



The Relationship between Institutional Investors with (without) Business Relationship and Operating Cash Flow Return in Accepted Companies of Tehran Stock Exchange (TSE)

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ABSTRACT

Institutional investors with (without) Business Relationship with the company, have different effects on the companies' Operating Cash Flow Return. According to the theoretical literature, institutional investors with business relationship, interfere in the business and even can cause to transfer profits from the company and thus have a negative impact on the company's Operating Cash Flow Returns. In contrast, institutional investors without business relationship due to the nature of their investment, which is based on receiving dividends and increased stock market value, so company's profitability less affected and therefore the company's Operating cash flow returns will increase. Therefore, the aim of this paper is investigating the impact of institutional investors (from the aspect of with (without) Business Relationship) on the company's Operating Cash Flow Returns. The hypothesis of this research as follows: 1) Institutional investors with business relationship with companies have reverse effect on the companies Operating Cash Flow Returns. 2) Institutional investors without business relationship with the companies have a positive effect the company's Operating Cash Flow Returns. This research is in the descriptive - regression area and benefited of financial information 35 accepted companies in Tehran Stock Exchange during the period of 1381 to 1385. The results of this research are consistent with initial expectations that, institutional investors with business relationship have a significant negative effect on company's Operating cash flow returns and in the other hand, institutional investors without business relationship have a significant positive effect on company's Operating Cash Flow Returns. Therefore, the first and second research hypothesis was accepted.

Keywords: Institutional investors with (without) business relationship, Operating Cash Flow Returns, Tehran Stock Exchange (TSE).

1. INTRODUCTION

A large group of economic scientists, particularly theorists of financial economics consider company as an agency in which, constantly contracts made between people participate their own wealth (such as raw materials, labor, credits, and management manpower) in one hand, and shareholders on the other hands. Therefore, company defined as a complex set of contracts in which, each of the parties seek to maximize their own economic interests. Given that the management and ownership of modern corporations are separate from each other, the managers of such companies are represent shareholders and their main task are regulating the contracts and supervising on their implementation. Formation of such representational Relationship, leads to a conflict between managers and potential shareholders, so called agency problem. Various solutions have been proposed to solve this issue that using these strategies can greatly reduce the severity of this problem and, necessity for corporate governance is one of these strategies. In the absence of strong corporate governance, the separation of ownership from control enables the management to act in favor of their personal interests rather than of shareholders'.

The scandals of corporations in recent years (companies like Enron and WorldCom in USA and Telwam in Australia) reflect the corporate governance mechanisms, and most of corrective measures such as the Sarbanes - Oxley law and changes made by Nada and New York stock exchange (NYSE) mostly focused on management decisions' quality monitoring. These decisions reflect increasing belief that, the board of directors has not been effective enough in management supervision. Therefore, due to enhance the quality of supervision on management it is necessary to form board of directors from independent agents. For example, the Sarbanes - Oxley requires that, the financial experts be present in audit committee and the board of directors must be composed of independent members. Since the company's major stock owned by institutional shareholders, therefor these shareholders can use their suffrage in selecting board of director's members and CEO. Unlike the board of directors, institutional shareholders increasingly tend to use property rights, in order to put pressure on managers to maximize their

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benefits. Parallel to the increase of the shareholders' shares, the focus on corporations' managers increases due to managers role in supervising and directing the operational activities. Also, all institutional shareholders are not the same (i.e. have not the same effect). Some institutional shareholders have a business relationship with their respective companies and due to maintain above mentioned business relationships, they are not willing to challenge management decisions and others without business relationships with companies use their supervisory ability to better control managers [5]. For example in Iran, banks and insurance institutions including social insurance organizations or pension funds of investment organizations are samples for institutional investors, whit business relationship and they are identified in the Commercial Law Article 129, deals with persons section, in financial statements notes. Companies, to achieve their goals need the navigation that designed and implemented by management responsibilities and done by management and employees of economic units and require the participation of all employees. Influence of institutional investors on corporation's performance is through their ability to control their management. Separation of management from ownership is not the only reason the agency problem between shareholders and managers but, scattering company's shareholders as the small shareholders can also be a reason [6]. In an extensive combination of ownership, none of the small shareholders have any incentive to monitor management. This is because every person that wants to monitor must pay related expenses while the rest of the shareholders benefit from it. Then, the amount and nature of agency problem is directly depends on the ownership structure. Diversity of ownership structure across countries results in diversity of form, results, and solutions to agency problems between managers and shareholders. In countries where ownership is the majority of shareholder, it appears that the agency problem of ownership is not very common [7, 8]. Some believe that the presence of large shareholders in monitoring activities potentially limit the agency problem. The researchers have also stated that, because all of shareholders benefits from supervisory activities without incur any cost, then the major shareholders have required incentives to supervisory activities. Empirical evidences about the supervisory role of major shareholders also support this theory [9] and reported that, the company's performance after selling a portion of its shares to an active shareholder improved [10]. They found that, presence of major shareholders is related to massive displacement of Management, indicating their monitoring task.

2. LITERATURE REVIEW

Cornett et al. (2007) examined the relationship between institutional investors and operational dimension of company's performance and their results showed that there is significant relationship between operating cash flow return on assets (earnings before interest and taxes plus depreciation divided by total assets) and the percentage of major shareholders in the company's ownership structure and this relationship only observed in shareholders with business relationship with the company. Almazan et al (2005) examine the relationship between the active institutional investors and control costs. Although in this study it is proposed that, institutional investors have major role on management control, but the effect of institutional investors is not identical. Institutional investors without business relationship, have a major role on ownership structure in order to properly control the activities and management decisions. Chen et al (2007) examined the relationship between management and institutional investors. Using the same classification, they found that institutional investors will lead to better decisions in the company. But this effect is not identical for all institutional investors and is mostly valid for institutional investors without business relationship. Maug (1998) states that, whether institutional investors' use of their ability to influence company's decisions is to the extent related to amount of stock owned by them. He concludes that, if the ownership percentage of institutional shareholders is high, the ability to sell shares of stock is less and therefore they need for longer term maintenance. In this case there is a strong incentive to monitor company management. However, when institutional investors have relatively small shares, if the company performance will be poor, they can easily convert their investment into cash, and so the incentive to monitor management, reduced. Smith (1996) examined whether institutional shareholder lead to more focus on corporation performance, and thus concluded that the company monitoring by institutional investors can lead to more focus on corporation's performance, and less focus on opportunistic and profiteer behaviors. Noravesh and Kordlar (1384) reviewed and explained the relationship between shareholders with information asymmetry and the usefulness of the accounting standards for accepted companies on the Stock Exchange during the period of (1372-1382). Institutional shareholders can be categorized in two groups, institutional shareholders who focus on short-term profits and the second group, investors who are considered on more information about future earnings that is not reflected in current earnings. Therefore, with increase in second group of institutional shareholders more information about future earnings will be reflected, hence logically, asymmetry of information should reduce. Results indicated that, in companies whose institutional

investors and focus on future earnings, more information about future earnings will be reflected and the information symmetry for these companies is high. Shariat Panahi (1380) examine the effect of ownership type on performance of managers of accepted companies in Tehran Stock Exchange in years (1372-1377). Results showed that, although the company's most control mechanisms (such as managers' shares percent, non-duty members of board of directors, and, ...) influence on each other (Of course, there was no significant relation between the number of non-duty managers and shares of institutional investors,) as well as ownership types (major shareholders, the public sector, private sector etc.) have no effect on company's performance. Saber sheri and Mohammad Marfu (1385) examined the relation of non-duty members of the board of directors and institutional investors about the accuracy, direction, timeliness, and frequency of reconsidering about profit forecasting. The research period was (1382-1384) in Tehran Stock Exchange. Findings indicate very weak role of non-duty managers and institutional investors in influencing the features of companies' profit expectations. Mashayekh and Esmaeili (1385) studied the relationship between earnings quality and some aspects of corporate governance, including ownership percentage of board of directors' members and non-duty managers in accepted companies on the Stock Exchange during the period of (1381-1383). Therefore, in this study earnings quality from the aspect of continuity of profitability by using the criterion of total accruals has been tested, and results showed that there is no relationship between earnings quality and the ownership percentage of board of directors' members and non-duty members. However, the non-linear relationship between total accruals and the ownership percentage of board of directors' members was observed.

3. DATA AND METHODOLOGY

Method used in this study, is descriptive - regression and regression combination was used to test the hypotheses, and also to evaluate the significance of the patterns the T test, F, R2 (coefficient of determination), and Durbin Watson statistical tests were used. Hypotheses are as follows:

- Institutional investors with business relationships, have reverse effect on the Operating cash flow return of company.
- Institutional investors without business relationship, have a positive effect on the Operating cash flow return of company.

To perform this study, the companies accepted in Tehran Stock Exchange considered as statistical population and the sample was extracted from these companies. Samples include companies that have all the following conditions:

- Accepted in Tehran Stock Exchange prior to 1381.
- The end of their fiscal year is the Persian date Esfand 29.
- In the course of the study may not stop or change the fiscal period.
- At least have two institutional shareholders. This restriction applied due to the neperian logarithm of independent variables.

After applying all the above constraints, sample size of 35 companies during the period of 1381 to 1385 achieved.

In the present study Cornett model, where the influence of institutional investors on the operating cash flow returns, using variables such as the disposal of shares in institutional shareholders, the number of institutional shareholders, institutional shareholders representation on the board of directors, rate of institutional shareholders representations on board of directors and control variables (non-duty members of the board of directors, board of directors' size, firm size and dummy variable for the Chairman) was used.

$$\Delta IARO A_{it} = a_1 + b_1 \Delta FIISOWN_{it-1} + b_2 \Delta \ln(NII_{it-1}) + b_3 \Delta \ln(NIIOB_{it-1}) + b_4 \Delta FIIOB_{it-1} + b_5 \Delta FINDDIR_{it} + b_6 \Delta CEOCHD_{it} + b_7 \Delta \ln(BRDSZE_{it}) + b_8 \Delta \ln(SIZE) + e_{it}$$

Above model once tested for institutional shareholders with business relationship and again for institutional shareholders without business relationship. To recognize institutional investors with business relationships with companies, the transactions with related persons and to recognize institutional investors' agents in the board of directors, the financial statements and financial reporting activities of the board of directors in the lack of financial statements was used. To obtain information about non-duty managers, the General Assembly summary reports and also the board of directors' report will be used.

Given that in the above model the natural logarithm (Ln) and the number of institutional investors considered, the companies have chosen that at least have two institutional investors,

$\Delta IARO A_{it}$: Operating cash flow return on assets and is equal to the profit before interest and taxes plus depreciation cost over book value of total assets at the end of the year.

$\Delta FIISOWN_{it-1}$: Proportion of shares owned by institutional investors, which is calculated by the number of shares available to institutional shareholders on the company's total shares. Institutional investors of organizations are investment organizations and foundations that have a greater share of companies' equity.

$\Delta \ln(NII_{it-1})$: The number of owner institutional investors in the company.

$\Delta \ln(NIIOB_{it-1})$: Total number of institutional investors on board of directors (i.e. board of directors that are from institutional shareholders).

$\Delta FIIOB_{it-1}$: The ratio of board of directors of directors composed of institutional investors (i.e. number of board of directors members from institutional shareholders divided on total number of the board of directors).

$\Delta FINDDIR_{it}$: The ratio of board of directors of Directors comprised of executives from outside the organization, which is calculated by dividing the total number of non-duty board of directors' members by total number of board of directors.

$\Delta CEOCHD_{it}$: Imaginary variable and if the Chairman is the CEO its value is of 1 and otherwise zero.

$\Delta \ln(BRDSZE_{it})$: Represents the board of directors' size that calculated from the number of board of directors' members.

$\Delta \ln(SIZE)$: Represents the company's size and is equal to the neperian logarithm of total book value of assets.

4. RESULTS

The combinational regression results of first hypothesis - shareholders with business relationship are presented in Table 1.

Table 1: Results of the first hypothesis test

Independent variable	Coefficient	Standard deviation	T-statistics	Prob	Relation	The significance level
$\Delta FIISOWN_{it-1}$	-0.1426	0.0413	-3.449	0.0008	Negative	99%
$\Delta \ln(NII_{it-1})$	-0.0283	0.0116	-2.423	0.0168	Negative	99%
$\Delta \ln(NIIOB_{it-1})$	-0.0327	0.0739	-0.442	0.6588	Negative	Non-significant
$\Delta FIIOB_{it-1}$	0.096	0.0319	3.008	0.0032	Positive	99%
$\Delta FINDDIR_{it}$	-0.016	0.0154	-1.049	0.2957	Negative	Non-significant
$\Delta CEOCHD_{it}$	0.0156	0.0019	7.99	0	Positive	95%
$\Delta \ln(BRDSZE_{it})$	0.0792	0.042	1.86	0.065	Positive	95%
$\Delta \ln(SIZE)$	-0.086	0.0131	-6.593	0	Negative	99%
Statistic of F (P-Value)			5.45 (0.0000)			
R ²			0.2527			
Adj - R ²			0.2064			
Durbin - Watson			2.233			

The combinational regression results of the first hypothesis are presented in Table 1, F statistics is significant at the 99 percent level. The coefficient of determination and adjusted coefficient are 0.2527 and 0.2064, respectively and statistics of Durbin - Watson is equal to 2.233 and represents the absence first order autocorrelation in disturbing part.

Variable coefficient $\Delta FIISOWN_{it-1}$ is equal to -0.1426T and T statistics and P-VALUE indicates the significance of coefficient at 1% level of error. These findings indicate that the coefficients of institutional shareholders with business relationship have a negative effect on Operating cash flow returns and thus H1 assumption of first research hypothesis is confirmed.

The combinational regression results of second hypothesis - the shareholders without business relationship are presented in Table 2.

Table 2: the second hypothesis test results - shareholders without business relationship

Independent variable	Coefficient	Standard deviation	T-statistics	Prob	Relation	The significance level
$\Delta FIISOWN_{it-1}$	0.161	0.0332	4.84	0.0000	Positive	99%
$\Delta \ln(NII_{it-1})$	-0.0279	0.009	-3.06	0.0027	Negative	99%
$\Delta \ln(NIIOB_{it-1})$	-0.031	0.0193	-1.61	0.0109	Negative	90%
$\Delta FIIOB_{it-1}$	0.0398	0.0539	0.752	0.453	Positive	Non-significant
$\Delta FINDDR_{it}$	-0.0267	0.0207	-1.29	0.198	Negative	Non-significant
$\Delta CEOCHD_{it}$	0.0146	0.002	6.19	0.000	Positive	99%
$\Delta \ln(BRDSZE_{it})$	0.091	0.048	1.89	0.0609	Positive	90%
$\Delta \ln(SIZE)$	-0.076	0.018	-4.14	0.0001	Negative	99%
Statistic of F (P-Value)			4.27 (0.0002)			
R ²			0.2068			
Adj - R ²			0.1583			
Durbin - Watson			2.246			

Regression results of the second hypothesis are presented in Table 2; F statistics is significant at the 99 percent level. The coefficient of determination and adjusted coefficient are 0.2068 and 0.1583, respectively and Durbin - Watson statistics is equal to 2.246 and indicates the absence of first order autocorrelation in disturbing part.

Variable coefficient $\Delta FIISOWN_{it-1}$ is equal to 0.161 and T statistics and P-Value are significant at 1% of error level. This coefficient indicates that the percentage of institutional investors without business relationship, have a positive effect on operating cash flow returns and the H1 assumption of this hypothesis is confirmed.

5. Conclusion

With regard to the estimation models in section 4 and their analysis results of the research hypotheses as follows:

The results of first hypothesis regression estimation presented in Table 3-4 shows that, the percentage coefficient of institutional shareholders with business relationship have a negative effect on operating cash flow returns and thus the first research hypothesis was confirmed.

The results of this hypothesis are not similar to Cornett et al findings (2007). In their research, they found that institutional investors with business relationship have non-significant positive effect on operating cash flow returns while this study shows the negative significant relationship between institutional investors with business relationship and operating cash flow returns.

The results of second hypothesis regression estimation presented in Table 2 shows that, the percentage of institutional investors without business relationship have a positive effect on operating cash flow returns and thus the second hypothesis of this study was confirmed.

The results from this hypothesis test are consistent with the findings of Cornett et al (2007). They found significant positive relationship between institutional investors with business relationship and operating cash flow returns, similar to our findings.

Management must act in the interests of shareholders; therefore the change in ownership structure in joint stock companies is along with changes in the approaches and operational procedures used by them. With presence of institutional shareholders in the company's ownership structure, the corporation's performance is changed. These changes' findings indicate that the type of institutional investors (with (without) business relationship) have different effects on operating cash flow returns. Institutional investors with business relationships are trying to transfer profits to their advantage due to their involvement in company's operational activities. Therefore, it will reduce operating cash flow returns so that, increase in these shareholder's interests reduces the profitability and return on equity of the firm that hold these shares. In contrast, institutional investors without business relationship due to the nature of their investment that is mostly based on profits and stock values, increase affect the company's profitability and therefore reduce company's operating cash flow returns.

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