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Efficiency Evaluation of Corporate Governance Mechanisms and Conservatism in Predicting of Financial Performance of Accepted Firms in Tehrans Stock Market

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ABSTRACT

With regard to the subject of separation of management from ownership and appearance of conflict of interests between owners and managers, topics of interest to various stakeholders such as creditors, owners, government and even managers is performance evaluation of firms and managers. By the same token this paper is paid to the efficiency evaluation corporate governance mechanisms and conservatism in Predicting of Financial Performance of accepted firms in Tehran's stock market. In this study, data for the 46 firms accepted for years 1388 and 1389 were evaluated based. In order to analyze the data employ statistical technique of factor analysis and discriminant analysis. The finding express to conservatism indexes allied with financial ratios have significant relationship with company's performance and significant role in separation of strong performance and poor performance companies but corporate governance variable have not significant influence in separation of strong performance and poor performance companies and can't employ for improvement of the model accuracy of company's performance prediction. On the whole provided model for performance prediction, predicted correctly the %80/4 of classification to two groups of strong and poor companies.

KEY WORDS: Corporate Governance, Conservatism, Predicting of Financial Performance, Efficiency Evaluation, Accepted Firms in Tehran's Stock Market.

1. INTRODUCTION

As a system that interrelate several scientific fields such as accounting, economics, finance, and law, and creates a balance between social and economic, and individual or public goals, corporate governance encourages and boosts the efficient use of resources and binds the firms with the necessity of being accountable to those who have interests in them. On the other hand, corporate governance could lead to the optimum dedication of resources, promotion of information transparency, and finally economic development and growth (John and Senbet, 1998). In fact, the final goal of corporate governance is not only to solve the problem of representation and put the interests of the employer and the agent on agreeable terms, but also to assure the interests of all those that have actually an interest in firms or businesses. Therefore, it is theoretically expected that the characteristics of a governance system affect the financial performance of companies. Efficient governance decreases the indelicate consequences of incongruity between the interests of managers and owners such as the abuse of power. The results of many experimental researches carried out in other countries show that a good corporate governance leads to the better performance of companies (Gompers et al. 2003, and Balatbat et al. 2004). Today, the application of scientific techniques, methods, and models has become increasingly popular in the financial management to generally help in taking wise decisions concerning the financial affairs of companies and organizations. This, on one hand, has accelerated the development of technology and economic growth, and on the other hand, has limited the ever more increasing competition of companies in making profit, and increased the probability of their bankruptcy. So compared to the past, financial decisions have become more directing and following this, many accounting and financial researches have focused on creating a model to estimate the economic and financial status of companies. One of the ways to help investors is to provide them with models that estimate the financial status of companies. The more precise are the estimations, the more accurate will be the decisions that are based on them (Adnan et al. 2006). If there are tools and models to evaluate and estimate the performance of companies, they will be good leads for decision-makers such as managers, investing companies, credit givers, banks, auditors, and shareholders to follow. According to the fact that the unfavorable financial status of companies could lead to the waste of resources, losses for different people, and economic consequences, it seems quite necessary that there should be techniques to assess the performance of companies and researches that help resolving such issues (Mohammad Zad'i and Nofarasti, 2009). Since the management of bankrupt companies have opportunistically concealed performance problems by profit smoothing and increasing net assets, if the performance estimation models are based on financial ratios acquired from companies' modified

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data, then, it will be probable that the models are designed and created inaccurately. The accuracy of the performance estimation model could be affected by the deliberate modification of a company's financial data. So, accounting conservatism methods are needed to avoid such modification. Meanwhile, the structure of the management and the board of directors act as a mechanism of a company's internal control. Therefore, the accuracy of corporate performance estimation models improves by taking corporate governance and conservatism into account (Smith, 2011). In chapter 2 and 3 of this research, theoretical fundamentals and literature of the research are discussed, respectively. Focusing on research methodology in chapter 4, we will go through research findings in chapter 5, and finally in chapter 6, conclusion and suggestions are presented.

2. RESEARCH LITERATURE

In this chapter, some researches carried out in the same field are mentioned:

In their research, Ghaemi and Shahriari (2009) studied the relation between the corporate governance and the financial performance of the companies admitted to Tehran Stock Exchange between 2003 and 2005. The findings of their research showed that there was no significant relation between the structure of the directors board and the ownership of a company and its financial performance. In their research, Badavar Nahandi et al (2011) studied the relation between some corporate governance mechanisms and conservatism in financial reporting. The results of their research showed that there was no significant relation between conservatism and institutional shareholders' ownership, ownership concentration, and the independence of directors board. In their research, Hung &Chyuan (2004) studied the effect of research and development on the performance of electronics industry in Taiwan. They used Cobb-Douglas Model to study 83 large electronic enterprises in the time interval of 1994 to 2000. The results of their research showed that for each percent of change in research costs, industrial production increased by 19% averagely. Kim & Yi (2006) studied the effect of ownership structure, business dependence among several groups, and the type of ownership on discretional accruals. The results of her research showed that the stock market motivated public limited companies to manage their profits in achieving their goals. Karjalainen (2007) studied the relation between research and development costs and the profitability of companies in Australia, Canada, Germany, Finland, France, Japan, Sweden, Netherlands, and England. The results of his research showed that there was no significant relation between the research and development costs and the profits in a given period, while there was a positive relation between such costs and future profits. In their research, Ahmed &Duellman (2007) studied the relation between conservatism and the characteristics of directors boards in a sample comprised of 833 companies in the time interval of 1999 to 2001. The results of their research showed that the ownership percentage of executive and non-executive members in directors boards had a negative and positive relation with conservatism, respectively. Using meta-analysis technique on 33 former researches, Sanchez and Garsia (2007) studied the relation between the ownership structure and corporate performance, and in the end, they concluded that there was no significant relation between these factors. However, this relation is balanced by environmental effects, and the respective results show that the ownership concentration in the countries where investors are less supported leads to the better performance of companies. In their research, Garay and Gonzalez studied the relation between the corporate governance system and the corporate performance assessment criteria such as dividend percentage, the ratio of market value to stocks book value, and Tobin's q in Venezuela Stock Market (IBVC). The results of their research showed that the increase in the corporate governance index also increased the dividend percentage, the ratio of market value to stocks book value, and Tobin's q by 11.3%, 9.9%, and 2.7%, respectively. In his research, Kajola (2008) studied the relation between governance and performance of Nigerian companies from 2000 to 2008. The results of his research showed that there was a significant and positive relation between the rate of return on shareholders' equity and the size of directors board and the managing director's influence, and no significant relation between the rate of return on shareholders' equity and the audition committee and the structure of the directors board. Also, there was a significant and positive relation between the profit margin and the managing director's influence, and no significant relation between the profit margin and the firm size, audition committee, and the structure of the directors board. In their research, Garcı´a Lara et al (2009) studied the relation between the characteristics of the directors board and conservatism. The results of their research showed that bankrupt companies were less intended to reveal profits from conservatism compared to healthy companies. In his research, Rosalinda (2009) studied the relation between the corporate governance and conservatism in creating financial lists. The results of his research showed that there was a poor relation between the corporate governance and the increase of conservatism in creating financial lists, and that the independence of audition committee and the size of directors board has no effect on the increase of conservatism in creating financial lists. In their research, Smith et al (2011) studied the estimation potential of conservatism and governance variables in companies' financial revelation to create a model that could estimate the performance of manufacturing companies in Australia. The results of their research showed that financial ratios, firm size, corporate governance, and conservatism were useful factors in estimating the corporate governance. The classification percentage of conclusion model based on the classified cases, the accuracy of model durability, and the accuracy of the estimation for the next year were 80.6%, 75%, and 62.2%, respectively.

In most of the estimation models of former researches, little accounting data in the form of financial ratios and firm size have been used for estimation, and the variables of corporate governance and conservatism and their effect on the models have been ignored. Here, the basic questions are: Besides financial ratios, do the

variables of corporate governance and conservatism affect the financial performance? And could the models designed based on the variables of corporate governance and conservatism estimate the dependent variable of corporate performance so accurately that they could compensate for the defects of estimation models that are based on financial ratios? So, the study of the estimation potential of governance and conservatism variables in revealing the financial performance of companies was included in this research.

3. METHODOLOGY

Methodology was chosen according to the goals, nature, subject, and implementation facilities of this research. The current research could be categorized as an applied research. Field and causal-comparative methods were used based on historical data from companies' financial lists. Corporate governance data was collected from directors boards' reports to their usual annual assemblies, and financial data from audited financial lists placed on Research, Development, and Islamic Studies website of Tehran Stock Exchange and Rahavard Software, manually. First, the researches on performance estimation were reviewed and their important variables were identified. Then, 11 financial ratios, 2 indices of corporate governance, and 2 indices of conservatism and firm size were chosen, and a model to estimate the corporate performance was presented. After data collection, the research hypotheses were analyzed using statistical techniques and SPSS Software. First, correlation analysis was performed and independent variables were chosen; then, factor analysis was used to integrate independent variables, and discriminant pattern analysis to estimate the performance. The statistical method of discriminant analysis was used to test the research hypotheses, Wilks' Lambda Test statistic to extract effective coefficients, and significance discrimination test for poor and strong pattern groups to estimate the performance.

3.1. Statistical Population and Sample

The statistical population of the current research was all the companies admitted to Tehran Stock Exchange. The reason behind using this statistical population was that the financial data of these companies was accessible, and it was homogeneous in respect to the specific rules and regulations of the exchange. This way, the data could be analyzed more easily. The statistical sample of the current research was chosen according to the research temporal and spatial domains and in a way that the companies in it were not among investing or intermediary ones and had the following characteristics:

1. In order to prevent inhomogeneity and to increase the potential of comparing the results together, the financial year of all the companies in the sample had to end at March 19.
2. Companies under study had to remain in Tehran Stock Exchange in the research interval.
3. The needed managerial and financial data had to be accessible for the research.

3.2. Research Hypotheses

The following hypotheses were proposed and tested in order to realize the research goals:

Hypothesis 1: Corporate governance variables have a positive relation with the corporate performance and could be used to improve the accuracy of the corporate performance estimation model.

Hypothesis 2: Conservatism variables have a positive relation with the corporate performance and could be used to improve the accuracy of the corporate performance estimation model.

4. RESEARCH FINDINGS

4.1. Correlation Test Results

Table 1 shows the results of the correlation test for independent variables and corporate performance. The variables that have a significant relation with the corporate performance are starred. The results showed that the significance level of corporate governance variables namely directors board independence and the free float was higher than 0.05, so, these variables didn't have a significant relation with the corporate governance, while the significance level of conservatism variables – the ratio of research and development costs to sales, and the ratio of advertisement costs to sales – was lower than 0.01, therefore, these variables have a significant relation with the corporate governance.

Table 1: The results of the correlation test for independent variables and corporate performance

Correlation coefficient	Variables
0.143	Current liabilitiestototal assets
0.353*	Current ratio
0.167	Liquidityratio
0.128	Totalliabilitiestototal assets
0.404**	Current assetsto totalliabilities
0.388**	Retained earningstototal assets
0.027	Earnings before taxes to current liabilities
0.512**	Operating profittototal assets
0.255	Operating profittooperatingassets
0.571**	Working Capitalto TotalAssets
0.614**	Market value ofequityto totalliabilities
-0.065	Independenceof Board
-0.180	Free float
0.525**	R & D expenditurestosales
0.419**	Advertisementexpenses to sales
0.519**	Firm size

4.2. The Results of Factor Analysis Test

KMO Coefficient and Bartlett Test were used to determine the propriety of the data. The Findings showed that KMO Coefficient was 0.67, and also based on the results of Bartlett Test (668.82) the data correlation matrix was not an identity matrix. Therefore, the research data were capable of being factorized, and factor analysis could be done on them. Principle Component Analysis was used to extract the factors. Table 2 shows that the net values of 6 factors are greater than 1. The first factor explains about 34.48% of the total data variance, and other factors about 13.75%, 10.51%, 8.77%, 7.61%, and 5.79%. Besides, the total explained variance by the six factors equals 80.95%.

Table 2: Data variance explained by the factors

Factor	Eigen Value		
	Special value	Percent of variance	Aggregate percentage of variance
First	5.51	34.48	34.48
Second	2.20	13.75	48.24
Third	1.68	10.51	57.75
Fourth	1.40	8.77	67.53
Fifth	1.21	7.61	75.15
Sixth	1.1	5.79	80.95

Factor loadings greater than 0.4 are accepted for factor analysis. Taking this into account and as it's obvious in Table 3, the variables of retained profit to total assets, operating profit to total assets, operating profit to operating assets, and earnings before tax to current liabilities could be put in a factor subcategory labeled profitability. On the other hand, the variables of current ratio, liquidity ratio, current assets to total liabilities, liquid capital to total assets, and stocks market value to total liabilities have factor loadings of 0.63, 0.78, 0.81, 0.65, and 0.63, respectively, and will be subcategorized as liquidity factor. The variables of directors board independence and free float with the respective factor loadings of 0.52 and 0.76 are subcategorized as corporate governance factor, and the variables of research and development costs to sales and advertisement costs to sales with the respective factor loadings of 0.67 and 0.75 as conservatism factor. Finally, the variable of total corporate assets with the factor loading of 0.82 is considered as the firm size factor.

Table 3: The results of factor analysis test

Factors	Factor loadings					
	1	2	3	4	5	6
1 – Profitability						
Retained earnings to total assets	0.63					
Operating profit to total assets	0.78					
Operating profit to operating assets	0.81					
Earnings before taxes to current liabilities	0.65					
2 –Liquidity						
Current ratio		0.63				
Liquidity ratio		0.78				
Current assets to total debt		0.81				
Working Capital to Total Assets		0.65				
Market value of equity to total debt		063				
3 – liability						
Current liabilities to total assets			-0.63			
Total Debt to total assets			0.78			
4 - Corporate Governance						
Independence of Board				0.52		
Free float				0.76		
5- Conservatism						
R & D expenditurestosales					0.67	
Advertisementexpenses to sales					0.75	
6- Firm size						
Total Assets						0.82

4.3. The Results of Discriminant Analysis Test

Table 4 shows the results of Wilks' Lambda statistic and the significance level of the test. The output of the results' Wilks' Lambda statistic showed that the variables of current ratio, current assets to total liabilities, retained profit to total assets, operating profit to total assets, liquid capital to total assets, stocks market value to total liabilities, research and development costs to sales, advertisement costs to sales, and the firm size play a significant role in recognizing the strong-performing companies from the poor-performing ones.

Table 4: The results of Wilks' Lambda and significance level

Variables	Wilks' Lambda	F	Df1	Df2	Significant level
Current liabilities to total assets	0.979	0.924	1	44	0.342
Current ratio	0.875	6.282	1	44	0.016
Liquidity ratio	0.972	1.265	1	44	0.267
Total debt to total assets	0.984	0.733	1	44	0.397
Current assets to total debt	0.837	8.564	1	44	0.005
Retained earnings to total assets	0.849	7.807	1	44	0.008
Earnings before taxes to current liabilities	0.999	0.032	1	44	0.858
Operating profit to total assets	0.738	15.626	1	44	0.000
Operating profit to operating assets	0.935	30.051	1	44	0.088
Working Capital to Total Assets	0.674	21.270	1	44	0.000
Market value of equity to total debt	0.623	26.587	1	44	0.000
Independence of Board	0.996	0.189	1	44	0.666
Free float	0.967	1.479	1	44	0.230
R & D expenditurestosales	0.725	16.719	1	44	0.000
Advertisementexpenses to sales	0.825	9.346	1	44	0.004
Firm size	0.734	15.944	1	44	0.000

Table 5 shows the results of Box's M Test and the significance level. According to the fact that the significance level is lower than 0.05, we can say that there is no difference between the covariance matrices of the strong and poor performing companies.

Table 5: The results of Box's M Test and significance level

Box's M Value	F Value	DF1	DF2	Significant level
558.71	2.45	136	5601	0.000

Table 6 shows the results of eigenvalue percentage of variance and canonical correlation for the function variables. Eigenvalue for the extracted discriminant function is 0.85 that shows its high capability for explanation. Canonical correlation coefficient shows the group correlation with discriminant scores. As it's obvious in Table 6, there is a strong relation between groups and discriminant scores, and the respective function has considerably distinguished between strong and poor performing companies.

Table 6: The results of eigenvalue percentage of variance and canonical correlation

Function	eigenvalue	Percentage of variance	Cumulative variance	Canonical correlation
1	0.85	100	100	0.89

The second column of Table 7 shows the values of the structure matrix. Table 7 shows that the variables of current ratio, current assets to total assets, retained profit to total assets, operating profit to total assets, liquid capital to total assets, stocks market value to total assets, research and development costs to sales, advertisement costs to sales, and the firm size have the biggest role in explaining the value of the total variance. Table 7 also shows the canonical discriminant coefficients of non-standardized scores for each of independent variables. Using these coefficients we could formulate the discriminant function as below:

Z= + 0.40 (current ratio) + 0.72 (current assets to total liabilities) – 8.84 (constant) + 1.72 (retained profit to total assets) + 1.43 (earnings before interest and taxes to total assets) + 0.65 (liquid capital to total assets) + 42.11 (stocks market value to total liabilities) + 13.02 (research and development costs to sales) + 26.22 (advertisement costs to sales) + 0.24 (firm size)

Table 7: The values of structure matrix and coefficients

Variables	Structure Matrix Value	Non-Standardized Coefficient of determination	Classification function coefficients	
			Weak	Strong
Current ratio	0.19	0.40	7.63	9.21
Current assetsto totaldebt	0.22	0.72	5.72	8.51
Retained earningstototal assets	0.21	1.72	17.28	23.96
Operating profittototal assets	0.30	1.43	-7.94	-2.38
Working Capitalto TotalAssets	0.35	0.65	-8.64	-6.18
Market value ofequityto totaldebt	0.40	42.11	-24.64	137.69
R & D expenditurestosales	0.37	13.02	196.49	246.70
Advertisementexpenses to sales	0.23	26.22	60.42	161.51
Firm size	0.30	0.24	4.46	5.39
Constant	-	-8.48	-60.26	-93.72

Table 8 shows the accuracy of classification in company groups. As it's obvious in this table, in the tested classification of companies, all the 21 poor-performing companies (100%) were classified as poor-performing. From among 25 strong-performing companies, 9 companies (36%) were incorrectly classified as poor-performing and 16 companies (64%) were correctly classified as strong-performing. In general, based on the total classification accuracy percentage in both groups, 80.4% of the companies were correctly classified as

strong or poor performing, and the rest were incorrectly classified. According to the findings of this table, the classification of the companies as strong or poor performing could be done with an accuracy of 80.4%.

Table 8: The accuracy of classification in the groups

		Performance	Predictedgroup membership		Total
			Weak	Strong	
Initial classification	Number	Weak	21	0	21
		Strong	2	23	25
	Percent	Weak	100	0	100
		Strong	8	92	100
Tested classification	Number	Weak	21	0	21
		Strong	9	16	25
	Percent	Weak	100	0	100
		Strong	36	64	100
Percentage of accuracy of model prediction		80.3			

4.4. The Results of Hypotheses Testing

The findings showed that based on the information from Table 1 two variables of corporate governance namely the directors board independence and free float had a correlation coefficient of 0.065 and 0.18 with corporate performance, respectively, and a significance level greater than 0.05. Therefore, these 2 variables had no significant correlation with corporate performance. Moreover, based on the findings of Wilks' Lambda Test, the above-mentioned variables had no significant effect on distinguishing between the strong and poor performing companies, and could not be used to improve the accuracy of corporate performance estimation models. This finding is compatible with the results of Izadi Nia and Rasaian's (2010) and Rajabi and Gajni's (2009) researches and incompatible with Smith et al (2011) and Namazi and Kermani's (2008) researches. The research results showed that the capability of the observation tools was low in improving corporate performance and the directors were non-duty-bound and not specialized enough. They also didn't perform their observation duties well so that their presence in directors board had become more of a formality. Meanwhile, the reason behind the lack of a significant relation between the ownership structure and corporate performance was probably the governmental and semi-governmental structure of companies so that despite the inclination toward a non-concentrated ownership structure and free float, the corporate governance was not affected by the ownership structure. Also, the results showed that the correlation coefficients for the variables of research and development costs to sales, and advertisement costs to sales were 0.52 and 0.41, respectively. These coefficients were significant at the level of $P<0.01$. Moreover, based on the results of Wilks' Lambda Test, the variables of research and development costs to sales, and advertisement costs to sales with a respective value of 0.725 and 0.825, and a respective significance level of 0.000 and 0.004 ($sig<0.05$) had a significant effect on distinguishing between strong and poor performing companies and could be used to improve the accuracy of corporate performance estimation models. This finding was compatible with the results of Smith et al (2011) and Hejazi et al (2010) researches, and incompatible with the results of Komijani and MemarNejad's (2004) research. The findings of this research showed the effective role of research and development and advertisement costs on estimating the performance. The results showed that investing to meet these costs would increase corporate income and lead to the higher profitability of companies. This is an important factor in improving the performance. Table 9 shows the results of research hypotheses analysis.

Table 9: The results of research hypotheses analysis

Hypothesis	Studied variables	Wilks Lambda	F statistic	Significant level	Result
First Hypothesis	Independence of Board	0.996	0.189	0.666	Rejected
	Free float	0.967	1.479	0.230	
Second hypothesis	R & D expenditures to sales	0.725	16.719	0.000	Approved
	Advertisement expenses to sales	0.825	9.346	0.004	

5. DISCUSSION, CONCLUSION AND SUGGESTIONS

Users of financial data often make decisions based on the future performance estimation, so assessing the past performance has always been one of the bases of the formation of future expectations and estimations. Financial reports give their users information about the profits rate and its forming elements based on which users assess, measure, estimate and predict the risks. By presenting major financial lists, financial accounting feeds the users with detailed information about the performance (Bahramfar and Kardan, 2008). Now, the primary questions concerning this area of study are: 1. Do corporate governance and conservatism variables affect the financial performance in addition to financial ratios? 2. Could the model actually designed based on corporate governance and conservatism variables estimate the corporate performance dependent variable so that the defects of the estimation models that are based on financial ratios are compensated for? The findings of this research showed that the variables of research and development costs to sales, and advertisement costs to sales along with the variables of financial ratios and the firm size have a significant correlation with the corporate performance and a significant role in distinguishing between the strong and poor performing companies. According to these results, decision-makers and financial lists users must pay attention to the costs mentioned

above. So companies' directors are recommended to value research and development and advertisement, because on one hand, both investors and credit-givers pay attention to them, and on the other hand, this has a positive effect on any company's performance and prevents solely bearing costs for these activities so that based on logical and rational measures, such activities are considered a capital and shown as an asset in balance sheets. The variables of directors board independence and free float don't have a significant correlation with corporate governance, and a significant effect on distinguishing between the strong and poor performing companies, so, they could not be used to improve the accuracy of corporate performance estimation models. It seems that one of the reasons behind the lack of a positive and significant relation between the non-duty-bound members of directors boards and performance is the ignorance of non-duty-bound directors about their organizational duties, and the inefficiency of the members of directors boards for different reasons such as insufficient expertise, being the member of several directors boards at the same time, and the absence of a competitive labor market based on the specialties and capabilities of directors. It is recommended that more attention is paid to the role of non-duty-bound members of directors boards as a corporate performance observation tool so that their presence in the directors boards is less of a formality and they could play an effective practical role in observing the companies and increasing their performance. Meanwhile, the reason behind the lack of a significant relation between the ownership structure and corporate performance is probably the governmental and semi-governmental structure of companies so that despite the inclination toward a non-concentrated ownership structure and free float, the corporate governance is not affected by the ownership structure. Investors are generally recommended to use this model to evaluate the companies and make decisions about whether or not to buy their shares. They are also recommended to use research and development and advertisement costs of a company as a measure for investing in it, because such costs have a positive effect on a company's performance and its market value, and greatly help the market flourish. The following topics could be focused on in the future researches in the same field:

1. Using other qualitative and nonfinancial variables that are related to corporate performance or other corporate governance and conservatism indices to estimate the performance.
2. Performance estimation using other methods such as logistic regression method, data envelopment analysis, artificial neural networks, and also other performance assessment criteria, and comparing the results against the discriminant analysis method.
3. Developing the model for non-manufacturing companies and the companies that are not admitted to the exchange.
4. Reviewing the characteristics of corporate governance and conservatism in investing companies and financial institutions and studying the same relations studied in this research in them.

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