# THE EFFECTS OF INTERNAL AND EXTERNAL MECHANISM ON GOVERNANCE AND PERFORMANCE OF CORPORATE FIRMS IN NIGERIA

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**Abstract**

There is a renewed interest on the need to strengthen mechanisms to ensure that managers and directors take measures to protect the interest of a firm's stakeholders. This study made use of panel data regression analysis between 2002 and 2006 for a sample of 62 firms listed on the Nigerian Stock Exchange to examine the relationship between internal and external governance mechanisms and corporate firms' performance. The results have the implication that regulatory agencies should encourage firms to achieve a reasonable board size since overly large boards may be detrimental to the firm. Our results also show no significant evidence to support the idea that outside directors help promote firm performance. In addition, the study found that the measure of performance matter for analysis of corporate governance studies. We found in some cases different results from the use of Returns on Assets (ROA) and Tobin's Q as measures of firm performance.

**Keywords:** Firms, Panel Data, Corporate Governance, Nigeria

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## I. Introduction

It is possible to identify three levels of determinants of firms' performance. The first, relates to external factors that are beyond the control of the firms, and are generally economy-wide. Second, are factors that are internal and under the direct purview of the firms. These factors, which include managerial efficiency, governance structure, ownership structure etc affects the ability of the firms to cope with external factors. Finally, there are other factors such as size, leverage, and nature of the industry that affect firms' performance. However, corporate governance is considered to involve a set of complex indicators, which face substantial measurement error due to the complex nature of the interaction between governance variables (such as board size, board composition, return on assets etc) and firm performance indicators. Nevertheless, previous empirical studies have provided the nexus between corporate governance and firm performance. However, despite the volume of the empirical work, there is no consensus on the impact of corporate governance on firm performance. Consequently, this lack of consensus has produced a variety of ideas (or mechanisms) on how corporate governance influence firm performance.

In the case of Nigeria, poor management and weak internal control systems account for some of the lapses in the operation of some corporate organizations. In addition, technical mismanagement involving inadequate polices, lack of standard practices, poor lending, mismatching of assets and liabilities, weak and ineffective internal control systems as well as poor and lack of strategic planning has bee prevalent in the Nigerian corporate industry. Thus, the significance of this study is very high in an environment like Nigeria, which is characterized by growing calls for effective corporate governance, particularly for public limited liability companies. This call is understandable in view of the importance of effective governance at both microeconomic and macroeconomic levels. Understanding the effect of internal and external mechanisms and pattern of corporate governance among the Nigerian corporate firms will proved invaluable information to top policy makers and assist the government on the restructuring of the Nigerian corporate sector.

In the present changing economic environment, the corporate sector must brace up to the challenges of globalization where firms that cannot adapt to modern business culture may not survive. It is therefore important for firms to find out the best corporate practices in other parts of the world and how they can integrate these into their business culture to enhance their performance. Consequently, this study investigates the relationship between internal and external mechanisms on corporate governance and firm performance. It provides an analysis of the governance structure of Nigerian firms and their managerial characteristics and the extent to which the governance structure and internal/external monitors influence their performance. There is no doubt that the structure of ownership of a firm and its internal/external effect has important impact on the capability of the firm to respond to external factors impinging on its performance. In addition, despite the renewed interest in issues of corporate governance in the African continent, relevant empirical studies are still few and far in-between in Nigeria (except for the studies of Oyejide and Soibo, 2001; Sanda et al; 2005; Kajola;2008). However, these studies suffers from the weakness of excluding important mechanisms for addressing the corporate governance and firm performance relationship. This has limited the depth of our understanding of corporate governance. Thus, we believe that this study should improve our understanding of the relationship between corporate governance and firm performance in Nigeria.

In addition, the studies are usually generalized for all the sectors of the economy. This may lead to making sweeping generalization that did not cut across the sectors. This study focuses on the manufacturing sectors that are quoted on the Nigerian Stock Exchange (NSE) to enhance the reliability of information obtained since they are required by law to publish their annual report and accounts.[1] The scope of the study shall cover a period of five years. This is between 2002 and 2006. The choice of the period and the firms included in the analysis were guided by data availability considerations. The rest of this study is divided into four sections. Section II discusses the background to the study while section III presents a brief review of related studies. The analytical framework is discussed in section IV while section V presents and discusses the empirical findings. Section V summarizes and concludes.

## II. Structure and Performance of the Corporate Sector in Nigeria

The Nigerian stock exchange (NSE), the apex body on the Nigeria capital market was established in 1960 as the Lagos Stock Exchange. It later became the Nigeria Stock Exchange in 1977. At present there are six branches with each having a trading floor. The branch in Lagos was opened in 1961, Kaduna 1978, Port Harcourt 1980, Kano 1989, Onitsha February 1990; and Ibadan August 1990. The exchange which started with only 19 securities traded on its floors in 1961 has about 257 securities as at 2002 with a total market capitalization of approximately N763.9 billion. The total value of reading transaction on the exchange rose from N13.6 billion in 1998 to N59.0

[1] However, additional information was obtained from interviews conducted with the companies, the from Nigeria Stock Exchange (NSE Fact books. Banks and Insurance companies were excluded because the recapitalization policy effect have not really been captured in the Nigerian banking system. Also the debt structure of banks and insurance institutions are not comparable to the firms in other sectors. This is consistent with some other studies in the literature (Adenikinju, 2005).

billion in 2002. As at 2003, 180 companies were listed on the first tier market of the stock exchange and there were 19 listed on the second tier securities market (Adenikinju, 2005). There is an increase in all the parameter use to capture the performance summary of the Nigerian stock exchange from the year 2003-2006.

However, the Nigerian stock market is small illiquid and volatile. Although the number of listed securities is increasing, trading activity is still very thin due to the observed reluctance of institutional and individual investors to trade in the secondary market. Table 1 provides summary information on the performance of the capital market in Nigeria between 1998 and 2006.

The regulatory body of the Nigeria capital market is the security and Exchange Commission (SEC) which was established in 1979, almost 2 decades after the NSE was established. Furthermore, the first comprehensive legal document providing rules sand regulations for the conduct of operations in the stock exchange, the Securities and Investment Act No. 45 was promulgated in 1999. the implication of this is very clear "the stock exchange operated for almost two decades with a regulatory organ and for another two decades with a regulatory organ weakened by the absence of a comprehensive legal document to assist in the discharge of its regulatory system" (Sanda, et al 2003). Whilst, the SEC supervises the activities of the various entities that operate on the capital market, the statutory body that deals with incorporation is the Corporate Affairs Commission (CAS) through the provisions of the Corporate and Allied Matters Act No. 1 of 1990. The board picture of shareholding in Nigeria across the various sectors of the capital market is presented in Table2.

**Table 1.** NSE's Performance Summary (1998-2006)

| Performance | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|---|---|
| No of listed securities | 264 | 269 | 260 | 261 | 257 | 263 | 262 | 268 | 267 |
| Total Mkt. Capitalization (Nb) | 263.3 | 299.9 | 478.6 | 662.9 | 783.9 | 840 | 865 | 941 | 986 |
| Share Trade (in billions) | 2.1 | 3.9 | 5.0 | 6.0 | 6.6 | 6.9 | 7.1 | 7.3 | 8.2 |
| Value securities traded (Nb) | 13.6 | 14.1 | 28.2 | 57.6 | 59.8 | 59.9 | 60.4 | 65.8 | 67.5 |
| Daily avg. vol. of shares (mill) | 8.4 | 15.6 | 19.9 | 24 | 26.4 | 28.2 | 29.4 | 30.1 | 31.0 |
| Daily avg. val. Of shares (mill) | 54.3 | 55.7 | 112.2 | 121.8 | 130.6 | 132.6 | 133.8 | 140.7 | 160.4 |

Source: IPG (2007): Confidence Restored: Nigeria (1998-2007)

**Table 2.** Ownership Structure of Nigerian Quoted Companies,1995-1998 (Percentages)

| Sector | Dom.Inst | Forinst | Govt | Dom.Ind | For.Ind | Mgt | Staff | Cr |
|---|---|---|---|---|---|---|---|---|
| Agriculture | 28.25 | 0 | 36.95 | 34.47 | 0.33 | 0.31 | 0 | 88.96 |
| Airlines | 0 | 0 | 0 | 84.88 | 0 | 15.12 | 0 | 99.62 |
| Automobiles | 3.4 | 44.3 | 30 | 22.30 | 4.0 | 0 | 0 | 89.57 |
| Food, Beverage & Tobacco | 20.34 | 36.88 | 4.66 | 32.71 | 1.29 | 3.28 | 0.85 | 69.29 |
| Footwear | 0 | 48.05 | 0 | 49.78 | 0 | 2.17 | 0 | 25.26 |
| Healthcare | 29.99 | 15.82 | 0 | 32.87 | 0 | 22.3 | 0 | 65.25 |
| Industrial/Domestic Products | 20.56 | 27.19 | 8.29 | 49.78 | 0 | 11.59 | 1.56 | 59.1 |
| Breseries | 5.55 | 30.18 | 12.26 | 32.77 | 0 | 8.23 | 0.18 | 69.62 |
| Building Materials | 32.32 | 15.95 | 27.75 | 43.74 | 0.22 | 0.04 | 0 | 61.71 |
| Chemicals and Paint | 25.1 | 10.33 | 0 | 23.71 | 0 | 5.26 | 0 | 71.71 |
| Commercial Service | 18.32 | 0 | 0 | 60.37 | 0 | 52.27 | 0 | 85.67 |
| Computer & Office Equipment | 40 | 8.8 | 0 | 29.7 | 32.2 | 10.3 | 0 | 58.57 |
| Packaging | 20.93 | 27.75 | 2.95 | 17.7 | 3.42 | 15.32 | 0 | 37.79 |
| Conglomerates | 2.26 | 40.04 | 0.28 | 29.19 | 8.95 | 1.13 | 0.2 | 60.65 |
| Constriction | 6.31 | 25.93 | 9.66 | 20.33 | 3.02 | 19.9 | 0.2 | 69 |
| Petroleum (Marketing) | 0.2 | 40 | 12.03 | 41.16 | 0 | 0.5 | 0 | 61.26 |
| Machinery | 8.87 | 60.5 | 0 | 36.49 | 0 | 2.81 | 0 | 61.26 |
| Printing & office equipment | 13 | 18.24 | 0 | 65.02 | 0 | 7.31 | 056 | 75 |
| Textiles | 13 | 36.06 | 5.3 | 25 | 8.74 | 11.84 | 0 | 49.02 |
| Insurance | 11.3 | 3 | 15.4 | 60.5 | 0.0 | 0.53 | 0 | 73.21 |
| Average | 17.31 | 26.42 | 7.76 | 37.37 | 1.51 | 9.36 | 0.34 | 63.45 |

Source: Adenikinju and Ayorinde (2001)

Note: Dom.Inst = % of shares by domestic institutions; For.Inst = % of shares held by foreign institutions; Govt = % of shares held by the Government; Dom.Ind = % of shares held by domestic individuals; For.Ind = % shares held by foreign individuals; Mgt = % of shares held by management; Staff = % of shares held by staff of the firm; CR = concentration ratio (% of shares held by top 10 shareholders).

The information in Table 2 shoes that concentration varies across the sectors. But on the average it may be safe to conclude that concentration ratio is quite high. Most of the sectors have a concentration ratio that is above 50 percent. CR is highest in Airline (99%), Agriculture (88.%), Automobile (89.6%),Commercial Services (85.7%) and Chemical and Paints (72%). It is however low in Footwear (25%) and Printing and Office Equipment (49%). The mean value of CR for the entire corporate sector is 63.5 per cent. The concentration of shareholding could have positive or negative effect on firm performance. While it can help reduces agency problem, it can also lead to poor governance as a small group can exercise control over a firm and pursue the objectives of the insider at the cost of the outsiders, or small shareholder (Claessens et al, 1999).

Another feature of ownership structure shown in Table 2 is that foreign institutions were more

prominent than individuals in the foreign shareholdings. In other words, foreign institutions held the bulk of the shares by foreigners. Thus, in many cases, foreigners hold block minority shares that would have give them the leverage to control the firm. In addition, on the aggregate, institutions account for 43 per cent of shareholdings compared to 38.9 per cent for individuals. In other words, institutions are ahead of private individuals in term of total shareholdings. However, when we compare foreign institutions with foreign private individual, it is obvious from the table that foreign institutions' holding (26.4%) is several multiple of foreign private individuals. One explanation for this is that in a weak property rights environment, institutions are more able to exact protection over their investment compared to private individuals.

The above pattern is however different for Nigeria investors. Private individuals in Nigeria control more share than their local institutions counterpart. The former has 37 per cent compared to 17 per cent for domestic institutions. Perhaps, it should be mentioned the fact that in most cases foreigners (institutions) are the single largest shareholders accounting for 40 per cent of shareholding in many instances. This implies that by and large the bulk of Nigerian shareholder own minority shares in their own companies. It also suggests that foreign institutions come close to outright ownership of most of these companies. Again this could be explained by the fact that most of these companies have foreign origin. They stated out as subsidiaries of parent companies located in the western countries.

## Internal Mechanisms for Good Governance

A well governed corporation needs to balance the roles of three groups of players: shareholders (and employees, if they have a governance role), boards of directors, and manages, while meeting all of its financial commitments and other obligations to a broad array of stakeholders. Shareholders provide (risk) capital in return for the opportunity to benefit from profits and increases in corporate value. Shareholder may have a range of rights and powers under law and regulation that can include the right to elect and remove directors and auditors and to appoint and approve or disapprove fundamental changes, such as mergers or changes in capital structure. The shareholders' interest is generally in maximizing the value of the firm's equity and distributions relative to risk over time.

The board of directors represents the interests of shareholders and may have obligation to other stakeholders under various statutory and voluntary provisions. An independent board of directors, the core internal governance mechanism, is the bridge between management and owners, other stakeholders, and the outside world. The board need to be independent particularly of management, and its members should be well-versed in the firm's line of business or in general business areas such as business law, accounting, marketing, finance, or production. The board should also be of reasonable size, and the terms of its directors should be fixed. Making the board more effective is at the centre of the corporate governance debate. Internal mechanisms of corporate governance work to check and balance the power of mangers, shareholders, directors and stakeholders. But while internal incentives are necessary for efficiency, they are not sufficient for good governance. In addition to these internal factors, corporations in market economics are also disciplined externally.

## External mechanisms for good Governance

Formal legal and regulatory obligations are part of the external incentive structure designed to ensure that competing companies abide by common standards of fairness, transparency, accountability, and responsibility to protect shareholders, consumers, workers, the environment, and even competitors from abusive practices. A good legal and regulatory framework efficiently addresses the entry, operations, and exists of firms. Other external elements are developed by national and international bodies on best practices (quality of disclosure, accounting and auditing standards, labour rules, environment standards, industrial product standards, listing requirements) and other areas of practices that are qualitative them in law can lead to overregulation and can curb entrepreneurial spirit.

Both equity and debt markets impose substantial discipline on management. Equity markets continuously monitor and place an objective value on

corporations and, by extension, on their management. The day-to day performance of a company's shares on a stock exchange is a transparent reminder to managers and Owners of the company's perceived viability and value. This assessment permits shareholders to assess management performance and gives managers an incentive to minimize the costs of equity, since failure to do so will make them vulnerable to takeover. An active market for corporate control, fluctuations in stock prices and the influence of shareholders keep managers focused on efficiency and commercial success.

## III Review of Related Studies

The literature identifies several channels through which corporate governance effects growth and development. The first is the increased access to external financing by firms. This in turn can lead to larger investments, higher growth and greater employment creation. The second channel is a lowering of the cost of capital and associated higher firm valuation. This makes more investments attractive to investors, also leading to growth and more employment. The third channel is better operational performance though better allocation of resources and better management. This creates wealth more generally. Fourth, good corporate governance can be associated with a reduced risk of financial crises. This is particularly important, as financial crises. This is particularly important, as financial crises can have large economic and social costs. Fifth, good corporate governance can mean generally better relationships with all shareholders. This helps to improve social and labour relationships and aspects such as environmental protection. All these channels matter for growth, employment, poverty reduction and well being more generally. Empirical evidence, using various techniques, has documented these relationships at the level of the country, the sector and the individual firm and from the investor perspectives (Claessens, 2003).

There are two basic principles of corporate governance (Charkam, 1994). The first is that management must be bale to drive the enterprise forward from undue constraint caused by government interference, fear of litigation, or fear of displacement. Second, is that this freedom – to use managerial power or patronage – must be exercised within a framework of effective accountability. Essentially, corporate governance failures may come about for two broad reasons. One, management may operate the firm inefficiently, resulting in an overall decrease in firm profits, compared to the potential profitability of the firm. Two, while management may operate the firm efficiently and generate maximum profits, they may divert a proportion of those profits from shareholders via the consumption of excess perquisites, for example, through remuneration which is not related to performance. Hence, a system of corporate governance needs to consider both efficiency and stewardship dimensions of corporate management. Stewardship emphasizes issues concerning, for example, the misappropriation of funds by non-owner manager. Equally important, however, is the issues of how the structure and process of governance motivate entrepreneurial activities which increase the wealth of business (Short et al, 1998).

The relationship between corporate governance and performance is based on the principal agent approach. The agency relationship is defined as a contract under which one or more persons (the principal(s) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. The separation of ownership and control, which occurs as a result of the introduction of external investors, bring to fore the agency problem: managers are expected to represent the interests of the external owners of the enterprise; however, it is difficult for owners to ensure that managers do so. Shleifer and Vishny (1996) argue that managers and equity investors should be capable of entering into a binding contract, which would ensure that investors' interest are fully represented.

However, it is unlikely that it will be possible to specify contracts ex-ante that accommodates all possible future contingencies. If unforeseen circumstances arise, managers assume contingent control rights that proved them with the potential to operate against investors' best interests, by, for example, expropriating investors' funds or engaging in assets stripping. The discretionary control rights of managers are further increased by the existence of asymmetric information between themselves and external investors. Although it is precisely this insider knowledge that encourages investors to permit mangers to operate as their agent, this allows managers the freedom to conceal information from external investors.

Such action serves to increase the costs of monitoring and therefore enables managers to pursue their own goals rather than those of the shareholders, by entrenching their position or engaging in behaviour that is sub-optimal for the shareholder. The possibility of higher monitoring costs is particularly strong if there are a large number of dispersed external investors, because a free-rider problem emerges if there are large costs to monitoring which the benefits accruing to each individual are relatively small.

Metrick and Ishii (2002) identify four dimensions of corporate governance at the level of the firm that can help to minimize the agency probable: board of directors, ownership structure, executive incentive contracts, charter and bye law provisions.

**(a) Board of Directors:** This is often considered to be one of the major sources of monitoring firm's conducts and performance. It is responsible for hiring and firing executives, setting executive compensations and making key decisions in the life of the firm. The board of directs should in principle be

one of the major checks one the management. It is directly elected by the shareholders to act on their behalf. A high level of independence is important for it to perform its monitoring duties more effectively.

The standard view is that the board of directors is more independent as the number of outside directors' increases. Executive directors are not likely to self monitor effectively the performance of the CEO because their career is closely tied to the incumbent CEO (Jensen 1999). Several studies show that board membership is related to the degree of agency problems at a firm (see for example, Borokhovich, Parrino and Trans (1996), Weisbach (1988) and Rosenstein and Wyatt (1990). The larger the percentage of outside directors, the more likelihood of (i) an outside executive being appointed chief executive officer (CEO) (ii) a non-performing, CEO to be dismissed and (iii) significant positive share reactions. With respect to the size of the board and performance, Yermack (1996) provides evidence of a negative relationship between the size of the board and firm value. However, Hermalin and Weisbach (1999) found no significant relationship between board composition and performance while Yermack also shows that the percentage of outside directors does not significantly affect firm.

Jensen (1993) and Hermalin and Weisbach (1991) argue that CEOs often control the composition of the board and lessen its monitoring role. This is especially possible when a person combine the position of chairman and CEO, and the use of exclusively large boards which increases communication problems among board members. Yermack (1996) report a negative relationship between board size and firm value for large and small firm respectively.

**(b) Ownership Structure:** This is another method of mitigating agency problems. The free-rider problem is minimize and internal constrains on managerial discretion can probably be imposed if ownership is concentrated in the hands of a large block of shareholders irrespective of whether they are individuals, organizations or investment funds. In this event, the returns to monitoring will increase monitoring activity, which may also be subject to economies of scale.

Moreover, large shareholders will be more likely to be able to utilize their voting power to influence managerial behaviour, although, as Shleifer and Vishny (1996) note, this does require shareholding voting rights. This leads to the proposition that large shareholders will exercise more effective corporate governance; a finding that has been supported by a host of studies on developed market economies. For example, Franks and Mayer (1994), in a study of German Private Enterprises find that concentrated share ownership is associated with high rates of turnover of directors. In the study of Japan, Kaplan and Milton (1994) find that the existence of large shareholders raises the probability that managers of poorly performing firms will be replaced. La Porta et al (1999) posit that high concentration could minimize agency costs since it could serve as a substitute for legal protection. "Even without strong legal institutions, large investors have the means and the incentives to monitor managers, large investors have the means and the incentives to monitor managers, though they bear the cost of undiversified risk". However, the cost here is that large shareholders may use their control rights to expropriate minority interests.

Nevertheless, there is no consensus yet as to the impact of ownership concentration on performance. In some countries, such as Austria, the Netherlands and Spain, companies with dispersed ownership perform inadequately than those with concentrated shareholdings, while in others the reverse seems to be true (Gugler 2001). On the contrary, Holderness and Sheehan (1988) find little evidence that high ownership concentration directly affects performance. The composition of ownership may also matter for performance. Institutional investors have been very active in the firm level corporate governance.

Frydman et al (1997) examined the impact of private ownership on corporate performance in the transition economies. The study reports that private ownership dramatically improves the most essential aspects of corporate performance in the countries undergoing post-communist transition. Furthermore, the study also reports that outsider-owned firms perform better than insider-owned firms on most performance measures. Jensen and Meckling (1970) suggest that agency costs can be reduced through the concentration of ownership and control within one single owner-manager. However the possibility of interplay between incentive alignment effect and entrenchment effect suggest a non-monotonic relationship between managerial stock ownership and firm value.

(c) A third mechanism through which shareholders can induce managers to behave efficiently is incentive contracts which tile managers' compensations to measures of corporate performance. This can be accomplished through performance related bonuses, stock grants and stock options. However, executive incentives pay has been criticized as being manipulated or controlled by the executive themselves. Jensen and Murphy (1990) examine the link between pay and performance for CEOs in the U.S. They argue that the conflict of interests between the shareholders and CEO represent a classic example of principal-agency problem. Agency theory predicts that compensation policy will be designed to give manager incentives to select and implement actions that increase shareholders wealth".

**(d)** Finally corporate charter and bye law provisions are an important source of governance. Federal and State laws containing provisions that establish firm level rules for a variety of areas such as shareholders voting, managers and directors liability and takeovers. State laws that provide takeover

protection may increase agency costs (Bertrand and Mullainathan 1999).

Klapper and Love (2002) examine corporate governance and performance in a sample of firms in 14 countries, most of which are developing economies. They find that better corporate governance is associated with better performance in the form of Tobin's q and Returns on Asset (ROA) and that good governance seems to matter more when the legal environment of a county provides investors with weaker protections. John and Senbet (1998) provide a comprehensive review of the Stakeholders theory of corporate governance. The main issue raised in the theory is the presence of many parties with competing interests in the affairs of the firm. They also emphasized the role of non-market mechanisms such as the size of the board, committee structure as important to firm performance. Jensen (2001) critique the stakeholders theory for assuming a single-valued objective. He proposed an extension of the theory called an enlightened stakeholder theory. However, problems relating to empirical testing of the extension have limited its relevance (Sanda et al 2003).

Although the empirical works in the general areas of corporate governance have grown considerably, not much has been documented on the being industry in Nigeria. Lack of consensus on how toe resolve the agency problem has produced a variety of mechanisms on how to deal with it, such mechanisms include: striking a balance between outside and inside directions; promotion of insider (i.e. mangers and directors) shareholding; keeping the size of the board low; and encouraging ownership concentration.

Studies on corporate governance in Nigeria include Adenikinju and Ayorinde (2001), Oyejide and Soyibo (2001), Alshi (2002) and Sanda et al (2003), Sobodu and Akiode (1998) examined managerial efficiency in the banking industry. The study focused on the managerial efficiency of the banks using Data development Analysis (DEA) approach. Managerial efficiency is measured in operating expense to total assets. There are several problems associated with the measurement of banks' operational efficiency. First, there is the problem of identifying banks' inputs and outputs. Second, though not peculiar to banking, is the existence of several heterogeneous inputs and outputs that cannot be easily compared. Besides, rates of return, instead of operational efficiency, are most often used by investors to appraise the performance of their investments.

In the study by Adenikinju and Ayorinde (2001), the implication of ownership structure and control (governance) on the performance of publicly listed companies (excluding banks) in Nigeria was investigated. Banks were excluded because that is regarded as income in the banking sector is a liability in other sectors and vice versa. Also, the study by Oyejide and Soyibo (2001) reviews and analyses the practice and the standard of corporate governance in Nigeria. Their review of the legislations on corporate governance and the analysis of its standard between 1995 and 1998 show clearly that the institutions and the legal framework for effective corporate governance exists in Nigeria. However, compliance and/ or enforcement appear to be weak of non- the other hand, investigated the efficiency of corporate governance mechanism as a means of increasing firm financial performance between 1996 and 1999, in its analysis of 93 firms quoted on the Nigerian stock exchange, the study sampled 10 banks, a figure not reprehensive of the banking industry. Its findings show that small boards perform better than large boards, although it does not state what an optimal board size should be.

The conclusion of the literature reviewed that corporate governance has been variously defined by different authors, and the relationship between corporate governance and performance is board membership is related to the degree of agency problem at a firm. Good corporate governance can mean generally better relationships with all stakeholders. This helps to improve social and labour relationships and aspects such as environmental protection.

## IV Analytical Framework

Corporate governance, as a concept, can be viewed from a narrow and broad perspective. The narrow view perceives corporate governance in terms of issues relating to shareholder protection, management control and the popular principal-agency problems of economic theory. In contrast, the broad perspective notes that issues of institutional, legal and capacity building and the rule of law are important to corporate governance. The theoretical framework upon which this study is based is the stakeholder theory, a modified version of the agency theory, which posits that in the presence of information asymmetry, the agent (in this case, the directors and managers) is likely to pursue interests that may hurt the principal or shareholder and other stakeholders (Ross, 1973; Fana, 1980; John and Senbet, 1998). Thus, corporate governance is a means by which various stakeholder exert control over a corporation by exercising certain rights as established in the existing legal and regulatory frameworks as well as corporate byelaws.

John and Senbet (1998) classify agency problems on the basis of conflicts among particular parties to the firm, such as conflicts between stockholders (principals) and management (agent) (managerial agency), between stockholders (agents) and bondholders (debt agency), between the private sector (agent) and the public sector (social agency), and even between the agents of the public sector (e.g regulations) and the rest of the society or taxpayers (political agency). They noted that agency problems detract from efficient operation of an enterprise. Departures from efficient investment strategies are detrimental to financial environment that fosters efficient corporate governance and efficient

contracting among parties with diverse interests, promotes efficient allocation of resources, and hence ultimately economic development.

The existence of agency problem is potentially harmful to the owners of the firm and may lead to inefficiency and wealth destruction in an economy. It is in the best interests of owners to resort to control mechanisms that move the operation of the firm toward full efficiency of the Fisherian principle. This approach that attempts to align the interest of managers and all stakeholders it known as the stakeholder theory. The stakeholder theory, as discussed by John and Senbet (1998), emphasizes the role of non-market mechanisms, citing as an example, the need to determine an optimal size of the board of directors especially in view of the tendency for board size to exhibit a negative correlation with firm performance. Other non-market mechanisms include the need to design a committee structure in a way that allows the setting up of specialized committees with different membership on separate critical areas of operations of the firm. Such a structure would allow, for example, the setting up of productivity-oriented committees and monitoring-oriented ones.

In an extension of the stakeholder theory, Jensen (2001) also recognizes the multiplicity of stakeholders. He agreed with John and Senbet that certain actions of management might have conflicting effects on various classes of stakeholders. This implies that the managers have multiplicity of objective functions to optimize, something that Jensen sees as an important weakness of the stakeholder theory "because it violates the proposition that a single-valued objective is a prerequisite for purposeful or rational behaviour by any organization" (Jensen 2001). In search of a single valued objective function that conforms to rationality, Jensen suggests a refinement of the stakeholder theory- the enlightened stakeholder theory. For him, the enlightened stakeholder theory offers at least two advantages.

First, unlike the earlier version with multiple objectives, the modified form of the theory proposes only one objective that managers should pursue: the maximization of long run value of the firm. If the interest of any major stakeholder were not protected the objective of long run value maximization would not be achieved. A second, related appeal of the enlightened stakeholder theory is that it offers a simple criterion to enable managers decide whether they are protecting the interests of all stakeholders: invest a dollar of the firm's resources as long as that will increase by, at least, one dollar the long term value of the firm. There is an important caveat, however – Jensen himself cautions that the criterion may be weakened by the presence of monopoly situation or externalities. Despite its appeal, Sanda et al (2003) note that the stakeholder theory of the variety proposed by Jensen has not been subjected to much empirical evaluation. At least two factors might have contributed to the gap between theory and evidence. The first concerns the prevalence of externalities and monopoly situation. The second is the problem of measurement. Jensen himself offers no clue on how to obtain an accurate measure of the long-term value of the firm, let alone offer an indication of how to assess the possible impact of an investment on that long term value.

**Model specification**

Following the studies carried out by Miyajima et al (2003), Fich and Shivdasani (2004), Magbagbeola (2005), Adenikinju (2005) and Sanda et al (2005), and based on the method of data collection and analysis, we discovered that there is similarity between their works and this study. Consequently, this forms the basis of the adoption of the analytical framework for this study. We therefore have:

$$TQ = \gamma_1 bs + \gamma_2 out + \gamma_3 drs + \gamma_4 blk + \gamma_5 aud + \gamma_6 debt + \gamma_7 size + u_t \text{ -----------------------------------(1)}$$

$$ROA = \gamma_1 bs + \gamma_2 out + \gamma_3 drs + \gamma_4 blk + \gamma_5 aud + \gamma_6 debt + \gamma_7 size + u_t \text{ -----------------------------------(2)}$$

The variable definitions are given in Table A1 in the appendix. Equations (1) and (2) are specified to capture the industrial fixed-effect and random effect while the time fixed-effect is ignored for two reasons. First, corporate governance indicators have been shows to be time invariant (Gompers et al, 2003; Core et al, 2005 and Johnson et al, 2008). Second, if at all there is a time effect in the case of Nigeria-especially due to the release of code of corporate governance by SEC-CAC in 2003 – our third objective, via the adopted methodology, would capture this effect adequately.

The data for this study were obtained from the Annual Reports of Statement of Accounts of Selected Companies and the Nigerian Stock Exchange (NSE) Factbook. The data covers the period 2002 – 2006 (5 financial years) for 62 manufacturing firms. Only firms with adequate data were included in the analysis. This period was chosen to encompasses the years before and after the release of the code of Corporate Governance in Nigeria by the Nigerian Stock Exchange (NSE) and the Corporate Affairs Commission (CAC) in 2003.

## V Empirical Analysis

We start by examining the effects of internal control mechanisms (director shareholding, board size, ownership concentration, and outside directors, block holders, independence of audit, leverage and firm size) on firm performance. The results are presented in Table3, the table shown the results obtained by regressing the governance mechanisms on an important measure of firm performance, ROA. Both director shareholding and board size show no significant relationship with return on assets.

**Table 3.** Panel Regression Result on Corporate Governance and Firm Performance

| Fixed Effect | | | | Random Effect | | | |
|---|---|---|---|---|---|---|---|
| TQ | | ROA | | TQ | | ROA | |
| Variable | Coefficient | Variable | Coefficient | Variable | Coefficient | Variable | Coefficient |
| Constant | 2.980** (2.585) | Constant | 2.843*** (4.197) | Constant | 6.583*** (3.510) | Constant | 4.731 (0.008) |
| BS | 0.142 (0.355) | BS | 2.088* (1.832) | BS | 0.275 (1.215) | BS | 2.708 (2.117) |
| OUT | -0.001*** (3.270) | OUT | -0.015 (-0.921) | OUT | 0.001 (0.218) | OUT | -0.052 (0.439) |
| DRS | -0.022*** (4.798) | DRS | -0.176** (-2.171) | DRS | -0.346** (1.980) | DRS | -0.322** (1.968) |
| BLK | 0.045*** (4.798) | BLK | 0.158*** (3.514) | BLK | 0.041** (2.085) | BLK | 0.102* (1.891) |
| AUD | -0.019*** (3.624) | AUD | -0.230*** (-6.656) | AUD | -0.007 (0.537) | AUD | -0.174 (0.548) |
| DEBT | 0.0003 (0.480) | DEBT | 0.080** (2.020) | DEBT | 0.001 (0.155) | DEBT | -2.410 (0.009) |
| SIZE | -0.109** (1.960) | SIZE | -1.163** (-2.785) | SIZE | -0.316** (4.243) | SIZE | -0.201** (2.013) |
| $R^2$ | 0.826 | $R^2$ | 0.578 | $R^2$ | 0.621 | $R^2$ | 0.668 |
| $AdjR^2$ | 0.776 | $AdjR^2$ | 0.558 | $AdjR^2$ | 0.598 | $AdjR^2$ | 0.551 |
| DW | 1.965 | DW | 1.84 | DW | 1.79 | DW | 1.70 |

Note: The fixed effect regression result contains White Heteroskedasticity-Consistent Standard Errors and Covariance; ***, **, * significance at 1%, 5%, and 10% level of significance.

From Table 3, there is a positive and significant relationship relationship between board size, block shareholders, leverage and firm size and the dependent variable Tobin's Q. For example, A 1% increase in B.S will lead to 0.14% increase in TQ while a 1% increase in BLK will lead to 0.05% increase in TQ. However, the empirical result in Table 3 reveals an inverse relationship between director's shareholdings, size, independence of the audit committee and the numbers of outside directors on board. A similar result however emerged when the return on asset (ROA) was used as the dependent variable as presented in Table 3. The result supports the existence of the positive relationship between board size, block holders, leverage and return on asset. However, there was a negative relationship between the number of outside directors on board, director's shareholdings, independence of the audit committee and the return on asset.

However, our result did not support Adenikinju and Ayorinde (2001), who found no significant relationship between firm performance and insider ownership in Nigeria. Perhaps, the conflicting results could be due to the differences in the methods used in measuring some of the variables as well as the sample size. For example, in computing directors shareholdings, we included only the shareholding of directors while they included those of directors and all other staff of the firms. Inadequate data did allow us to do this. The results of the random effects model is presented in Table 3. The result in Table 5 reveals a positive relationship between board size, number of outside directors, block holders, leverage and the Tobin's Q measure of firm performance. However, there is a negative effect of director's shareholding and independence of the audit committee and the Tobin's Q. However, using the return on asset as a measure of firm performance, we found a positive relationship between board size and block holders and the dependent variable. In addition, a negative relationship was reported in the case of number of outside directors, director's shareholding, independence of the audit committee, leverage and firm size and the return on asset.

Taking a synopsis of this result, both the fixed effect and random effect models reveals that there is a mixed result with result to the performance of some of the governance variables. Contrary to studies by Jensen (1993), Lipton and Lorsch (1992), Yemarck (1996), this study show that the larger the size of the board (BS), the better the Tobin's q. This explains the view that larger boards have better corporate performance because members have a range of expertise to help make better decisions, and that it is difficult for the chief executive officer (CEO) to influence the decision of the board. The board size is highly significant in explaining Tobin's q for firms in Nigeria.

Similar to the board size, the board composition (OUT) has a negative relationship with Tobin's q implying that when there are more external board members, performance of the firm tends to be worse. This contradicts the empirical study of Brickley and James (1987) that outside directors support the beneficial monitoring and advisory functions to firm shareholders. However, this is consistent with findings by Agrawal and Knoeber (1996) who suggest that boards expanded for political reasons often result in to many outsiders on the board, which does not help performance. It must rather be indicated that this variable is not significant.

Our results also show that leverage has significant positive influence on firm performance, indicating the tendency for firms with higher levels of debt as a proportion of equity to perform better, a finding that is consistent with the literature. We also found that the concentration ratio has negative impact on performance, therefore the directors shareholding can improve on their effort in order to exert positive impact on performance. These seemingly contradictory finding seems to suggest that concentration ratio is positively related to performance up to a point beyond which it has a negative impact. In other words, excessively high concentration may lead few shareholders to use their positions to benefit only themselves. The policy implication flowing from this finding is self evident. Firms must motivate their chief executive officers (CEOs) in order to encourage them to deliver good returns on the shareholders' investments. It is also imperative that the salary and other perks attached to the position of the CEO if tied to performance indices will be a useful tool in the hands of shareholders/stakeholders in ensuring greater overall company performance.

## VI. Summary and Conclusion

There has been a renewed interest within academic circles as well as amongst policy makers in both government and industry on the need to strengthen mechanisms to ensure that managers and directors take measures to protect the interest of a firm's stakeholders. The events at Enron and other cases of spectacular failure have helped to bring to the limelight the important role that the strengthening of governance mechanisms could play to improve firm performance. This study made use of panel data regression analysis between 2002 and 2006 for a sample of 62 firms listed on the Nigerian Stock Exchange to examine the relationship between internal governance mechanisms and firm financial performance. The results have the implication that regulatory agencies should encourage firms to achieve a reasonable board size since overly large boards may be detrimental to the firm.

The results of the study point to the need for a reasonable number of individuals and/or corporate bodies with more than a typical share of equity of the firm as this will encourage them to undertake the monitoring process. Unlike the findings in developed countries, our results show no significant evidence to

support the idea that outside directors help promote firm performance. This suggests the need for the regulatory authorities to reassess the procedures for the appointment of outside directors in order to remove the influence of CEOs from the appointment process. In addition, the study found that the measure of performance matter for analysis of corporate governance studies. We found in some cases different results from the use of Returns on Assets (ROA) and Tobin's Q as measures of firm performance. Furthermore, we also found the type of governance environment a firm operates also has implications for its overall performance, as well as on the directional and quantitative impact of managerial characteristics on firm performance.

In spite of the findings in this study, there are many issues in corporate governance in Nigeria that remain unresolved. The dearth and poor quality of data continue to be a major constraint in a comprehensive study of corporate governance in Nigeria. It is common knowledge that there are some margins of error in Nigeria statistics. However, it should be noted that the main general trends and findings that have been disclosed in this study are so pronounced that potential data biases have to be very large indeed to reverse them. Nevertheless, data on some specific variables that would have made the study more interesting were unavailable. A number of points could be classified by further work, which could give greater specificity to policy guidelines. The sample itself was determined by data availability, not by a probability criterion.

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## Appendix

Table A1: Variables Definitions

| | Variable | Definitions | Measurement |
|---|---|---|---|
| Dependent variables | TQ | Tobin's Q | Market Value of common equity plus book value of liabilities, divided by the book value of total assets |
| | ROA | Returns on Assets | Net profit as percent of total assets |
| | | | |
| Independent variables | BS | Board Size | Number of executive directors |
| | OUT | Number of outside directors on board | Proportion of outside directors sitting on boards |
| | DRS | Director's Shareholding | Percent of total shares owned by the directors |
| | BLK | Block Holders | Percent of shares held by the largest shareholders |
| | AUD | Independence of the Audit Committee | Percent of independent members of audit committee |
| | DEBT | Leverage | The ratio of debt to share capital |
| | SIZE | Firm size | Total Assets owned |