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CORPORATE GOVERNANCE MECHANISM AND BUSINESS PERFORMANCE: ANALYSIS OF EXTERNAL FORCES IN NIGERIAN'S TELECOMMUNICATION COMPANIES

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Abstract

Corporate governance mechanisms are of paramount importance in managing any organization. This study examines the influence of the external forces of governance mechanism and how they impact on telecommunication firms' financial performance in Nigeria. Secondary data were obtained from the annual financial reports of the six active telecommunication operators in Nigeria. This information was collated to estimate the external influence of board composition (EXTBC), institutional shareholding (IS) and external audit committee composition (EXTAC). The dependent variable used in the study is the mean value of return on assets (ROA) and return on equity (ROE); while the method of regression analysis is Fully Modified Ordinary Least Square (FMOLS). The results of the study revealed that the proportion of external audit committee to their internal committee members has a depressing impact on the financial performances. The results also show that institutional shareholding proportion has significant negative impact on the firms' financial performance. The study, therefore, recommends that telecommunication firms may do better by increasing the proportion of external directors; and reduce the proportion of their external auditors and institutional shareholdings. The reasons are that the proportion of Board Composition (BC) is too small while that of Audit Committee (AC) and institutional shareholding are too large.

Keywords: Corporate governance, external directors, external auditors, institutional shareholdings, business performance, fully modified ordinary least square OLS.

1.0 Introduction

The relevance of telecommunication in the economic system and the nature of the telecommunications business make the problems involved in Corporate Governance of the industry highly specific. The Telecommunication system is a key element in

the intra-industries economic system and plays a major role in the functioning of the entire economic system. Telecommunication firms are subject to more intense regulation, which represents several challenges on their corporate governance than many other industries. They are responsible for safeguarding the interconnections of the other industries. This is why there is the need for the study.

There are a number of factors, trends, and developments that influence the operations of Corporate Governance (Audu, 2007). The complex linkages between the internal and external factors that affect the operating environment of corporations are referred to as structures or mechanisms of the corporations. The achievement of corporate performance relies on the mechanism of efficiency both internally and externally. External factors according to Audu (2007) are the ones that the corporations cannot control, they can only react towards them. The management must of necessity be sensitive because sudden changes in the external environment happen more often. Among the common ones are the liberalization, government regulation, competition, external auditors, outside director, debt holders, creditors, and institutional shareholders. The major internal factors are the board size, the Board Members, ownership ratio, the directors' remuneration, among others.

This study is designed to examine the impact of an external factor of corporate governance on the performance of telecommunication firms in Nigeria. The specific objective is therefore to examine the impact of Board Composition (BC), Institutional Shareholding (IS) and Audit Committee Composition (AC) on the business performances of the firms. It has thus hypothesized that each of the three external mechanisms has no impact on the performances of the telecommunication firms in Nigeria.

2.0 Literature Review

The term corporate governance refers to the legal rules, institutional arrangements, and practices that determine who controls business corporations and who gets the benefits that flow from them (Weston, 1992). Corporate Governance includes how major policy decisions are made in business corporation, how various stakeholders can influence the process, who is held accountable for performance, and what performance standard should be applied. Furthermore, Theresa (2000) defines it as management of a company. This refers to company's management techniques and processes in general or the way a particular company is managed.

Corporate governance according to Adam (2006) at its simplest form is the system of which organizations are controlled and directed. In essence, he added that it is a function of direction and leadership, risk management, control, transparency, and accountability. Corporate governance, therefore, comprises a country's private and

public institutions both formal and informal which together governs the relationship between the people who manage corporations (corporate insiders) and all others who invest resources in corporations in the country.

These definitions imply that corporate governance is the nature and extent of accountability of people in the business, and mechanisms that try to decrease the principal-agent problem. Corporate governance also includes the relationship among the many stakeholders involved and the goals for which the corporation is governed.

2.2 Concept of Organizational Performance

Haneni (2003) writes that organizational performance management and measurement is one of the most popular terms in today's public sector management terminology. The idea of managing organizational performance is being widely accepted and adopted all over the world. It spread rapidly from the private sector to the public sector in the developed world and has recently found its way in many developing countries. New initiatives and legislations continue to being issued as a sign of governments' insistence on following the new focus on performance orientation.

Financial ratios, according to Chirantan (2010) are used in measuring organizational performances. Although they provide historical data, management can use ratios to identify internal strengths and weaknesses and estimate future financial performance. Investors can use ratios to compare companies in the same industry. Ratios are not generally meant as stand-alone numbers, but they are meaningful when compared to historical data and industry averages.

The two major financial ratios as reported by Hagel, Brown and Davision (2010), are Return on Assets (ROA) and Return on equity (ROE).

Megginson, Mathias, Nash, Robert, Randenborgh, & William (1994) claim that Return on Assets-ROA is a better metric of financial performance than income statement profitability measures like return on sales. ROA explicitly takes into account the assets used to support business activities. It determines whether the company is able to generate an adequate return on these assets rather than simply showing a robust return on sales. Asset-heavy companies need the higher level of net income to support the business relative to asset light companies where even thin margins can generate a very healthy return on assets. In order to ameliorate the short comings of ROA and ROE, this study opted to use the mean of both ROA and ROE as performance measurement tool which is the dependent variable. This is the summation of ROA and ROE, divide by two.

2.3 External Factors in Corporate Governance Mechanism

A positive relationship is expected between firm performance and the proportion of outside directors sitting on the board. It is believed that outside directors are more independent in appropriating issues in the board room. Unlike inside directors, outside directors are better able to challenge the CEOs. It is perhaps in recognition of the role of outside directors that in the UK, a minimum of three outside directors is required on the board (Bhagat & Black, 2012).

2.3.2 Composition of Audit Committee (AC) and Business Performance

It is argued that the more the number of external members in the committee, the higher the independence of the committee in working more independently for achieving the desired result. It is also argued that the more experienced and knowledgeable members are in accounting and finance the better will be the output of the committee. Given the requirement for firms to have an audit committee, any differential in performance related to governance will be related to the differences in AC characteristics.

2.3.3 Institutional Shareholding and Company Business Performance

The role that the institutional investors can play in the corporate governance system of a company is a controversial question. While some scholars believe that the institutional investors must interfere in the corporate governance system of a company, others believe that these investors have other investment objectives to follow. Those who believe that institutional investors need not play a role in the corporate governance system of a company argue that the investment objectives and the compensation system in the institutional investing companies often discourage their active participation in the corporate governance system of the companies (Whorton, Lorsh and Hanson, 1991).

Carter, Simkins & Simpson (2003), however, argue that institutional investors need to take an active interest in the corporate governance of a company because the institutional investors have their primary fiduciary responsibility to their own investors and beneficiaries, which can lead to a conflict of interest with their acting as owners.

2.4 Theoretical Review

Much of the research into corporate governance derives from agency theory, which posits that corporate governance is necessary in order to ensure that the principal-agent problem is mitigated (Eisenhardt, 2009; Donaldson & Davis, 2001 Berle & Means, 2002).

Hidden information according to Fama & Jensen (2009) occurs when agent possess knowledge that the principal is unaware, and the agent has an incentive to conceal this knowledge from the principal, *ceteris paribus*. This theory is very relevant to this study because the complexity of the telecommunication business which firms are not publicly quoted increases the asymmetry of information and diminishes stakeholders' capacity to monitor the telecommunication managers' decisions.

2.5 Empirical Review

Dulewicz & Herbert (2004) studied the impact of Board Composition on Return on Assets (ROA). The study was based on the original study of 134 responses from a cross section of companies. The data of the study were collected from (1997 – 2000). They found that Board practices identified tasks were not clearly linked to company performance. This limited the support that companies with independent board members are more successful than others.

Idigbe (2001) examined external auditors' role in corporate governance and financial performance in the banking industry. He used all the 24 banks listed in CBN after the consolidation of banks in 2000. He used questionnaire and analyzed his findings using the simple percentages. He found out that external auditors' role in corporate governance has a positive and significant effect on adherence to the codes of best practices of corporate governance but that the level of transparency in disclosure of information of banks was not in accordance with international practices.

On the institutional shareholding mechanism, Agrawal & Knoeber (1996), examined the relationship between two cross-sectional Australian sample firms for 1986 and 1989. The study revealed no significant correlation between institutional ownership and firm financial performance after examining a sample of 867 acquisitions' of publicly traded firms in the US between 1988 and 1998. Also, Guyang (2013) conducted research on the impact of Institutional Shareholding (IS) on the financial performance of listed insurance firms in Nigeria. He used a generalized least square regression model to test his hypothesis. He found that though positive (IS) does not significantly improve the firm's performance.

3.0 Methodology

This study used exploratory research design. Exploratory research determines the cause and effect relationship between two or more variables (Saunders, Lewis & Thornhill, 2009). Robson (2002) also wrote that exploratory design is suitable where the investigator is concerned with understanding how a system works while studying a phenomenon using historical data that is not amenable to manipulation of both the dependent and independent variables. This study fits into the requirements of

explanatory, non-experimental analysis. This research studies the impact of external forces of corporate governance in explaining the business performances of telecommunication companies in Nigeria.

In the study, the independent variables are Board Composition (EXTBC), which is the ratio of outside directors over the entire number of active directors. External Audit Committee Composition (EXTAC) is the ratio of External Auditors over the Corporate Auditors and Institutional Shareholding (IS) is the ratio of institutional (outside companies) shareholding over the entire corporate shares. The dependent variable for performance is the Mean of summation of ROA and ROE.

The population of the study is the six active telecommunication firms in Nigeria during the period of study. They are MTN, Airtel, Globacom, Etisalat, Starcom, and Multilink. All the firms were used as the sample for this research. The period of research was 2004-2013, the acclaimed most rapid growth period in telecommunication technology and marketing and also based on available data at the time of the study. The data were obtained from annual accounting report of the active firms as reported by NCC Report (2015). Data not available in websites were collected from the firms.

3.1 Analytical Model Applied

The study applied the Fully Modified Ordinary Least Square (FMOLS) method of regression. This model is used in order to avoid the usual problem caused by having a feedback relationship between the dependent variable and independent variable. The feedback relationship occurred where the independent variable influences the dependent variable and vice-versa. The proxy of performance (dependent variable) is the mean of Return On Assets (ROE) which is ROA plus ROE/2. The dependent variables are the proportion of External Board members on total members, External Audit members on total audit members, institutional (outside companies) shareholding over total shareholding. This kind of problem is referred to as simultaneous problem or endogeneity problem. Specifically, the regression model estimated is:

$$PERF_{it} = \alpha_1 + \alpha_2 EXTBC_{it} + \alpha_3 IS_{it} + \alpha_4 EXTAC_{it} + e_{it} \quad (1)$$

Where PERF is the performances of telecommunication companies; EXTBC is the external board composition proportion; IS represents institutional shareholding; EXTAC is external audit committee. The *i* and the *t* represent the individual communication companies and the time period, respectively. The α_1 , α_2 , α_3 , and α_4 are constant, the coefficient of EXTBC, and IS and EXTAC, respectively. Their priori signs are positive for all except for the constant.

4.0 Results and Discussion

Table 1: Fully modified OLS regression (PERF is the dependent variable)

Variable	Coefficient	Std Error	t-Statistic	Probability
ExtBC	0.506276	0.232401	2.178456	0.0350
IS	-0.093535	0.248255	-0.376768	0.7082
AC	-1.004889	0.223374	-4.498676	0.0001
Adjusted R ²	0.611			

Source: Eviews Printout, 2016

Table 1 shows that two of the variables applied in this study are significant in explaining the performances of firms in the telecommunication industry in Nigeria. These are external board composition and external audit committee members. The prior expectations of the variables are correctly signed except in the case of the external audit committee. The expected sign for external audit committee is positive but the actual sign in the regression exhibited negative. This implies that the proportion of external auditors in the Audit Committee is too large and it is depressing the performance of the firms. Before application of the regression results in testing the hypotheses formulated, it is necessary to carry out diagnostic tests. These tests are the test for multicollinearity and the test for heteroscedasticity and autocorrelation. Multicollinearity is tested using variance inflation factor (VIF) and coefficient variance decomposition (CVD). This study applies autocorrelation (AC), partial autocorrelations (PAC), Q-statistic and the probability of Q-statistic.

Table 2a: Variance inflation factor

Variable	Coefficient Variance	Uncentere VIF
ExtBC	0.054010	1.136392
IS	0.061631	1.029864
AC	0.049896	1.116465

Source: Eviews Printout, 2016

The findings revealed in the Table 2a that the values of coefficient variances are generally very low. They also exhibit very low variances that are smaller than 100. These clearly means that the collinearity from these data are very low and do not amount to high collinearity that can affect the results of regression analysis. The results of the FMOLS regression are not adversely affected by multicollinearity, which implies that the type of Regression Analysis used for the study is quite apt.

Table 2b: Coefficient variance decomposition

Variable	Condition Numbers	Associated Eigenvalues
ExtBC	0.4779	0.669365
IS	0.5528	0.285057
AC	1.000	0.339649

Source: Eviews Printout, 2016

Table 2b shows the values of conditional numbers and associated eigenvalues. The conditions to be satisfied for high to severe multicollinearity to exist are two. First, at least two conditional numbers must be below 0.0001. Secondly, at least two or more associated eigenvalues must be above 0.85. From the results of Table 2b, none of the two conditions is satisfied. Therefore, this study concludes that multicollinearity does not exist in the regression results of FMOLS in Table 2b above.

Table 3: Autocorrelation (AC), Partial AC, Q-statistic and probability

Lags	AC	PAC	Q-statistic	probability
1	0.295	0.295	4.6910	0.060
2	0.013	-0.081	4.7001	0.095

Source: E Views Printout, 2016.

Table 3 shows the results of autocorrelation, partial AC, Q-statistic and the probability of the q-statistic. The results show that the values of the Q-statistic are generally very high. This is confirmed by the probabilities of the Q-statistics that are very low. This shows that this study cannot reject the null hypothesis that autocorrelations and heteroscedasticity do not exist in the estimated FMOLS regression. Thus, this study concludes that the results of FMOLS do not suffer from multicollinearity. The study also concludes that the results of FMOLS have neither the problem of autocorrelation nor that of heteroscedasticity. Based on this conclusion, this study tests the hypotheses of this study in the next section.

4.1 Discussion and Hypothesis Testing

The study hypothesized that the proportion of external board members has no impact on the performance of telecommunication companies in Nigeria. The selected critical probability or significance value for this test is 0.05. the computed probability is 0.035 (Table 1).

Since the computed probability exceeds the critical probability this study concludes that the proportion of external board members has a significant impact on telecommunication performance of telecommunication companies in Nigeria. This means that the higher the proportion of external board members, the better for the performance of telecommunication companies.

This study also has earlier hypothesized that institutional shareholdings have no significant impact on telecommunication companies' performance. Since the computed significance, value 0.708 exceeds the critical significance value 0.05, this study accepts the null hypothesis. The study concludes that institutional shareholdings have no significant influence on telecommunication companies'

financial performance in Nigeria. This shows that proportion of (IS) is optimum. Thirdly, the study also hypothesized that external auditors' proportion to internal auditors in telecommunication has no significant impact on performance. The computed probability is 0.000. Since the computed probability is lower than the critical probability, 0.05 this study rejects the null hypothesis. The study concludes that high proportion of external auditors to internal auditors depressed telecommunication performance. It shows that the AC is not optimal and should be reviewed down.

5.0 Conclusion and Recommendations

Thus, this study has established that high proportion of external board members to internal board members have a significant impact on telecommunication companies' performances. This conforms with Mehran (1995) who produced evidence in support of a positive role for outside directors. The study also established that institutional shareholding does not influence telecommunication companies' performances. This finding agrees with Agrawal and Knoeber (1996) who found no significant association between institutional ownership and firm performance. It was also established that higher proportion of external auditors to internal auditors decreases telecommunication companies' performances. This can also be related with Klein (2002) who reports a negative correlation between earnings management and audit committee independence.

Since a high proportion of external board members to internal board members stimulates telecommunication companies' performance in Nigeria, this study is of the opinion that the optimum members of external board members to internal one has not been attained.

This study, therefore, recommends that more external board members be recruited. This will stimulate the performances of telecommunication companies. The companies, however, should watch their actions as a threshold will be reached beyond which further increase in the proportion of external board members to internal would lead to a reduction in performance.

Institutional shareholdings do not have any significant influence on telecommunication companies in Nigeria. This means that institutional ownership of shares in the firms does not go well with the telecommunication companies' performance in Nigeria. Thus, when next they are selling shares, preference should not be laid on institutional ownership, preference should be given to individual owners. It is recommended that the companies should be quoted in stock exchange so that Nigerian individuals can buy shares.

External audit members' proportion to internal auditors has a depressing influence on telecommunication companies' performances. The reason is perhaps, the composition of auditors skewed in favour of external auditors.

Telecommunication companies should reduce the proportion of external auditors employed. This may improve the performances of telecommunication companies' performance.

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