

## Corporate Governance and Financial Performance of Banks: Evidence from Nigeria

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**Abstract:** Banks are the backbones of any economy therefore it is of immense importance for economies to possess a healthy and buoyant banking system with effective corporate governance practices. In Nigeria, the Central Bank replaced the past governance codes with the CBN code (2012). Therefore this study examines corporate governance and financial performance in Nigerian banks, using this new code. The main issues in this study are: what is the relationship between board size and financial performance of banks in Nigeria? What is the effect of the proportion of non- executive directors on the financial performance of banks in Nigeria? To what extent is the corporate governance disclosure of banks in Nigeria in compliance to CBN governance code (2012)? Does a relationship actually exist between banks that disclose on corporate governance and their financial performance in Nigeria? These questions were answered by examining the yearly published reports of the listed banks in Nigeria. In examining whether or not there is a relationship between corporate governance and the financial performance of the banks, this research employed the regression analysis method to determine the relationship. However, the variables that was employed for corporate governance are: board size, board composition (the ratio of non-executive directors to total directors), and corporate governance disclosure index. Variables used in this study for examining the financial performance of these banks were the financial accountant measure for performance. These measures are return on equity (ROE) and return on asset (ROA). In examining the level of compliance of the banks in this study to the CBN (2012) governance code, the research employed the content analysis method. Employing the content analysis, a disclosure index was formed and the annual report for each bank was examined using the CBN code of corporate governance (2012) as a guide. The results of the study showed that a positive relationship exists between the corporate governance variables and the performance variables.

**Keywords:** Corporate governance, Board size, Financial performance

### 1 Introduction

The idea of corporate governance is mostly common to banks and multinational firms. Corporate governance has been an item of great importance on the policy agenda in most

developed countries for many years now. Further to this, the idea of corporate governance is steadily gaining huge recognition in the African continent.

Several recent activities have led to the increased pursuit in effective corporate governance policies in all nations. The case of having effective governance policies gained universal recognition from a period of absolute ambiguity after series of high profile collapses led to significant interest.

The rise in company failures and increased fraudulent activities in recent time have led to significant pursuit in terms of literature and study of governance principles to determine best codes of practices that will improve company performance and going concern. A significant element in the pursuit of an effective corporate governance system is the responsibility bestowed on the board of directors of the company. The board is in place to supervise and monitor the activities of management and also determine the strategic position of the company. The board appraises and approves management proposals, and they are the first and most significant check for effective governance practices in the firm (Brennan, 2006 and Jonsson, 2005).

The agency theory which has also been employed in this research is widely regarded as the genesis for any argument on matters of corporate governance (Jensen and Meckling, 1976). Various corporate governance structures have been suggested to combat and mitigate against this agency problem that seem to exist between the agent and the owners. The governance structures suggested by the agency theory involve size of the board, composition of the board, CEO pay performance sensitivity, directors' shareholding and shareholder right.

Generally, banks are the backbones of any economy, therefore it is of immense importance for economies to possess a healthy and buoyant banking system with effective corporate governance practices. Poor corporate governance may could have a significant impact on any economy, it can lead to bank failures while on the long run impact on the public's trust on an economy's banking system efficiently manage its assets and liabilities. A bank's assets and liabilities involve its customers' deposits and if these funds are not efficiently managed could lead to a liquidity crisis.

It is constantly debated what the right mix of governance structure (size of the board, composition of the board and directors shareholdings) is. Das and Gosh (2004), argued that how a company performs is dependent on how effective these corporate governance structure is and therefore makes this area one for further research. Although, this area has been highly researched in the developed economies to determine the effect of this governance structures on performance, it has rarely been researched in terms of Africa and Nigerian banks based on past literatures reviewed. As a result of this lapses that occur ignoring the events in the banking industry in Nigeria for past recent years, this study seeks to eliminate the gaps and disconnects that exist in corporate governance literatures. However, the following are the objectives of this paper, to determine if a relationship exists between size of the board and financial performance of banks in Nigeria, to determine if the proportion of non-executive directors has an effect on the financial performance of banks in Nigeria. also to determine the corporate governance disclosure of banks in Nigeria in compliance to CBN governance code (2012), and to appraise if there is a relationship between banks that disclose and comply on corporate governance and their financial performance in Nigeria.

## **2. Theoretical Framework for Corporate Governance**

Rashid (2011) argued that there are various theories that can be used to explain corporate governance conventions and also the issues that arise as a result of these conventions. Various theories have been employed in explaining these governance conventions; these theories include the agency theory, stakeholder theory and stewardship theory. Sanda, Mikaila and Garba (2005) also identified these three theories as the main and

most significant theories of corporate governance and they are explained further respectively below.

### 2.1. Agency Theory

The agency theory can be tracked way back to Adam Smith (1776) and his explanation of main issues that arises as a result of separation of ownership and control of a business. He was of the opinion that managers of funds cannot be expected to have a very watchful eye like the owners or providers of funds. Also, he opined that oversight and extravagant behavior will always persist in the management of the activities of a firm (Smith, 1776).

Jensen and Meckling (1976) established this relationship as an agreement involving at least two parties. The two parties usually involved are the principal and the agent. The principal usually the provider of the fund employs the agent (usually the managers) to perform and run the company on their behalf. Included in the contractual agreement, the principal will bestow upon the agent decision-making authority.

However, the agency problem arises because managers are after their selfish interests and individuals are generally opportunist. The managers (agent) who are put in control of the affairs of the organization may not always consider the best interest of the owners and firm and may pursue their self-activities to the detriment of the welfare of the principals (Sundaramurthy, 1996).

As a result of these agency problems, the principal might end up incurring costs known as Agency costs. This Agency cost is a value loss to the shareholders and usually involves the cost of monitoring the activities of managers so that goal congruence can be achieved between shareholders and managers. Jensen and Meckling (1976) suggested that agency costs include the cost of monitoring, bonding costs, and residual loss.

The effect of this agency theory is that one can only try to mitigate against this agency problem when the board is composed largely by non-executive directors (independent and dependent) who will be able to control the activities of managers and thereby maximize shareholders' wealth (Rashid, 2011; Kaymark & Bektas, 2008 and Luan & Tang, 2007). The theory also suggests that the role of the chairman and the role of the CEO should not be occupied by the same person as this can limit the monitory role bestowed on the board of directors and can also have a negative impact on the performance of the firm. It was suggested that the reason for limit in the monitory role by the board will be loss of board independence as a result of CEO duality (Elsayed, 2007 and Kang & Zardkoohi, 2005). This theory is based on the belief that there is a basic conflict of interest between the owners and managers of the company (Kiel & Nicholson, 2003).

Stewardship theory is a contrast or a direct opposite to the agency theory and this theory adopts a more idealistic view of humans. This theory is based on a model and believes of the agent not being a self-opportunist but a steward that perceives greater utility in the interest of the principal and the organization as a whole. The theory assumes that a significant correlation exist between the firm's success and the manager's satisfaction. This trade-off is achieved by the steward admitting that working towards achieving company's and collective goals will lead to self-actualization. The theory argues for the post of Chief Executive Officer and Chairman to be held by the same person. Therefore, control lowers the motivation of steward and weakens motivational attitude (Davis et al., 1997).

Stewardship theory poses that stewards are likely to ignore selfish interests in order to pursue the best interest of the firm. Donaldson and Davis (1991) observed that when a steward has been in a company for so long, the steward and the firm becomes one entity. Instead of using the firm for their own selfish interest, the stewards seems to be more in ensuring the continuous existence and long term success of the firm because they now see the firm as an extension of themselves.

## 2.2. Linkage Between Corporate Governance and Firm Performance

Exceptionally sound corporate governance practice is meant to improve corporate performance by blocking the control of the company by the significant shareholders and encouraging improved decision making in the process. In return to improved governance practices, the value of the firm may react immediately to information showing improved corporate governance practices. It should be noted that material report backing the link or association between the disclosure and compliance to corporate governance and firm performance is scarce (Imam, 2006).

This implies there should be no existence or possibility for managers or significant shareholders to expropriate the resources of the firm. This should in return to better management of resources and improve performance. Also providers of funds will be easily attracted and would also want to invest in companies with good management of resources, good performance with effective governance practices, it might likely lead to a lower costs of capital, which can further improve the performance of the company. Also, good governance practices tend to attract potential stakeholders like employees because they will also want to be linked and work with such companies, as they see such company to be healthy, profitable and has a going concern than firms with no or less governance.

It should also be noted that there are some advantages for the economy as a whole with good governance practices. This will lead to a financial stable and sustainable economy because of necessary actions in place to mitigate against systematic risk. Also, good corporate governance tends to be the starting point for a fair and just society. A company with poor corporate governance tends to be the building blocks for fraudulent activities and in the long run leading to corporate failures. A limit on the exploitation of the less significant shareholders and less fraudulent activities between the large organisations and political power can lead to a suitable condition for these so called little and more equitable income distribution (Iskander and Chamlou, 2000).

According to a research conducted by McKinsey and Company (2002) cited in Adams and Mehran (2003), the study showed that most investors in Malaysia showed the desire to pay more for the shares of a good governance company. The research also showed that the investors were ready to pay a mean premium within the limit of 20% to 25%.

## 3. Model Specification

This paper made use of the econometric model of Miyajima et al (2003) as employed by Coleman and Nicholas- Biekpe (2006) to determine the relationship between performance and governance practices. The model is therefore stated below as;

$$Y_{it} = \beta_0 + \beta_1 G_{it} + \beta_2 C_{it} + e_t$$

Based on this research, the above model has been adjusted to examine the relationship that exists between performance of banks and corporate governance practices in Nigeria. Two simple models have been developed for performance variables and the corporate governance variables. Below are the models;

### Model 1

$$ROE_{it} = \beta_0 + \beta_1 BSZE_t + \beta_2 BCOMP_t + \beta_3 CGDI_t + \beta_4 FSZE_t + \beta_5 DBT_t + e_t$$

.....(1)

### Model 2

$$ROA_{it} = \beta_0 + \beta_1 BSZE_t + \beta_2 BCOMP_t + \beta_3 CGDI_t + \beta_4 FSZE_t + \beta_5 DBT_t + e_t$$

.....(1)

### Where:

ROE and ROA represents firm performance variables which are: Return on assets and Return on equity for banking firms at time t.

BSZE stands for Size of the Board; Composition of the Board is proxied by BCOMP which is explained as the proportion of non-executive directors to total size of the board, while CGDI represents Corporate Governance Disclosure Index.

FSZE represents firm size and for the purpose of this study, log of assets was used because the values are widely spread; DBT represents gearing (debt). These two variables are the control variables.

$e_t$ , the error term which account for other possible factors that could influence  $ROE_{it}$  and  $ROA_{it}$  that are not captured in the model.

#### 4. Data Analysis and Results

A descriptive analysis was used to give a summary result of the variables. This was followed with a correlation analysis to measure the degree of association between different variables under consideration. Lastly, the regression analysis was used to determine the impact of the corporate governance variables on performance.

**Table 1: Descriptive Statistics**

	N	Minimum	Maximum	Mean	Std. Deviation
ROA	60	-1.1	0.37	0.028	0.224
ROE	60	-2.0	1.6	0.015	0.456
BSZE	60	7.0	20.00	14.53	2.52
BCOMP	60	0.50	0.92	0.615	0.07
CGDI	60	0.72	1.0	0.88	0.078
FSZE	60	8.15	9.43	8.89	0.31
DBT	60	0.00	0.97	0.35	0.21

Source: Authors' Computation, (2013)

From Table 1 it can be seen that the 15 listed banks included in this research generates Return on Equity (ROE) of about 1.5% and there is a standard deviation of 45.6%. This means that the value of the ROE can deviate from mean to both sides by 45.6%. The maximum and minimum values of ROE are 160% and -200% respectively. However, a Return on Asset (ROA) of 2.8% was generated on the average, with a minimum and maximum percentage of -110% and 37% respectively. Also with regards to ROE and ROA, it can be seen that there is a wide deviation between banks.

Also for the banks studied, the average board size is about 15 and a deviation of 2.52 which signifies that banks in Nigeria have a relatively similar board size. The maximum and minimum board sizes are 20 and 7 respectively. In addition, the average proportion of non-executive directors on the board is about 62% with a deviation of 7%.

The average CGDI is 0.88 and this can deviate to both sides by 7.8%. The bank with the highest level of disclosure has 100% and that with the least has 72%.

Also it can be seen that in terms of firm size which is shown by the value of asset base for the banks, they are of relatively similar sizes with a maximum and minimum 9.43 and 8.15 respectively and most of the banks are less dependent on debt in their capital structure with a mean of 0.35.

The correlation analysis measures the degree of association between the governance variables and performance variables i.e. whether or not the governance variables will improve performance. Figure 4.4 and 4.5 presents the correlation results for all the variables reviewed in this study.

**Table 2: Correlation Result for Model 1 (ROA)**

Covariance Analysis: Ordinary

Date: 09/09/13 Time: 15:51

Sample: 1 60

Included observations: 60

Correlation Probability	ROA	BSZE	BCOMP	CGDI	FSZE	DBT
ROA	1.000000 -----					
BSZE	0.152335 0.2453	1.000000 -----				
BCOMP	0.147201 0.2617	-0.147753 0.2599	1.000000 -----			
CGDI	0.285055 0.0273	0.110295 0.4015	0.232649 0.0736	1.000000 -----		
FSZE	0.170919 0.1916	0.453236 0.0003	-0.307185 0.0170	0.162736 0.2141	1.000000 -----	
DBT	0.147843 0.2596	-0.213096 0.1021	0.319456 0.0128	0.283542 0.0281	-0.203510 0.1189	1.000000 -----

Source: Authors' Computation, (2013)

From the correlation result in table 2 above for ROA, the board size has a positive weak correlation with ROA with a correlation coefficient of 0.15. This means the ROA improves as the board size increases but this increase is not much and it is also not significant with a p-value of 0.24.

Also, the board composition has a weak positive correlation with ROA. Therefore as the proportion of non-executive directors to executive directors increases, ROA improves but this variable is not significant with a p-value of 0.26.

The corporate governance disclosure index is positively correlated at 0.285 and it is also significant at 5%. This might indicate that banks that disclose more governance issues seem to perform better.

The two control variables firm size and gearing also seem to be positively weakly correlated to ROA and these two variables are also not significant at 5%. This can mean the size of a bank measured by its asset base tends to improve performance and gearing also tend to improve performance.

**Table 3: Correlation Result for Model 2 (ROE)**

Covariance Analysis: Ordinary

Date: 09/09/13 Time: 16:17

Sample: 1 60

Included observations: 60

Correlation

Probability	ROE	BSZE	BCOMP	CGDI	FSZE	DBT
ROE	1.000000 -----					
BSZE	0.187287 0.1519	1.000000 -----				
BCOMP	0.060928 0.6438	-0.147753 0.2599	1.000000 -----			
CGDI	0.114592 0.3833	0.110295 0.4015	0.232649 0.0736	1.000000 -----		
FSZE	0.269285 0.0375	0.453236 0.0003	-0.307185 0.0170	0.162736 0.2141	1.000000 -----	
DBT	-0.111617 0.3959	-0.213096 0.1021	0.319456 0.0128	0.283542 0.0281	-0.203510 0.1189	1.000000 -----

Source: Authors' Computation, (2013)

From the correlation result in table 2 above for ROE, the board size has a positive weak correlation with ROE with a correlation coefficient of 0.187. This means the ROE improves as the board size increases but this increase is not much and it is also not significant with a p-value of 0.15.

Also, the board composition has a very weak positive correlation with ROE. Therefore as the proportion of non-executive directors to executive directors increases, ROE improves with a correlation coefficient of 0.06 but this variable is not significant with a p-value of 0.64.

The corporate governance disclosure index is very weakly positively correlated at 0.11 and it is also not significant at 5% with a p-value of 0.38. This might indicate that banks that disclose more governance issues might just seem to perform a little better than others but this value is not significant. The firm size measured by its asset base seems to be weakly positively correlated to ROE and also significant at 5% with a p-value of 0.03. This might mean the size of bank tends to improve ROE.

The gearing measured by debt to equity is negatively correlated to ROE with a correlation coefficient of -0.11. This means as value of debt to equity increases, it has a negative effect on performance (ROE). This variable is not significant at 5% with a p-value of 0.39.

In this section, the panel data regression analysis is used to investigate the impact of corporate governance on banks' financial performance using return on equity and return on asset. Table 4 and 5 presents the regression results for all the variables reviewed in this study.

**Table 4: Regression Result for Model 1 (ROA)**

Dependent Variable: ROA

Method: Least Squares

Date: 09/09/13 Time: 15:49

Sample: 1 60

Included observations: 60

Variable	Coefficient	Std. Error	t-Statistic	Prob.
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C	-1.866851	0.985331	-1.894643	0.0635
BSZE	0.009170	0.012828	0.714809	0.4778
BCOMP	0.423273	0.453872	0.932582	0.3552
CGDI	0.534164	0.400604	1.333395	0.1880
FSZE	0.111240	0.108438	1.025843	0.3095
DBT	0.110819	0.148104	0.748251	0.4576
R-squared	0.131027	Mean dependent var	0.028255	
Adjusted R-squared	0.050567	S.D. dependent var	0.224061	
S.E. of regression	0.218322	Akaike info criterion	-0.111049	
Sum squared resid	2.573891	Schwarz criterion	0.098386	
Log likelihood	9.331462	Hannan-Quinn criter.	-0.029127	
F-statistic	1.628469	Durbin-Watson stat	1.497498	
Prob(F-statistic)	0.168199			

Source: Authors' Computation, (2013)

The regression result is shown in table 4. The regression equation employed ROA as its dependent variable and board size, board composition, corporate governance, firm size and debt as independent variables. Firm size and debt are control variables.

The result shows that all these independent variables are not significant in explaining effect on bank's profitability in terms of ROA, even though there is a relationship between the dependent variable and the independent variables; it seems not to be significant because of the p-value which confirms the relationship between the variables could be as a result of random events. The r-squared clarifies this further by indicating that about 13% of the variation in ROA is accounted for by these independent variables.

Board size has a positive effect on bank's profitability, one unit increase in board size will increase the ROA by the coefficient and vice versa, reaffirming the fact that the larger the board size, the better the performance.

Board composition also improve profitability, one unit increase in the ratio of non-executive directors to total directors will increase the ROA by the coefficient. Thereby, increase in the number of non-executive directors sitting on the board, the better the financial performance in terms of ROA.

The corporate governance disclosure index follows the same trend in terms of affecting profitability as board size and board composition. This thereby indicates that a bank that tends to disclose more on governance issues is more likely to perform better than a bank that discloses less.

The firm size and leverage both have a positive relationship with ROA. For the firm size, increase in bank's asset base should lead to improved profitability and this should be the case if the banks make maximum use of its assets. For leverage, increase in debt in its capital structure should lead to improved profitability which could mean banks with more debt tend to perform better.

**Table 5: Regression Result for Model 2 (ROE)**

Dependent Variable: ROE

Method: Least Squares

Date: 09/09/13 Time: 16:13

Sample: 1 60

Included observations: 60



Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	4.421382	2.026675	2.181594	0.0335
BSZE	0.011488	0.026385	0.435405	0.6650
BCOMP	1.130007	0.933545	1.210447	0.2314
CGDI	0.335306	0.823981	0.406934	0.6857
FSZE	0.378309	0.223040	1.696150	0.0956
DBT	-0.249095	0.304627	-0.817706	0.4171
R-squared	0.112451	Mean dependent var		0.015063
Adjusted R-squared	0.030271	S.D. dependent var		0.456010
S.E. of regression	0.430271	Akaike information criterion		1.331299
Sum squared resid	10.88914	Schwarz criterion		1.540733
Log likelihood	-33.93896	Hannan-Quinn criter.		1.413220
F-statistic	1.368348	Durbin-Watson stat		1.776561
Prob(F-statistic)	0.250714			

Source: Authors' Computation, (2013)

The regression result is shown in table 4. The regression equation employed ROE as its dependent variable and board size, board composition, corporate governance, firm size and debt as independent variables. Firm size and debt are control variables.

The result also shows the same result as that of ROA, that all the independent variables are not significant in affecting bank's profitability in terms of ROE, even though there exist a relationship between the dependent variable and the independent variables, it seems not to be significant because of the p-value which confirms the relationship between the variables could be as a result of random events. The r-squared clarifies this further by indicating that about 11% of the variation in ROE is accounted for by these independent variables.

Board size has a positive effect on bank's profitability; one unit increase in board size will increase the ROE by the coefficient and vice versa. This follows the same pattern as ROA.

Board composition also improve profitability, one unit increase in the ratio of non-executive directors to total directors will increase the ROE by the coefficient. Board composition seems to have the most influence on ROE amongst all the variables. This result is consistent with that observed above in ROA.

The corporate governance disclosure index follows the same trend in terms of affecting profitability (ROE) as that of ROA above. A bank that tends to disclose more on governance issues is more likely to perform better than a bank that discloses less.

The firm size has a positive relationship with ROE. An increase in bank's asset base should lead to improved profitability. This result is consistent in the two models with firm size having a positive relationship on profitability (ROA and ROE).

The Gearing (leverage) has a negative relationship with ROE; increase in debt in a bank's capital structure would lead to reduced profitability which could mean banks with no or less debt tend to perform better in terms of ROE.

## 5. Conclusions and Recommendations

The first objective of the study was to examine the relationship between board size and financial performance of banks in Nigeria. The study found board size both in terms of ROA and ROE has a positive relationship with the variables. This result tend to be consistent with Coleman and Biekpe (2006), they observed a positive relationship exist between firm performance and board size. This also contradicts Manas and Saravanan (2006), they conducted a research on listed banks in India and discovered that there is no presence of a relationship between the size of the board and the performance of the banks. This could imply that the large board size leads to better decision making as result of the availability of wide range of expertise.

The second objective of the study was to examine the effect of the proportion of non-executive directors (board composition) on the financial performance of banks in Nigeria. The study found board composition in terms ROA and ROE follows the same trend as board size with a positive relationship. This is consistent with Sang-Woo and Lum (2004), reported that there is the existence of a positive relationship between having a significant proportion of non-executive directors on the board and return on investment. This also contradicts Sanda, Mukaila and Garba (2005), examined companies quoted on the Nigerian stock exchange to examine this relationship and came to conclusion that there is no relationship between the variables. This could imply that the non-executive directors perform its advisory and monitoring function, thereby reducing or eliminating the agency conflicts.

The third objective of the study was to determine the corporate governance disclosure of banks in Nigeria in compliance to CBN governance code (2012). The study found a high level of compliance to CBN corporate governance code (2012) by all the banks reviewed over the period and this could be the reason of improved disclosure and transparency in Nigerian banking industry.

The fourth objective of the study was to determine if there is any significant relationship between the level of corporate governance disclosure and the financial performance of banks in Nigeria. The study found that corporate governance disclosure has a positive relationship with the two performance proxies. This implies that a bank that tends to disclose more on governance issues in line with the CBN code (2012) is more likely to perform better than a bank that discloses less.

Other findings from descriptive analysis show that the average board size is about 15 among the listed banks in Nigeria. This is consistent with the suggestions of Coleman and Biekpe (2006) that a board size of 12 to 16 is appropriate. Also, it was noticed that the average proportion of non-executive directors on the board (board composition) among the listed banks in Nigeria is about 62% which is in line with the CBN code (2012) where it was stated that "the number of executive directors shall not exceed 40% of the entire board size". Lastly, although a mean disclosure of 0.88 was achieved in terms of corporate governance disclosure, the banks disclosed fully on items 2-7, 10-12, 14-17, 20, 23, 25, 27 and 31-32 (see appendix 2 for governance code).

Also the regression analysis of the study shows that the independent variables employed only account for about 11-13% of the variations in the dependent variables, therefore more other appropriate variables should be considered for future studies.

Lastly, future studies could examine other sectors since this study covers the banking sector. It would be of great benefits to have a picture of corporate governance roles in other sectors or organisations.

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