CORPORATE GOVERNANCE AND FIRM PERFORMANCE IN NIGERIA

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ABSTRACT

This study examines the relationship between corporate governance (governance scores) based on data set provided by institutional investors (shareholders) services (IIS) and three firm performance indicators: return on equity (ROE), Net profit margin (NPM) and Dividend Yield (DY) of ten quoted companies in Nigeria. The study used the r and t -test at 5% level of significance in relation to time series and cross sectional data on the variables. The result shows a positive and significant relationship between return on equity (ROE) and corporate governance, Net Profit margin (NPM) and corporate governance, dividend yield (DY) and corporate governance. This paper advocate that better governed firms have higher divided yields, net profit margin and return on equity than poorly governed firms. However, minimum amount of information in line with the requirement on corporate governance should be provided by companies in Nigeria.

INTRODUCTION

Corporate governance has, in recent years, become a topical issue both in business and academic circles. The concern in business arose out of the perceived importance that a tradition should be developed that supports moral and ethical conduct in business affairs which will create a general climate (both legal and social environment) that will promote good governance of firms.
In the academic world, it is established that business decisions are not made in a vacuum. Business decision makers have objectives outside the firms' objectives, for example managers are interested in their own personal satisfaction, in their employees' welfare, as well as in the good of the community (society) at large and these objectives impact on shareholders wealth adversely. (Fama and Jensen, 1983), (Sheifer and Vishny, 1997).

By definition, corporate governance is a system or an arrangement that comprises of a wide range of practices (accounting standards, rules concerning financial disclosure, executive compensation, size and composition of corporate boards) and institutions (legal, economic and social) that protect the interest of corporation's owners. According to Laporta et al (2000) "corporate governance is to a certain extent a set of mechanism through which outside investors protect themselves against expropriation by the insiders." Insiders are defined as both managers and controlling shareholders.

The corporate governance structures specifies the distributions of rights and responsibilities among different stakeholders in a corporation, like the board, managers, shareholders and others, and spell out the rules and procedures for making decisions on corporate affairs. This is in conformity with the view of Uche (2004) and Akinsulwe (2006).

Effective corporate governance reduces the "control right" conferred on managers and increases the chances that manager's investment decisions enhance the maximization of shareholders wealth. (Shleifer and Vishny, 1997). This however, suggests that better corporately governed firms have better operating performance. According to a study of Latin America's largest Banks, it is observed that, apart from the obvious reputation benefits of corporate adherence to ethical standards, there is another reason why firms should adhere to corporate governance standards: Companies tend to be unpopular with customers and thus easier political targets, especially as regulators, politicians; the media and investors increase their focus (attention) on corporate ethics and sustainability. The increasing cost associated with non-compliance and the rise of socially responsible investing has made ethics and corporate governance performance a higher priority to investors.

A UK study by the Association of British Insurers (ABI) has found a strong link between corporate governance standard and share price performance. It shows that a persistent imbalance in board composition tends to go hand-in-hand with a reduced ability to create value. It then follows that the corporate management's goal is stockholders wealth maximization which translates into maximizing the value of the firm, which is measured by the price of the firm's common stock. This further suggest that, properly governed firms are more valuable, pay out more cash dividend, have high return on equity and have higher sales growth than those poorly governed.

Bebchuck, Cohen and Ferrett (2004) show that firms with stronger stockholders' right have higher value. In a latter study that used Nigeria data on twenty firms, the result shows a positive and significant relationship between ROE and board size, between Return on Equity (ROE), board composition and Audit committee, between profit margin and chief executive status. It further shows that there is no significant relationship between profit margin and board size, board composition and audit committee. (Kajola, 2008). Corporate governance advocates argue that stock price collapse of some firms in the US such as Adelphia, Enron, Parmalet, Tyco and Worldcomm was due largely to poor governance. (Gompers, *et al* 2003).

There is also a widely held view that better corporate governance is associated with better firms' performance, but the evidence is not sufficiently available in the Nigeria context. As such, providing an additional empirical evidence of the relationship between corporate governance standards and firms performances is cardinal to this study. The significance of the relation of firm performance is a function of the corporate governance provisions and the level of compliance to the set standard.

In order to chart present and future paths for firm's adherence to corporate governance standards, it is important to first determine its impact on firms' performance in the past. It is necessary to investigate the response or behavior of important performance indicators such as return on equity, dividend yield, net profit margin and sales growth in the light of the effects of various corporate governance provisions that rule the business world today. Unlike the earlier studies by the authors, this paper attempts to shed light on the critical response or behavior of firm performance indicators to corporate governance provisions or standards in Nigeria. The logical point of departure is to determine the relationships between corporate governance index and firm performance indicators of ten quoted companies in Nigeria. It also attempts to investigate the extent of the relationship.

The findings of this study will be of importance to regulatory authorities in the Nigeria economy, investors (both private and institutional), academics, politicians and other corporate stakeholders as the knowledge will enable them to validate the benefit of good corporate governance in increasing return on equity, net profit-margin, dividend yield, sales growth and even the confidence of the investing public. (Donaldson, 2003). The result of this study also will add credence to the fact that good corporate governance can be associated with good firm performance.

LITERATURE REVIEW

According to Carol Bowie, Vice President of Institutional Investors (shareholders) Service (IIS) in a study on Governance Research based in the U.S.; the report demonstrates that companies are responding to shareholder concerns regarding board structure, independent leadership and board composition.

A UK study by the association of British insurers (ABI) which track 14 companies in 2004-2006 found a strong link between governance standard and share price performance. It shows that a persistent imbalance in board composition tends to move hand-in-hand with a reduced ability to create value.

Fosberg (1989) examined the relationship between the proportion of outsider directors and various performance measures such as expenses volume, sales, number of employees and return on equity. It was found that there exists no relationship between them. Bhagat and Black (2002) demonstrated that there is no relationship between the proportion of outsider directors (a corporate governance index) and return on assets, asset turnover and stock returns (firm performance measures). Kojola (2008) for instance, studied the impact of a relationship between board size, board composition, chief executive officer status (examined the separation of CEO and chairman of board); audit committee independence and firm performance indicators such as return on equity (ROE) and profit margin (PM). He however found a positive and significant relationship between ROE and chief executive status, between profit margin and chief executive status but there was no significant relationship between ROE, board composition and audit committees as well as between profit margin and board size, board composition and audit committee in Nigeria.

The proponents of agency theory, advocate that corporate governance should lead to higher stock prices or better long-term performance of firms because managers are better supervised and agency cost are reduced. However, Gompers and Metrick (2003) studied the effect of board membership and structure on firm performance and submit that the evidence of a positive association between corporate governance and firm performance may have little to do with the agency explanation. Empirical studies of the effect of board membership, and structure on firm value show better performances for firms with boards of directors dominated by outsiders (Weiback 1988, Resentein and Wyatt 1990 Mehran 1995, John and Senbet 1998). According to a similar study by Laing (2001) and Pinteris (2002), no relationship was found between the proportion of outside directors and various performance measures including profit. In the same vein Hermalin and Weisbach (1991) found no correlation between the degree of board independence, ownership characteristics, board size and four measures of firm performance. They opine that poorly performing firms were more likely to increase the independence of their board. Mac Avoy, Dana, Cantor and Peck (1983), Baysinge and Butler (1985) and Klein (1998) found that firm performance is insignificantly related to higher proportion of outsiders on the board. Thus, the relationship between the proportion of outsider directors and firm performance is mixed. A study of 228 small private firms in China by Laing and Li (1999) shows that the presence of outside directors is positively associated with higher return on investment. Klein (2002) found a negative correlation between earnings management and audit committee independence while Mansi and Reeb (2004) found that independent audit committees have lower debt financing cost. Other related studies have been conducted to address the impact of the separation of CEO and chairman of the board on firm value. Yermack (1996), for instance, studied a sample of 452 firms in the annual Forbes magazine ranking of the 500 largest USA public firms between 1984 and 1991 and found that firms are more valuable when the CEO and the chairman of the board positions are occupied by different persons. He also posits that agency problems are higher when the same person occupies the two positions.

Attiye and Robina (2007) studied the relationship between corporate governance indicators and firm performance in Karachi Stock Exchange (Pakistan). Fifty firms were studied using their annual reports of 2003 to 2005. The result shows that listed firms that are likely to grow faster usually adopt better corporate governance practices. The coefficient of growth is significant and positive because higher growth is associated with higher value.

CORPORATE GOVERNANCE MECHANISMS IN NIGERIA

Taking cognizance of the cardinal importance of good corporate governance practice in business survival, business growth and in appreciating the value of the firm as well as its contagion effect on the Nigeria economy at large, the Federal Government of Nigeria instituted the arrangement to protect investors' fund from being mismanaged by the management of quoted companies in Nigeria. As such, the "Code of Corporate Governance Best Practices" was issued in November, 2003 to institutionalize the arrangement. The provisions include the roles of the board and management of quoted companies, the rights and privileges of shareholders and the role of the audit committee. The variables that may constitute the yardsticks by which corporate governance can be measured in an organization (with acceptance from each category of governance sub-index) are:

1. **Board of Directors:** The number of directors (Board Size) is one prominent yard stick. Empirical studies on board size show that there exist a negative relationship between board size and firm value. For instance, Mak and Yuanto (2003) in a study in Malaysia and Singapore, demonstrates that firm value is highest when board sizes are relatively small. A Nigerian study by Sanda et al (2003), found that firm performance has a positive correlation with small and not large board size.

   - The composition of board of directors and a clear cut job definition of all board members is another index.
   - Separation of CEO from the chairman of the board of directors. Yermark (1996) shows that firms are more valuable when the CEO and the chairman of the board positions are manned by different persons.

2. **Audit Committee**: A study by Klein (2002) shows a negative correlation between earnings, management and audit committee independence. Anderson, Mansi and Reeb (2004), observed a significant relationship between independent audit committee and low debt financing cost.

3. **Bye-Laws**: Company either has no poison pill or a pill that shareholders approved.

4. **Director Education**: At least one member of the board should have participated in an accredited director education program.

5. **Executive and Director Compensation**: Directors should receive all or a portion of their fees in stock.

6. **Ownership**: All directors with more than one year of service should own stock.

7. **Progressive Practices:** There should be mandatory retirement age for directors.

8. **State of Incorporation:** Firms should be incorporated in a state without any anti-takeover provisions. The corporate governance provision by Institutional

Investors Service (IIS) as at February 2007, form the basis of the firm's corporate governance scores.

METHODOLOGY

The study sought to determine the effects of corporate governance on firm performance using 10 firms based on 51 corporate governance provision provided by Institutional Investors Services (IIS) as at February 2007. We consider three performance measures from two categories: operating performance (return on equity, net profit margin), and shareholder payout (dividend yield).

The corporate governance score is constructed as follows: for every firm, 51 governance proxies or indicators are selected; these indicators are categorized into eight categories or sub-indices consist of indicators: Four factor for audit, seventeen for board of directors, seven for charter/byelaw, one for director education, ten for executive and director compensation, four for ownership, seven for progressive practices and one for incorporation. A maximum score of 1 is assigned if factor is observed, and 0 if factor is not observed. The average is taken out and we arrive at the rating of a sub-Governance score. By taking the average of the eight sub-indices we obtain Governance score for a particular firm.

In the same vein, the performance indicators: Return on equity (ROE), net profit margin (NPM), and dividend yield (DY) were derived through ratio analysis, using data in financial statement of the firms under study between the period of 2004-2008.

Below are the variables used in the computation of the performance indicators:

$$\textbf{ROE} = \frac{\text{profit after tax}}{\text{Shareholders equity}}$$

$$\textbf{NPM} = \frac{\text{profit after tax}}{\text{Turnover}}$$

$$\textbf{DY} = \frac{\text{dividend per shared}}{\text{MKT price per share}}$$

We used data derived from the audited financial report of the firms quoted on the Nigerian Stock Exchange (NSE) between 2004 and 2008. The samples of ten firms were selected using simple random sampling technique. This ten firms cut across different sectors of the Nigeria economy ranging from banks, food, construction to oil companies.

The panel data methodology was adopted for the purpose of this study since it combined time series and cross sectional data. The study used the r and t-test at 0.05 significance. The data was analyzed using the simple linear regression. The governance score was correlated with each firm performance indicator after ordering the governance scores from the highest to the lowest (i.e. from best to worst governed firm) to see if firm performance differ.

THE MODELS

From the foregoing, we can hypothesize that (ROE) return on equity, dividend per share (DPS), and net profit margin (NPM) are positive functions of corporate governance index. Depending on the level of compliance of the firms, these variables could be postulated to be negatively related to the corporate governance indicators.

However, we state the hypothesis for this study in their null forms as follows:

1: There is no significant relationship between corporate governance index and return on equity of quoted companies in Nigeria.

2: There is no significant relationship between corporate governance index and net profit margin of quoted companies in Nigeria.

3: Compliance to corporate governance provisions is not important in predicting changes in dividend yield of quoted companies in Nigeria.

The empirical specification of model is patterned after Attiya and Robina (2007) model with modification to suit our purpose.

ROE = ao + a1 CGS + ET ....(1)

NPM = bo + b1 CGS + ET ....(2)

DY = co + c1 CGS + ET ....(3)

Where:

ROE	represents	Return on equity
NPM	represents	Net Profit Margin
DY	represents	Dividend yield
CGS	represents	Corporate Governance score
ET	is the Error Term.	

STATISTICAL TOOLS EMPLOYED

This study employs two basic statistical tools which include; the simple regression (Pearson Product Moment Correlation r, coefficient of determination r2) and t-test of significance. The simple regression is adopted to test the strength of relationship between corporate governance and firm performance (Return on equity, net profit margin, and dividend yield). Both the simple regression and t-test values were calculated automatically using the Statistical Program for Social Sciences (SPSS).

DATA PRESENTATION

The data presented in the table below provides the basic inputs for this study.

TABLE 1: **CORPORATE GOVERNANCE SCORES AND FIRM PERFORMANCE MEEASURES**

G. Score	ROE	NPM	D.Y
29.353	51.35	2.048	0.576
24.126	3.316	2.51	0.264
26.126	15.96	13.14	0.41
23.618	24.38	2.94	0.142
22.783	9.63	49.31	0.24
21.976	24.20	7.43	0.69
21.000	10.13	5.58	0.09
20.216	11.94	6.24	0.26
19.116	12.10	6.66	0.28
17.111	10.56	6.78	0.28

Source: (1) Company annual reports and account (2004 - 2008)
(2) Computed from survey data.

PRESENTATION OF RESULTS

The computational results of the simple regression and t-test values are presented below.

TABLE 2: **CORRELATION OF GOVERNANCE SCORE WITH THREE (3) INDUSTRY-ADJUSTED PERFORMANCE MEASURES**

Performance Variables	No. of companies	Expected direction	R	R2	T cal	T critical
Return on equity	10	Positive	0.60	0.36	12	2.179
Net profit margin	10	Positive	0.64	0.4096	2.89	2.179
Dividend yield	10	Positive	0.51	0.260	2.19	2.179

Source: Computed form survey data, 2010

SIMPLE CORRELATION TEST

To test the hypotheses, our decision rule is to reject the null hypothesis if the computed value of the t-statistics for the correlation is equal to or above the critical value at our preferred 0.05 level of significance and degree of freedom. Accordingly, the null hypothesis in *Hypothesis I* and *Hypothesis II* were rejected because the t-critical values were less than the computed values. However, the null hypothesis of *Hypothesis III* was accepted.

DISCUSSION OF FINDINGS

The first hypothesis which stated that there is no significant relationship between corporate governance and return on equity was nullified by the experimental data with r, and t-test of significance at 0.05. The r and r2 showed a value of 0.60, 0.36 (36%) respectively. The value of (r), 0.602 implies a positive relationship between corporate governance and return equity, while the t-test values indicate that there is a significant relationship between corporate governance and return equity (tcal 12 > 2.179).

The findings above are in line with earlier findings by Kojola (2008), which found that there is link between four corporate governance mechanisms, (board size, board composition, chief executive status and audit committed) and return on equity. However, the findings are not in support of earlier findings by Farsberg (1989), Blagat and Black (2002) and Sanda et al (2005).

The result of the second hypothesis with r, 0.64 and r2 (0.41) or 41% revealed a positive relationship between corporate governance measures and net profit margin. In the same vein, result from the t-test values revealed that there is significant relationship between corporate governance and net profit margin. This result is in agreement with previous empirical studies (see Yemack, 1996, Yuan 2003, Sanda et al 2005 and Kojoka 2008).

Finally, the result of the third hypothesis reveal that there is significant relationship between corporate governance and dividend yield since the t-calculated 2.19 is greater than t- critical 2.179 at 0.05% level of confidence.

CONCLUSION

There is no doubt that several studies have been conducted so far (and is still ongoing) to determine the relationship between firm performance measures and corporate governance mechanisms, however the outcomes of these studies are mixed.

All the performance measures are significant with their expected positive signs. That means, better governed firms have higher net profit margins, return on equity and dividend yield than poor governed firms. It was also observed that there is no uniformity in the disclosure of corporate governance practices made by the companies. Though they all disclose their corporate governance practices, what is disclosed does not conform to any particular standard. More so their disclosure on directors' remuneration is not extensive.

This study reveal that there is a positive and significant relationship between return on equity and corporate governance; there is positive and significant relationship between net profit margin and corporate governance; there is positive and significant relationship between dividend yield and corporate governance. Although our results show that corporate governance code potentially improves the governance and decision making process of firms listed on the Nigeria Stock Exchange, we need to point out that adequate firm governance standards cannot replace the solidity of the firm. The low production and bad management practices cannot be covered with transparent disclosures and good ethical standards.

Finally, we associate corporate governance with firm performance, but our results do not necessary imply causality. Our caveat regarding absence of causality is consistent with other studies (e.g Laker *et al* 2004) that recognize the impossibility of solving the endogeneity issue, especially given the very limited data. Far more data are needed before one can attempt to find causality, perhaps by using granger causality.

Corporate governance is advocated for reasons outside firm performance such as fairness, equity, and appearance of propriety. Some factors we do not find to be related to firm performance may be important for other purposes.

RECOMMENDATIONS

- The development of an effective legal framework that specifies the rights, and obligation of a company, its direction, shareholders, and specific disclosure requirements and provides for effective enforcement of the law is needed to promote strong corporate governance in the system.

- It was observed that there is no uniformity in the disclosure of corporate governance practices made by companies under study. Though they all disclose their corporate governance practices, what is disclosed does not conform to any standard. To this end, it is recommended that companies should provide a certain minimum amount of information requirement on corporate governance to allow uniformity and easy appraisal of the corporate practices. Particularly, the standard set out by OECD, Organization of Economic Council and Development adopted or CAMA provision should be follow to the letter.

- Board independence is recommended, however, proponents of board independence should note with caution the negative relation between board independence and future operating performance. Hence, if the purpose of board independence is to improve performance, then such efforts might be misguided. However, if the purpose of board independence is to discipline management of poorly performing firms, then board independence has merit.

- Senior policy makers and corporate boards in their efforts to improve corporate governance should focus on stock ownership of members – since it is positively related to both future operating performance, and to the probability of disciplinary management turnover in poorly performing firms.

- To further enhance corporate governance practice in the Nigerian companies, the executives should be subject to stock ownership guidelines, mandatory retirement age for director should exist and performance of the board should be reviewed regularly.

- Since independent of board of directors, nominating committees, and compensation committees are associated with good firm performance, the regulators (e.g Nigeria stock exchange) should consider requiring the presence of a separate corporate governance committee that meets at least once a year.

- Disclosures on director's remuneration and disclosures about employees' benefits should be extensive, so as to provide information on who gets what and for what purpose (directors' remuneration) and to show analysis of their emoluments by category and not just by number (Employees benefits).

- There should be effective structure to encourage companies to have well – developed and well-enforced, risk management system. Companies need corporate governance structure that promotes effective identification, monitoring and management of all business risks.

- The system (or the authorities) needs to develop and enforce robust financial disclosures requirements for companies.

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