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Comparison of the Price to Earnings Ratio before and after the Implementation of Corporate Governance in Companies Listed in Tehran Stock Exchange

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Abstract: The aim of this study was to compare the proportion of financial leverage in companies before and after the implementation of corporate governance in firms listed in the Tehran Stock Exchange. The research method was descriptive and causal-comparative. The population was all the accepted companies in Tehran Stock Exchange (cars and car fragments, petrochemicals, petroleum products, cement, pharmaceutical, home and sugar appliances) between years of 2010 and 2014 that 82 companies were selected based on Morgan table as a sample. Data were analyzed using independent t-test. Results showed that the average ratio of stock price to earnings per share in companies after the implementation of corporate governance had no significant difference with an average ratio of stock price to earnings per share before the adoption of corporate governance. Other findings showed that the average ratio of stock price to earnings per share in the companies that used corporate governance had no significant difference with an average ratio of stock price to earnings per share in companies that did not use the corporate governance.

Keywords: Price to Earnings Ratio, Corporate Governance, Liquidity.

Introduction

Most of financial theories have been based on the fact that the market value of the company will be determined by the two variables of after-tax expected profit and risks associated with it. The liquidity of the company could and should be run by corporate policies and activities that will help to maximize the value of the company. The relationship between the liquidity and value of the company may not be based on the causal effect from the liquidity (Saghafi & Safarzadeh, 2011). At first, the liquidity may be correlated with other variables that affect the value of company. For example, Fang (2009) believed that stock liquidity attracts more aware investors to the transactions due to lower transaction costs and causes entrance of more unaware investors that it improves corporate governance and the value of company finally that means he believed that liquidity through the influence on corporate governance mechanisms may increase the company's value (Liao et al., 2010). Given the importance of the stock's role as a market in attracting the capital, it is needed to steer investors to the correct ways of investing so that to increase the turnover. The main variable that is concerned by investors in buying shares is the company's value. Liquidity is considered as an important aspect of the process of optimum allocating resources. The liquidity states the vicinity of financial assets to the cash. Liquidity of a financial asset would be assessed through its ability to convert into the cash at any time and without losses (Pourheidari, 1995). Saleable securities can converted into cash through the sufficient sale in the market at any time, but there is no guarantee against loss. One of the main functions of the financial market, especially the capital market is the conversion of assets into securities and then increment of the liquidity of the securities and reduction of the premium risk on liquidity. Financial markets facilitate the access to money besides the optimal allocation of capital by providing a combination of money market instruments on the one hand and on the other hand by improving the mechanisms and regulations of securities converting the open space securities to the attractive and safe environment to return the cash of people to the backside of production to grow it and in the other side, all people interest from the profits of productive activities (Shirzadeh, 2005). All is possible if certain conditions would be provided including the liquidity of the stock to be high. The aim of this study was to compare the ratio of price to earnings in companies before and after the implementation of corporate governance in companies listed in the Tehran Stock Exchange.

Materials and Methods

The research method was descriptive and causal-comparative. The population was all the accepted companies in Tehran Stock Exchange (cars and car fragments, petrochemicals, petroleum products, cement, pharmaceutical, home and sugar appliances) between years of 2010 and 2014. The companies with the following conditions were considered as the sample.

1. Those that their financial period conduces to the end of March.
2. Those that have been accepted in the Tehran Stock Exchange prior to 2013.
3. Those that are not among the mediation, financing, leasing and insurance companies.
4. Those that their needed financial information is available.
5. Those that are not among companies with the initial supply of the stock.

The number of 82 companies was selected as the sample through Morgan table. Following regression model was used to achieve the research goals.

$$Corporate\ governance_{it} = \alpha_0 + \alpha_1 ROI_{it} + \alpha_2 ROE_{it} + \alpha_3 ROA_{it} + \alpha_4 Lev_{it} + \alpha_5 P/E_{it} + \alpha_6 Size_{it} + \varepsilon_{it}$$

$Corporate\ governance_{it}$: Corporate governance of companies in the years studied

ROI_{it}: Return on investment (ROI) ratio in the years studied

ROE_{it}: Return on owners' equity (ROE) ratio in the years studied

ROA_{it}: Return on assets (ROA) ratio in the years studied

Lev_{it}: Financial leverage ratio in the years studied

P/E_{it}: Price to earnings per share ratio of companies in the years studied

$Size_{it}$: The size of the companies in the years studied

The research variables were measured as follows.

Profitability index: According to the study of Glen and Singh (2004), the criterion of profitability index may affect the relationship between capital structure and other variables. Profitability indices involve return on investment, return on owner's equity and return on assets that are calculated as follows.

A) Return on investment:

$$ROI_{i,t} = \frac{\text{Profit and loss before taxes (gross)}}{\text{Total assets}}$$

B) Return on owners' equity

$$ROE_{i,t} = \frac{\text{Profit and loss after taxes (net profit)}}{\text{Equity}}$$

C) Return on assets

$$ROA_{i,t} = \frac{\text{Profit and loss after taxes (net profit)}}{\text{Total assets}}$$

D) Financial leverage ratio:

To calculate the financial leverage ratio of firm i in year t, we have (Maquieira et al., 2012):

$$Lev_{i,t} = \frac{\text{The book value of total debts}}{\text{The book value of total assets}}$$

E) Price to earnings per share ratio:
It will be proceeded to calculate the ratio of stock price to earnings per share of the firm i in year t as follows.

$$PEration_{i,t} = \frac{\text{Price per share}}{\text{Earnings per share}}$$

Off-balance sheet financing of the firm i in year t was measured using rental costs disclosed in the notes to the financial statements of companies listed in Tehran Stock Exchange (Faramarzi and Pormosa, 2014). And sale variable was considered as replaced variable for the size of the company as a controlling factor (Chay and Suo, 2014). Independent t-test was used to analyze the data. In all analyzes, the significant level was considered as p <0.05.

Results

Kolmogorov-Smirnov test showed normal distribution of the data (p>0/05). The average ratio of stock price to earnings per share in the companies after the implementation of corporate governance was compared with the average ratio of stock price to earnings per share before the adoption of corporate governance using independent t-test. Results showed that the average ratio of stock price to earnings per share in the companies after the implementation of corporate governance did not differ significantly with an average ratio of stock price to earnings per share before the adoption of corporate governance.

Table 1. Results of independent t-test

P/E	N	Mean	t	df	sig	Mean	Std. Deviation	Lower limit	Upper limit
Before corporate governance	18	3.0307	0.789	17	0.398	0.85632	4.63780	-1.37903	3.09166
After corporate governance	18	2.5742							

The average ratio of stock price to earnings per share in companies that used corporate governance was compared with an average ratio of stock price to earnings per share in companies that did not use the corporate governance. Results showed that the average ratio of stock price to earnings per share in the companies using corporate governance had no significant difference with an average ratio of stock price to earnings per share in companies that not using the corporate governance (Table 2).

Table 2. Results of independent t-test.

P/E	Levene's Test for Equality of Variances		t-test for Equality of Means					
	F	Sig.	t	Sig. (2-tailed)	Mean Difference	Std. Error Difference	%95 Confidence Interval of the Difference	
							Lower	Upper
Variance equality hypothesis	2.035	0.162	0.704	0.452	79.96810	113.64275	-143.54494	303.48115
Variance inequality hypothesis			1.039	0.300	79.96810	76.88662	-71.49338	231.42958

Conclusion

The aim of this study was to compare the price to earnings ratio in companies before and after the implementation of corporate governance in firms listed in the Tehran Stock Exchange. Results showed that the average ratio of stock price to earnings per share in companies after the implementation of corporate governance had no significant difference with an average ratio of stock price to earnings per share before the adoption of corporate governance. Other findings showed that the average ratio of stock price to earnings per share in the companies that used corporate governance didn't differ significantly with an average ratio of stock price to earnings per share of companies that did not use the corporate governance. These findings were compatible with results of Ghalibaf-asl and Rezaei (2007). Conducted researches in the field of corporate governance are based on representation theory and focuses on the issue of conflict of revenues. Conflicts of revenues arise when the interests of managers and owners are not in line. Representation theory states that firms with better corporate governance structure have better and a higher value performance and it's due to the low cost of representation. In general, it can be said that companies that rank higher corporate governance have more company's value than other companies.

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