are effective in avoiding the overinvestment. The findings revealed that CEO duality results in the overinvestment. It was also found that when the CEO compensation is excessive, the overinvestment of IPO firms is being motivated and this is popular among the privatized firms rather than the public ones.

Pincel and et al (2000) studied the profit management in England. In this study, the focus was on the role of irresponsible managers and audit commission in board of directors. The results indicated that the number of irresponsible managers has a reverse relationship with the probability of management of abnormal accruals in order to avoid reporting loss or profit reduction. More investigations show that this relationship is limited to the firm having separate corporate governance and controlling more decisions.

Shelifer and Winsi (1986) noted that all the stakeholders benefit from the supervision of a major stakeholder because there is no cost for this supervision, and also the major shareholders are motivated enough to supervise actively on profit management.

Chung, Firth and Kim (2002) investigated the potential control and management of profit resulted from lost opportunity, and found that potential investors avoid to be included in management of accruals for smoothing profit in order to reach to the optimal profit level.

Que (2003) studied the relationship between potential investors and profit management in Australian firms. The results indicated that the relationship between potential investors and profit management is nonlinear and concave. It means that first, increases in profit management causes shareholders' ownership till it reaches to maximize level then starts to decrease.

Research Methodology

This is an applied study using descriptive methods to implement the research steps. In terms of the relationship between the variables, the present study is a correlation study, because its findings might be practically employed. The type of the data has been measured quantitatively and the required information has been collected from the verified databases of the Tehran Stock Exchange.

Hypotheses Development

The research hypotheses are classified into four categories:

1- There is a significant relationship between SIZE and over financial responsibility

2- There is a significant relationship between CEO duality and over financial responsibility

Population and Sample

The population of this study is composed of the firms listed on the Tehran Stock Exchange. To determine the sample, the firms with the following criteria have been selected:

a) There should be no change of the fiscal year from 2007 to 2012.
b) The required information should be available.
c) There should be no transaction stop for more than 70 days.
d) The firms should have been subscribed since 2007.

Data Analysis Method

The data is described by using descriptive statistics and the hypotheses are analyzed by multivariate regression methods. The collected data is analyzed by EXCEL and EVIEWS software.

The following model is used to analyze the data and test the hypotheses:

$$\mathbf{OF = \alpha_0 + \alpha_1 Dirp_t + \alpha_2 Dirsize_t + \alpha_3 Z_t + \alpha_4 Eps_t + \alpha_5 Control_t + €}$$

CEO duality, firm size are considered as the independent variables. The dependent variable is defined as the finance through overinvestment.

In the present study, the investment opportunities, earnings per share, control nature of the owner, the independent director's ratio and board size are used as the control variables.

Findings

Based on the prior literature, the relationship between SIZE and over financial responsibility is not expected to be positive and significant. The results of the first main hypothesis are provided in the table below.

Method	Statistic	Prob.**	Cross-sections	Obs
Null: Unit root (assumes common unit root process)				
Levin, Lin & Chu t*	-46.9082	0.0000	100	400
Null: Unit root (assumes individual unit root process)				
Im, Pesaran and Shin W-stat	-12.1252	0.0000	100	400
ADF - Fisher Chi-square	384.922	0.0000	100	400
PP - Fisher Chi-square	473.636	0.0000	100	400

Model	$OI_{t+1} = \alpha_0 + \alpha_1 Stock_t + \alpha_2 Lpay_t + \alpha_3 SIZE_t + \alpha_4 Dirp_t + \alpha_5 Dirsize_t + \alpha_6 Z_t + \alpha_7 Eps_t + \alpha_8 Control_t + €$		
Regression level	High growth opportunity firms		
Statistics	Coefficient	t statistic	Sig. level
Board size	-0.007262	-1.317931	0.0143
Independent directors	-0.001043	-0.647821	0.0304
Owner's control	0.013180	1.579198	0.0426
Earnings per share	0.000117	0.141793	0.0898
Growth opportunity	-2.09E-06	-1.244906	0.2390
CEO duality	0.001857	0.860365	0.0079
F statistic	2.745514		
Sig. level	0.006319		
Durbin-Watson	2.139073		
Adj. R^2	0.259886		
R^2	0.468385		

Testing the hypotheses

The first hypothesis: There is a significant relationship between size and over financial responsibility of firms.

The following model is developed to examine the first hypothesis:

$$y_{it} = \alpha_0 + \alpha_1 A_{it} + \alpha_2 E_{it} + \alpha_3 F_{it} + \alpha_4 G_{it} + \alpha_5 H_{it} + \epsilon_{it}$$

Wherein it;

A_{it}- size

E_{it}- Earnings per share

F_{it}- The owner's control

G_{it}- The ratio of the independent directors

H_{it}- Board size

ϵ_{it}- Error term

The significance level of the is 0.057 which is higher than 0.05, and it confirms the no positive significant association between size and the over financial responsibility. In addition, the R^2 of the model is 0.66 and indicates that about 66 percent of the changes in the dependent variable is explained by the independent and control variables. Durbin-Watson statistics for the firms with high growth opportunity and the ones with the low growth opportunity indicate that there is no autocorrelation between the variables.

The second hypothesis: There is a significant relationship between CEO duality and over financial responsibility of firms.

The following model should be tested to examine the above hypothesis:

$$y_{it} = \alpha_0 + \alpha_1 B_{it} + \alpha_2 E_{it} + \alpha_3 F_{it} + \alpha_4 G_{it} + \alpha_5 H_{it} + \epsilon_{it}$$

Wherein it;

B_{it}- CEO duality

E_{it}- Earnings per share

F_{it}- The nature of the owner's control

G_{it}- The ratio of the independent directors

H_{it}- Board size

ϵ_{it}- Error term

The significance level of CEO duality is 0.0079 which is lower than 0.05, and it shows that CEO duality and overinvestment are positively associated. In addition, R^2 of the model is 0.46 and confirms that the independent and control variables explain 46 percent of the changes in the dependent variable.

Discussion and Conclusion

The present study seeks to examine the significance of corporate governance and its relationship with the over financial responsibility of the firms. The most significant advantage of corporate governance is that successful corporate governance plays an essential role in mitigating the agency costs, expropriating the ownership of the shareholders and increasing the firm value. Undoubtedly, investment type and finance of the firms are the most important components of the capital structure. Therefore, providing an appropriate capital structure might result in suitable dividend policy, low tax costs and incremental monitoring over the directors and the firms.

As one of the controlling devices which monitor the directors, the board of the directors aligns the interests of the shareholders to have more control over the directors. The non-executive ratio is considered as one of the monitoring factors, because the lack of the executive role directs the tendency of the non-executive members to monitor the other directors and board members.

Suggestions

Over finance and corporate governance have been much debated in different settings and play significant roles in increasing the firm value and improving the performance. Therefore, it seems necessary to pay special attention to these topics and conduct studies about these subjects. The following suggestions are provided for the future studies:

1. The time limitations might change the results of the hypotheses and it is suggested to conduct a study in another time period in order to compare the findings with the present results.
2. Future studies might be concentrated on examining the relationship between dividend policy and firms.
3. In the future studies, the production volume, size and performance might be considered as the control variables.

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