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# Evaluation of the relationship between the transactions and the sales levels of the affiliates to corporate governance in companies listed in the Tehran Stock Exchange

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A B S T R A C T

The transactions of affiliated individuals have always raised many questions and been a critical concern for the users. Considering this important fact that the genuine nature of the transactions by affiliated individuals might be considerably different in appearance, it is highly required to assess this relationship meticulously. In some special conditions, the nature of relations and transactions with affiliated individuals might be in way that the risk of significant distortions in financial statements is enormously higher than the transactions with unaffiliated individuals. The findings of the current research have disclosed that the role of corporate governance in the Tehran Stock Exchange is significantly weak in the context of the transactions level of corporate affiliates.



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## INTRODUCTION

Appropriate establishment of corporate governance mechanism can be regarded as a fundamental step to take advantage of the resources, enhance accountability and transparency, respect equity and the rights of all corporate beneficiaries. The primary assumption of corporate governance and independent auditing process, which is considered as one of its most important components, is that the business generally seeks to maintain the benefits of its shareholders and increase their shares' values (Jalali, 2008). Therefore, there should be a professional relationship between auditors and the managers that the financial statements are typically audited by them. Independent auditors are required to apply their professional talents neutrally, while they are maintaining their independence and critical viewpoints. In this regard, members of the board of directors, as the designers of the company's strategies, should put their efforts to facilitate this relationship between auditors and executive managers more conveniently. This procedure should be done in such a way that managers would be well-aware of their responsibilities and while controlling their internal business, move forward towards continuation of their activities and present their necessary explanations for auditors (Yeganeh and Dadashi, 2009). Corporate governance is a system in which commercial corporations are monitored and controlled. Corporate governance specifies the division of rights and responsibilities amongst different partners in the company including the board of directors, managers, shareholders, and other beneficiaries and determines the rules and decision-making procedures in corporate affairs.

As a result, some structures are provided through which, the company's objectives will be determined and also, the means for achieving the targets and observing the performance are provided. Although the specifications of corporate governance reflect its responsibility for various roles of ensuring the success of companies, it is ultimately the accountability role that affects the commercial economy (Guler and Gowther, 2009). Gathering information about the transactions, the remained value among parties, and the relations with affiliated individuals might impact on the evaluation by financial statements users with regard to risk assessment and future opportunities of the business. If a transaction is made between affiliated individuals, in order to understand the potential effect of the relationship among affiliates on financial statements, the business should reveal the nature of this relationship with some information about the transaction and the remained values between parties (Hasas Yeganeh *et al*., 2006).

Regulators, investors, creditors, shareholders, and other market practitioners consider the transactions with affiliated individuals as a critical and complex issue in financial markets and commercial corporations and

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institutes. They believe that these transactions can be one of the main factors for fraud in financial statements and to seduce users. Hence, with respect to appropriate monitoring, studying and even auditing of these transactions may raise some concerns and doubts. For responding to such concerns, no solution can simply disregard corporate governance and its mechanisms, because the monitoring and controlling role of corporate governance on these transactions is of significant importance. According to Gordon, Honde, and Paldya (2004), there are two perspectives regarding the transactions with affiliated individuals. In one perspective, such transactions have conflicting benefits and from another one, these are efficiency transactions. These two conflicting perspectives present different tacit concepts of potential profit and costs of the transactions with affiliated individuals. In one hand, the perspective of conflict of benefits, which is compatible with the results of representative of the type introduced by Berl and Maniz (1932) and Jensen and Meckling (1976), describe the transactions with affiliated individuals as a potential loss in shareholders' benefits. On the other hand, according to the perspective of efficient transactions by Coase (1937) and Williamson (1975), it was claimed that the transactions of the affiliated party is not loss-making, and can be even beneficial and fulfil the essential and economic needs of the company.

*Literature review:*

About the history and empirical literature of corporate governance system, it can be stated that due to the bankruptcy and corruptions of some companies such as Enron and WorldCom, the need to create appropriate strategic systems of companies was proposed as one of the most important issues in all countries. However, these defeats were not the main stimulation to construct corporate governance regulations.

Some of the corruptions date back to 1980s (such as Maxwell and Polly Peck) and even 1960s (Penn Station collapse), which highlighted the need for an optional or a compulsory framework to be applied as corporate governance guidelines. In fact, the central reason is related to the necessity of redirecting the lost trust of investors towards commercial activities through transparency, accountability, equity, and responsibility. However, the corporate governance procedures are not the same amongst various countries. Each country, according to some factors including regulation and financial systems, corporate ownership structure, culture, economic situation of individuals and investors, has its unique corporate governance procedures (Madahi, 2008)

The initial concept of corporate governance was obtained from the term “Gubernare”, which means governance, and is generally used to guide a vessel. It means that corporate governance needs guidance in order to be controlled. The existing evidences present that corporate governance has become one of the most prevalent terms in global commerce in the beginning of new millennium. Corporate governance is created to provide the possibility of monitoring and balancing between the benefits of managers and shareholders and as a result, to decrease the representative conflicts. Thus, the companies with higher quality of corporate governance system should encounter lower problems with regard to the conflict of representative (Kashanipour and Rasaeian, 2010).

Corporate governance is called to a set of processes, routines, policies, regulations, and entities, which affect the method of a company in terms of administration, governance, and controlling. Moreover, corporate governance includes the relationship between numerous stakeholders (beneficiaries) and the objectives that based on them, the corporation is administered. Major stakeholders are the directing manager, shareholders, and board of directors. Other beneficiaries are employees, goods suppliers, customers, banks, other loaners, regulators, the environment, and the society in general. Corporate governance is a multi-dimensional issue. One of the important intrinsic issues in corporate governance is related to accounting and financial management, which fundamentally supports the application of policies and mechanisms that ensure the correct behavior and support the shareholders accordingly.

Another principal element is the economic efficiency perspective, through which corporate governance system should improve the economic objectives by precise consideration of the shareholders' wealth. There are other approaches in the field of corporate governance including beneficiaries perspective, which typically demands auditing and more attention to beneficiaries. Corporate governance is chief element to increase the trust of investors, enhance a competitive sense, and finally improve the economic growth. This factor is on the top of the list of international developments. James Wolfensohn, the former president of the World Bank stated: "Corporate governance is of higher importance for the global economy growth in comparison with countries governance".

The initial principals of corporate governance include equity, transparency, and responsibility, which are the equal in the entire parts of the world. Prevalence and enhancement of corporate governance can be much more effective for today's global commercial companies (Yadong Lou, 2005). In order to acquire better concept of corporate governance, two following perspectives can be explained, macro and micro approaches:

According to micro approach, corporate governance includes a set of relations between the company management, the board of directors, shareholders, and other beneficiaries. These relations that include different rules and motivations establish the structure by using some specified methods and some means to obtain the targets and monitor the execution. Thus, the initial principals of corporate governance are the transparency of structures and corporate operations, responsibility of manages and members of the board of directors with regard to employees, loaners, goods supplier, and local communities, where the company is active in.

Based on macro perspective, an appropriate corporate governance would mean the extent that companies are administered in an open and honest atmosphere in order to attract the trust of the market, capital efficiency, re-structuring the industrial structure of countries, and ultimately, increasing the public wealth of the society. It is worthwhile to express that in both micro and macro definition, the concept of transparency plays a major role. In macro dimension, transparency in corporate level can induce trust among capital suppliers. In micro dimension, transparency can inspire the general trust in macro economics. In both conditions, transparency can allocate the efficiency of the capital.

Members of the board of directors and other responsible individuals in corporate governance are increasingly using external service means to direct education, conscience, and accounting with no corruption. According to the mentioned concepts, corporate governance is of considerable importance due the following reasons:

- It provides a framework to induce long-term trust amongst companies and external capital suppliers.
- It endows strategic thinking to the top-level management of the company, by assignment of the managers with novel experiences and ideas.
- It rationalizes the management and monitoring of the future global risk in the company.
- It restricts the reliance on managers and their responsibilities by dividing the decision-making process.

The relationship with affiliated individuals is among the typical specifications of commercial activities. For instance, some businesses perform some parts of their activities through sub-units, special participations, and their affiliates. In such conditions, the business through controlling its processes (shared control or considerable diffusion) can impact on the financial and operational policies of capital unit (Lin *et al*., 2010). The relation with an affiliated individual may influence on the financial situation, financial performance, and commercial flexibility. The affiliates may function specific transactions that un-affiliated individual are unable to operate them. For instance, a sub division of a business might sell its goods with lower price or different conditions to other major businesses. In addition, the amounts of the transactions between affiliated individuals may be different in comparison with similar amounts between unaffiliated ones. The financial status, performance, and financial flexibility of the business may be affected by the relations with affiliated individuals, even if the transaction is not made with them.

The existence of a relation might be enough to impact on the transactions of business with other individuals. For example, as soon as one business is acquired by another one, due to the competition between the business in the deal and one division of the group, it might terminate its commercial relations with the business in the deal.

Moreover, the existence of a relation between affiliated individuals might lead to a situation, in which one party avoids to pay, due to a considerable diffusion of the other party. For example, one division of a business might be prevented from performing its R&D activities by the order from the main division (Lin, W., Lie, U., Keng, I., 2010).

According to above-mentioned reasons, having information about the transactions, the remained values between parties, and the relations with affiliated individuals may influence on evaluation of the users of financial statements from the business, including risk assessment and developing the business opportunities. There are two perspectives about the transactions with affiliated individuals:

- The perspective, in which these transactions are conflicting benefits. Gordon *et al*. (2004) have realized in their researches that weaker mechanisms are correlated with higher amounts in the transactions with affiliated individuals. Chong and Stourtis (2006) showed that dependent transactions have very low and negative intellectual efficiencies compared to typical similar transactions. Aharoni *et al*. (2009) presented in their study that selling goods to individuals and services to affiliated individuals can be used opportunistically to manage high profits, in the period before the first share supply.
- This perspective assumes these transactions as efficiency transactions. Estean (1997) showed in his research that personal benefit and authoritative behavior of the company's managers, is not essentially an unfavorable issue and by considering the controlling extent, which it can devote to managers, these intentions towards personal benefits can be restrained and more or less avoid linearization in some aspects of the maximization of shareholders' value. The results of Hang and Chang research (2007) disclosed that the companies dependent on the group members are diversified by dividing the financial and intangible benefits with other company members. Jin Wung (2010), by studying the companies listed in the Stock Exchange, concluded that these companies maintain their earnings at high level by intellectual dependent sales to the owners.

*The research method:*

The applied method of research in the current research is correlation research, because the relationship between the product market competition and corporate governance has been studied. Thus, multivariable regression method has been employed to test the hypotheses. In order to validate the test results using regression method, default regression tests including Durbin–Watson test, multicollinearity, and standard error level should be carried out.

*Hypothesis 1:*

The transactions level of affiliated individuals has a negative relationship with corporate governance.

*Hypothesis 2:*

The sales level of affiliated individuals has a negative relationship with corporate governance.

*The research theoretical model:*

In this research, in order to estimate the standard level of the transactions of affiliated individuals by using the study done by Wong and Jian (2010), the research theoretical model was determined as follows:

$$RPT(t) = \beta_0 + \beta_1 \text{In(Assets)} + \beta_2 \text{Debt} + \beta_3 SG + \beta_4 MB + \beta_5 D(group) + \sum \beta_{6+1} D(ind) + \varepsilon_i \quad (1)$$

Where:
**SG**: Sales growth rate
**MB** : Market-to-book ratio
**D(group)**: Group dummy variables
**D(in)**: Industry dummy variable
**ε** : The model error, which is defined as the transactions of unusual affiliated individuals
Additionally, in order to support the above assumptions, the below regression model has been applied:
**RPT_sales** = $a_0 + a_1$ CGI + $a_3$ ΔEPS + $a_4$ In(Assets) + $a_5$ Debt + $a_6$ MB + $\sum_{t=1}^{n} a_{6+t}$ Yearly dummy + ε (2)
**RPT_sales**: Sales transactions of affiliated individuals, which is measured according to the industry comparative model, model error, and sales' gross level.
**CGI**: Corporate governance Indicator
**In(Assets)**: The natural logarithm of company's total assets
**Debt**: The debt ratio
**MB**: Market-to-book ratio

*Information collection method:*

The required data for variables of the current study have been directly extracted from annual financial statements, financial reports presented by companies to the Tehran Stock Exchange, the Securities and Exchange News Agency, some softwares (such as Dena Sahm, Tadbir pardaz), in addition to the CDs of the companies' information. The sample population of this research included some companies that have the following conditions:

a) The companies that have been admitted in the Tehran Stock Exchange from the early 2007 (After 20th of March).

b) The companies that auditing of their annual financial statements for the specific period has been performed by verified auditors of the Stock Exchange. The end of their financial period should be the month, "Esfand" (20 Feb-20 Mar).

c) The companies that their required information for analysis of the research variables in the studied period is accessible and reliable.

Based on the mentioned conditions, 152 companies had the acceptable conditions. After determination of sample population, number of samples was estimated by using Corcoran formula.

$$n = \frac{NZ^2_{\alpha/2}pq}{\varepsilon^2(N-1) + Z^2_{\alpha/2}pq}$$

Z value in table for α = 0.05 is equal to 1.96. As far as p and q values are unspecified, in order to maximize the number of samples, we set those values 0.5. The number of society members is 152 companies and by assuming a logical value for ε at 6 %, the number of samples can be calculated. Therefore, the number of required samples was estimated at 97.

The research models were estimated by using combinational regression and by considering the constant coefficient of the equation. In order to select from the methods of combinational regression model and panel regression, F-Limer test was applied:

The results obtained from the above test for these equations show that the applied structure of data is panel. As the significance level of F-Limer in lower than 0.05, thus the null hypothesis is rejected and the opposite hypothesis is accepted.

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| Null hypothesis | Research models | F-Limer test | p-value | Test results |
|---|---|---|---|---|
| The data structure is combinational. | First model | 2.73 | 0.000 | The null hypothesis is rejected |
| | Second model | 1.89 | 0.000 | Null hypothesis is rejected |

The results from Hausman test for equations indicate that the estimation through constant effects method is confirmed.

**Table 3-4:** Hausman test results (selection between constant and random effects)

| Null hypothesis | Research models | Kido test | Degree of freedom | p-value | Test results |
|---|---|---|---|---|---|
| There is no difference between coefficients. | First model | 8.77 | 4 | 0.01 | Null hypothesis is rejected |
| | Second model | 87.98 | 8 | 0.000 | Null hypothesis is rejected |

*Examination of hypotheses and analysis of research findings:*

Regression estimation of the first model for testing the first hypothesis:

$RPT(t) = \beta_0 + \beta_1$ CGI+ $\beta_2$ In(Assets) + $\beta_3$ Debt + $\beta_4$ SG + $\beta_5$ MB + $\varepsilon_i$

According to presented values in the table, the fist model with regression coefficients are shown as below:

**Table:** Regression estimation of first model

| Dependent variable: The transactions level of affiliated individuals; Method: Panel EGLS; Period: 2007-2011; Number of observed years: 5 years; Number of samples: 100; Total observations: 500 | | | | |
|---|---|---|---|---|
| Variable | Coefficient | Standard error level | T-statistics | Significance level |
| C | 1.27 | 0.29 | 4.34 | < 0.05 |
| Corporate governance | 9.36 | 5.83 | 1.6 | > 0.05 |
| Logarithm of Assets | 1.49 | 0.23 | 6.36 | < 0.05 |
| Debt level | - 1.01 | 0.422 | - 2.39 | < 0.05 |
| The sales growth | 1.94 | 3.87 | 0.5 | > 0.05 |
| The market-to-book ratio | 2.4 | 1.8 | 1.31 | > 0.05 |
| The model's coefficient of determination: 71%<br>The significance of model, F-Limer: 3.96*<br>Significance level: (0.00 < 0.05)<br>Durbin–Watson statistics: 2.81 | | | | |

The results of Fisher statistics shows that the significance of first regression model is at the level of 95 percent. The significance level of F statistics is lower than 0.05 (0.00 < 0.05). The model's coefficient of determination shows that the studied model can explain 71 percent of the dependent variable changes (the transactions level of affiliated individuals). Durbin–Watson statistics value shows its correlation between residuals. The results from significance of the coefficients of model present that between the transactions level of affiliated individuals and corporate governance, and logarithm of assets, there is a positive and meaningful relationship and between the transactions level of affiliated individuals and debt level, there is a negative and meaningful relationship. But, between the transactions level of affiliated individuals and sales growth rate and marker-to-book ratio, there is no meaningful relationship.

Regression estimation of the second model for testing the second hypothesis:

$RPT\_sales = a_0 + a_1$ CGI + $a_2$ ΔEPS + $a_2$ In(Assets) + $a_5$ Debt + $a_6$ MB +ε (2)

According to the presented values in the table, the second model has been presented with regression coefficient as below:

The results of Fisher statistics show the significance of second regression model at 95 percent level. The significance level of F statistics is lower than 0.05 (0.00 < 0.05). The coefficient for determination of the model presents that the studied model can explain up to 69 percent of the dependent variable changes (the transactions level of affiliated individuals to sales). Durbin–Watson statistics value is 2.63, which reflects that there is no correlation between residues.

The results from the significance of the model's coefficients demonstrate that between the transactions level of affiliated individuals to sales and corporate governance, and the shareholders' rights, there is a positive and meaningful relationship. In addition, between the transactions level of affiliated individuals and logarithm of assets and debt level of the company, there is a negative and meaningful relationship. However, between the transactions level of affiliated individuals to sales, sales growth rate, and the market-to-book ration, there is no meaningful relationship.

**Table 3-4:** The regression estimation of the second model

| Dependent variable: The transactions level of affiliated individuals to sales; Method: Panel EGLS; Period: 2007-2011; Number of observed years: 5 years; Number of samples: 100; Total observations: 500 | | | | |
|---|---|---|---|---|
| Variable | Coefficient | Standard error level | T-statistics | Significance level |
| C | 4.56 | 2.27 | 2.04* | < 0.05 |
| Corporate governance | 4.9 | 2.5 | 1.96 * | < 0.05 |
| Shareholders rights | 25.41 | 14.6 | 1.74 * | < 0.05 |
| Logarithm of assets | -5.05 | 1.85 | -2.72 * | < 0.05 |
| Debt level | -2.45 | 1.49 | -1.74 * | < 0.05 |
| The market-to-book ratio | 0.29 | 0.96 | 0.3 | > 0.05 |
| The model's coefficient of determination: 69%<br>The significance of model, F-Limer: 8.29*<br>Significance level: (0.00 < 0.05)<br>Durbin–Watson statistics 2.63 | | | | |

*Results:*

Corporate governance has aimed to support the long-term objectives of business and maintain the benefits of shareholders against the management of organizations. In fact, corporate governance has tried to decrease the power of the strong minority of shareholders and reduce the associated risks through improvement and enhancement of transparency and accountability. Thus, considering the research results, it can be perceived that corporate governance role in the Tehran Stock Exchange is considerably weak in the transactions level of affiliated individuals. Hence, based on the findings of the current research, it can be claimed that by considering the specifications of the sample companies under study, there is no relationship between the entire transactions of affiliated individuals (including purchasing, sales, loan, guarantee, and debt) and corporate governance. In addition, considering the specifications of sample companies under study and the promising variable of shareholders' rights, there is a positive relationship between the transactions of affiliated individuals to sales and corporate governance. Finally, it should be declared that the results are not in line with the findings of Yo *et al*. (2012) in the study of the Taiwan Stock Exchange.

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