

**THE NIGERIAN JOURNAL
OF RISK AND INSURANCE
(N.J.R.I.)**



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THE IMPACT OF BOARD SIZE AND DIRECTORS' SHAREHOLDING ON SHARE PRICES IN THE DOWNSTREAM SECTOR OF THE NIGERIAN ECONOMY

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ABSTRACT

Global events and high corporate failures had necessitated the study of the role of corporate governance mechanisms in the determination of a company's equity price. This study attempts to look at four companies in the downstream petroleum sector of the Nigerian economy by analyzing the impact of board size and directors' shareholding on equity prices. A non probability sampling technique was used to pick the four companies used in this study. This was done based on the varying degrees of ownership structure of these firms. The ordinary least square (OLS) regression and correlation analysis were used to estimate the relationship between share prices and two independent variables namely: board size and directors' shareholding. Two hypotheses were tested. The study finds that there is a negative but statistically significant relationship between market price of equity share and board size. Similarly, a negative but statistically significant relationship between market price of equity share and directors' shareholding exist. The study recommends an improvement in the size of the boards and the composition of non-executive directors as members of the board in order to have attractive share prices.

Keywords: Corporate governance, market price share, board size, directors' shareholding

I INTRODUCTION

Corporate Governance has succeeded in attracting a good deal of public interest because of its apparent importance for the economic health of corporations and society in general. International Finance Corporation (IFC) (2005) noted that commitment to good corporate governance which is characterized by a well-defined shareholder rights, a solid control environment, high levels of transparency and disclosure, and an empowered board of directors has the potential of making a company both more attractive to investors and lenders, and more profitable. Their study suggested that good corporate governance make companies to attract a premium on their valuations. This view is also supported by the study of Black, Bernard, Jang, Hasung, Kim and Woonchan (2004) which found that well-governed firms in Korea traded at a premium of 160 percent to poorly governed firms. In a 2002 McKinsey survey, institutional investors said they would pay premiums to own well-governed companies. The premiums averaged 30% in Eastern Europe and Africa while average of 22% in Asia and Latin America were noted. Although all these studies suggested an improved premium as a result of good governance, specific links were not noted to market prices. Hence, this study intends to fill that gap by providing empirical evidence from Nigeria.

Bruno (2005) opined that Brazilian firms with above-average corporate governance had return on equities (ROEs) that were 45% higher and net margins that were 76% higher than those with below-average governance practices. The study emphasized that corporate governance should be improved upon in order to have an improved return on equities.

The aim of this study is to examine the impact of corporate governance variables represented by board size and directors' shareholding on share valuation in Nigeria. In order to achieve this aim, the study (i) examines how the size of the board affects share prices and (ii) investigates the extent to which directors' shareholding impact equity prices. The following two research questions are addressed: How does board size influence valuation of shares? What is the effect of directors' shareholding on share prices?

The importance of corporate governance can be illustrated under the principal-agent relationship. The demand for appreciable level of return to shareholders is directly related to the fact that it is the directors (the agents) who prepare the financial statements, which is primarily based on cost reasons. Therefore, this study is expected to provide useful insight into improving corporate governance activities. This study contributes to the audit literature as it provides additional empirical evidence on the impact of the board structure on share prices.

The remaining parts of the paper are organized thus: Section II considers the conceptual framework. The sample/ research design, model specification and variable description are contained in Section III. Section IV captures empirical results and discussion while Section V concludes the paper.

II. CONCEPTUAL FRAMEWORK

There is no single or simple definition of corporate governance and certainly no definition that all countries agree on (Mayes, David and Liuksila, 2001). Corporate governance is

defined and practiced differently throughout the world, depending upon the relative power of owners, managers, and providers of capital (Craig, 2005). Basically, different national systems of corporate governance reflect major differences in ownership structure of firms in different countries, and particularly differences in ownership concentration (Shleifer and Vishny, 1997).

The concepts of corporate governance relate to the relationships between a company's Management, Board, Shareholders and other Stakeholders. The narrow approach to corporate governance views the subject as the mechanism, through which shareholders are assured that managers would act in their best interests. As far back as Adam Smith, as indicated in Henderson (1986), it has been recognized that managers do not always act in the best interests of shareholders. For example, Jensen and Meckling (1976) addressed the principal-agent problem, which occurs when managers with private information have incentives to pursue their own interests at the owners' expense. The broad view of corporate governance, however, refers to the process that seeks to direct and control the affairs of an organization so as to protect the interest of all stakeholders in a balanced manner. The process is underpinned by the principles of openness integrity and accountability.

The theoretical framework upon which this study is based is 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 (Ross, 1973; Fama, 1980). It should be noted that this theory relates to the management-shareholders relationship while excluding all other stakeholders in the business. However, this theory has been developed to include all the stakeholders in the business.

Directors' Shareholding

The bulk of the sensitivity of a Chief Executive Officer's wealth to a company performance arises from the executive's stock and option holdings (Jensen and Murphy, 1990). A large body of literature suggests that, for most companies, executive ownership increases shareholder value and helps executive make better decisions. According to Morck, Shleifer and Vishny (1988) and McConnell and Sevaes (1990), firm evaluation multiples are higher when executives own more stock and executive stock options. In particular, McConnell and Sevaes (1990) found a significant curvilinear relationship between insider ownership and firm performance. While Loderer and Martin (1997) find no significant relationship, Core, Holthausen and Lacker (1999) reported a non linear relationship.

Board Size

The size of the board has been shown to have a material impact on the returns generated by the firm (Yermack, 1996; Eisenberg 1998). According to the Code of Best Practices on Corporate Governance in Nigeria, "the board should comprise of a mix of executive and non executive directors, headed by a chairman of the board, so however as not to exceed fifteen person or be less than five persons in total. According to a Global Corporate Finance Report released in 2002, companies that announced decreases in board size had an average market adjusted stock return of 2.9 percent while those that increased board size has the stock prize decrease by 2.8 percent adjusted for market movements. Brown and Caylor

(2004) suggested that limiting board size leads to improved firm performance as the increased monitoring benefits of larger boards were outweighed by poorer communication and decision making.

Determinants of Equity Price

Thapa and Brown (2007) noted positive stock price reaction to the passage of the Sarbanes-Oxley Act. The study suggested that investors believe the Act will provide for better oversight of management by the board of directors. In essence, good corporate governance practice which is characterised by close scrutiny of accounting records by the board of directors, independent auditors, and regulators will lead to increase in stock prices. Khurana (1991) investigated the stock price reaction of firms to the adoption of SFAS No. 94, which requires firms to consolidate all majority-owned subsidiaries, including foreign subsidiaries and subsidiaries with heterogeneous operations. They report a negative stock price reaction to the adoption of this rule. Similarly, Espahbodi, Strock and Tehranian (1991) noted the impact of SFAS No. 106 on equity prices and report a negative stock price reaction. SFAS 106 requires companies to use the accrual method of accounting for non-pension post-retirement benefits. Beatty, Chamberlain and Magliolo (1996) studied the impact of the adoption of SFAS 115 on equity prices of bank holding companies and insurance companies. This rule requires the use of fair value accounting for some categories of investment securities and requires that unrecognized gains and losses on these securities be accounted for on the balance sheet. This view is also supported by Boyd, Hayt, Reynolds and Smithson (1996); Mittelstaedt and Warshawsky, (1993). Although these studies focused specifically on equity prices, there were no links with corporate governance variables such as board size and directors' shareholding.

It is widely believed that market information plays a major role in the determination of a company's equity price. This is the concept of market efficiency where the prices of equities are expected to reflect all available information to investors. It is the demand and supply of equity that ultimately determine its price. According to Singhania (2006), in a research conducted on Indian companies, the study found out that the significant determinants of company's equity prices include; Price Earnings Ratio, Net Profit Margin, Dividend Per Share and Earnings Per Share while the those variables that marginally contributed to a company's share prices were; Dividend Cover, Return on Equity and Dividend yield.

In Nigeria, Kajola (2008) examined the relationship between four corporate governance mechanisms (board size, board composition, chief executive status and audit committee) and two firm performance measures (return on equity and profit margin) using panel methodology and OLS as a method of estimation, the results provide evidence of a positive significant relationship between ROE and board size as well as chief executive status. The study, however, could not provide a significant relationship between the two performance measures and board composition and audit committee. Mohammad and Kolawole (2008) also measured the relationship between corporate governance and the performance of firms in Nigeria. The study used return on equity, net profit margin, sales growth, dividend yield, and stock prices as the key variables that defined the performance of the firm. On the other hand, for the measure of corporate governance, board Independence, board size,

audit independence, ownership, and the progressive practices of the company were used. The study found that there is a high relationship between the board's size of the companies use in the study and their performances. However, the findings of this study have not been conclusive as industry classifications of companies were not considered. Hence, this study considered the downstream sector of the Nigerian Economy.

III. METHODOLOGY

Research Design

This study is an explanatory study. Saunders, Lewis and Thornhill (2007) stated that studies that establish causal relationships between variables may be termed explanatory studies. They emphasized that this has to do with studying a situation or a problem in order to explain the relationships between variables. This research strategy was considered necessary because of its ability to view comprehensively and in detail the major questions raised in the study.

Data for Study

Since this study is on corporate governance and share prices of companies in the downstream sector of Nigeria, population of the study is made up of companies in the downstream sector that are listed on the floor of the Nigerian Stock Exchange (NSE). A sample consisting of companies listed on the NSE was considered a good representation of quoted companies in Nigeria since the ultimate test of a sample design is how well it represents the characteristics of the population it purports to represent (Emory & Cooper, 2003). A sample size of four (4) quoted oil companies was chosen. Hence, the data used for this study was sourced from the respective company's annual report for the period 2005 - 2007 year-ends. The market capitalization figures are sourced from the Nigeria Stock Exchange website. The annual report also provides the list of directors, position, the number of shares of the firm owned by each director and the number of outstanding shares. The data on board size and equity prices measured in terms of Market Price Share (MPS) were extracted from the financial statements of the respective companies. Since this study focuses on the downstream petroleum sector of the Nigerian economy where we have only six companies listed. A non probability sampling technique was used to pick the four companies used in this study. This was done based on the varying degrees of ownership structure of these firms. The first two (Total Nigeria PLC and Mobil Oil Nigeria PLC) have foreign shareholding in the region of sixty percent, while the others (Conoil Nigeria PLC and Oando Nigeria PLC) have significant domestic shareholding also in the region of sixty percent.

The Model

The econometric model used in the study which is in line with what is mostly found in various literatures is given as:

$$MPS = \hat{a}_0 + \hat{a}_1 BSIZE_t + \hat{a}_2 DSHR_t + \varepsilon$$

Where:

MPS = Market Price Share

DSHR = Directors shareholding

BSIZE = Board Size

$\hat{a}_0$ = Intercept coefficient

$\hat{a}_1, \hat{a}_2$ = Coefficients for each of the independent variables

t = Year/Period (t= 2005, 2006, 2007)

Definition of Variables

The dependent variable is market share price. The choice of this variable follows the study of IFC (2005) which noted that commitment to good corporate governance which is typified by a well-defined shareholder rights, a solid control environment, high levels of transparency and disclosure, and an empowered board of directors has the potential of making a company both more attractive to investors and lenders, and more profitable. The choice of the independent variables was informed by previous studies of Yemark (1996) and Eisenberg (1998) which found that firms with smaller board size have more favorable financial ratios and that the relationship between board size and corporate performance is not spurious.

IV. EMPIRICAL RESULTS AND DISCUSSION

This section of the study is devoted to presenting the results of the analysis performed on the data collected to test the propositions made in the study and answer the research questions. Analyses were carried out with the aid of the Statistical Package for Social Sciences, (SPSS Version 15.0).

Regression Analysis

Table 1 shows the results of the coefficient estimates with MPS as dependent variable. The coefficient of board size (-2.226) is significant at 5%. This means that there is a relationship between BSIZE and MPS. Similarly, the result reveals a significant ($p < 0.01$) relationship between DIRSHD and MPS. It is interesting to note that the coefficients are negative, which is contrary to the expectation in the theoretical model.

Table 1: Coefficients Estimates of Variables

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	229.594	33.304		6.894	.000
	BSIZE	-7.295	3.277	-.388	-2.226	.040*
	DIRSHD	-4.81E-005	.000	-.515	-2.954	.009**

Source: Analysis of survey data (2010)

*Correlation is significant at the 0.05 level (2-tailed).

** Correlation is significant at the 0.01 level (2-tailed).

From the output of the analysis in Table 2, the analysis of variance (ANOVA) returns significant p-values of 0.002. This shows that the explanatory variables are linearly related to MPS and the model seems to have some validity.

Table 2: Regression Model Fit (ANOVA)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	18721.685	2	9360.843	9.198	.002
	Residual	17301.448	17	1017.732		
	Total	36023.133	19			

Source: Analysis of survey data (2010)

A Pearson correlation analysis is performed on the variables to check for the extent of relationship among the variables. The results are shown in Table 3. There are indications that there is a negative relationship between MPS and board size (BSIZE), though statistically significant at $p < 0.05$. Evidence also exist that there is a negative relationship between market price per share (MPS) and director shareholding (DIRSHD). This relationship is also statistically significant at $p < 0.01$.

Table 3: Correlation of Market Price with Board Size and Directors' Shareholding

		MPS	BSIZE	DIRSHD
MPS	Pearson Correlation	1	-.523(*)	-.616(**)
	Sig. (2-tailed)		.018	.004
	N	20	20	20
BSIZE	Pearson Correlation	-.523(*)	1	.262
	Sig. (2-tailed)	.018		.264
	N	20	20	20
DIRSHD	Pearson Correlation	-.616(**)	.262	1
	Sig. (2-tailed)	.004	.264	
	N	20	20	20

Source: Analysis of survey data (2010)

* Correlation is significant at the 0.05 level (2-tailed).

** Correlation is significant at the 0.01 level (2-tailed).

Test of Hypotheses

Hypothesis One:

H_0 : There is no relationship between board size and market prices of shares in Nigeria.

H_1 : There is relationship between board size and market prices of shares in Nigeria.

Based on the results presented in Tables 1 and 3, H_0 is rejected. It can therefore be concluded that the size of the board is related to market prices of company shares in the downstream sector of Nigeria.

Hypothesis Two:

H_0 : Directors' shareholding has no significant impact on market prices of shares in Nigeria.

H_1 : Directors' shareholding has significant impact on market prices of shares in Nigeria.

Based on the results presented in Tables 1 and 3, H_0 is rejected. This means that directors' shareholding has significant impact on market prices of company shares in the downstream sector of Nigeria.

V CONCLUSION AND RECOMMENDATIONS

The aim of this research was to empirically examine the components of corporate governance in Nigerian quoted companies and its relationship with market price. In achieving this aim, the study obtained data on the dependent and independent variables. These variables included board size, director shareholding and market price. On the basis of these variables, hypotheses were postulated. Results from the study indicate that there is a negative relationship between MPS and board size (BSIZE). Similar results also exist between market price per share (MPS) and director shareholding (DIRSHD). Both relationships are significant at $p < 0.05$ and 0.01 respectively. Therefore, this study recommends an improvement in the size of the board and the composition of non-executive directors as members of the board in order to have attractive share prices and increase shareholders confidence. Future research could include other corporate governance variables such as board composition, audit committee membership and ownership concentration.

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