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# Corporate Governance and Financial Performance of Selected Quoted Companies in Nigeria

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**Abstract**
This study examines the relationship between corporate governance and financial performance of randomly selected quoted firms in Nigeria. It investigates corporate governance variables and analyses whether they impact on firm performance as measured by return on asset (ROA) and profit margin (PM). Based on the review of existing literature, four corporate governance variables were selected namely: composition of board member, board size, CEO status and ownership concentration which served as the independent variables. The ordinary least square regression was used to estimate the relationship between corporate governance and firm performance. Findings from the study show that there is positive and significant relationship between composition of board member and board size as independent variables and firm performance. CEO status also has positive relationship with firm performance but insignificant at P<0.05. However, ownership concentration has negative relationships with return on asset (ROA) but positive relationship with profit margin (PM). The relationships are not significant at 5%. The study recommends among other things that companies' board should be majorly dominated by independent directors and board size should be in line with corporate size and activities.
**Keywords:** Firm performance, Board Composition, Board Size, CEO Status

## 1.0 Introduction

Corporate governance is all about running an organization in a way that guarantees that its owners as stakeholders are receiving a fair return on their investment. It is the process of a virtuous circle that links the shareholders to the board, to the management, to the staff, to the customer and to the community at large (Clarkson and Deck, 1997). They observed that a company is a separate legal entity which no one actually owns. It can therefore be implied that shareholders do not own a company (Ofiafoh and Imoisili, 2010). A typical firm is characterized by numerous owners having no management function and managers with no equity interest in the firm. Shareholders or owners of equity are large in numbers and an average shareholders control a minute proportion of the shares of the firm. This gives rise to shareholders to take no interest in monitoring of managers, who are left to themselves and maybe pursuing interest different from those of the owners of equity.

Corporate governance has found a way to address this problem which arises and a number of significant researches have been conducted towards resolving it. For instance, Magdi and Nedareh (2002) emphasize the need for organization managers to act in the interest of the firm, core stakeholders particularly minority shareholders or investors by ensuring that only action that facilitate delivery of optimum returns and other favourable outcome are taken at all times. This study will further empirically explore this subject matter by finding the relationship between some selected corporate governance mechanisms and financial performance of quoted firms in Nigeria.

### *1.1 Objectives of the Study*

The overall objective of this study is to examine the relationship between corporate governance and firm financial performances in Nigeria. Specifically, the study seeks, to:

i. Ascertain the influence of the composition of board members on firms' financial performance;
ii. Examine the relationship between board size and firms' financial performance;
iii. Find out whether or not the separation of the posts of CEO (Chief Executive Officer) and board chair is of any value in the promotion of firms' financial performance; and
iv. Examine the extent to which shareholding may be related to firms' financial performance.

### *1.2 Research Hypotheses*

In line with the research objectives, the hypotheses to be tested in this study are:

i. There is a significant relationship between composition of board directors and firms' financial performance;
ii. There is a significant relationship between board size and firms' financial performance;
iii. There is a significant relationship between CEO status and firms' financial performance;
iv. There is significant relationship between shareholding (ownership concentration) and firms' financial performance.

 

## 2.0 Review of Extant Literature

The role of corporate governance has been identified as indispensable to firm performance and this is so because of the tendency for managers and some other stakeholders to engage in unethical business practice that may undermine the rights of "less informed" stakeholders in corporate organizations (Agbonifoh, 1999). These unethical practices include tampering with the financial statements to give a false impression of the financial health of the organization to the recipients of these reports, in the case of Nigeria, African Petroleum (AP) gave misleading information on its financial statement, (Onyenankeya, 2003).

Corporate governance is about promoting corporate fairness, transparency and accountability (Glossary, 2013). While Adedotun (2003) sees corporate governance as the framework for accounting for decision making, it is effective management relationship within the organization integrity to enhance firm performance for the benefit of all stakeholders. Okeahalam and Akinboade (2003) outlined specific benefits of corporate governance to include moral uprightness among organization workforce and it could be counted upon to safeguard the resource and entitlements of all stakeholders. Also, it improves the confidence of the investing public and attracting foreign investors to the companies in particular and the economy in general. Corporate governance enhance the performance and ensure the conformance of corporate to creating and maintaining a business environment that motivates managers and entrepreneurs to maximize firm operational efficiency, returns on investment and long-term productivity growth. The ultimate outcome of these corporate governance benefits are higher cash flows and superior performance of the firm (Love, 2011).

Emerging economy like Nigeria needs well governed and managed business enterprises or organizations that can attract investment, create jobs and wealth for the youth, remain viable, sustainable and competitive in the global market. A good corporate governance is a prerequisite for national economic development. The focus of this section is to explore some fundamental concepts that relate to the subject matter.

### *2.1 Corporate Financial Performance*

This study adopted ROA and PM as the more pragmatic variables for use as proxies for firm performance in Nigeria than stock value. This is especially as the samples of firms that were used for the study are quoted companies in Nigerian Stock Exchange (NSE). Therefore, ROA and PM remain preferred measures which should provide reliable result for analysis.

#### *2.1.1 Return on Asset (ROA)*

Return on asset is an indicator of how profitable a company is relative to its total assets. It gives an idea as to how efficient management is at using its assets to generate earnings, that is, it measures efficiency of the business in using its assets to generate net income. It is a profitability ratio. Calculated by dividing a company's annual earnings by its total assets, ROA is displayed as a percentage. Sometimes this is referred to as "return on investment". Return on assets is the ratio of annual net income to average total assets of a business during a financial year. Net income is the after tax income. It can be found on income statement. Average total assets are calculated by dividing the sum of total assets at the beginning and at the end of the financial year by 2. Total assets at the beginning and at the end of the year can be obtained from year ending balance sheets of two consecutive financial years.

The formula to calculate return on assets is:

$$ROA = \frac{Annual\ Net\ Inome}{Average\ Total\ Assets}$$

#### *2.1.2 Profit Margin (PM)*

Due to the samples that were used for this study from the Nigerian Stock Exchange, operating and financing arrangement vary so much that different entities are bound to have different levels of expenditure, so comparing one to another has little or no meaning. Profit margin is a company's pricing strategies and how well it controls cost. Profit margin is profit after tax divided by turnover of the selected samples of firms. Thus, it is represented by:

$$PM = \frac{Profit\ After\ Tax}{Turnover}$$

### *2.2 Corporate Governance Mechanisms*

Corporate governance mechanisms assure investors in corporations that they will receive adequate returns on their investments (Emmon and Schmid, 1999). If these mechanisms did not exist or function properly, outside investor would not lend to firms or buy their equity securities and economic performance would suffer because many good business opportunities would be missed and temporary financial problems at individual firms spread quickly to employee and consumers. This study adopts four corporate governance mechanisms namely: composition of board member, board size, CEO status and shareholding (ownership) concentration. They are succinctly explained as follows:

#### *2.2.1 Composition of Board Members*

Zahra and Pearce (1989) pointed out that boards are among the most venerable instruments of corporate governance. A positive relationship is expected between firm performance and the proportion of outside director

 

sitting on the board, unlike inside directors, outside director are better able to challenge the CEOs. It is perhaps in recognition of the role of outside directors that in UK, a minimum of three outside directors is required on the board and also in the US, the regulation requires that they constitute at least two third of the board (Bhagat and Black, 2001).

Empirical studies have grown but the results are conflicting. Studies by Weisbach (1988), Mehran (1995) and Pinteris (2002) have produced evidence in support of a positive role of outside directors on firm performance. Unlike the preceding argument in support of board structure, Laing and Weir (1999) play down their importance, stressing instead the importance of business experience and entrepreneurship. According to them, firms managed by dynamic CEOs tend to performance better than other categories of firms. To the best of our knowledge, firms run by experience and skills CEO's could play as a means for improving firm performance.

*2.2.2 Board Size*

There is a convergence of agreement on the argument that board size is associated with firm performance. However, conflicting result emerge on whether it is a large, rather than a small board, that is more effective. For instance, Yermack (1996) in a review of the earlier work of Monks and Minow (1995), argues that large boardrooms tend to be slow in making decision and hence can be an obstacle to change. A second reason for the support for small board size is that directors rarely criticize the policies of top managers and that this problem tends to increase with the number of directors (Lipton and Lorsch, 1992; Yermack 1996).

Empirical studies have shown that small boards were more positively associated with high firm performance (Mak and Kusnadi, 2005; Sanda, Mikailu, and Garba, 2005). However, result of the study of Kyereboah-Colemon (2007) indicates that large boards enhanced shareholders wealth more positively than smaller ones.

*2.2.3 Chief Executive Officer Status (CEO's Status Duality)*

A lot of studies that have examined the separation of office of board chair from that of CEO generally sought to reduce agency costs for a firm. Kajola (2008) found a positive and statistically significant relationship between performance and separation of board chairman and CEO. Yermack (1996) also found firms are more valuable when different persons occupy the CEO and board chairman. The results of the studies show that boards that are structured to be independent of the CEO are more effective in monitoring corporate financial accounting process and therefore more valuable (Klein, 2002). Abor and Biekpe (2005) demonstrate that duality of both functions constitute a factor that influences the financing decision of the firm. They found that firms with structure separating these two functions are more able to maintain the optimal amount in capital structure than firms with duality.

*2.2.4 Ownership Concentration*

This mechanism of ownership concentration refers to the proportion of a firms share owned by a given number of the largest shareholders. A high concentration of shares tends to create more pressure on managers to behave in ways that are value maximizing. In support of this argument, Gorton and Schmid (1996) and Shleifer and Vishy (1997) suggested that a low level of ownership concentration will be associated with an increase in firm value, but that go beyond a certain level of concentration, the relationship might be negative. Studies like Renneboag (2000) reported result not totally in agreement with the hypothesis of a positive relationship between firm performance and ownership concentration.

## 3.0 Methodology

This study focuses on evaluating the empirical relationship between firm performance level and corporate governance mechanisms. The study adopts a cross-sectional research design by analysing some quoted companies on the Nigerian Stock Exchange selected at random from the total of 263 quoted companies in the capital market (Taofik, 2011).

*3.1 Population and Sampling*

The population consists of all the companies quoted on the Nigerian Stock Exchange and active as at 31st December, 2011. In December 2011, there were 263 securities listed on the capital market. The population have their annual financial report for the year end 2011. Making use of 2012 was not possible because as at time of this study, most companies have not published their annual financial report for year 2012.

The sample on the other hand refers to the subset of the population. Taro Yamane's formula was used to determine the appropriate sample size.

The formula is: $n = \frac{N}{1+N(e^2)}$

Where: n = sample size; N = Population size; e = level of significance desired

Given that: N = 263; e = 5% ≡ 0.05, the sample size for the study will be calculated thus:

$$n = \frac{263}{1 + 263(0.05^2)} = 159$$

From the above formula, the minimum sample size for this study will be 159 companies. However, 143 quoted companies were found useable and were finally selected using simple random sampling through the Microsoft

 

Excel.

*3.2 Sources of Data*

The data used for this study is secondary data and this data was sourced from the annual reports of the selected companies. The data was on the following variables; return on asset, profit margin, ownership concentration, composition of board members, board size and CEO status.

*3.3 Model Specification*

In this study, econometric model was formulated. The model basically relates to firm performance as dependent function of selected corporate governance variables.

The measures of the key variables of the research are discussed below.

***Operationalization and Measurement of Variables***

| Variables | Measurement |
|---|---|
| ***Dependent Variables*** | |
| Return on Asset (ROA) | Annual Net Income/Average Total Assets |
| Profit Margin (PM) | Profit After Tax/Turnover |
| ***Independent Variables*** | |
| Composition of board members (BOARDCOMP) | Ratio of insider director (executive directors) to outsider directors (non-executive directors). |
| Board size (BOARDSIZE) | Number of directors on the board |
| CEO Status (CEOSTATUS) | A dummy variable taking "O" for separate office and for CEO from the chairman and "1" otherwise (duality) |
| Ownership Concentration (OWNCONCEN) | Percentage of major shareholding of shareholders |
| Ɛ | Error term |

***Source:*** *Researcher's Construction, 2013*

We now present the models of the study as follow:

*Econometric Model I:*

$ROA = \beta_0 + \beta_1 BOARDCOMP + \beta_2 BOARDSIZE + \beta_3 CEOSTATUS + \beta_4 OWNCONCEN + \varepsilon$

*Econometric Model II:*

$PM = \lambda_0 + \lambda_1 BOARDCOMP + \lambda_2 BOARDSIZE + \lambda_3 CEOSTATUS + \lambda_4 OWNCONCEN + \varepsilon$

In this study both descriptive and inferential statistics were employed. Descriptive statistics such as: mean, mode, median and standard deviation were used to describe the data while inferential statistics such as correlation and regression analyses were used to test the stated hypotheses. Econometric view software (EView 7.0) and Statistical Package for Social Sciences (SPSS 20) were used in carrying out necessary computations.

## 4.0 Data Analysis and Presentation

This section contains the presentation, analysis and interpretation of the data collected for this study. Consequently, it entails the application of both mathematical and statistical techniques to provide the basis for the testing of the research hypotheses. Hence, it is a vital part of any research work since it forms the basis for recommendations and conclusions at the end of the research. This section contains the descriptive statistics, correlation result, Ordinary Least Squares regression (OLS) results as well as discussion of findings.

*4.1 Descriptive Statistics*

The table below presents the descriptive statistics of the data employed for this study.

Table 4.1.1. Descriptive Statistics

| | Board Composition | Board Size | CEO Status | Ownership Concentration | Profit Margin | Return on Asset |
|---|---|---|---|---|---|---|
| Mean | 0.619 | 9.469 | 0.133 | 0.208 | 8.029 | 5.336 |
| Median | 0.600 | 10.000 | 0.000 | 0.120 | 7.600 | 4.700 |
| Maximum | 0.900 | 18.000 | 1.000 | 0.820 | 119.300 | 88.700 |
| Minimum | 0.280 | 3.000 | 0.000 | 0.001 | -206.600 | -176.800 |
| Std. Dev. | 0.111 | 2.653 | 0.341 | 0.202 | 27.007 | 23.420 |
| Observations | 143 | 143 | 143 | 143 | 143 | 143 |

***Source:*** *Researcher's Computation (2013)*

The analysis begins by examining the basic features of the data using descriptive statistics. The mean ROA of the sampled firms is 5.336 and the mean PM is 8.029. The average board size of the 143 firms used in this study is 9, while the proportion of the board composition is 61.9%. The result also indicates that 86.7% of the sampled firms have separate persons occupying the posts of the CEO and board chair while mere 13.3% of the firms have the same person occupying the two posts. The mean ownership concentration of the sampled firms is 0.208.

*4.2 Pearson Correlation Results*

 

The table below present the Pearson correlation coefficient result for the variables

Table 4.2.1 Correlations (Pearson)

| | Return on Asset | Profit Margin | Board Size | Board Composition | CEO Status | Ownership Concentration |
|---|---|---|---|---|---|---|
| Return on Asset | 1 | | | | | |
| Profit Margin | .580** | 1 | | | | |
| Board Size | .204* | .343** | 1 | | | |
| Board Composition | .192* | .248** | 0.024 | 1 | | |
| CEO Status | 0.073 | 0.002 | -0.155 | -0.146 | 1 | |
| Ownership Concentration | -0.018 | 0.058 | -0.109 | -0.157 | .277** | 1 |

**. Correlation is significant at the 0.01 level (2-tailed).

*. Correlation is significant at the 0.05 level (2-tailed).

***Source:*** *Researcher's Computation (2013)*

As shown in the result above, Return on Asset (ROA) is positively related to Board Size (0.204), Board Composition (0.192) and CEO Status (0.073). The relationship between Return on Asset (ROA) and Board Size and Board Composition are significant at P<0.05 while that of CEO Status is insignificant. A negative and insignificant relationship exists between Return on Asset (ROA) and ownership concentration (-0.018). Furthermore, Profit Margin (PM) is positively correlated with Board Size (0.343), Board Composition (0.248), CEO Status (0.02) and Ownership Concentration (0.058). However, only Board Size (0.343) and Board Composition (0.248) are significant at P<0.05. There are no high correlations of 0.90 or above in the result shown in Table 4.2.1. However, the highest coefficient of correlation found is 0.277 which is below the cut-off of 0.80 for the collinearity problem. Hence, collinearity and multicollinearity do not present data problems in this research.

*4.3 Regression Analysis Results*

Two indices of financial performance namely: Return on Asset (ROA) and Profit Margin (PM) were utilized in the analyses. The results are shown below.

Table 4.3.1 : Regression Results

| | *Model I* *Return on Asset (ROA)* | | | *Model II* *Profit Margin (PM)* | | |
|---|---|---|---|---|---|---|
| *Variable* | *Coefficient* | *t-statistic* | *Prob* | *Coefficient* | *t-statistic* | *Prob* |
| C | -41.2476 | -3.0595 | 0.0027 | -70.8994 | -4.8420 | 0.0000 |
| BOARDCOMP | 43.4121 | 2.5042 | 0.0134 | 64.9224 | 3.4482 | 0.0007 |
| BOARDSIZE | 1.9475 | 2.6845 | 0.0082 | 3.6595 | 4.6445 | 0.0000 |
| CEOSTATUS | 9.4666 | 1.6099 | 0.1097 | 4.9789 | 0.7796 | 0.4369 |
| OWNCONCEN | -0.0004 | 0.0000 | 1.0000 | 16.3975 | 1.5257 | 0.1294 |
| R-squared | | 0.0948 | | | 0.1970 | |
| Adjusted R-squared | | 0.0685 | | | 0.1737 | |
| F-statistic | | 3.6119 | | | 8.4636 | |
| Prob (F-statistic) | | 0.0078 | | | 0.0000 | |
| Akaike info criterion | | 9.1084 | | | 9.2736 | |
| Schwarz criterion | | 9.2120 | | | 9.3772 | |
| Durbin-Watson stat | | 2.0128 | | | 2.0755 | |

***Source:*** *Researcher's Computation (2013)*

*Model I: Return on Asset (ROA) as the Dependent Variable*

*ROA = -41.2476+ 43.4121BOARDCOMP + 1.9475 BOARDSIZE + 9.4666 CEOSTATUS -*
*(-3.0595) (2.5042) (2.6845) (1.6099)*
*0.0004OWNCONCEN*
(-4.14E-05)

As can be seen in the above regression result, when the explanatory (independent) variables: Board Size, Board Composition, CEO Status and Ownership Concentration were regressed on Return on Asset (ROA) an $R^2$ value of 0.0948 is noticed. Given the value of Adjusted $R^2$ of 0.0685 indicates that the independent variables (Board Size, Board Composition, CEO Status and Ownership Concentration) explain 7% of the systematic variation in the dependent variable (ROA). The result reveals that only Board Composition and Board Size are significant at P<0.05. However, CEO Status and Ownership Concentration are not significant as P-Values are greater than 5%. The sign of the coefficients of the variables are all positive except ownership concentration.

 

*Model II: Profit Margin (PM) as the Dependent Variable*

$$PM = -70.8994 + 64.9224BOARDCOMP + 3.6594BOARDSIZE + 4.9789CEOSTATUS + 16.3975\ OWNCONCEN$$
$$(-4.8420) \quad (3.4482) \quad (4.6444) \quad (0.7796) \quad (1.5257)$$

The result above shows that Board Size, Board Composition, CEO Status and Ownership Concentration were regressed on profit margin (PM) and $R^2$ value of 0.1969 is noticed. Given the value of Adjusted $R^2$ of 0.1737 indicates that the independent variables jointly explain 17.4% of the systematic variation in the dependent variable (PM). Only Board Composition and Board Size are significant at $P<0.05$ with positive sign for all coefficients of the variables. The F-statistic of 3.6119 and 8.4636 are significant at $P<0.01$ for both models respectively. This means that there is a statistical significant relationship between the independent variables and the dependent variable as a group. Moreover, the Durbin-Watson statistic of 2.0128 and 2.0755 for the two models respectively reveal the absence of first order serial correlation.

Summarily, the two models reveal that only Board Composition and Board Size are significant corporate governance variables that explain financial performance. However, profit margin is a better proxy of financial performance as it shows higher Adjusted $R^2$, SIC and AIC.

*4.4 Discussion of Findings*

Firstly, the study reveals that there is a positive and significant relationship between composition of board member and firm performance. The implication of this is that as firm maintain sizeable number of internal and external directors, the financial performance of the firm is expected to increase. A number of similar studies carried out by some scholars confirm this standpoint (Mehran, 1995; Pinteris, 2002; Weisbach, 1988). However, Laing and Weir (1999) play down the importance of this argument by stressing the importance of business experience and entrepreneurship. Secondly, the study reveals that there is a positive and significant relationship between board size and firm performance. It can be deduced that as companies maintain appropriate board size, the financial performance of the firm would increase. This finding corroborates the result of Yermack (1996) who examined the relationship between board size and financial performance and concludes that the smaller the board size the better the performance, and proposing an optimal board size of ten or fewer.

Moreover, the study showed a positive but insignificant relationship between CEO status and financial performance. Several studies have examined the separation of CEO and chairman of the board, positing that agency problems are higher when the same person occupies the two positions. Using a sample of 452 firms in the annual Forbes Magazine rankings of the 500 largest USA public firms between 1984 and 1991, Yermack (1996) shows that firms are more valuable when the CEO and the chairman of the board positions are occupied by different persons. However Liang and Weir (1999) do not find a positive relation on the separation of the position of CEO and board chair. Finally, there is no significant relationship between ownership concentration and financial performance. A high concentration of shares tends to create more pressure on managers to behave in ways that are value-maximizing. At low levels of ownership concentration, an increase in concentration will be associated with an increase in firm value, but that beyond a certain level of concentration, the relationship might be negative (Gorton and Schmid, 1996; Shleifer and Vishny, 1997). Holderness and Sheehan (1988) find little evidence that high ownership concentration directly affects performance.

## 5.0 Conclusion

This study examined the relationship between corporate governance and firm performance of quoted companies on the Nigerian Stock Exchange (NSE). When return on asset (ROA) was used as dependent variable, all the corporate governance variables were positively associated with performance except ownership structure. The result shows that only composition of board member and board size were significant at $P<0.05$. Also, when profit margin (PM) was used as dependent variable, all the corporate governance variables were positively related with performance. However, only composition of board member and board size were significant at $P<0.05$. Finally, the outcome of this study reveals that CEO status and shareholding (ownership concentration) do not have significant relationship with firm performance as proxied by return on asset (ROA) and profit margin (PM).

## 6.0 Recommendations

The study has empirically examined the relationships that exist between corporate governance variables and firm performance using randomly selected quoted firms on the Nigerian Stock Exchange (NSE). The study therefore recommends that:

- Companies should ensure that majority of their board members are independent meaning that the directors are not employees of the company and do not depend on it for their livelihood so that they can fearlessly and

 

honestly monitor the activities of the CEO and other directors (executive). This will help constraint CEO and executive directors from taking advantage or exploiting other stakeholders;

- The board size should be in line with corporate size and activities. Setting arbitrary benchmark for board size may not be productive especially in relatively small firms; and
- The office of CEO should be separated from Chairman of the Board to promote selflessness, integrity, accountability and honesty which are the principles of good corporate governance.

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