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Telephone: 08058177360
E-mail: angoaliyu76@yahoo.com

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EFFECT OF CORPORATE GOVERNANCE ON FINANCIALS OF MANUFACTURING COMPANIES IN NIGERIA

Kasum, Abubakar Sadiq¹

Fafeyiwa, Olajumoke Oluwafeyikemi¹

Nassar, Mashood Lanre²

Salman, Ramat Titilayo¹

1) Department of Accounting, University of Ilorin, Ilorin Nigeria

2) Department of Management & Accounting, Obafemi Awolowo University, Ile-Ife Nigeria

ABSTRACT

The nature and extent of accountability to people who have pulled their resources together to invest in a business and the mechanisms that try to decrease the principal agent problem is the subject matter of corporate governance. Corporate governance builds credibility, assure transparency to maintain accurate disclosure of facts and figures and brings about corporate accountability that results to improved overall performance of the firm. This study examined the effect of corporate governance mechanisms on firm performance and other key financials using manufacturing firms in Nigeria as case study. The study was for a period of eleven (11) years from 2004 to 2014. The study obtained data from the library of Securities and Exchange Commission (SEC and the case study companies' websites. A total of ten (10) manufacturing firms were selected for the study. In analyzing data collected, the study took advantage of both descriptive and inferential statistical tools. The study used panel data regression technique with a choice between Fixed Effect Model (FEM) and Random Effect Model (REM) i. e. (Error Component Model) estimation technique using Hausman test. The result of the study showed that the corporate governance mechanism have significant influence on firm's financials at 5% level of significance with $R^2 = 0.3583, 0.4162, 0.3308, 0.7419$ and 0.3425 respectively and $p\text{-value} = 0.000, 0.000, 0.022, 0.000$ and 0.000 respectively. The study therefore recommended that the necessary institutional and legal system to enforce compliance must be put in place for good corporate governance to have a meaningful impact in Nigeria.

Keywords: Corporate Governance; Company Financials; Performance; Owners' Equity; Company Assets; Manufacturing Companies

INTRODUCTION

Corporate governance has attracted a good deal of public interest in recent years because of its apparent importance to the economic health of corporations and the society in general as it ensures accountability, transparency and fairness in reporting.

Corporate governance involves a system of running an organization in a way that guarantees that its owners or shareholders receive a fair return on their investment, while the expectations of other stakeholders are also met. It addresses the need for organizational stewards or managers to act in the best interest of the firm's core stakeholders, particularly, minority shareholders or investors, by ensuring that only actions that facilitate delivery of optimum returns and other

favourable outcomes are taken at all times. Corporate governance is considered to have significant impact on the growth and development of an economy (Alalade, Onadeko and Okezie, 2014). Sound corporate governance practices leads the economy towards the achievement of higher performance, provide sources for capital investment by increasing the creditability of shareholders (Jenkinson and Mayer, 2012).

Corporate governance emerged as a critical business issue in the world stage as a result of high profile corporate failures (Sternberg, 1997). The prominent corporate accounting scandals of Enron Corporation, World Com, and Satyam have led to contemporary discussion on the best mechanisms for protecting stakeholder's interest and ensuring shareholders wealth maximization. Also, in Nigeria the emphasis on the need for corporate governance reform sprung up with the incidence of fraudulent financial reporting as reported in the case of Cadbury Nigeria Plc, Afribank Nigeria Plc, and improper management as in the case of Rizonpalm Limited and Unizon Limited.

The collapse of corporate organizations in Nigeria and around the world has put the credibility of organization's corporate image in doubt. The loss of confidence by the investors on the operations of organization, the conflicting interest of the stakeholders with that of the firm and the persistent agency problem as a result of financial improprieties has posed a lot of problems (Mayer, 2007). The financial scandals and the collapse of major corporate institutions around the world such as USA, South East Asia, Europe and Nigeria have shaken investors' faith in the capital markets. It has also casted doubt on the efficacy of existing corporate governance practices in promoting transparency and accountability and as such, organizations during the course of conducting their businesses contend with different parties such as providers of capital, communities, competitors, employees, suppliers, customers and government and its regulators; all with interests often at conflict with those of the firm (Wessels and Wansbeek, 2014). The shares of the listed companies on the Nigerian Stock Exchange (NSE) are gradually declining. Shareholders have lost interest in trading on the stock exchange because of the crash in share prices just as in the case of Afribank Nigeria Plc. and Cadbury Nigeria Plc. when these companies overstated their earnings and shares thereby misleading their shareholders (Stephen and Benjamin, 2013). All these are fundamental corporate governance issues that have impacted on the organizations and their stakeholders and it is in the light of these that this study investigate the effects of corporate governance on company financials of manufacturing firms in Nigeria. The study specifically:

- evaluate the effect corporate governance has on profitability of Nigeria manufacturing companies;
- evaluate the effect of corporate governance on return on assets of Nigeria manufacturing companies;
- examine the extent to which corporate governance affect return on equity of Nigeria manufacturing companies;
- examine the extent to which corporate governance affect business assets of Nigeria manufacturing companies; and
- evaluate the extent to which corporate governance influence value of equity of Nigeria manufacturing companies.

Hypotheses of the Study

The following hypotheses are tested to be able to achieve study objectives:

- Corporate governance does not affect profitability in the Nigeria manufacturing sector
- Corporate governance does not affect return on assets of Nigeria manufacturing companies
- Corporate governance does not affect return on equity of Nigeria manufacturing companies
- Corporate governance does not affect business assets of Nigeria manufacturing companies
- Corporate governance does not affect the value of equity of Nigeria manufacturing companies

LITERATURE REVIEW

2.1 Conceptual Framework

2.1.1 Corporate Governance

Corporate governance is about how an organization is directed and controlled. It is also about structures and monitoring effective management of an organization, including mechanisms that ensure legal compliance and prevent improper or unlawful behaviour. (Meredith and Reid, 2005). Corporate governance ensures putting in place the structure, processes and mechanisms that a firm is being directed and managed in a way that enhances long term shareholder value through accountability of managers and enhancing organizational performance.

Organization for Economic Cooperation and Development (OECD) takes a broad view of corporate governance and defines it as the full set of relationships among a company's management, its board, its shareholders and other stakeholders. It provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring the performance. (OECD, 2004).

Corporate governance refers to the procedures and mechanisms which direct the business and which leads the firms towards corporate performance that ultimately bring enhancement in the value of shareholders equity and their accountability (Jenkinson and Mayer, 2012). Corporate governance builds the credibility, assures transparency to maintain accurate disclosure of financial figures and brings the corporate accountability that result to improve the overall performance of firm. An important subject of corporate governance is the nature and extent of accountability of people in the business and mechanisms that try to decrease the principal agent problem (Babalola and Adedipe, 2014).

Corporate governance in the manufacturing sector requires judicious and prudent management of resources and the preservation of resources (assets) of the corporate firm, ensuring ethical professional standards and the pursuit of corporate objectives, it seeks to ensure customer satisfaction, high employee morale and the maintenance of market discipline, which strengthens and stabilizes the organization.

Characteristics of Corporate Governance

Stan (2012) discussed seven characteristics of good corporate governance to include **strategy** that is, a good corporate governance starts with a clear strategy for the organization which helps in creating a product line to meet the needs of the market. Others are **effective management**, which must be in place in order to cope with operations and economy fluctuations that might erode the buying capabilities of the target market; **discipline** in order to mobilize

workforce to implement the strategy, if not initiative will fail, **fairness** to customers, both for ethical and public relations reasons, **transparency**, **social responsibility** which identifies ways to improve company practices and also promotes social goal by reinvesting in the local community and **self-evaluation** which is done through employees and customer surveys to provide feedback about the effectiveness of current policies or by hiring outside consultants to analyze your operations, which helps in identifying ways of improving company's efficiency and performance.

Principles of Corporate Governance

The OECD Principles of Corporate Governance were endorsed in 2004 to respond to corporate governance developments including corporate scandals that further focused the minds of governments on improving corporate governance practices. The main area covered by the OECD principles includes **respecting the rights and ensuring equitable treatment of shareholders** by organizations through effective communication of information that is understandable and encouraging shareholders to participate at general meetings, having the **interests of other stakeholders** recognizing that they have legal and other obligations to all legitimate stakeholders, i.e. employees, customers government etc., board members should align themselves with roles and responsibility in order to deal with various business issues and the ability to review and challenge management performance, **integrity and ethical behaviours** is not only important for public relations but it is also a necessary element in risk management and avoidance of lawsuits, directors and executives of organizations should have **code of conduct** to promote ethical and responsible decision making, adequate **disclosure and transparency** should be ensured that is disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear and factual information.

Corporate Governance in Nigeria

Corporate governance is not an entirely new concept in Nigeria. There are a number of corporate governance provisions in the Companies and Allied Matters Act 1990, the Bank and other Financial Institutions Act 1991 (as amended), the Investment and Securities Act 1999 (as amended), the Securities and Exchange Commission Act 1988 (as amended). These laws which place the responsibility for regulating corporate governance on the CAC, SEC and CBN reflect some of the OECD principles of corporate governance following the growing concerns on issues of corporate governance and realizing the need to align with the International Best practices, the Securities and Exchange Commission (SEC) in collaboration with the corporate Affairs Commission (CAC) inaugurated a seventeen member committee to identify weaknesses in the current corporate governance practice in Nigeria and fashion out necessary changes that will improve our corporate governance practices. The final report of the committee was eventually approved by the Boards of the SEC and CAC and released as the code of best practices on corporate governance in Nigeria for public quoted companies in 2003. The code of corporate governance issued in 2003 focused on the following issues.

Challenges of Corporate Governance in Nigeria

Despite the continuous development of corporate governance codes, there have been various challenges in the process of implementing these codes and this is evident worldwide and the Nigerian experience was summarized by the Central Bank in its Codes of Corporate Governance for Banks in Nigeria Post Consolidation and they include establishing codes to guide stakeholders, lack of enlightenment on corporate governance issues, weak internal controls, non-compliance with laid down internal controls and opinion procedures, inability to plan and

respond to changing business circumstances, ineffective management information systems and ineffective board oversight function.

2.1.2 Firm Performance and other Financials

Firm financial performance relates to the various subjective measures of how well a firm uses its given assets from primary mode of operation to generate profit. Eyenubo (2013) defines firm's performance as the success in meeting pre-defined objectives, targets and goals within a specified time target.

Qureshi (2007) stated four different approaches in which the value of a firm can be identified in corporate finance literature. These are: the financial management approach which is focused on the evaluation of cash flows and investment levels before identifying and assessing the firm's financing sources on firm value; the capital structure approach which studies the impact of capital structure changes on the value of firm and how different factors impact differently on the debt and equity component of the firm capital structure; the resource-based approach which explains the value of firm as an outcome of firm's resources; and finally the sustainable growth approach which is a summary of the above three approaches to firm value, taking into account the firm's operating performance, its investment and financing needs, its financing sources, and its financing and dividend policies for sustainable development of firm resources and maximization of firm value. This study therefore examines some key financial measures of firms' such as Return on Equity, Return on Asset, Net Profit, Business Assets, and Equity.

Return on Equity: The Return on Equity (ROE) is a profitability ratio that measures the ability of a firm to generate profits from its shareholders' investments in the company and it is one of the accounting based measures of performance in corporate governance research. The ROE shows how much profit each kobo of common shareholders' equity generates. It measures the profitability of shareholders' investment and shows the net income as a percentage of shareholders' equity.

Return on Asset: The Return on Asset (ROA) is a profitability ratio that measures the income produced by total assets during a period by comparing net income to the average total assets. In other words, ROA measures how efficiently a company has managed its assets to produce profits during a period. Since a company's asset sole purpose is to generate revenue and produce profits, this ratio helps both management and investors see how well a company converts its investments in assets to profits by showing the net income as a percentage of total assets.

Profit Margin: The net profit margin is an accounting measure designed to gauge the financial health of a business or industry. It is a measure of profitability that establishes the relationship between net profit and revenue and indicates management's efficiency in manufacturing, administering and selling the products of. It is calculated as net income divided by revenue.

Assets: Assets can be defined as resources held by a company resulting from past events and from which economic benefits are expected to flow to the company. Since a company's sole purpose is to generate revenues and produce profits, the interest of both the management and investors would be on how well the company can efficiently and effectively convert its investments in assets to profits.

Equity: Equity is the residual interest of an entity or company's asset after its liabilities have been deducted. The shareholders' equity represents the equity of a company as divided among individual shareholders of common or preferred stock.

2.2 Theoretical Background

The basic theoretical structures of corporate governance include the agency theory, stakeholder theory, stewardship theory, and resource dependency theory. However the agency theory is the focal point because it is a foundational theory of corporate governance which relates to internal mechanisms of corporate governance but this theory had some limitations and because of these limitations, scholars therefore laid more emphasis on the stakeholder theory.

2.2.1 Agency theory

The agency theory stems from the existence of agency relationships in corporate environments where there exists a fiduciary relationship between two individuals described as the principal and agent. The Institute of Chartered Accountants of England and Wales (2005), explains that an agency relationship arises when one or more principals (e.g. an owner) engage another person as their agent (or steward) to perform a service on their behalf.

It is expedient that a principal engages in a contract with an agent based on trust and interest in achievement of overall organizational goals and objectives. This suggests that though the principal may have personal goals, loyalty and dedication lies in the ability to place corporate goals ahead of personal goals.

In corporate governance, the agency theory appears to be the foremost and the most emphasized because it borders on the cost of agency. Agency costs include monitoring expenditures by the principal such as auditing, budgeting, control and compensation systems, bonding expenditures by the agent and residual loss due to divergence of interests between the principal and the agent (Kyereboah, 2007).

The agent has largely been described as an opportunistic individual whose desire is for personal enlargement whereas both principal and agent weigh the costs and benefits of engaging in a contractual relationship. The behaviour of the agent in a bid to optimize benefit and minimize cost results in agency cost which is termed as a reduction in company value. (Bricker & Chandar, 1998).

Limitations of Agency Theory

Agency theory has been criticized to exhibit a dyadic relationship overlooking diversities between the relevant actors and their interdependencies (Nanka-Bruce, 2009). The peculiarities of these relevant actors as well as likelihood of a symbiotic relationship need to be taken into consideration. Agents are often viewed as opportunistic and self-centered but there are scenarios where agents are able to act as true captains based on the motivation and rewards they receive. Donaldson & Davies (1991) also corroborates that identification by managers with the company, especially likely if they have served there with long tenure and have shaped its form and directions, promotes a merging of individual ego and the corporation, thus melding individual self-esteem with corporate prestige.

There are also other parties that are likely to be affected by the expropriation activities of managers and directors besides the shareholders. The stakeholders including the employees, creditors, financial institutions, potential investors, the government and the public are also victims of this exploitation either directly or indirectly.

2.2.2 Stakeholders' Theory

The stakeholders' theory recognizes not only the shareholders or owners of the organization but also the stakeholders. Stakeholders are a combination of those individual or group that influences an organization and those that are being influenced by the organization. Stakeholders therefore comprise of the shareholders, creditors, employees, customers, competitors, suppliers and the community. Stakeholders' theory is a general theory of the firm, incorporating corporate

accountability to a broad range of stakeholders. Put simply by Sternberg (1997), stakeholder theory is the doctrine that businesses should be run not for the financial benefit of their shareholders but for the benefit of all stakeholders. The role of companies in the society has received increasing attention over time, with the impacts on employees, the environment, communities, as well as their shareholders.

The basis for the stakeholder theory is that companies are so large, and their impact on society is so pertinent that they should discharge accountability to many more sectors of the society than solely their shareholders (Branco and Lucia, 2007). The most extreme promoters of stakeholder theory suggest that the environment, animal species and future generations should be included as stakeholders and the relationship has been described as one of exchange, where the stakeholder groups supply companies with contributions and expect their own interest to be satisfied in return (inducement/encouragement).

For good practice of corporate governance and in order to achieve the overall corporate objectives, managers of business corporations need to understand, appreciate and conscientiously apply the propositions of stakeholder theory. For every individual or groups that have stake in the organization, effort must be made by the agents to preserve and protect their interests for the survival of the corporation.

2.3 Empirical Studies

Faisal and Abdul (2015) examined the impact of corporate governance index on firm performance in Pakistani. A total of 58 manufacturing companies listed in the Karachi Stock Exchange were selected and data was taken from annual reports of the companies for the period of 2009 to 2013. The result of the regression analysis based on the 21 CG index used showed that corporate governance index (CGI) and firm performance has positive and significant association but the relationship for each specific index is dependent upon the measure of firm performance. The result also shows that companies having strong corporate governance mechanism have greater chances to acquire finance.

Alalade, Onadeko and Okezie (2014) examined the relationship between corporate governance practices and firms' financial performance in Lagos State, Nigeria. The study employed comparative analysis to gauge the changes in corporate governance practice between the years 2003 to 2010 by manufacturing companies. The study used both descriptive statistics and ordinary least square (OLS) method of analysis on a panel data for the ten (10) companies over eight (8) years. Consequently, the results of the descriptive statistics showed that majority of the companies implemented the code of conduct that emphasized appropriate composition of the board of directors and forecast of operations. Further analysis showed that there was no significant relationship between the return of equity and legal compliance, though the relationship is positive. Also, there were weak relationships between return on equity (ROE) and board compliance. This implies that the companies obeyed the regulations in term of board composition, legal compliance and production projections, which are the major concerns of the study while other variables impacted more on ROE.

Waseem, Saleh and Fares (2011) examined the effect of corporate governance on the performance of Jordanian industrial companies on Amman Stock Exchange. The study provided evidence of whether or not the corporate governance & performance indicators of Jordanian industrial companies listed at Amman Stock Exchange (ASE) are affected by variables that were proposed and to provide the important indicators of the relationship of corporate governance and firms' performance that can be used by the Jordanian industrial firms to solve the agency problem. Forty four (44) firms were selected randomly selected forty four firms

of ninety six (96) Jordanian firms for the study. The result of the study indicated that there is a direct positive relationship between profitability measured either by Earnings per share (EPS) or Return on assets (ROA) and corporate governance. Also a positive direct relationship between each of liquidity, dividend per share, and the size of the company with corporate governance and a positive direct relationship between corporate governance and corporate performance was established.

Velnampy (2013) examined the impact of corporate governance and firm performance in Sri Lankan manufacturing companies with a sample of 28 manufacturing companies using the data representing the periods of 2007-2011. Board structure, board committee, board meeting and board size including executive directors, independent non-executive directors, and non-executive directors were used as the determinants of corporate governance whereas return on equity (ROE) and return on assets (ROA) were used as the measures of firm performance. The study found that determinants of corporate governance are not correlated with the performance measures of the organization. Regression model showed that corporate governance does not affect companies' return on equity (ROE) and return on asset (ROA) and that the observed variability in performance can be explained by the differences in both the independent variables namely board size, board committee, board structure, and board meeting.

Sanda, Mukaila and Garba (2005) examined the relationship between corporate governance mechanisms and firm performance in Nigeria. Using pooled ordinary least square regression analysis for a sample of 93 firms quoted on the Nigerian Stock Exchange for the period 1996 - 1999, they found out that corporate governance mechanisms have positive relationship with the firm performance in Nigeria. The researchers made a case for a board size of ten (10) and for concentrated as opposed to diffused equity ownership, they made claim for the separation of the posts of Chief Executive Officer (CEO) and chairman and that firms run by expatriate CEOs tend to achieve higher levels of performance than those run by indigenous CEOs.

METHODOLOGY

3.1 Research Design

The study is cross sectional research which examined the several sample units. The population of the study is the manufacturing companies listed on the Nigerian stock exchange as at 2014. However, because of the difficulties in accessing the whole population, a sample was utilized and in selecting the sample, the study made use of the random sampling technique which provides an equal probability of selection and as such minimizes selection bias.

3.2 Model Specification

The independent variables for this study emanated from the principles of corporate governance as endorsed by OECD in 2004 and these variables (board quality, number of reported financial statement in compliance with IFRS, value added to employees, the risk management of the company and code of conduct) helped to investigate the effect in which corporate governance have on profitability, business assets and the value of equity. Based on these, the model for the study is derived as follows:

$$PERF_{it} = f(BQ_{it}, NRS_{it}, VA_{it}, RM_{it}, COC_{it})$$

$$ROA_{it} = \alpha + \beta_1 BQ_{it} + \beta_2 NRS_{it} + \beta_3 VA_{it} + \beta_4 RM_{it} + \beta_5 COC_{it} + \varepsilon_{it} \quad 3.1$$

$$ROE_{it} = \alpha + \beta_1 BQ_{it} + \beta_2 NRS_{it} + \beta_3 VA_{it} + \beta_4 RM_{it} + \beta_5 COC_{it} + \varepsilon_{it} \quad 3.2$$

$$PM_{it} = \alpha + \beta_1 BQ_{it} + \beta_2 NRS_{it} + \beta_3 VA_{it} + \beta_4 RM_{it} + \beta_5 COC_{it} + \varepsilon_{it} \quad 3.3$$

$$NP_{it} = \alpha + \beta_1 BQ_{it} + \beta_2 NRS_{it} + \beta_3 VA_{it} + \beta_4 RM_{it} + \beta_5 COC_{it} + \varepsilon_{it} \quad 3.4$$

$$SHF_{it} = \alpha + \beta_1 BQ_{it} + \beta_2 NRS_{it} + \beta_3 VA_{it} + \beta_4 RM_{it} + \beta_5 COC_{it} + \varepsilon_{it} \quad 3.5$$

where:

BQ_{it} = Board Quality of company i at time t is measured by the qualifications of the members on the board that is various skills and expertise available among the board members.

NRS_{it} = Number of reported financial statement of company i at time t is measured by the number of financial statements reported in accordance with the disclosure requirements of the International Financial Reporting Standards (IFRS).

VA_{it} = log of value added to the employees of company i at time t represents the monetary value added to employees of the organization in respect to their salaries, pension and other benefits due to the employees.

RM_{it} = log of risk management of company i at time t represents the liquidity risk management reported by the organization, that is the amount provided by the organization to meet both expected and unexpected cash flows and collateral needs without adversely affecting the daily operations or financial conditions of the institution.

COC_{it} = Reported code of conduct in company i at time t represents the reported activities of the board of directors during the year in respect to community development.

ROA_{it} = Return on assets of company i at time t

ROE_{it} = Return on equity of company i at time t

PM_{it} = Net profit margin of company i at time t

BA_{it} = Value of total assets of company i at time t

VOE_{it} = Value of shareholder equity of company i at time t

$\varepsilon_{it} = Y_{it} + \mu_{it}$, accounting for individual heterogeneity and random error terms in that order

3.3 Source of Data

The data used for this study were secondary in nature and were obtained from the annual reports and statements of the selected manufacturing companies listed on the Nigerian Stock Exchange covering eleven (11) years period from 2004 to 2014.

3.4 Population and Sample size

The population of this study consists of all eighty six (86) listed manufacturing companies on the Nigerian Stock Exchange (NSE) as at 2014 (NSE Fact Book, 2013/2014). Twenty (20) manufacturing companies were randomly selected with a time frame from 2004 to 2014 and this

11 year period allows for a significant time lag for firms to have reviewed and followed strictly the principles of OECD on corporate governance.

3.5 Method of data Analysis

In analyzing the data collected, the study used both descriptive and inferential statistical tool. The descriptive statistics consist of mean, variance, standard deviation and normality statistics. The essence of these tools is to describe the basic features of the data for the study and provide summaries about the sample and the measures.

3.6 Estimation Techniques

The study used panel data regression technique with a choice between Fixed Effect Model (FEM) and Random Effect Model (REM) i. e. (Error Component Model) estimation technique using Hausman test. Gujarati (2004) observes that the null hypothesis underlying the Hausman test is that the FEM and ECM estimators do not differ substantially. The test statistic developed by Hausman has an asymptotic χ^2 distribution. If the null hypothesis is rejected, the conclusion is that ECM is not appropriate and that using FEM may be better off, in which case statistical inferences will be conditional on the ϵ_i in the sample. Although, both FEM and ECM approaches account for individual heterogeneity, fixed effect assumes λ_i is a fixed parameter (i.e. it does not change with time) whereas λ_i is assumed to be a random parameter under random effect model.

RESULT AND CONCLUSION

4.1 Result

This section is designed to cover presentation of panel data regression outputs and testing of hypotheses stated in section one in order to provide empirical answers to the research questions and achieve the objectives of the study.

Table 1: Multicollinearity Test

	NSR	VA	RM	COC	BOQ
NSR	1.00				
VA	0.39	1.00			
RM	0.38	0.39	1.00		
COC	0.48	0.57	0.21	1.00	
BOQ	0.24	0.19	0.22	0.20	1.00

Source: Authors' Computation, 2015.

Table 1 displays the pairwise correlation values for the independent variables to detect any possible perfect linear relationship between the variables before the regression. From the table, it is clear that while there is no perfect relationship between most of the variable, VA and COC has a correlation coefficient of above 50% suggestive of multicollinearity. Hence, COC was excluded from the set of explanatory variables for analysis.

