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## Examining the Effect of Organizational Strategic System's Traits on Financial Performance

Amir Shams Koloukhi<sup>\*1,2</sup>, Somayeh Pordareh<sup>2</sup>

<sup>1</sup>Department of Management, Torbat-e-Jam Branch, Islamic Azad University, Torbat-e-Jam, Iran

<sup>2</sup>Young Researchers and Elite Club, Neyshabur Branch, Islamic Azad University, Neyshabur, Iran

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### ABSTRACT

This study examined the relationship of organizational strategic system's traits including family management, CEO compensation, and tenure of managing director with corporate financial performance. To measure financial performance, Tobin's Q and ROA measures were used. Financial performance can be affected by different factors among which organizational strategic system's traits can be the most important ones. To do this research, 193 listed firms in Tehran Stock Exchange were studied from 2011- 2015. For testing data consistency, Hardi test, for testing the hypotheses, panel regression, and for selecting among combined models, fixed and random effects, Hausman test were used. Results showed a negative and significant correlation of family management and financial performance with both Tobin's Q and ROA. In addition, there was no significant correlation between CEO compensation and financial performance when the performance measure was Tobin's Q, but when it was ROA, there was a significant correlation between them. Moreover, there was no significant correlation between tenure of managing director and financial performance with both Tobin's Q and ROA.

*Keywords:* Organizational Strategy, Financial Performance, Family Management, CEO Compensation, Tenure of Managing Director

### Introduction

Organization management has different responsibilities to assure that efficiency that operations are done with efficiency and effectiveness, financial reports are qualitative, and laws and standards are considered. One important responsibility of the management is increasing stockholders' wealth (corporate performance). Nowadays, managing organizations and

companies are under the direct supervision of the board of directors, and they are responsible for all actions which lead to providing stockholders' benefits and managerial goals. These responsibilities include decision-making, performance evaluation, and financial reports representation. Also, based on the agency theory, there is interests' conflict between the managers and owners of the firms; since in agency relationship, each side tries to maximize its own benefits. One solution is the managers participate participation in the company ownership. The results of most experimental studies show that the schemes of CEO rewards, especially the ones in which CEOs participate in corporate ownership in real or nominal forms, increase stockholders' wealth (or improve corporate performance). Although the results of different schemes may differ in various societies, Jensen and Meckling (1976) found that increasing ownership percentage of management stocks helps to conform to the benefits of stockholders and managers in a way that by increasing CEOs' stock ownership percentage, corporate performance increases through decreasing agency costs.

Normally, in family firms, commitment is seen with higher intensity. Ownership of a family firm is considered as a gift from previous generation or an obligation towards the next generation. The goal of a family firm is transferring the firm to the next generation with a better position than it had been received from previous generation.

In the family firms, long-term strategies are more favorable than transient achievements. This thought deeply affects performance. A long-term and active commitment of the family business to the business improves corporate performance. Studies show that family management is one of the most efficient organizations with minimum agency cost (Fama & Jenson, 1983). Moreover, the unique structure of family management motivates corporate goals, leading to the better corporate performance (Kim & Gao, 2013). On the other hand, family management has the necessary motivation for improving the corporate situation, since it seeks to gain reputation. Thus, family management increases financial performance.

Today, management has a determining role in increasing return and productivity of the firms. Among four key success factors in the organizations including labor, capital, raw materials, and management, the last one has been more highlighted than the others. In the competitive world of today, there is much pressure for fast achievement of desirable results and consequently, fast decision-making in which the managers have vital roles. In fact, not reaching desirable results in the shortest time, may lead to managerial changes the organization. After gaining this position, managers would not move the stockholders' benefit along, since they would not predict a long-term tenure for themselves. Instead, they maximize their own benefits by their acquired short-term tenure. On the other hand, managers may refrain from investing in long-term projects, since these projects don't yield return in their tenure. It means that the decisions which can be to the personal benefits of the management may not be optimal from corporate view. One conflict of the manger and stockholders is that decision-making horizon of the managers is shorter than the stockholders' one. Managers' claim toward the firm is not limited to their tenure, and this may decrease the stockholders' interest and corporate value.

Thus, regarding the importance of family relations of CEOs, management reward, and tenure of managing director, and performance assessment measures, this study examines the relationship of ROA and Tobin's Q with CEO Compensation, family management, and tenure of managing director with the financial performance of the listed firms in Tehran Stock Exchange.

### **Review of the Literature**

Mazzi (2011) has examined the relationship of ownership, control, family management, and institute performance, highlighting financial relations. In this respect, 23 studies which were classified in the reliable databases of social sciences as systematic examinations were selected. Inconsistency of previous studies led to the ambiguity and uncertainty in the relation of family business and corporate performance because of some missing factors in these studies. Block, Jaskiewicz, and Miller (2011) evaluated distinct effects of ownership, family management, and the founder on the performance for the first time, using Bayes analysis. Studying S & P 500 firms from 1994-2003 showed that in over 90% of the cases, higher family ownership or the founder's ownership increases financial performance of the institute. On the other hand, firms managed by the family had better performances in 50% of the cases than the firms managed by non-family owners. However, the situation was better in the firms whose founder was their managing director as well. In a study titled "Europe Family Ownership and Corporate Performance, Empirical Evidences from Western Countries of Europe", Corstjens, Peyer, and Van der Heyden (2006) found that family control increases corporate performance in Western Europe countries. Active family ownership enhanced profitability under the condition that at least one family member was in a high management position. Villalonga and Amit (2006) studied all Fortune-500 firms from 1994-2000. They found that family ownership creates value only when the founder is the managing director as well. Also, conflicting interests' costs were higher in the firms with non-family ownership compared with the firms with family ownership. Cabrera-Suárez and Martín-Santana (2015) examined the effect of CEO qualities on the performance of Spanish family businesses. Regression analyses of 544 firms showed that a higher ratio of executives has a negative correlation with corporate performance while the duality of managing director has a positive effect on the corporate performance. The researchers did not find any correlation between diversity of family (executive and non-executive) managers and performance. As a result, the correlation of non-executive managers and performance was negative, while it was positive in relation with the duality of managing director.

Saito (2008) and Gonzalez, Guzman, Pombo, and Trujillo (2012) found that firms with family management outperformed others. Some studies (e.g. Allouche, Amann, Jaussaud, & Kurashina, 2008; Charbel, Elie, & Georges, 2013; Sciascia, 2014) have showed a positive correlation of family management and financial performance. However, Blocket al. (2011) showed that family management has an ambiguous effect on the financial performance. Besides, Sciascia and Mazzola (2008), Cucculelli and Micucci (2008), and Miralles-Marcelo, del Mar Miralles-Quiros, and Lisboa (2014) studied the effect of family management on the corporate

performance. They found a negative correlation of family management and financial performance.

Concerning the mentioned studies, the following hypotheses were stated:

H1: There is a significant correlation between family management and financial performance.

H1a: There is a significant correlation between family management and Tobin's Q.

H1b: There is a significant correlation between family management and ROA.

Ittner, Larcker, and Pizzini (2003) showed that the sensitivity of CEO compensation based on the performance, significantly increases proportional to the increased responsibility diversity, firm size, and professional expertise. The larger the firm, the more likely is the difference in its CEO reward with other firms, since firm size affects supervision precision and informativeness of performance measurement scales.

Evaluating firm performance based on accounting measures, Kato and Kubo (2004) found that cash rewards of Japanese managers are sensitive to the corporate performance. They concluded that the performance trend of stock market is in a way that it plays less role in Japanese managers' rewards. Haid and Yurtoglu (2006) examined the relationship of ownership structure and CEO compensation in 160 German firms from 1987-2003. They found that for the agency theory, CEO compensation decreases corporate earnings significantly. On the other hand, the lack of controlling the owners enabled CEOs to increase their rewards. Also, in the firms in which the managers tried to increase their voice considering the amount of received cash rewards, the correlation of performance and CEO compensation was weaker.

Jiang, Habib, and Smallman (2009) examined the effect of ownership structure on the relationship of CEO compensation and corporate performance in New Zealandian firms from 2001 to 2005. Results showed that in the firms with centralized ownership structure, the correlation of CEO compensation and corporate performance was negative, while this correlation was positive in the firms with decentralized ownership structure.

Unite, Sullivan, Brookman, Majadillas, and Taningco (2008), Dodonova and Khoroshilov (2014), and Upneja and Ozdemir (2014) found a positive correlation between corporate outperformance and CEO compensation. However, Duffhues and Kabir (2008) found a negative correlation between CEO compensation and corporate performance. CEO compensation was naturally correlated with the financial performance (Jensen & McClelland, 1976; Shao, Chen, & Mao 2012).

Considering these studies, we assumed to find a significant correlation between CEO compensation and corporate performance for which the following hypotheses were stated:

H2: There is a significant correlation between CEO compensation and financial performance

H2a: There is a significant correlation between CEO compensation and Tobin's Q.

H2b: There is a significant correlation between CEO compensation and ROA.

McClelland, Barker, & Oh (2012) examined the effect of professional horizon and tenure of managing director on the future corporate performance. They believe that a managing director with a short-term professional horizon (measured by their age) uses risk-aversion strategy which negatively affects their future corporate performance. Besides, they believed that high ownership

level of managing director intensifies this relationship for its power. Increasing management tenure's by using this paradigm hurts future corporate performance, especially in the dynamic industries. They supported their suppositions in their study including a sample of 500 American firms.

Zheng (2010) studied the effect of tenure on the reward structure of managing director. He found that for non-board managers in their early tenure, rewards based on the equity percentage had been increased, while these rewards had been decreased for the internal managers in their late tenure. Also, non-board managers had higher and faster growth percentage for the rewards based on equity before retirement.

Based on the results of above-mentioned previous studies, the following hypothesis is stated:

H3: There is a significant correlation between tenure of managing director and financial performance.

H3a: There is a significant correlation between tenure of managing director and Tobin's Q.

H3b: There is a significant correlation between tenure of managing director and ROA.

## Methodology

### Sample

The population of this study included listed firms in Tehran Stock Exchange from all industries since 2011-2015. The firms with the following conditions were selected as the sample:

Table 1  
*Analysis of Sample Firms*

N	Description	Row
497	Study population	Total
149	Firms belonging to financial intermediaries, holdings, banks, insurances	1
128	Omitted firms from Tehran Stock Exchange	2
27	Firms not accepted from early 2011	3
193	Sample	

### Procedure

In this study, to evaluate the relationship of family management, CEO compensation, and tenure of managing director with financial performance (with measurement index of Tobin's Q), the regression method of Subekti and Sumargo (2015) was used, as follows:

Model (1)

$$Q = \beta_0 + \beta_1 FM + \beta_2 LNCOM + \beta_3 Tenure-CEO + \beta_4 LOSS + \beta_5 \ln\_SALE + \beta_6 \ln\_ASSETS + \beta_7 LEV + \beta_8 CASH\_FLOW + \beta_9 AR\_INV + \beta_{10} BD\_SIZE + \beta_{11} BD\_IND + \varepsilon$$

To evaluate the relationship of family management, CEO compensation, and tenure of managing director with financial performance (with measurement index of ROA), regression method of Subekti and Sumargo (2015) was used, as follows:

Model (2)

$$ROA = \beta_0 + \beta_1FM + \beta_2LNCOM + \beta_3Tenure-CEO + \beta_4LOSS + \beta_5ln\_SALE + \beta_6ln\_ASSETS + \beta_7LEV + \beta_8CASH\_FLOW + \beta_9AR\_INV + \beta_{10}BD\_SIZE + \beta_{11}BD\_IND + \varepsilon$$

Where,

*Tobin's Q*: (EMV+D)/(EBV+D)

*EMV* is equity market value resulting from multiplying the final price of the stocks by the stock number for each year.

*EBV* is equity's book value extracted from financial statements.

*D* is debt's book value extracted from the financial statements.

*ROA* is return on asset, estimated by dividing earnings into assets.

*FM* is the percentage of family members of CEO to total CEOs.

*LN-COM* is the natural logarithm of paid reward to CEOs in the related year.

*Tenure-CEO* is the number of consecutive tenure of managing director.

*Ln-ASSETS* is the logarithm of total assets.

*Ln-SALE* is the logarithm of total sale.

*LEVERAGE* is the ratio of total debts to total assets.

*AR-LNV* is the ratio of the sum of current assets except cash (receivable and inventory) to total assets as an indicator of operating risk.

*LOSS* takes the value of 1 if the firm reports for the related fiscal year otherwise 0.

## Results

### Estimation of Model Parameters Related to Testing H1A, H2A, H3A

After identifying the final applicable method for estimating related model in testing the hypotheses, parameters of this model were estimated as follows:

Table 2  
Results of Fitness Good for Testing H1A, H2A, H3A

	Std. Error	Coefficient	t-Statistic	Prop
$\alpha_0$	0/368	2/337	2/694	0/007
<i>FM</i>	0/221	-0/458	-2/069	0/039
<i>LNCOM</i>	0/017	0/019	1/105	0/269
<i>TENURCEO</i>	0/014	0/016	1/162	0/245
<i>LOSS</i>	0/147	0/317	2/158	0/031

<i>LNSALES</i>	0/054	-0/060	-1/114	0/266
<i>LNASSETS</i>	0/060	0/011	0/182	0/855
<i>LEVERAGE</i>	0/148	-0/102	-0/690	0/490
<i>CASHFLOW</i>	0/319	0/516	1/619	0/105
<i>ARINV</i>	0/209	-0/148	-0/705	0/481
<i>BDSIZE</i>	0/147	-0/128	-0/866	0/387
<i>BDIND</i>	0/209	0/642	3/074	0/002
<i>R-squared</i>	F-Statistic	0/044		2/932
<i>Adjusted R-squared</i>	Prop (F-Statistic)	0/029		0/000

As seen in Table 2, considering significant t value and regression coefficients of each variable, it is concluded that the variables of loss and independence of CEOs have positive and significant correlation with corporate financial performance (using measurement index of Tobin's Q). On the other hand, family management has a negative and significant correlation with corporate financial performance (using measurement index of Tobin's Q). Thus, H1a is accepted. However, H2a and H3a are rejected. F statistics with the likelihood of 2.932 and 0.000 shows the significance of the model. Modified correlation coefficient of 0.029 shows that about 3% of dependent variable is explained by the explanatory variables in the model.

### Estimating Model Parameters of H1b, H2b, H3b

After identifying the final applicable method for model estimating in testing the research hypotheses, parameters of this model were estimated as follows:

Table 3  
Results of Fitness Good Related to H1b, H2b, H3b

Variable	Std. Error	Coefficient	t-Statistic	Prop
$\alpha_0$	0/090	-0/006	-0/070	0/943
<i>FM</i>	0/023	-0/057	-2/513	0/012
<i>LNCOM</i>	0/001	0/008	4/922	**0/001>
<i>TENURCEO</i>	0/001	0/002	1/822	0/068
<i>LOSS</i>	0/015	-0/179	-11/698	0/000
<i>LNSALES</i>	0/005	-0/005	-0/972	0/331
<i>LNASSETS</i>	0/006	0/004	0/757	0/450
<i>LEVERAGE</i>	0/015	-0/038	-2/488	0/013
<i>CASHFLOW</i>	0/033	0/548	16/521	**0/001>
<i>ARINV</i>	0/022	0/091	4/197	**0/001>
<i>BDSIZE</i>	0/015	0/002	0/142	0/887
<i>BDIND</i>	0/022	0/016	0/751	0/453
<i>R-squared</i>	505/0	F-Statistic	64/531	
<i>Adjusted R-squared</i>	497/0	Prop (F-Statistic)	0/000	

As seen in Table 3, considering the significant t value and regression coefficients of each variable, it is concluded that the variables of natural logarithm of CEO compensation, operating cash flow, and the ratio of inventory and receivable to assets have positive and significant correlation with corporate financial performance (using the measurement index of ROA). On the other hand, family management, loss, and financial leverage have a negative and significant correlation with financial performance (using the measurement index of ROA). Thus, H1b is accepted. About H2b implying a significant correlation of CEO compensation and financial performance (measurement index of ROA), the results confirmed a positive and significant correlation between these two variables. Thus, H2b is accepted. On the other hand, for the lack of a significant correlation between tenure of managing director and financial performance (using measurement index of ROA), H3b is rejected.

Moreover, F statistics with the likelihood of 64.531 and 0.000 shows the significance of the model. Modified coefficient of determination ( $R^2 = 0.497$ ) shows that about 49% of the dependent variable is explained by the explanatory variables in the model.

## Conclusion

This study examined the effect of family management, CEO compensation, and tenure of directing manager on the corporate financial performance. Users of financial reports evaluate corporate performance by applying different measures. There are different methods for evaluating corporate performance that can be divided into two groups of accounting and economic models. In this study, two measures of ROA and Tobin's Q were used. Family management refers to CEO members who are from one family, and it was identified as a percentage of total CEOs. CEO compensation was extracted from the decisions of public meeting sessions. Tenure referred to the number of the years that directing management had not been changed.

Regarding H1, using regression model of Subekti and Sumargo (2015), a negative and significant correlation was found between family management and financial performance. This result is line with the findings of Anderson and Reeb (2003), Corstjens et al. (2006), Gonzales et al. (2012), McConaughy, Matthews, and Fialko (2001), Saito (2008), Villalonga and Amit (2006) who have reported a positive and significant correlation between family management and financial performance regarding the existence of a correlation, but the type of their correlation was different.

However, the results of this study regarding the existence of a correlation and the type of correlation, were in agreement with the results of studies by Cucculelli and Micucci (2008), Miralles et al. (2014), and Sciascia and Mazzola (2008). On the other hand, a negative correlation between family management and financial performance supports the finding of Cabrera-Suárez and Martín-Santana (2015). However, this later finding of the present study conflicts with the findings of Mazzi (2011) and Blocket al. (2011), showing that the correlation of family management and financial performance is blurred.

Regarding the second hypothesis implying the correlation of CEO compensation and financial performance of the firms based on regression model of Subekti and Sumargo (2015), when the measurement scale was Tobin's Q, no significant correlation was found despite a positive correlation between these two variables. This lack of correlation is in agreement with the findings of Jensen and Murphy (1990) and Elayan et al. (2001).

On the other hand, this lack of significant correlation between CEO compensation and financial performance of the firms is in disagreement with the findings of Kato and Kubo (2004) and Jiang et al. (2009) who had reported a significant correlation between these two variables.

There was a significant and positive correlation between CEO compensation and financial performance of the firms based on the regression model of Subekti and Sumargo (2015) when the measure was ROA. This finding is in agreement with the findings of Kato and Kubo (2004), Unite et al. (2008), Jiang et al. (2009), Dodonova and Khoroshilov (2014), and Upneja and Ozdemir (2014) who had found a significant correlation between them. However, this result conflicts with Jensen and Morphy's (1990) Elayan's et al. (2003) finding showing no significant correlation between them.

Regarding the third hypothesis, the results showed a positive correlation between tenure of managing director and financial performance of the firms; however, this correlation was not significant. This finding contradicts the finding of McClelland et al. (2012) who had reported a significant correlation between them.

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