

INTERNAL AND EXTERNAL GOVERNANCE MECHANISMS: EVIDENCE FROM THE NIGERIAN BANKING INDUSTRY

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Abstracts

This paper examines the relationship between internal and external governance mechanism employed by Nigerian banking companies. Data for the study was obtained from the annual reports of bank in Nigeria. I find a higher portion of non-executive directors and a greater likelihood of separating the role of company chairman and CEO in banks compared to similar studies of Nigerian quoted companies. The proportion of non-executive directors who are former executives is low. These suggest those banks are more likely to employ non-executives for monitoring. Banks in Nigeria have utilized audit committees since 1991 and the audit committees in Nigerian banks possess a great proportion of non-executive directors.

Keywords: Corporate Governance, Governance Mechanisms, Board Composition, Audit Committee

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Introduction

The role of board of directors in corporate governance is essential both in developed and developing economies. The ultimate responsibility for ensuring that firms are properly managed rests with shareholders. However, with the separation of ownership from control in most major business enterprises, the responsibility for strategic decisions and ensuring that top managers discharge their day to day duties effectively and efficiently is entrusted to the board of directors.

Over the years, the government of developed countries especially UK and USA has taken a greater interest in the activities of the directors and officers. Reforms introducing new measures to prevent corporate malpractice have been carried out mainly in response to the collapse of Enron and WorldCom and it reflects governments concern to ensure that the accountancy standard practices and corporate governance protocols evolve, improve and are strengthened in response to such corporate disaster. It has resulted in a number of far ranging reports by Cadbury, Greenbury, Turnbull, Hampel, Smith, Higgs and Sarbanes-Oxley. The reports have been persuasive in crafting out frameworks for good corporate governance with particular relevance to

listed companies and the standard their directors will have to attain.

The Combined Code on Corporate Governance issued and incorporated into the listing regulations in 1998 codified the findings of the reports of Cadbury (1992), Greenbury (1995), Hampel (1998) and Turnbull (1998). It encourage among other recommendations an increased role for non-executive directors, who should exercise financial control, bring experience, knowledge and insight to the board, act as a power check on executive directors, and be a means of communication between shareholders and other groups within the company. However, the Combined Code is not prescriptive, essentially, corporate governance standards are imposed within a self-regulatory regime. Companies have a free hand in explaining their governance policies in the light of the principles set out in the Combined Code. Therefore the 'comply or explain' principle requires that where the company chooses not to comply with the provision of the Combined Code, it must provide an explanation.

Higgs and Smith reports were published in 2003. Higgs report set out to recommend changes to the Combined Code on corporate governance. The main proposal of the reports are greater transparency and accountability in the boardroom, formal

performance appraisal, closer relationship between executive directors and shareholders, at least half the members of the board should be independent non-executive directors selected from an open fair and rigorous appointment process from a wider pool of candidates and the roles of chairman and chief executive should be separated among others. The Report rejects a legislative approach and builds on the current self-regulatory framework of UK corporate governance and the 'comply and explain' principle of the Combined Code.

Smith's report commissioned by the Coordinating Group on Accounting and Audit, recommends reforms to audit committees and make recommendations that audit committees should include at least three members all of whom should be independent members with at least one having relevant financial experience. They should monitor the auditor's performance, especially on independence and objectivity, and should develop and implement policy on the purchase of non-audit services from the auditor with reference to tough ethical guidance.

In the US, the Sarbanes-Oxley Act, which was drawn in response to the recent corporate collapses, has radically tightened Securities and Exchange Commission (SEC) rules. It aims to cut the perceived conflicts of interest that external auditors face when providing other work for their clients and imposes criminal sanctions on non-compliant managers. Sarbanes-Oxley has a dimension outside the US requiring that the management of non-US companies having a quotation or American Depository Receipts (ADR) facility with in the US comply with its provisions. Although the SEC has tried to be obliging to non-US issuers, its priority has been the protection of US investors.

However, these changes have been subjected to criticism, generally on the ground that the combined effect of these reforms could result in corporate governance prevailing at the expense of commercial performance.

There has been series of unexpected bank failures in Nigeria since the 1990s and this has called for more control and accountability in banks. Notwithstanding the fact that the role and quality of corporate governance has been subjected to intense debate in developed countries such as USA and UK since the 1990s, studies of corporate governance in Nigeria has been scanty. There is no study known to the researcher till date that has investigated corporate governance of Nigerian banks. The objective of the study is to examine the internal and external governance mechanisms of Nigerian banks. The mechanisms investigated are board composition and leadership, utilization of board sub-committees and the relationship between the company and its external auditor. The rest of the paper is divided into four parts. Section 2 presents a review of selected literatures. Section 3 presents the Nigerian banking

industry and sample data and section 4 shows the analysis of findings. The conclusions were discussed in section 5.

2. Literature Review

More research attention is being focused on corporate governance in the developed countries with emphasis on the composition and role of board of directors, evaluation of performance of corporate directors, analysis of the influence of corporate directors on the remuneration of Chief Executive Officers, the relationship between director characteristics and company performance, the utilization and composition of board sub-committee, examination of women leadership positions in corporate firms and internal and external governance mechanisms of companies among others. (Burke and Mattis, 1997, Burke, 1999, O'Sullivan and Diacon, 1999). Brickley and James, (1987) examine whether internal governance, specifically the presence of outside directors, substitutes for the absence of external control in their investigation of mutual and proprietary US banks. Their results suggest that, in the absence of a takeover market, outside board members play an important role in controlling managerial expenditure. Mayers et al. (1997) examined the property liability insurance industry in the US and found that mutual companies had significantly more outside board members in their proprietary counterparts. Mayers et al. (1997) also found that companies who switched from proprietary to mutual status increase the proportion of outside directors on their boards, while switching from mutual to proprietary status decrease outside director representation. In their analysis of board compositions in companies, which are protected from an active takeover market, Arthur and Taylor (1995) provide support for this 'substitution hypothesis'. They also report a higher proportion of outside directors on boards in states, which possess restrictive takeover legislation, compared with more permissive states. Evidence presented by Rediker and Seth (1995) also suggests that US companies adopt specific internal governance mechanisms to meet their individual monitoring requirements. O'Sullivan and Diacon (1999) focused on board composition and leadership of insurance companies in the UK, the utilization of board sub-committees and the companies' relationship with its external auditor. They find a higher proportion of non-executive directors for mutual companies than proprietary companies. They also find that mutual companies possess remuneration committees than their proprietary counterparts and that audit and remuneration committee has been established in response to governance concerns since the mid-1980s. Generally, studies on corporate governance in Nigeria are scanty and just evolving. Attention of Scholars in Nigeria in the area of corporate governance has been concentrated on investigation

of the ownership and control structure of business enterprises (Teriba, Edozien and Kayode, 1977), analysis of pattern of share ownership (Ekpeyong, 1992) and an empirical analysis of the interrelationship between ownership structure, corporate governance and corporate performance (Adenikinju and Ayorinde, 2001) and a gender analysis of chairmen, chief executives and directors of quoted companies in Nigeria to document the level of involvement of women in leadership of corporate firms (Adelegan, 2001).

3. The Nigerian Banking Industry and Sample Data

The Nigerian banking system has witnessed tremendous changes in the last 10 years. The changes have been in area of bank regulations, use of technology to produce financial services and banks competition. More banks have been attracted into the industry as a result of ease of entry restrictions and bottlenecks (see table 1). The number of banks has increased from 58 in 1988 to 90 in 1990 and 120 in 1993. However, the number of distressed banks

increased from 15 in 1991 to 28 in 1993 and 60 in 1995. Only 20 out of the 90 banks in Nigeria are quoted on the Nigerian stock exchange (NSE). They are the ones whose financial statements are readily available to the public. The sample comprises of 14 Nigerian banks. 11 of the bank are quoted on the Nigerian stock exchange while 3 are not. Companies listed on the first tier of NSE are expected to have trading record of at least five years, and at least 25 per cent equity holding by the public, and not less than 500 shareholders. Such companies are also expected to give quarterly, half-yearly and yearly reports with no limit to the amount of money that they can raise from the securities market. The second tier securities market was introduced in 1986, with less stringent conditions, in order to accommodate more companies. Companies listed on the second tier segment of the securities market of (NSE) are expected to have a track record of at least 3 years and not less than 25 per cent equity shares in the hand of the public. They must not have less than 100 shareholders nor raise more than 20 million naira from the securities market.

Table 1. Characteristics of Banking Industry in Nigeria

Year	No of banks	Banks declared distress
1991	114	15
1992	119	16
1993	120	28
1994	116	55
1995	115	60
1996	115	50
1997	115	47
1998	89	22
1999	90	10
2000	89	11
2001	90	4

Source: Asogwa, R.C (2002): 'Financial Liberalization and Market Power in Banking: Tests of Industry Competition Relationship in Nigeria', Interim Research Report presented at the African Economic Research Consortium (AERC) Biannual Workshop, Durban, South Africa, 7-12 December, 2002

Data used in the study are from the annual reports of banks from 1985 to 1998 and NSE Fact books of 1989/90 to 1999. Most of the banks used for the study were quoted on the NSE because quotation makes information about the banks to be readily available.

Empirical Analysis and Results

4.1 Board Compositions and Leadership

An important aspect of governance deliberations concerns the composition of the board of directors. The board of directors is charged with promoting the interest of the owners of the company. The board has the legal authority to ratify and monitor managerial initiatives, evaluate the performance of top managers and reward or penalize that performance. Corporate board of most companies includes some of the top

managers of the firms as well as directors from outside the firm. Executive directors provide valuable information about the firm's activities, while non-executive directors are expected to contribute expertise and objectivity in monitoring management decisions (Baysinger and Hoskisson (1990), O'Sullivan and Diacon (1999)). Hampel (1998) suggests that non-executive board members should make up at least one third of board membership and a majority of these non-executives should be independent. Another aspect of board governance which causes concern refer to the prudence of having the same person serving as Chairman of the company and Chief Executive Officer (CEO). The function of the chairman is to run the board meeting as well as oversee the process of employing, firing, evaluating, and compensating the CEO. However, it is difficult for an individual to perform the duties of chairman and CEO effectively.

Hampel (1998) and Cadbury (1992) suggest that there should be division of responsibilities at the head of companies to ensure a balance of power and authority eliminating the possibility of one individual having unlimited powers of decision. However, if a

company must continue to combine the role of chairman and CEO, it should justify the decision to shareholders. Table 2 presents the descriptive statistics in respect of board composition for the banks in our sample.

Table 2. Internal governance characteristics of Nigerian Banks

Variable	Banks (n=14), Mean
Number of directors	10.5
% non-executive director	70.75
Separate chairman and CEO (yes = 1)	1
Non-executive chairman (yes=1)	1
CEO internal appointment (yes=1)	0.57
Audit committee (yes =1)	0.71

Source: Computed from Annual Reports of Bank in Nigeria from 1985-1998

Board size is large with an average of 10.5 directors. In terms of board composition, the proportion of non-executive directors is higher than that of executive directors. Non-executive directors account for 70.75 per cent of the directors. This complies with Higg’s recommendation that at least half of the board members should be independent non-executive directors. These findings supports research in the US which suggest that non-executives, without existing business link with the company, may be more effective monitors on behalf of shareholders (Weisbach (1988), Byrd and Hickman (1992)). Furthermore, my findings regarding non-executive directors suggest that banks place a greater emphasis on objectivity when recruiting executive directors and they use them for monitoring. In respect of duality of chairman /CEO, all the banks in the sample have different individual occupying these key position. This is not consistent with what obtains in the US where CEO/chairman duality is popular in large companies. Whidbee (1997) reports that only 14.2 per cent of US banks in his sample had separate individuals in the position of company chairman and CEO. However, in the UK, 82 per cent of the largest and 72 per cent of the smallest companies surveyed to analyze compliance with the recommendations of the Cadbury committee had different individual occupying the positions of chairman and CEO (Cadbury, 1995).

Board Sub-Committee

The role and composition of board sub-committees is another important aspect of corporate

governance. Companies and Allied Matter Decree (CAMD) (1990) in Nigeria, Cadbury (1992), Hampel (1998) and Smith (2003) in the UK argue that the existence of audit committee is expected to result in improved confidence in the overall system of corporate governance.

Audit committees are expected to serve as the principal point of contact between the statutory external auditor and the company and help to improve the quality of the external audit process.

An important part of board sub-committees refer to their composition, particularly the presence of a significant proportion of non-executive member and a non-executive chairman. The audit committee is an important forum for deliberating on the actual and potential problem between the company and the external auditor; the impartiality of such deliberation is expected to improve if the senior management of the company does not have significant presence on the audit committee (Sullivan and Diacon (1999)).

This is very important in Nigeria where auditing firms may also provide non-audit services to their audit clients. To preserve the independence of the audit process, an audit committee comprising a significant non-executive representation is necessary in such an environment. In Table 2, 71 per cent of the Nigerian banks in the sample disclose that they utilize audit committees. Table 3 provides information on the characteristics of audit committees in Nigerian banks. In terms of the number of years established, audit committees have been in existence in Bank in Nigeria since 1991.

Table 3. Characteristics of Audit Sub-committees in Banks in Nigeria

Variable	Banks (n=10), Mean
Years in operation	11
Number of audit committee	6.1
Number of executive directors	2.8
Number of non-executive directors	3.3
% non-executive directors	54.10
Non-executive chairman (yes=1)	0.80

Source: Computed from Annual Reports of Bank in Nigeria from 1985-1998

On the average the member of audit committees of Nigerian bank are 6.1 and they include 3.3 non-executive directors. This complies with suggestions in Cadbury and Smith's report that at least three non-executive directors should be members of audit committee. The audit committees have a greater proportion of non-executive directors (54.10 per cent). 80 per cent of the audit sub-committees of Nigerian banks in the sample have non-executive chairmen. This point to the fact that the composition of the audit committees of Nigerian bank is likely to help preserve the independence of the audit process.

4.3. The Auditor-Client Relationship

The quality of financial disclosures produced by companies is also an important aspect of corporate governance. The external audit provides an external check on the way the financial statement has been prepared and presented by the company

management. The annual audit is one of the cornerstones of corporate governance. However, its objectivity and effectiveness has been questioned in recent years. A number of studies have highlighted lack of confidence of the audit users with the audit process and the difficulties encountered by the audit users in making auditors responsible for the accuracy of audited financial statements (O'Sullivan (1993), O'Sullivan and Diacon (1999)).

A large part of the dissatisfaction with the audit process relates to the relationship between statutory auditors and the management of the company and whether that relationship undermines the auditor's independence. The length of the auditor-clients relationship and the extent to which the auditing firm undertakes consultancy work for the company may affect the auditor's independence. Table 4 provides descriptive statistics on the auditor-client relationship.

Table 4. Characteristics of the auditor-client relationship in Banks in Nigeria

Variable	Banks (n=14), Mean
Audit tenure (years)	12.5 years
Audit fee (naira '000)	3317.07
Provision of non-audit services (yes=1)	1.00
Analysis of Non-Audit Service:	
Taxation (yes=1)	0.80
Non-audit fee as a % of audit fee	0.25

Source: Computed from Annual Reports of Bank in Nigeria from 1985-1998

Auditors in Nigerian banks perform the role for a long period of time and the banks purchase non-audit services from their auditors. For all the banks analyzed, taxation is the single most important non-audit services purchased. Banks pay 25 per cent of the value of audit fees for non-audit services. The ratio of fee paid for audit to the fee paid for non-audit services reveal that Nigerian banks purchase significant amounts of non-audit services from their auditors.

Conclusion

This study provides some evidence of internal and external governance characteristics for Nigerian banks. Information on governance mechanism was obtained from the annual reports of 14 banks from 1985 to 1998. The study focused on three aspects of corporate governance. These are board composition and leadership, the utilization of board sub-committees and the relationship between the company and its external auditor. In terms of board composition, the result suggests that the proportion of non-executive directors is higher than that of executive directors. Non-executive directors account for 70.75 per cent of the directors. The greater emphasis on non-executive independence is consistent with the substitution hypothesis, which suggests that banks seem to compensate for weak

external governance by utilizing stronger mechanisms of internal governance. In respect of duality of chairman / CEO, all the banks in the sample have different individual occupying these key position.

Audit committees have been in existence in Nigeria since 1991. They have a greater proportion of non-executive directors and mostly non-executive chairmen. This point to the fact that the composition of the audit committees of Nigerian bank is likely to help preserve the independence of the audit process.

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