Studying the relationship between board independence and audit committee on bankruptcy in Tehran Stock Exchange

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Abstract. 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. On the other hand, bankruptcy is a highly significant worldwide problem that affects the economic well-being of all countries that good corporate governance as tool for prevention. The aim of this paper is examining the relationship between corporate governance mechanisms and bankruptcy of firms. This study used a sample of 51 bankrupt and 81 non-bankrupts from Tehran Stock Exchange in 2009 to 2013. The results show that corporate governance mechanisms is beneficial for firms and can be reduced likelihood of financial distress. In additional, greater levels of blockholder and director ownership and the existence of a separate audit committee are associated with lower bankruptcy likelihood.

Key words: Corporate governance, bankruptcy, board independence, audit committee, Tehran Stock Exchange.

1. 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. On the other hand, bankruptcy is a highly significant worldwide problem that affects the economic well-being of all countries that good corporate governance as tool for prevention.

Focusing on a time period incorporating no formal corporate governance requirements provides an opportunity to directly assess: (i) whether companies that are closer to, or have a higher probability of bankruptcy, adopt corporate governance structures that differ compared to those employed by healthier firms; and (ii) whether there is a causal relationship between bankruptcy and corporate governance. This approach differs from prior studies which examined the link between corporate governance and the probability of bankruptcy in environments where formal corporate governance codes exist.

Few prior studies have examined the direct association between various corporate governance attributes and bankruptcy of firms. Exceptions are Abdullah (2006) for Malaysian firms, Elloumi and Gueyle (2001) for Canadian firms, and Lee and Yeh (2004) for Taiwanese firms. Elloumi and Gueyle (2001) examined the relationship between various corporate governance attributes, such as the presence of outside directors on boards, equity ownership of outside directors and CEO–chair duality, with the likelihood of financial distress of Canadian firms. They found that the presence of outside directors and ownership of outside directors are negatively related to the likelihood of financial distress. However, the presence of CEO and duality fail to show any significant association with financial distress of firms.

Prior studies have suggested that agency costs are higher for listed companies in Australia compared to other western countries such as the US and UK (Fleming et al., 2005; Henry, 2010). The existence of greater agency cost levels further raises concerns about the extent and effectiveness of traditional monitoring and incentive mechanisms. In light of this environment, it is our suggestion that firm corporate governance structure may have an increasingly important role as an effective monitoring mechanism and in reducing agency costs.

Prior studies, including Ang et al. (2000), Fleming et al. (2005) and Singh and Davidson (2003), provide evidence that corporate governance, including director ownership and board independence, reduce firm-level agency costs. Henry (2010) found that greater overall compliance with corporate governance is associated with a lower agency cost. There is also a wealth of literature examining the relation between corporate governance and firm performance (Brown et al., 2011), with mixed evidence regarding the nature of any association between the strength of firm corporate governance and performance outcomes.

An effective monitoring mechanism on the management is essential to ensure manager's action is in accordance with shareholder's interest. Conflict of interest between managers and shareholders becomes apparent when there is a separation between the people who own a firm and the people who manage the firm (Jensen & Meckling, 1976). In the current business ownership structure, this separation is unavoidable particularly in large listed firms i.e. the owners are more dispersed among shareholders and the appointed management may have very minimal shareholding. In these firms, failure to monitor the management may lead to inefficient resource allocation and to some extent, bankruptcy (Johari et al., 2008). The case of Enron, WorldCom and some other firms in the U.S., lead many stakeholders to question the effectiveness of monitoring mechanisms on the management. In an overall look, corporate governance includes the legal arrangements, cultural and institutional, that it determines corporate performance (Mousavi et al., 2012). Corporate governance has been generally defined as the system by which companies are directed and controlled (Moradi et al, 2012). Corporate governance is therefore about the organization of a company by taking into account the responsibilities towards the shareholders and other stakeholders (Mohamad Mokhtar et al., 2009). The accountability and transparency component of corporate governance would help companies gain shareholders' and investors' trust. These stakeholders need assurance that the company will be run both honestly and cleverly. This is where corporate governance is critical (Morck et al., 1988). Corporate governance improves stakeholders' confidence and this would aid the sustainability of business in the long run (Mohamad Mokhtar et al., 2009). Codes of best practice for corporate governance to attract more capital or foreign investment to the country. For example, following the Sarbanes-Oxley Act 2002, the New York Stock Exchange (NYSE) and NASDAQ proposed a new corporate governance listing-standard and were approved by SEC on November 4, 2003. The new listing standards include provisions regarding board composition and structure, audit committee composition and responsibilities and other corporate governance matters. Efforts in building a regulatory mechanism affecting the firm bankruptcy in Iran led to the formulation of corporate governance regulations has been in Tehran Stock Exchange (Abdollahi and Garkaz, 2010).

Efforts, which have been made for classifying the corporate governance systems, were associated with the complications. However, one of the best efforts, which are more acceptable by the experts, is the classifications known as the systems within and outside the organization. The terms "within and outside the organization" indicate efforts to describe two types of corporate governance systems. In fact, most of the corporate governance systems are between these two groups and are common in some of their features. This dichotomy of corporate governance is due to the differences which exist between the cultures and legal systems. However, countries are trying to reduce these differences, and it is possible that the corporate governance systems worldwide will be closer together. Benjamin Ahikoya (2007) studied the effect of corporate governance structure on the corporate performance in Nigeria. Findings of his research confirmed the positive effect of corporate concentrated ownership on their performance. There have been gained important evidences which indicated that the board independence had no effect on the corporate performance. The results of research indicated that the corporate size and financial leverage had no effect on their performance. In this paper we examine the association between board independence and audit committee as corporate governance mechanisms and the likelihood of bankruptcy of listed Iranian firms from 2009 to 2013.

2. Hypotheses.

Agency theorists argue that outside directors provide a means for monitoring management activities through an increased focus on firms' financial performance, resulting in the minimization of agency costs (Fama and Jensen, 1983). Bathala and Rao (1995) and Rediker and Seth (1995) discussed that outside directors play an important role in effective corporate governance, especially in terms of decision-making and control functions. Concerns about reputation effects and the ability to attract other directorships are also expected to motivate outside directors to maximize the financial health and value of firms under their stewardship. Elloumi and Gueyle (2001) found that independent directors play an important role in enhancing a firm's financial conditions, supporting the belief that inside directors lack objectivity and independence from management. The first hypothesis is therefore as follows:

H1: There is a negative association between board independence and bankruptcy.

An audit committee works as a corporate governance mechanism and reduces agency costs (Forker, 1992), and plays an important role in helping boards of directors in fulfilling their corporate governance responsibilities (Spira, 2003). Collier (1993) found that the presence of an audit committee helps directors in meeting their statutory and fiduciary responsibilities, such as producing accounting records and completing the

annual audit process, and ensuring the quality of the financial reporting and control system. The second hypothesis is therefore as follows:
H2. There is a negative association between the existence of an audit committee and bankruptcy.

3. Data.

We collect accounting, financial and corporate governance data from the information and data available in library of Tehran Stock Exchange and Rahavad Novin software. Our initial sample consists of all Tehran Stock Exchange (TSE) listed firms as at March 2009.

According to the information and data available in library of Tehran Stock Exchange, in that span of time only 51 companies were in accordance with Article 141 of Business law of Iran. To compare with bankrupted companies, some 81 non-bankrupted companies were also chosen via random sampling. So, the sample consists of 132 companies (51 bankrupted and 81 non-bankrupted ones).

Applying conditions that were necessary to do this research, the number of sample companies is shown according to industry, bankruptcy and non-bankruptcy in table 1.

Table 1. Sample information

Industries	Bankrupt		Non-bankrupt	
	Number	Percentage	Number	Percentage
Energy	5	9.8%	8	9.876%
Materials	7	13.72%	11	13.58%
Textile	13	25.5%	20	24.69%
Pharmaceutical	12	23.53%	17	20.987%
Rubber	6	11.76%	13	16.25%
Transportation	4	7.84%	7	8.64%
Non-metallic Minerals	4	7.84%	5	6.17%
Total Firms	51	100%	81	100%

4. Empirical result.

The following logit regression model is used to test the association between corporate governance attributes and firm financial distress probability:

$$BANKRUP_{it} = \alpha_0 + \beta_1 OUTSIDERS_{it} + \beta_2 AUDITCOM_{it} + \beta_3 SIZE_{it} + \beta_4 MGTEFF_{it} + \sum \beta_m Yr_{it} + \sum \beta_n Ind_{it} + \varepsilon_{it}$$

Table 2 presents the descriptive statistics of the sample firms and tests of differences between bankrupt and non-bankrupt firms.

Table 2. Descriptive statictics

Variable	N	Mean	Standard deviation	Median	Minimum	Maximum	Mean difference	p-value
Board independence (OUTSIDERS)								.014
Bankrupt	51	60	22	60	0.00	100.00	-11.023	
Non-bankrupt	81	47	29	50	0.00	100.00		
Audit committee (AUDITCOM)								0.91
Bankrupt	51	0.9	0221	1.00	0.00	1.00	-0.42	
Non-bankrupt	81	0.4	0.44	0.00	0.00	1.00		
Firm size (SIZE)								2.32
Bankrupt	51	8.98	0.87	8.2	6.24	11.002	-1.74	
Non-bankrupt	81	6.02	0.66	6.81	3.87	9.14		
Management efficiency (MGTEFF)								.175
Bankrupt	51	1.187	1.033	0.9	0.00	8.21	-0.89	
Non-bankrupt	81	0.301	1.079	0.027	0.00	18.88		
Model Summary: Adjusted R^2 0.461								
F-statistic 43.6								

5. Conclusion.

We examine the association between board independence and audit committee as two of corporate governance mechanisms on the financial bankruptcy in Tehran Stock Exchange for the period 2009 to 2013. Our results showed that both greater levels of director independence and the existence of a board audit committee reduce the likelihood of bankruptcy.

The results show that board independence and audit committee positively associated with the firm bankruptcy. Also, according to research results, when the financial audit is performed by Iran Auditing Organization, firm bankruptcy has been reported to lower rates. There are two main limitations identified in this study. Firstly, the sample only covers five years of Iranian data and an external validity problem exists that the results may not be transportable over different time periods and locations. Secondly, only two corporate governance variables were considered. Many more variables could be considered. Future research should include the examination of the association other corporate governance variables such as the roles of non-executive directors, CEO duality, internal auditing, institutional ownership and managerial ownership on firm bankruptcy.

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