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Corporate Governance and Its Effect on the Corporate Financial Leverage

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ABSTRACT

In this study we have examined the relationship between the components of corporate governance (institutional share level, independency of board, presence of internal auditors, and the number of responsible board members) and the financial leverage of companies. This is an applied study. In this study, a descriptive survey method has been used according to the nature of issue, objectives and questions of research; and the study has been conducted based on the data collected from the financial statements of companies in the Tehran Stock Exchange during the fiscal year 1388. The number of statistical sample has been calculated according to the relevant formulas and the restrictions in the 77 companies; and 101 companies have been considered for generalizing with high confidence to the society. The main objective of this research is to find an answer to this question whether the mechanisms of corporate governance can affect the corporate financial leverage or not? In this regard, the research model, which is a regression equation, has been fitted with the appropriate statistical methods by SPSS software. According to the fitted model and statistical methods of Pearson correlation coefficient, and Durbin Watson and Kolmogorov Smirnov test, the hypotheses of research have been tested, and analyzed; the results indicate that:

1. The board independence has an inverse relationship with the ratio of debt (financial leverage).
2. The presence of internal auditor has a significant and direct relationship with the financial leverage.
3. The number of responsible board members has a significant and direct relationship with the financial leverage ratio.
4. The institutional share has a significant and direct relationship with the financial leverage ratio.

KEYWORDS: Corporate governance; financial leverage; concentrated ownership; capital structure; Altman Bankruptcy Index

INTRODUCTION

One of the issues which have been arisen in the financial markets in the recent years is the "corporate governance" which most of the scholars and experts from different fields such as accounting, marketing, finance, economics, law and etc have examined it from different aspects, and each one has explained and interpreted it from his own vision. The corporate governance Issue can affect the various aspects of company and its management including the performance management, earnings management and capital structure. The management of capital structure, which reflects the financial leverage of companies and the way by which the capital of company is applied by the managers, is one of the important issues in this section. This study examines the effect of variables in the corporate governance, such as the ownership structure (the concentration rate of corporate ownership) on the responsible members, and the quality of auditing on the corporate performance and financial leverage; and determines the performance and movement of companies. Elements which take part in this stage are: shareholders and their ownership structure, board members and their components, independence of board and other interested parties who may affect the movement of company.

The importance of implementing this research is that, it can explain the factors affecting the financial performance of companies and their financial policies, so the investors and shareholders will make a more accurate assessment about the capital market and make more accurate investment decisions.

This paper is organized as follows. First, the history and theoretical principles and then the background of subject are studied. In the third section, the methodological research and in the forth section the findings of research are provided; and finally, section 5 will conclude and discuss.

History

The issue of corporate governance was raised in the advanced industrial countries such as England, Australia and some European countries in 1990. The history of this subject dates back to a famous report, called

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the Cadbury report, which was published in 1992. This report emphasized on the presence of institutional shareholders and maintaining the internal control and internal audit system. In addition, this report was reviewed by Greenbury committee in 1995, and was finalized by this committee in 1998. Most countries including Britain, China, Korea, Canada, Australia and ... have such a written governance code. Moreover, in America, the disclosure, implementation, elections, and also the fraud in the capital market of America in 2001 were led to a legislation called Sarbanes-Oxley or the corporate governance. [5]

Despite the fact that the stock exchange market of Iran was established in early 1340s and was partly raised in the Commercial Code and especially in the amended bill in the cases related to the method of establishment and management of companies in Esfand 1347, the corporate governance with its current concept has been proposed in past few years. In the early 80s, this subject was raised and studied in the discussion by the officials of Stock Exchange Market at that time and in the Majlis Research Center; in addition, a Committee in the Ministry of Economic and Finance Affairs has studied the issue of corporate governance.

Theoretical principles and background of subject

The corporate governance or strategic system is a mechanized system which monitors and controls the behavior of corporate executives in various areas such as financial one which can be applied by the Board of Directors (responsible members, Non-Forced members and their independence), audit committees, and institutional investors [18].

Studies have defined the financial leverage as the amount of debt which is obtained for needed financing in order to acquire the necessary property (Hampton, p. 2001). According to the mentioned definition, the companies can be defined based on the financing as companies with high and low degree of financial leverage. According to Douglas's view (2001), the financial leverage has the ability to change the output and risk of companies [8].

Financial Leverage is one of the Leverage ratios and indicates the ability of company to pay debts. In general, the leverage ratios indicate the amount of debts in the capital structure of company funding.

The issue which should be described in the topic of financial leverage is the components of capital structure which is composed of two parts. The first part is the amount of required capital and the second part is the combination of funding sources. Generally, the loan and share are considered as two original species forming the capital structure.

The capital structure subject was first raised by Modigliani and Miller for the time in 1960; it was believed that the obtained understanding in the valuation of companies based on their assets and the way of funding depends on the understanding of capital structure.

Theories of capital structure

1. **Balance theory:** According to the theory of balance, the capital structure is estimated by the balance between the interests and cost of debt.
2. **Net Income theory:** This is based on the point that the enterprise can reduce the cost of capital by the debt. According to this theory, the optimal capital structure is achieved when there is the minimum capital cost.
3. **Theory of net operating income:** is based on this belief that the profit unit cannot affect the total cost by using the financial leverage and this is due to the increase of shareholders' sensitivity to higher debt in the capital structure.
4. **Traditional theory:** is based on these assumptions that there is an optimal capital structure and the cost of capital depends on the capital structure and the company can maximize their value by using the leverage.
5. **Modigliani and Miller's theory:** these two by the criticism of the traditional theory have proven that the cost of corporate capital does not depend on the degree of financial leverage and is constant at all levels. In addition, the value of a company, regardless of financing through debt or share distribution, is the same. According to the role of market, we cannot raise the value of company by changing the capital structure; it means that the value of company is independent of the degree of financial leverage and its capital structure.
6. **Static exchange theory:** According to this theory the company tries to balance between the value of tax savings of interest and bankruptcy costs and the agency costs. According to this theory, company should replace the debt with share and the share with debt until the maximum value is achieved.
7. **Information asymmetry theory:** According to this theory, the managers have more information than the investors about the future of company and this phenomenon is called asymmetric information. Therefore, because the managers have more information about the future of company, they do not involve others in the future profit of company; hence, they provide the financial needs of company through the debt; and when they do not have the favorable predictions about the future of company, they will meet the financial needs of company through the share distribution.
8. **Hierarchy theory of financing options:** According to this theory, the companies implement corporate a certain hierarchy for their needed financing. Formation of this hierarchy is the result or consequence of information asymmetry. Based on this theory, when there is an information asymmetry between the managers and investors outside the organization, managers prefer to finance by the internal sources of company to finance by the external sources; first they finance from the cumulative profit or reserves and then if there have not been

enough internal resources, they will choose the low-risk securities or the debt securities from the outer sources, and if the borrowing is not adequate and more money is needed, they will distribute the shares [3].

Finally, it should be noted that the financing by the interest loans has several strengths as follows. First, the interest of loan is the acceptable tax cost and this reduces the effective cost of loan especially if the rate of return resulted from these sources is higher than the cost rate of financing. Second, lenders cannot vote and shareholders can have more control of the larger companies with less money. However, financing of loans with interest has several weaknesses as follows: First, the long-term debts make the financial commitments for company on one hand; and on the other hand, dependency on them more than enough increases the financial leverage and consequently the likelihood of bankruptcy will increase and it will lead to the failure to pay the original loan and its interest. Second, in some countries the more the ratio of loan is increased, the more its risk is increased, and consequently the expected rate of return for creditors and the rate of lending cost will increase, therefore this can affect the cost of *tax* exemption.

International Researches

Sabour, Al-Farouq and Karim evaluated the effect and relationship between the ownership structure and board structure, and the financial performance of companies in Botswana Stock Exchange. In their researches, they chose the kind of shareholders and type of business in companies as the controlling variable and the model of research. Their studies concluded that there was a difference between the corporate governance systems among the companies due to the difference in the measured performance. Different capital market with different combinations is one of the reasons which they cited in their study [28].

In a study titled "The corporate governance and corporate financial performance", Mark examined the relationship between the level of corporate governance and the financial performance of companies listed in Poland. The results of study suggest a model which shows that the level of corporate governance in companies of Poland is related to their ability to duplicate with financial closure based on what is expressed by the degree of liquidity, profitability and the financial leverage variables [21].

Hong and Jian John concluded in their study that the stronger corporate governance led to the higher value of share, lower leverage, and lower concentrated ownership [25].

Hurd and Joud investigated the effect of corporate governance mechanisms on the fiscal policies of companies in New Zealand during 2004 to 2008. The results of their research show that: companies with weak corporate governance mechanisms have more financial leverage than companies with strong corporate mechanisms. Meanwhile, it can be observed that the companies with different levels of corporate governance quality apply various mechanisms of corporate governance relating to their financial policies [24].

Ron Jana (2010) evaluated the relationship between some of the board characteristics and the corporate capital structure in Nepal in his studies. The result of his research shows that: the corporate governance leads to lower financial leverage and disputes in the agencies. Experimental results of relationships are only significant statistically about the combination of board and conservative tenure, but it is not significant about the size and skill of board. On the other hand, the results show a positive correlation between the number of executive leaders in the board and the level of debt. Finally, the findings show that the management of building companies uses the higher debt level as a mean of expropriation for a few shareholders, not as a punitive and disciplinary mean [27].

Jian and colleagues (2003) evaluated the relationship between some of the characteristics of board and the capital structure of company in their study in the listed companies in China. Findings provide some initial evidences and it seems that when the administrators encounter with the stronger corporate governance by the board, they will use lower financial leverage. However, the experimental results of relationship are only significant statistically about the establishment of board and the conservative tenure. Results about the board size and fixed reward are not statistically significant [30].

Internal researches

Sinai and Rezaeian (1384) evaluated the effect of company feature on the financial leverage; the results of their research indicated that the compliance of adaptive principles such as the adaption principle and special attention to the unstable environmental variables and also to the advantages and disadvantages of various methods of funding lead to the proper adjustment of key decisions of corporate financing, and effective market efficiency of company [8].

Arab (1386) examined the relationship between the funding outside the organization and the operational performance. This study evaluates the operational performance of companies by four criteria including the Return On Assets (ROA), Return On Sales (ROS), ratio of Operating Interest to Income (OIOA), and Operating profit margin (OIOS); His results indicate that there is no significant relationship between the financing outside the organization and the operational performance before the funding in companies which have financing outside the organization more than 10 percent during the years 1374 to 1381. In addition, there has not been significant relationship in the confidence level 95% between financing outside the organization and the operational performance criteria including the OROS and ROS in the year after financing, but there has been a weak inverse relationship about the criteria of operational performance including the ROA and OIOA in the year after financing and this inverse relationship has been as the result of financing through the debt. The results of hypotheses test about the relationship of financing outside the organization and the operational performance of companies in the next years showed that except the ROA ratio which had direct relationship, other criteria of operational performance such as ROS, OIOA, and OIOS did not have significant relationship with the financing operations outside the organization [9].

Namazi, Hallaj and Ebrahimi (1388) found by evaluating the relationship between the institutional ownership and current and future financial performance of listed companies in Tehran Stock Exchange that there was a significant relationship between the institutional ownership and performance of company; and this relationship is positive. Moreover, the intensity of this relation is higher than the honorary industries about the current performance in the pharmaceutical and chemical industry, and about the upcoming performance in the automotive and machinery industries, but the type of relationship is not obvious in the industry [14].

Aghaei and Chalaki (1387) found a significant relationship between the features of corporate governance and earnings management by studying this relation [2].

In a research conducted by Nourvash, Karami and Vafi Tani (1387) a indicate a significant negative relationship was found between the percentage of non-responsible members of board and also the ownership percentage of institutional investors with agency costs; in the other hand, the results of research does not match with agency costs according to the hypothesis of the relationship among the debt ratio of companies [16].

Research Questions

This research seeks to answer a question and four sub-questions as follows:

Main question: Is there a significant and direct relationship between the components of corporate governance and the financial leverage of company?

Sub-questions:

1. What kind of relationship is there between the board independence and the ratio of financial leverage in the company?
2. What kind of relationship is there between the presence of independent auditor and the ratio of financial leverage of company?
3. What kind of relationship is there between the ratio of responsible board members and the financial leverage ratio of company?
4. What kind of relationship is there between the institutional share of company and financial leverage ratio of company?

Research hypotheses

1. There is a significant and direct relationship between the independence of board and the ratio of financial leverage in a company.
2. There is a significant and direct relationship between the presence of independent auditor in the company and the ratio of financial leverage in the company.
3. There is a significant and direct relationship between the ratio of responsible members of board and the ratio of financial leverage in the company.
4. There is a significant and direct relationship between the institutional shares of company the ratio of financial leverage in the company.

Research variables

Variables of this study are quantitative and according to their role, three types of dependent, independent, and controlling variables have been used. The corresponding values for these variables have been prepared from the financial statements, board reports, and audit reports of company. The variables of this study are as follows by the separation of their types.

Independent variables

1. **Board Independence:** If the board chairman of company is the CEO, there has not been the board independence; therefore the value zero is given to this variable. Otherwise the value one is given.
2. **Percentage of responsible board members:** It is obtained from the ratio of responsible board members to the total number of board members [23].
3. **Amount of institutional shares:** The institutional investors are those shareholders including banks, pension funds, insurance companies, and foundations which have more than 20 percent of company individually or collectively; and the amount of institutional share is equal to the total square of institutional investors' total shares [23].
4. **Presence of Internal Auditor:** If the company has an internal independent auditor, the value one is given to this is varied, otherwise the value zero is given.

Dependent variable

Debt ratio: is the ratio of total debt of company to total assets of company [12].

Controlling variables

1. Company size: logarithm of total assets of company or the logarithm of total sales of company is considered as its size [23].
2. Type of ownership: according to the law, if the percentage of direct or indirect ownership is provided for the public institutions more than 50 percent, the company is private, otherwise it is public [23].
3. Bankruptcy: In order to determine whether a company is bankrupt or not, the Altman Z score is used; and if the score is less than 1.81, the company is assumed to be bankrupt [10].

RESEARCH METHODOLOGY

The present study seeks to examine this question: Does the ownership structure of listed companies in Tehran stock exchange have an effect on their financial leverage? Therefore, this is an applied study. The research design is quasi-experimental and uses the post-event approach (through the past data).

Data Collection Method

Useful data for conducting the research includes two categories. First category of information is about the generalities, definitions, theoretical principles and researches carried out in the field of research, and it has been prepared by referring to books, journals, authoritative websites, Persian and Latin articles, and so on. The second category is related to the data which are necessary for calculating the variables of research. Method of collecting data related to each of the independent, dependent and controlling variables has been prepared by referring to the financial statements of companies at the end of fiscal year 1388 and they are available in the Stock Exchange Site.

Method of obtaining the research model

Model of this research, which is based on the dependent, independent, and controlling variables, is obtained by the following equation.

Controlling variables + Independent variables = Dependent variables

According to the above equation, the following research model is a kind of Multivariate linear regression which seeks to estimate the dependent variables of research by considering the controlling variables and based on the independent variables. The following equation is used for fitting the regression model.

$$\mathbf{P = A_0 + F(X, Y, Z, E, S, N, V) + \varepsilon_0}$$

$$\mathbf{Financial\ Leverage = A_0 + b_i\ (Corporate\ Governance) + \varepsilon_0}$$

In the model above, **V, N, S, E, Z, Y, X** represents the concentration of ownership, the ratio of responsible members, qualities of auditing, board independence, size of company, type of company, and bankruptcy index, respectively.

The regression relationship of financial leverage is calculated by fitting the above model to the data collected and by forwarding using the software **SPSS**.

$$\mathbf{Financial\ leverage = 0477 + 0.00001\,X + 0.14Y + 0.039\,Z - 0.0826E + 0.05\,S - 0.023N - 0.214V}$$

Method of calculating the statistical population and sample

Statistical population of research is the companies listed in Tehran Stock Exchange which can be adjusted according to the following limitations:

1 – They should not include the investing and intermediary companies. 2 – Their end of fiscal year should be at the end of Esfand. 3 – Their share should be within the trading period.

The statistical sample of study was randomly selected, and only 408 companies were eligible among all stock Exchange companies. After placing the numbers in the formula, the number of samples in 77 companies were obtained, but based on the access to the information of companies we equal the number of sample companies to 101 in order to generalize the result of sample to the society more confidently.

Analysis Method

The process of data analysis, as a stage of scientific method, has been one of the main bases of each research and by which all research activities are controlled and driven to achieve the results. In this research, collected data are analyzed by the techniques including the descriptive statistics, inferential statistics, drawing tables, and fitting the regression model. Descriptive statistics is used for summarizing the collected information and for more identification of community, and the inferential statistics is used for analyzing data in sample and measuring the uncertainty in deductions, in addition, the fitted model has been used for data analysis.

Research Findings

In order to test the hypotheses, the null and against hypotheses are written as follows:

H_0: There is no direct and significant relationship between the independence of board and the financial leverage.

H_1: There is a direct and significant relationship between the independence of board and the financial leverage.

In order to test this hypothesis, first the ratio of financial leverage is measured by fitting the following regression model to data and then the ratio of financial leverage is estimated.
By fitting the above model to the collected data and using the forward method by the software SPSS, the regression relation of financial leverage is obtained during the seven steps; the results are as follows.

Table 1- Estimating the regression coefficients

	Estimate	Standard deviation	T-VALUE	P-VALUE
Constant value	0.477	0.121	2.261	0.026
Bankruptcy	-0.214	0.04	-5.405	0
Company Size	0.05	0.031	3.616	0
Rate of Concentration of ownership	0.00001	0.025	2.433	0.022
Members ratio	0.14	0.101	2.390	0.025
Internal Audit	0.039	0.038	2.048	0.03
Board independence	-0.0826	0.119	-2.069	0.049
Type of company	-0.023	0.036	-2.646	0.008

Based on the estimation of coefficients, the fitted regression model is obtained as follows:
Financial leverage = 0477 + 0.00001 X + 0.14Y + 0.039 Z - 0.0826E + 0.05 S - 0.023N - 0.214V

The above regression equation is fitted by the forward method and the results indicate that: the order of influence of independent and controlling variables on the dependent variable (the ratio of financial leverage) is in a way that the highest effect is related to the bankruptcy, and the size of company, the rate of concentration of ownership, ratio of responsible members of Board, presence of internal auditor, independence of board, and type of company are in the lower rank, respectively.
In order to test the relationship between the variables in hypotheses, the Pearson correlation coefficient is used.

First hypothesis

According to the table of correlation coefficient, the correlation coefficient between the board independence and financial leverage ratio is equal to -0.432, and its probable vale is equal to 0 which is smaller than 0.01. Thus, the significant inverse relationship between the board independence and financial leverage ratio is approved with confidence 99%.

Table 2- Correlation coefficient

	Board Independence	Financial leverage ratio
Board independence:		
correlation coefficient	-0.432	1
probability value	0	0
Total	95	95
Financial leverage ratio: correlation coefficient		
probability value	1	-0.432
Total	0	0
	95	95

Second hypothesis

According to the correlation coefficient table, the correlation coefficient is equal to 0.632 between the presence of internal audit and financial leverage ratio, and its probability value is equal to 0 which is smaller than 0.01. Thus, the significant direct relationship between the presence of internal audit and the financial leverage ratio is approved with confidence 99%.

Table 3- Correlation coefficient

	Presence of internal audit	Financial leverage ratio
Presence of Internal audit:		
correlation coefficient	0.632	1
probability value	0	0
Total	95	95
Financial leverage ratio: correlation coefficient	1	0.632
probability value	0	0
Total	95	95

Third hypothesis

According to the correlation coefficient table, the correlation coefficient is equal to 0.546 between the ratio of board members and financial leverage ratio, and its probability value is equal to 0 which is smaller than 0.01. Thus, the significant direct relationship between the ratio of board members and the financial leverage ratio is approved with confidence 99%.

Correlation coefficient

	Ratio of Board members	Financial leverage ratio
Ratio of Board members: correlation coefficient	0.546	1
Probability value	0	0
Total	95	95
Financial leverage ratio: correlation coefficient	1	0.546
Probability value	0	0
Total	95	95

Fourth hypothesis

According to the correlation coefficient table, the correlation coefficient is equal to 0.448 between the ratio of institutional shares of company and the financial leverage ratio, and its probability value is equal to 0 which is smaller than 0.01. Thus, the significant direct relationship between the ratio of institutional shares of company and the financial leverage ratio is approved with confidence 99%.

Table 4- Correlation coefficient

	Institutional Shares of company	Financial leverage ratio
Institutional Shares of company:		
Correlation coefficient	0.448	1
Probability value	0	0
Total	95	95
Financial leverage ratio: correlation coefficient	1	0.448
Probability value	0	0
Total	95	95

Interpretation of Research findings

As mentioned before, in this study we seek to examine the relationship between the corporate governance and financial leverage of companies listed in Tehran Stock Exchange. The results indicate that there is a significant relationship between the components of corporate governance and financial leverage of companies.

The results of separating the subject based on the components of corporate governance to several sections and their interpretations are as follows:

There is a significant and inverse relationship between the board independence and the corporate financial leverage. However, the board independence is not reliable in Iranian companies because although the CEO is apparently independent and is not one of the board members, the majority of managers is employed base on their relations and cannot be independent, so the result cannot be reliable and practical.

Direct and significant relationship between the presence of internal audit and financial leverage indicates that the presence of internal audit increases the debt ratio of company and this is due to the impossibility of altering the financial reports of companies and therefore the presence of more realistic values.

Direct and significant relationship between the ratio of responsible members and financial leverage indicates that the more the number of responsible members increase compared to non-responsible ones, the more the power of risk and tendency to increase the benefit, increases for members. Therefore, the board seeks to finance through providing the bonds or getting the loans and have no desire to increase the shareholders.

Direct and significant relationship between the ratio institutional shares and financial leverage suggests that the more the concentration of ownership is higher in state enterprises or limited individuals and legal entities, the more financing is through the loans or bonds, and this could be due to the shareholders' easy access of these sources of financing. Therefore, assigning the companies to the private sector and offerring new shares for companies can reduce the amount of corporate debt and then reduce the probability of bankruptcy.

Policy proposals

As noted, the corporate governance and its effect on various aspects of companies is one of the most important modern issues. Unfortunately, the background of internal research is too low compared to the external background. However, nowadays the focus on these researches has been increased. According to research findings the below research and policy recommendations are presented:

1. The additional variables including the number of ownership years for institutional owners should be used in order to evaluate the relationship between the institutional ownership and the corporate financial leverage.
2. The additional related to the board member's characteristics such as age, gender and management experience should be used in order to evaluate the relationship between the board members and the corporate financial leverage.
3. Researchers should conduct this study by replacing the controlling variables with independent variables; In this case, the ruling criteria can be applied as controlling variables, the type and size of company are considered as independent variables, and their effect on the corporate financial leverage can be investigated.

4. Topics related to the independence of board and the presence of internal auditors should be further investigated.
5. The probability to have a relationship between the risk of bankruptcy and corporate governance can be an interesting subject for conducting new researches.
6. Evaluating the relationship between the probability of corporate bankruptcy and the financial leverage is also a good topic for future research.
7. It is recommended that the managers consider the issues related to the independence of board and the presence of internal auditor more than before.
8. It is recommended that the individuals and legal entities consider the corporate governance indexes in their decisions for purchasing the stock of companies.
9. It is recommended that the shareholders increase the number of non-responsible members of board in order to reduce the conflict between their interests and the members of board's interests.

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