IMPACT OF INTERNAL GOVERNANCE MECHANISMS ON CORPORATE PERFORMANCE IN DEPOSIT MONEY BANKS IN NIGERIA

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ABSTRACT

The importance of internal mechanism in corporate organisations is vital for deliberate effort to be placed in this area of financial institutions. Sequel to this, this study examines the relationship between the internal corporate governance mechanisms related to the board of directors, the audit committee characteristics and the performance of listed Deposit Money Banks (DMBs) in Nigeria. The study covers the period of seven years (2005-2011), with the population of seventeen (17), a sample of fourteen (14) DMBs. Multiple regression is employed as a tool of analysis on the data which are extracted from the annual reports of the sampled DMBs. The results indicate that board characteristics and audit committee characteristics are essential factors of internal control mechanism sequel to the fact that both board and audit committee characteristics have significantly influenced DMBs performance during the period of the study (Board composition (BC), Audit committee activities/meetings (ACA)and Audit committee independence (ACI) have a significant and positive impact on performance while Board size (BZ) has a negative but significant impact on performance of DMBs. Consequently, we recommend, among others, that management/shareholders in the Nigerian DMBs to consider these board and audit committee characteristics (using these variables of the study) as benchmark of embarking on enhancing performance. As a matter of policy input, regulatory authorities such as CBN, NDIC, SEC, NSE and other stake holders of concern should strengthen and ensure compliance with best internal governance practices. Ensuring adequate compliance will boost the level of firms' performance and thereby improving the overall trust and confidence of stakeholders in the financial sector

Keywords: *Board Composition, Board Size, Audit Committee Activities, Audit committee Independence and corporate performance*

1. Introduction

Many studies have looked at the corporate governance and firm performance but there is still no consensus in their finding. One of the reasons for the awakening of corporate governance issues is because the separation of ownership and control. Besides, the asymmetric of information has introduced the conflicts between the principal and agent as they have a different self interest which may lead to the misuse of the corporate assets. To limit the conflicts and costs of the agency, various internal and external mechanisms have been suggested through the code of corporate governance.

The awake of recent accounting and auditing scandals throughout the world, the issue of audit firm versus firm performance has become the subject of debate among politicians, business leaders, and regulators. Corporate scandals such as Enron, Global Crossing, Tyco, and World Com to mention but a few, have shaken the investors' confidence and made it difficult for companies to raise equity from the stock market (Agrawal, 2005). In commenting on these scandals, many reports believed that the board of directors and its committees do not have a good supervision on the management. For example, Enron manipulated its financial statements through off-balance sheet financing. Therefore, the board was unable to disclose the distorted statements because the board lacked of independence from senior executives (Deakin and Konzelmann, 2004). Moreover, World Com materially overstated its earnings and finally filed for bankruptcy. The investigation showed that the audit committee failed to effectively oversee the managers' duties (Weiss, 2005).

As a result, these well-publicized corporate scandals together with the Asian financial crisis in 1997 have highlighted the importance of good corporate governance practices for the long-term survival of companies (Mokhtarul, Joher & Ahmed, 2009). In Saudi Arabia, their Stock Market also faced an extraordinary crash at the beginning of 2006, which leads the Capital Market Authority to suspend the trading of two firms. This became more topical after the simultaneous sack of eight banks chief executive officers by the governor of Central Bank of Nigeria in 2009 and the imposition of external auditors rotation after ten years of engagement by the apex bank. These events created a serious question about the effectiveness of different monitoring devices that were presumed to protect investors' interests in Nigeria. Based on the premises of the agency theory, Jensen and Meckling (1976) and Shleifer and Vishny (1986) pointed out that there is likelihood of principal-agent conflicts when management roles are separated from ownership roles, coupled with the existence of information asymmetric. They asserted that this is due to the improper use of corporate assets arising from manager's self interest satisfaction in pursuing projects that are very risky but not prudent with the adverse consequences on the providers of the capital.

The audit committee is one of the committees that is established by the board of directors and whose major responsibility has to do with financial reporting. Apart from the benefit that is gained from the audit committee establishment, previous studies suggested that the size, composition, expertise and meeting frequency of audit committees may impact their monitoring effectiveness (DeZoort, Hermanson, Archambeault, and Reed,; Walker, 2004). Therefore, different internal and external mechanisms have been considered via corporate governance to prevent agency conflicts as well as reducing costs associated with such agency.

This paper focuses on internal governance mechanisms (board size, board composition, audit committee activities/meetings and audit committee independence) and corporate performance principally within the context of listed DMBs in Nigeria. The findings of this research are expected to contribute to existing body of knowledge. Management and practicing auditors in Nigeria are anticipated to become more informed of the intricacies surrounding board and audit committee characteristics. The academic community will also benefit enormously from the outcome of this research.

Sound internal mechanisms can only be in place when the parties concerned in the running of the firm efficiently and objectively amongst others perform their duties. This study examines the relationship between board and audit committee characteristics on firm performance. The remainder of the paper has the following organization: Section 2 reviews empirical work of previous research and formulates hypothesis; Section 3 describes the research methodology; Section 4 reports and analyses the empirical results; Section 5 summarises and concludes.

2. Literature Review

Board Composition and Firm Performance

Boards mostly compose of executive and non-executive directors. Executive directors refer to dependent directors and non-Executive directors to independent directors (Shah, Butt, & Saeed, 2011). At least one third of independent directors are preferred in board, for effective working of board and for unbiased monitoring. Dependent directors are also important because they have insider knowledge of the organization which is not available to outside directors, but they can misuse this knowledge by transferring wealth of other stockholders to themselves (Beasly, 1996). According to Jensen and Meckling (1976), boards dominated by outsiders or NEDs may help to mitigate the agency problem by monitoring and controlling the opportunistic behavior of management.

The results of previous studies that investigated the relationship between board composition and firm performance are inconsistent. Rhoades, Rechner, Sundaramurthy, (2000),Dehaene, De Vuyst, Ooghe, (2001), and Omar (2003) found that non executive director has a positive relationship with financial performance. For example, Limpaphayom and Connelly (2006), Lefort and Urzúa (2008) also found a positive relationship between board composition (the proportion of independent directors on the board) and firm performance. Hasnah (2009) showed that non executive director is significantly related to firm performance that is measured by ROA.

On the other hand, Coles, McWilliams, Sen, (2001) demonstrated that there is a negative impact of outside directors on firm performance. Erickson, J., Park, Y., Reising, J., Shin, H. (2005), also found a negative relationship between greater board independence and firm value. However, Bhagat and Black (2002) and De Andres et al. (2005) found no significant relationship between the composition of the board and the value of the firm.

Board Size and Firm Performance

Board size is believed to be the basic aspect of the effective decision making. Vafeas (2005) suggested that the board size and its performance had a non-linear relationship. Both too small and too large of the board size is likely to make it ineffective. Jensen (1993), confirmed that the smaller board size is more correlated with the quality of monitoring. Lipton and Lorsch (1992) recommended that the ideal board size should not exceed eight or nine directors.

Jensen (1993) claimed that when the board is more than seven or eight members, it is less effective because of the coordination and process problem, which in turn adds to weak monitoring. Although average board size is comparatively large, previous studies have shown that small boards are more effective because the directors can communicate better among them, as well as easy to manage these factors promote a more resourceful conversation. For example, studies of the board size and corporate performance have indicated that small boards are linked with higher market values. Yermark (1996) documented a negative relationship between board size and firm value. Drawing from Yermark’s study, Eisenberg, Sundgren, and Wells, (1998) provided a similar conclusion on the board size and the firm value in a sample of small and mid-size Finnish firms.

Empirical evidence on the relationship between board size and firm performance provided mixed results .While, Ahmadu, Aminu, and Taker, (2005), De Andres, Azofra, Lopez,(2005), Mustafa (2006) and Chan and Li (2008), found that larger boards are associated with poorer performance, Beiner, Drobetz, Schmid, Zimmermann, (2004); Bhagat and Black (2002) and Limpaphayom and Connelly (2006) found no significant association between board size and firm performance.

Independence of Audit Committee and Firm Performance

The empirical result of the relationship between audit committee independence and firm performance is ambiguous. Chan and Li (2008) found that independence of the audit committee (i.e., To have at least 50 percent of expert-independent directors serve on audit committee) positively impacts the firm performance as measured by (Tobin's Q). Similarly, Ilona, (2008) showed that there is a positive relationship between audit committee independence and firm performance as measured by ROA.

Moreover, Erickson, Park, Reising, Shin, (2005), asserted that independent directors can reduce agency problems. Based on the argument provided by Erickson et al. (2005) that directors' independence can reduce the agency problem, it can similarly argue that independent audit committee can also reduce the agency problems. In other words a positive relationship between audit committee independence and firm performance is expected and justified.

Agency theory suggested that the independence of a non-executive director is a crucial quality that contributes to the effectiveness of audit committee monitoring function (Fama & Jensen, 1983). Some studies suggested that independent audit committees are less likely to be associated with financial statement fraud (Abbott, Parker, Peters, & Raghunandan, (2003); Abbott, Parker, Peters, 2004) and more likely to be associated with lower earnings management (Bedard, Chtourou, and Courteau, (2004); Davidson, Xie, and Xu, (2004); Klein, 2002; Xie, Davidson, DaDalt, 2003) and a lower incidence of earning restatement (Agrawal & Chadha, 2005). This is because independent audit committee is able to provide unbiased assessment and judgment and able to monitor management effectively.

Furthermore, Carcello and Neal (2000) suggested that the firms with a higher percentage of independent audit committees are less likely to receive a going-concern audit opinion from the auditors. Additionally, Carcello and Neal (2003) pointed out that independent audit committees are more effective in protecting auditors from dismissal following the going-concern audit report issuance. Abbott and Parker (2000) and Chen, Moroney, & Houghton, (2005), suggested that having a higher proportion of independent non-executive directors in audit committees increases the tendency to assign industry-specialist auditors. In summary, all of these studies suggested that independent audit committees are associated with lower earnings management because they can be regarded as effective monitors

Audit committee activity/meeting and Firm Performance

The numbers of audit committee meeting are considered to be an important attribute for their monitoring effectiveness (Lin, Li, and Yang, 2006). Anderson, Mansi, Reeb, (2004) noted that audit committee monitors the internal control and provides reliable information to the shareholders. Therefore, audit committee strengthens the internal auditing function and oversees management's assessment of business risk (Hsu, 2007).

The number of audit committee meetings is considered as a proxy for audit committee activity (Xie et al. 2003). Therefore, the audit committee that meets more frequently with the internal auditors is better informed about auditing and accounting issues. When an important auditing or accounting issue arises, the audit committee can direct the proper level of internal audit function to address the problem promptly. Therefore, an audit committee that meets frequently can reduce the possibility of financial fraud (Raghunandan, Rama, Scarbrough, 1998; Abbott, Parker, Peters, 2004). Inactive audit committees with fewer numbers of meetings are unlikely to supervise management effectively (Menon and Williams, 1994). Beasley, Carcello, Hermanson, Lapides, (2000), found that fraudulent firms with earning misstatements have fewer audit committee meetings than non-fraud firms. An active audit committee with more meetings has more time to oversee the financial reporting process, identify management risk and monitor internal controls. As a result, firm performance increases with audit committee activity. More importantly, there have been very few studies that examined the effect of audit committee meeting on firm performance. For example, Hsu (2007) found that there is a positive relationship between audit committee meeting and firm performance.

Previous studies suggested that firms with the higher number of audit committee meetings experience less financial restatement (Abbott et al., 2004), are less likely to be sanctioned for fraud as well as aggressive accounting (Abbott et al., 2000; Beasley et al., 2000) and are associated with lower earnings management incidence (Xie et al., 2003). These studies suggested that audit committees that meet regularly during the financial year are associated with effective monitoring. The more frequent they meet, the more efficient they discharge their oversight responsibilities.

Theoretical Framework

There are several theories that explain the relationship between board characteristics, audit committee characteristics and firms' performance in the literature of accounting. Few of these theories that are related to the study are namely stewardship theory, stakeholders' theory, agency theory and resource base theory. However for the purpose of this study agency theory will be preferred. This theory can be used to explain the impact of board characteristics, audit committee characteristics on firm performance.

The Agency theory view directors as the agent of the shareholders and therefore there is a need for them to act in the best interest of the shareholders. In this situation, sometimes the agent may not act in the best interest of the shareholders which result in an agency loss situation. The agency theory stress the separation of ownership (principal) and managers (agent) in an organization, therefore it is believed that managers may sometimes pursue opportunistic behaviour which may conflict with the goal of the owners (principals) and therefore destroy the wealth of the shareholders. Advocates of the agency approach view the manager (directors) as an economic institution that will mitigate the problems and serves as the guardian to shareholders (Hermalin and Weisbach 2000, Fama and Jessen 1988).

This study adopts agency theory due to its relevance in resolving conflict that may arise between managers (agent) and shareholders (principal) of the companies, its empirical evidence by the study conducted by several scholars on board and audit characteristics and firm performance in developed countries, will link the variables concern in the Nigerian situation. Key postulations of agency theory serve as the bases for the adoption.

3. METHODOLOGY

This research has adopted correlational research design. While the hypotheses used information obtained from historical data documented in the Nigeria Stock Exchange (NSE) published fact book, published annual reports and accounts of those firms under studied, the variables of study were not controlled since the phenomenon of the study has already occurred. This design is considered appropriate for determining the impact of board and audit committee characteristics on the performance of deposit money banks (DMBs) in Nigeria.

This study is limited to only deposit money banks in the financial sector. The population of the study therefore consists of all the seventeen (17) quoted deposit money banks operating in Nigeria as at 31st December 2011. The period of the study is seven years (2005 -2011) both years inclusive. The sample size is fourteen out of seventeen representing about eighty two percent of the population.

For the purpose of this study, secondary data were obtained from the annual reports and accounts of the sampled deposit money banks and NSE Fact Book of 2011 in order to achieve the objectives of this study. However, this study differs from most of the previous studies for the fact that it focuses primarily on board characteristics and audit committee's characteristics and their impact on the performance of DMBs in Nigeria. With this, it is hoped that the findings of this study will trigger more researches in this area.

Model Specification:

$ROA_{it} = f(\beta_1 BCOMP_{it,} \beta_2 BSZE_{it}, \beta_3 ACAM_{it}, \beta_4 ACIN_{it})$

$ROA_{it} = \beta_0 + \beta_1 BCOMP_{it,} \beta_2 BSZE_{it}, \beta_3 ACAM_{it}, \beta_4 ACIN_{it} + e_{it}$

Where;

ROA = Return on Assets
BCOMP = Board Composition
BSZE = Board Size
ACAM = Audit Committee Activity
ACIN = Audit Committee Independence
e = error term
i,t = firm i, time t
$\beta_0 - \beta_4$ = parameters

The model is specified on an empirical framework using the mechanisms mentioned for this study to investigate the impact of internal governance mechanisms on the performance DMBs in Nigeria. This research, considered linear regression model, hence, the assumptions of this model is well regarded. The integrity of regression assumptions can be determined by considering residuals distribution and its relationships with other variables. Residuals include the difference between the observed values of a dependent variable and the predicted values by regression line. In regression analysis considering linearity, normality, stability of variance and independence of observations is of vital importance. In this research, these assumptions were considered, but not mentioned here for brevity.

4. Discussion of Results

The results of the regression analysis are considered in this section. Mean as a measure of central tendency was used in averaging the data to suit the model specification of the study. In the model specification, performance which is proxied by return on asset (ROA), serves as the dependent variable, while board composition (BCOMP), board size (BSZE), audit committee activity/meeting (ACAM), and audit committee independence (ACIN) as the independent variables for the regression equation.

Table 1: Descriptive Statistics

	Mean	**Std. Deviation**	**Skewness**	**Kurtosis**
ROA	0.0095	0.05158	-7.469	5.185
BCOMP	0.3520	0.16450	-0.516	-0.958
BSZE	3.6122	3.11178	-0.179	0.283
ACAM	4.2857	0.96324	0.384	-0.750
ACIN	2.5818	0.25211	-0.948	0.923

Source: Output of data analysis by author 2013 using SPSS

Table 1 indicates that audit committee activity/meeting has the highest mean of 4.2857, which implies that the audit committee activity has significantly contributed the firm performance. On the other hand board composition contributes less to the firm performance, with the mean of 0.3520. The standard deviation of board size is 3.11178 and auditor committee activity is 0.96324, that of the audit committee independence is 0.25211 and board composition is 0.16450. The result of skewness ranges between -0.948 and .384 whereas the result of the Kurtosis is in the range of -0.958 and 0.923.

Table 2: Correlation Matrix

	ROA	BCOMP	BSZE	ACAM	ACIN
ROA	1				
BCOMP	.266***	1			
BSZE	.652***	-.310***	1		
ACAM	.623***	-.658***	-.542***	1	
ACIN	.317***	-.785***	-.461***	-.643***	1

Source: Output of data analysis by author 2013 using SPSS
The symbol * and ** represents 1% and 5% respectively**

Table 2 reports the correlation coefficients of the variables. The result shows that the independent variables board size, board composition, audit committee activity/meeting and audit committee independence have positive correlation with the dependent variable (ROA). This indicates that an increase in the board size, board composition, audit committee activity/meeting and audit committee will also increase the bank performance. The correlation matrix also reveals that all the independent variables are not significantly related, which reveals an absence of multicollinearity problem.

Table 3: Summary of Regression Result

Variables	Coefficient	T-Stat	P-value	VIF	T-value
Constant	0.619	3.700	0.000		
BCOMP	-0.227	-2.875	0.005	1.925	0.829
BSZE	0.328	3.452	0.001	1.472	0.679
ACAM	0.202	2.493	0.007	1.445	0.692
ACIN	0.382	3.420	0.001	1.779	0.830
Adj R^2	0.585				
F- Stat	89.123				
F- sig	0.001				
Durbin Watson	2.009				

Source: Output of data analysis by author 2013 using SPSS

ROA = 0.619+0.227(BCOMP)-0.328(BSZE)+ 0.202(ACAM)+ 0.382(ACIN)

We first hypothesized that, board composition has no significant impact on firm performance. The coefficient of the regression results is .227, which implies that for every 1% increment of board composition firm performance will improve by about 23% and the t-statistics of 2.875 which is significant at 1% (See Table 3). This signifies that, board composition positively contributes, with a strong effect on the management efforts towards the performance of Nigerian money deposit banks. The implication is that, the more independent directors on the board the better the ROE. The significance level of 1% produces an evidence of rejecting hypothesis two of the study. This result is in line with Rhoades et al. (2000), Dehaena et al. (2001), Bhagat and Black (2002), Omar (2003), De Andres et al. (2005), Limpaphayom and Connelly (2006), Lefort and Urzúa (2008), and Hasnah (2009) found that NED has a positive relationship with financial performance. Unlike the findings of Coles et al. (2001) and Erickson et al. (2005) who found a negative relationship between board composition and firm value.

Secondly, we hypothesized that board size has no significant impact on firm performance. The regression results reveal that, the coefficient with regards to board size is -0.328, which implies that for every 1% increment of the board size, firm performance will reduce by about 32% and the t-statistics of -3.452 which is significant at 1% (See Table 3). The implication is that, the larger the board size it will not increase firm performance and thereby affecting the confidence of stakeholders. The significance level of 1% produces an evidence of failing to reject hypothesis one of the study. This result supports the findings of studies carried out by Ahmadu et al. (2005), Chan and Li (2008), De Andres et al. (2005) and Mustafa (2006) found that larger boards are associated with poorer performance, Beiner et al. (2004), Bhagat and Black (2002) and Limpaphayom and Connelly (2006) found no significant association between board size and firm performance. But contrary to the finding of Jensen (1993) confirmed that the smaller board size is more correlated with the quality of monitoring. Lipton and Lorsch (1992) also stated that the board might become less effective in monitoring management when its size increases.

Moreover, it has been hypothesized that audit committee activity has no significant impact on the performance DMBs in Nigeria. It can be observed that the coefficient of audit committee activity reveals a positive value of 0.202, the t-statistics of 2.493 and statistically significant at 1% (see table 3). This implies that, for every 1% increment in audit committee activities firms' performance will increase by about 13% in terms of the quality of financial reporting. This signifies that, audit committee activities have a positive impact on the management efforts towards increasing performance in DMBs Nigeria. Implying that, at1% level of significance produces evidence to rejecting hypothesis three of the study. Our findings support the research conducted by Menon and Williams,(1994), Raghunandan et al., (1998), Beasley et al. (2000), Xie et al. (2003) Abbott et al., (2004), Anderson et al. (2004), (Lin, Li, and Yang, 2006) and Hsu (2007) noted that audit committee monitors the internal control and provides reliable information to the shareholders and have a positive relation with firm performance. However, our result contradicts the findings of Beasley et al., (2000) and Abbott et al.(2000).

Again, it has been hypothesized that audit committee independence has no significant impact on the performance DMBs in Nigeria. It can be observed that the coefficient of audit committee activity reveals a positive value of 0.382, the t-statistics of 3.420 and statistically significant at 1% (see table 3). This implies that, for every 1% increment in audit committee independence firms' performance will increase by about 2.517. This signifies that, audit committee independence have a positive impact on the management efforts towards increasing performance in DMBs Nigeria. Implying that, at1% level of significance produces evidence to rejecting hypothesis four of the study. Our result confirms the findings of Fama & Jensen, (1983) Abbott et al., (2000); Klein, 2002; Xie et al., (2003); Abbott et al., (2004) Bédard et al., (2004); Davidson et al., (2005), Agrawal & Chadha, (2005), Erickson et al. (2005) Chan and Li (2008). This is because independent audit committee is able to provide unbiased assessment and judgment and able to monitor management effectively. But Carcello and Neal (2000), Abbott and Parker (2000), Carcello and Neal (2003) and Chen et al. (2005) suggested that having a higher proportion of independent non-executive directors in audit committees increases the tendency to assign industry-specialist auditors.

The collective effect of all the exogenous variables put together is able to explain the dependent variable about 59% as indicated by the adjusted R^2 and remaining 41% is controlled by other factors. Similarly, the result of the F- statistic value of 89.123 implies that the model is well fitted and significant at

1%. This provides evidence that the model fits the data well and the joint effect of the explanatory variables is statistically significant in explaining the dependent variable. The Durbin- Watson of 2.009 indicates a tolerable serial correlation within the period of the study. The tolerance value and the variance inflation factor (VIF) are two advanced measures of assessing multicollinearity between the independent valuables of the study. In table 3, the variance inflation factors were consistently smaller than ten indicating complete absence of harmful multicollinearity (eg Neter, Wasserman, and Kutner, 1996). This shows the appropriateness of fitting the model of the study with the four independent variables. In addition, the tolerance values are consistently smaller than 1.00 thus, further substantiating the fact that there is absence of harmful multicollinearity among the independent variables (Tobachmel and Fidell, 1996).

5. Conclusion and Recommendations

The thrust of the paper is to find out the extent to which selected board and audit characteristics (board size, board composition, audit committee activities/meetings and audit committee independence) impact firm performance in Nigerian money deposit banks. The results show a significant positive, impact on board composition, audit committee activities/meetings and audit committee independence on firm's performance respectively, except board size which have a negative but significant impact on firm's performance. This led to the conclusion that the possibility of a high performance in firms is the function of its board and audit characteristics. In other words, stringent application of board and audit characteristics will enhance the financial performance in the Nigerian money deposit banks.

However, aligning with the findings and conclusions of this study, we recommend that deposit money banks in the financial sector of the Nigerian economy to consider these boards and audit characteristics (using these variables of the study) as yardstick in embarking on sound internal governance which will reflect in their firms performance. As a matter of policy input, regulatory authorities such as CBN, NDIC, SEC, NSE and other stake holders of concern should strengthen and ensure compliance with best internal governance practices. Ensuring adequate compliance will boost the level of firms' performance and thereby improving the overall trust and confidence of stakeholders in the financial sector.

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Table 4: Variables Description

Dependent Variables	**Acronym**	**Measurement**
Return on equity	ROE	$\frac{\text{PAT}-\text{Preference Share Dividend x100}}{\text{Ordinary Shares Capital + Reserves}}$
Independent Variables		
Board composition	BC	The proportion of non-executive directors to total number of directors on the board.
Board size	BZ	Total number of directors on the board.
Audit committee activity	ACA	The number of audit committee meetings held in a year 2010.
Audit committee independence	ACI	The proportion of independent directors on the audit committee.