The Impact of Corporate Governance on Chief Executive Officer (CEO) Duality in Iranian Banking Sector

Majid Abbasi[1], Elham Kalantari[2], Hamideh Abbasi [3]

Department of Accounting, Payam-e-Noor University, Behshahr, Iran

Department of Business Management, Payam-e-Noor University, Karaj, Iran

Department of Business Management, Abhar Branch, Islamic Azad University, Abhar, Iran

Abstract

The objective of this paper is to examine the effects of corporate governance mechanisms on Chief Executive Officer (CEO) Duality in Iranian Banking Sector. There are several aspects and dimensions of corporate governance, which may influence a CEO Duality but this study focused on three aspects namely Board's size (*BOSI*); Board's Independence (*BOIN*) and State ownership (*STOWN*). This paper utilizes a panel data analysis all the Iranian Banking Sector over a four-year period from years 2008 to 2011. In this paper, log of bank's annual total assets (*SIZE*) and total debt divided by total assets (*LEV*) are control variables. A logistic regression analysis is used to test the hypotheses. The results show has a positive and significant relationship between Board's Independence; Leverage and Chief Executive Officer Duality. Also, there is no relationship between Board's size; State ownership; size and Chief Executive Officer Duality.

Keywords: Corporate Governance, Chief Executive Officer, Agency Theory

1- INTRODUCTION

According to the Cadbury Report (U.K.), corporate governance is defined as the "system by which businesses are directed and controlled (Cadbury, 1992)." In other words, corporate governance is a general set of customs, regulations, habits, and laws that determine how a firm should be run. "Corporate governance is a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined (Hand et al., 2004, p.229)."

The definition presented by some institution is presented below:

Corporate governance is the system by which companies are directed and controlled (Cadbury Report, 1992).Set of relationships between a company's management, its boards, its shareholders and other stake holders (OECD Principles)

The literature generally distinguishes between internal and external governance mechanisms. The primary concerns of internal mechanisms are the boards of directors which monitors management operations and processes, while the external mechanisms include ownership structure, protection of minority shareholders, legal infrastructure, and market for corporate control (Gillan, 2006).On the other hand, corporate governance is concerned with the relationship between the internal governance mechanisms of corporations and society's conception of the scope of corporate accountability (OECD, 2004b). CEO duality occurs when the same person occupies both the CEO and board chairperson positions in a corporation (Rechner & Dalton, 1991). On the other hand, if different individuals serve in these two pivotal positions, the firm can be said to adopt a

[1]. Department of of Accounting, Payam-e-Noor University, Behshahr, Mazandaran, Iran
[2]. Department of Business Management, Payam-e-Noor University, Karaj, Iran
[3]. Department of Business Management, Abhar Branch, Islamic Azad University, Abhar, Iran

separate leadership structure. There is little by way of evidence on Corporate Governance and CEO duality. And the evidence on the relation between CEO duality and Corporate Governance is mixed.

Corporate governance is very crucial and essential element for the banking system because bank and financial institutions depends on the Other People's Money (OPM). There may be a gap among major stakeholder like owners, depositors and management. Corporate governance also enhances performance of the corporation by motivating manager to maximize returns on investment, raising operational efficiencies and ensuring long term productive growth (Bikram Thapa, 2008).

1-1- Iranian Banking Sector

In Iran, after the revolution of 1979, the banking system was nationalized. Shortly thereafter, in 1983, the Law of Usury-Free Banking was passed, and on March 21, 1984, interest free banks started to implement Islamic banking based on the 1983 law (Ashraf and Alizadeh, 2011).

After the Islamic Revolution, the Central Bank was mandated to establish an Islamic banking law. In 1983 the Islamic Banking law of Iran was passed by the Majlis (CBI). According to this law, Iranian banks can only engage in interest-free Islamic transactions (interest is considered as usury or riba and is forbidden by Islam and the holy book of Qur'an). These are commercial transactions that involve exchange of goods and services in return for a share of the assumed "profit" (karimzadeh, 2012). As system of Islamic banking is grounded in Islamic principles and all the undertakings of the banks follow Islamic morals so it could be said that financial transactions within Islamic banking are a culturally-distinct form of ethical investing. Two basic principles behind Islamic banking are the sharing of profit and loss and, significantly, the prohibition of Usury, the collection and payment of interest, also commonly called Riba in Islamic discourse. Although collecting and paying interest is not permitted under Islamic law, revenue-sharing arrangements are generally permitted (Shehzad Moin, 2008). According to some, usury or excessive and exploitative charging of interest; is forbidden by the Qur'an. For example:

"And that which you give in gift (loan) (to others), in order that it may increase (your wealth by expecting to get a better one in return) from other people's property, has no increase with Allâh; but that which you give in Zakât (sadaqa - charity etc.) seeking Allâh's Countenance, then those, they shall have manifold increase. ***Sura Ar-Rum (30:39)"***

"That they took riba (usury), though they were forbidden and that they devoured men's substance wrongfully – We have prepared for those among men who reject faith a grievous punishment. ***Sura An-Nisa (4:161)."***

2- Theoretical Framework

The Figure (1) shows the relationship of variables with each other. This model assumes that corporate governance is affected by Board's size can affect on CEO duality i.e. the holding of both the top offices of the chairman and the CEO by the same person. Moreover, the CEO duality has been determined by State ownership, namely, private and public sector banks have come to play an important part in the CEO duality. The impact on another variable that would be seen on corporate governance is board independence. The fraction of Board's Independence is expected to reduce agency problems and shareholders' monitoring costs.

Fama and Jensen (1983) argue that manager-monitoring activities of the board will be more effective when they are dominated by independent-outside directors. In brief, the research conducted until now into board governance indicates that outside directors seek to increase the quality of monitoring the management performance and to reduce information asymmetry. Therefore the presence of more outside directors in the board composition will reduce agency problems.

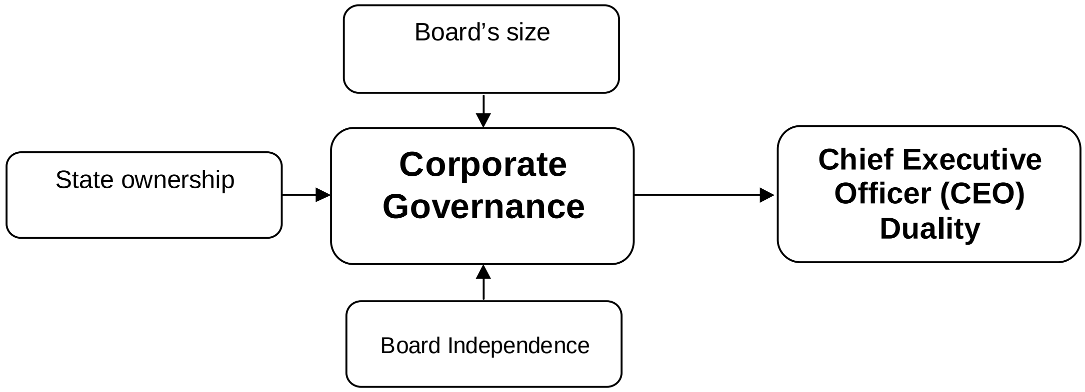

Figure (1) – Conceptual framewok of the research

3- Literature Review

Loebbecke et al. (1989) argue that firms whose CEO is also the chairman are likely to exhibit lower financial reporting quality because the CEO can manipulate financial reporting to achieve their own aims. In 75% of the fraud cases they examine, a single person controls the firm's operating and financial decisions.

Catherine and Dalton (1994) examine the relationships among corporate governance structures and corporate bankruptcy using data from 1972 to 1982. Logistic regression statistical technique was used to measure the relationship between dependent and independent variables. Profitability, Liquidity and, leverage are dependent variables and CEO duality and proportion of affiliated directors are independent variables. The results show that there is a significant relationship between corporate governance structures and corporate bankruptcy.

Brown and Caylor (2004) looked at 2327 U.S. firms, and found that better governed firms are also more profitable, more valuable, and pay higher dividends. Similarly, Gompers et al. (2003) found that firms that have strong shareholders' rights have higher firm value, higher profits, and higher sales growth. Mitton(2001), in a cross-country study of the Asia-Pacific region, found that firm level differences in corporate governance have significantly influenced firm performance during the East Asian crisis. The study also showed that higher price performance is related to higher disclosure quality, higher outside ownership concentration, and with firms that are focused rather than diversified.

In the study, Arlman (2004) shows the results empirical research into the practice of CEO duality in S&P 500 and FTSE 100 firms. For both groups of firms the data was collected in August of 2004. The composition and data for the S&P firms was accessed from The Corporate Library (including Board Analyst) and individual company websites. Information for the FTSE firms was acquired from FTSE, Hemscott and also from individual company websites. In his sample of 486 S&P 500 companies, he found that 24% (119 companies) had a different chairman than CEO. For the FTSE 100 companies 96% had a split between the function of CEO and chairman. In comparison with the results of Dalton and Kestner (1987), it seems that the amount of firms with a separate chairman from CEO has grown in the past years. However, while today the UK has almost complete separation between the office of chairman and CEO, the Americans still prefer to combine the two jobs in more than three out of four companies.

Kholief (2008) re-examining the predictions of agency theory with regard to the negative association between CEO duality and corporate performance by using the financial statements for the year 2006 of most actively traded companies in the Egyptian stock market. It examines the role of other corporate governance mechanisms (board size, top managerial ownership and institutional ownership) as moderating variables in the relationship between CEO duality and corporate performance. Moderated Regression Analysis is used to analyse the empirical data. Findings indicated that the hypothesized relationship between CEO duality, the moderating variables (top management ownership, board size and institutional ownership) and corporate performance has changed. He founds that board size was the only moderating variable, top management ownership was a suppressor variable and institutional ownership was simply another independent variable. For companies characterized by large boards and low top management ownership, corporate performance is negatively affected by CEO duality and positively impacted by institutional ownership.

Based on a sample of 290 large U.S. corporations, Hee Kim and Buchanan (2008) find that dual positioning on both CEO and board chairperson positions at the corporate top leads to reduced firm risk-taking propensity, serving managerial risk minimization preferences. They also find empirical evidence that traditionally emphasized control mechanisms of board independence and managerial ownership are ineffective in controlling managerial behavior when CEO duality leadership exists. Additionally, the power balance obtained from concentrated shareholder ownership in the firm has significant impact on controlling managerial behavior regarding firm risk taking. The findings of this research contribute to reducing the controversy surrounding CEO duality leadership by furnishing empirical evidence of how CEO duality leadership in corporate governance structure affects managerial behavior in corporate strategic management.

Sampson-Akpuru (2010) investigates the likelihood that a firm with a combined CEO/chair will pursue an international acquisition using 2,271 firms in the S&P 1500 from 1992 to 2007. He finds evidence that firms with a dual CEO/chair are more likely to announce an international acquisition, although the strength of the association varies with the specification of his control variables. International acquisitions are also more likely for larger, high-sales-growth firms with lower leverage and lower cash levels. This paper extends prior work on the relationship between leadership structure and acquisitions by investigating international acquisitions.

Dung To Th (2011) investigated the relation between corporate governance and firm value by using information taken from of Vietnamese Listed Companies on Ho Chi Minh Stock Exchange (HOSE) and Ha Noi Stock Exchange (HNX) at the year-end 2009. The empirical findings show that the dual position of CEO and Chairman has a positive relation with firm value. Besides, age of director and the number of directors meeting play important roles in firm value. However, no significant impact of board size, board gender diversity, top ten shareholders concentration and levels of state ownership on firm performance. Lastly, regression model of market performance shows that the duality of CEO and Chairman and the number of independent directors are significant impact on firm value.

4- Research Methodology

4-1- Research Hypotheses

In order to evaluate the effects of corporate governance mechanisms on CEO duality, hypotheses are tested:

H1: There is a significant relationship between board’s size and CEO duality in Iranian Banking Sector.

H2: There is a significant relationship between board’s independence and CEO duality in Iranian Banking Sector.

H3: There is a significant relationship between State ownership and CEO duality in Iranian Banking Sector.

4-2- Methodology

The methodology chosen to derive the results in this paper is based on panel data analysis.

4-3- Data Collection Method

This research aimed at examining the relationship between corporate governance mechanisms and Chief Executive Officer (CEO) Duality in the Iranian Banking Sector. Therefore, this study included all the Iranian Banking Sector during 2008 to 2011(1st April 2008 to 31st March 2011). In doing so, the main part of data was collected from the respective websites of banks and the remaining data were gathered from financial statements, websites of Securities and Exchange Organization of Iran (SEO), relevant auditing statements and other creditable sources and analysis of stock software’s as Dena Sahm and Pars Portfolio (two Iranian software programs).

4-4- The Empirical Model

According to the previous researches (Catherine & Dalton, 1994; Adeyemi & Fagbemi, 2010), the hypotheses formulated for this paper were tested with the use of logistic regression. This was used to examine the relationship between dependent and independent variables. According to Field (2000), logistic regression is multiple regression but with an outcome variable that is a categorical dichotomy and predictor variables that are continuous or categorical. The general multiple logistic regression models are as follows (Peng et al., 2002).

$$Logit(Y) = \ln\left(\frac{\pi}{1-\pi}\right) = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + ... + \beta_n X_n \quad (1)$$

therefore,

π = Probability (*Y = outcome of interest | X1 = x1, X2 = x2*

$$= \frac{\exp(\beta_0 + \beta_1 X_1 + \beta_2 X_2 + ... + \beta_n X_n)}{1 + \exp(\beta_0 + \beta_1 X_1 + \beta_2 X_2 + ... + \beta_n X_n)}, \quad (2)$$

4-5- Research Model

Based on the empirical research previously described and the theoretical considerations discussed above, the logistic regression model used in this paper is defined as follows:

$$\ln\left(\frac{\pi}{1-\pi}\right) = \beta_0 + \beta_1 BOSIZ_{it} + \beta_2 BOIND_{it} + \beta_3 STOWN_{it} + \beta_4 SIZE_{it} + \beta_5 LEV_{it} + e_{it} \quad (3)$$

where;

BOSIZ = Board's size, *BOIND* = Board's Independence, *STOWN*= State ownership, *SIZE*= log of bank's annual total assets, *LEV* = Total Debt divided Total Asset and e_{it} is the error term.

4-6- Measurement of Variables

A) ***Dependent Variable***

CEO duality is coded as 1 if an individual simultaneously serves as both CEO and chairperson of the board and ‗0'otherwise.

B) Independent Variables

1. Board's size (*BOSIZ*): the absolute number of members on the bank's board;
2. Board's Independence (*BOIND*): consists of the percentage of independent directors on board, i.e. the ratio of independent directors to total number of directors on board. Independent directors refer to those directors who have been explicitly and clearly announced as independent directors in a listed bank's annual report.
3. State ownership (*STOWN*): a dummy indicating if the shareholder of the bank is the government of a country or private sector. In other words, consists of a dummy variables shareholder of the bank (public =1, private =0).

C) ***Control Variables***

1. Bank's size (Size): log of bank's annual total assets in million Rials.
2. Leverage (LEV): a bank's ratio of total debt to total assets.

4-7- Results and Discussions

4-7-1 Descriptive Analysis

Table (1) provides the descriptive statistics for all variables used in the study over the period 2008 to 2011.

Table (1): Summary descriptive statistics of all variables

Variable	Mean		Std. Dev.		Min		Max	
	non-duality	CEO duality	non-duality	CEO duality	non-duality	CEO duality	non-duality	CEO duality
BOSIZ	5.955	6.186	1.134	1.129	5.000	5.000	7.000	8.000
BOIND	0.572	0.496	0.234	0.244	0.000	0.000	0.830	0.850
STOWN	0.191	0.137	0.339	0.376	0.000	0.000	1.000	1.000
SIZE	10.305	12.994	2.275	2.601	3.175	6.121	18.067	21.239
LEV	0.338	0.842	0.316	0.789	0.239	0.157	0.993	1.0873

4-7-2 Empirical Results

In this paper a multiple logistic regression model is used. The results of investigating the firms presented in Table (2). As you can see, R2 nagelkerke index in the model is 39.83%, which is indicative of the model's power of prediction. The comparison made for hosmer-lemeshow statistics with a 5% degree of error indicates the conformity of the model with real observations.

Table (2): Statistical Results

Statistics	model
-2 Log-Likelihood	395.603
Cox-Snell R2	0.3194
R2 nagelkerke	0.3983
Chi-Square Stat.	132.805
Degree of Freedom	3
Sig.	0.000
Goodness-of-fit test: hosmer-lemeshow stat.	5.6857
Sig.	0.4159
The Power of Prediction of Model	72.66

The meaningfulness values presented in Table (3) show that Board's Independence (*BOIND*) with a confidence level of 95% are all meaningful.

Table (3): Insignificant Coefficients of Model

Variables	β	SE(β)	Wald's $\chi 2$	p-value	Exp(β)
Constant	0.045	0.2453	0.8991	0.568	0.9887
BOSIZ	0.572	0.6074	2.4295	0.189	1.6522
BOIND	0.549	0.8829	4.9608	0.000	1.0845
STOWN	0.954	0.1304	3.5947	0.165	0.2486
SIZE	1.853	0.3256	2.7658	0.997	1.2272

LEV	0.697	0.3947	6.1157	0.005	1.0583

As shown in Table (3), the Board's size (*BOSIZ*) on CEO duality, that is H1, is not statistically meaningful. The result not supports the predicted hypothesis H1. Result from effect of Board's Independence (*BOIND*) coefficient on CEO duality is positive and statistically significant at 5 per cent level ($p<0.05$), and thus, the result supports the hypothesis H2. As for the coefficient of board independence is meaningful. The coefficient for State ownership (*STOWN*) on CEO duality, that is H3, is not statistically meaningful. The coefficient Bank's size is not statistically meaningful, and On the other hand, the coefficient for leverage, LEV, is statistically significant and positively related to CEO duality.

5- Conclusion & Discussions

This paper, based on the data of Iranian Banking Sector and using panel data methodology has proved the hypothesis that," relationship between corporate governance mechanisms and CEO Duality". The results from the first hypothesis test reveal a not meaningful relationship between Board's size and CEO duality. The results from the second hypothesis test show a significant positive relationship between the Board's Independence and CEO duality. This result is in line with the findings of Hee Kim and Buchanan (2008) study. Also, the odd ratios (Exp (β)) related to the variable of Board's Independence shows that increasing this variable will increase the possibility of choosing the Chairman and CEO. This result agrees with the findings of Dung To Th (2011) have argued that a strong dominant CEO may be essential for a developing economy where the system may be dependent on a few power corporate players to push performance. The findings from the other hypothesis test of the study show there is no significant relationship between State ownership and CEO duality. The coefficient for Bank's size is not statistically meaningful, and the coefficient for leverage, LEV, is statistically significant and positively related to CEO duality.

Finally, our research was conducted in Banking Sector of Iran. Since it may be different in many ways from other industries, the findings may not be generalizable to other industries. We call for future research to test our theory in other industry.

5-1- Further Research

A further study may be carried out including more factors in corporate governance mechanisms and by expanding its scope to other nations for better understanding and generalizing of the findings.

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