Impact of Corporate Governance Mechanisms on the Financial Performance of Listed Insurance Firms in Nigeria (*)

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Abstract

This paper examines the impact of Corporate Governance Mechanisms on the financial performance of listed insurance firms in Nigeria. The Paper investigates whether CEO status, board size and board composition have impact on the financial performance as measured by Return on Asset (ROA) and Return on Equity (ROE). The data used in this study where obtained from annual reports and accounts of selected insurance companies and other statistical documents/records maintained by the Nigeria stock Exchange. Regression analysis was used to estimate the relationship between financial performance measures and the corporate governance mechanisms. The study discovered that there is a positive significant relationship between Board Composition and the two firms performance measures (ROE & ROA). The study also shows that the relationship between Board size and ROA was significantly negative, while no relationship exists between board size and return on equity (ROE). The result of the relationship between CEO status and ROA was negative while no relationship exists between CEO status and ROE. The study recommends that the code on board composition of listed insurance companies should be sustained and

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encouraged so that corporate governance could be strengthened to allow room for enhanced financial performance of the listed insurance companies in Nigeria.

Key words: CEO status, Board Size, Board Composition, Financial Performance, Corporate Governance, Insurance Companies.
Jel Classificiation: M41, M48

1.0 Introduction

Risks and uncertainties are inevitable and have been the greatest challenges to man. The problem has remained unresolved despite the great advances in science and technology recently. From the social and economic viewpoint, insurance companies are the most ingenious creators of the human mind in response to this risk problem (Daniel, 2008). Over the years, insurance companies have been recognized as vital in the protection of the national economy due to their role in protecting the financial well-being of individuals, companies or other entities against unexpected losses. No modern economy can function effectively and efficiently without the support of a viable and disciplined insurance industry (Shittu, 2009).

The Securities and Exchange Commission (SEC) issued code of corporate governance for quoted firms effective in 2003, with the aim of ensuring that Nigerian quoted firms meet international best practices in corporate governance and ensure corporate survival, protect the interest of all stakeholders in the affairs of a company. Following the conclusions of the reforms in the industry, which resulted in mergers and acquisition, the NAICOM, in consonance with the code initiated and published by SEC in 2003, issued another code with effective date of 1st March, 2009 for listed companies in Nigeria.

There has been an increase of government scrutiny of publicly owned companies of fiduciary mismanagement and ethical misconducts in corporate organizations as a result of which corporate governance is now recognized as the most important issue that organizations have to carefully plan and address

(Uadiale 2010). The economic competitiveness of firms, whether private or public, are found to depend on the set of principles and practices that are put in place to assure all stakeholders that, their investments are being managed effectively and with appropriate probity. Business confidence usually suffers each time a corporate entity collapses. Most of the business failure in the recent past are attributed to failure in corporate governance practices, for instance, the collapse of banks and insurance companies in Nigeria in the early 1990s and onwards was as a result of inadequate corporate governance practices such as insider-related credit abuses, poor risk management and internal control system failure (Ogidefa, 2005).

NAICOM (2002) reports that 80 percent of the Insurance Companies that collapsed before the introduction of the code in 2003 was as a result of poor corporate governance practices. On site examination, the report showed that thirty three (33) out of 106 insurance companies failed to abide by the provisions of the Insurance Act in their operation. This is why government, shareholders and other stakeholders continue to show their concern on how the insurance companies are to be administered.

Several empirical studies were conducted on different mechanisms of corporate governance in developed and developing countries. These includes Brickley *et al* (1997), Short (1994), Dalton *et al* (1998), Core (1999), Carter *et al* (2003), Black *et al* (2003), Anderson (2005), Graig *et al* (2005), John etal (1998) and Kimambo (2007). In Nigeria similar studies were also conducted on corporate governance such as: Adenukinju and Ayorinde (2001), Sanda, *et al* (2005), Musa (2006), Tahir (2008),Hassan(2011), Uwuigbe(2011). However, most of the studies conducted in Nigeria focuses on banking sector, where as there are few similar studies on corporate governance and the performance of insurance companies in Nigeria. The only similar study is that of Nasser (2012) who used data from 5 listed insurance companies in Bahrain for the period 2005-2010 examines the impact of corporate governance mechanisms on firm's performance of the insurance industry in Bahrain using ROE only as the financial performance proxy, While this study looks at the impact of corporate governance mechanisms on the financial performance of listed

insurance companies in Nigeria using both ROA & ROE as the dependent variables using 17 listed insurance companies in the Nigerian stock exchange. Therefore, this provides bases for conducting this study.

The study aims at assessing the impact of corporate governance mechanisms on the financial performance of listed insurance firms in Nigeria with a view to strengthening corporate governance in the insurance industry for better financial performance.

The remainder of the paper is organized as follows: Section 2 discusses the relevant literature on concept of corporate governance, insurance business, nexus between CEO – Status, board size, board composition and corporate financial performance. The methodology adopted is discussed in section 3, while section 4 captures empirical results and discussion. Section 5 concludes the paper.

2.0 Literature Review

2.1 The Concept of Corporate Governance (CG)

Corporate governance is a uniquely complex and multi-faceted subject. Devoid of a unified or systematic theory, its paradigm, diagnosis and solutions lie in multidisciplinary fields i.e. economics, accountancy, finance, among others (Cadbury, 1992). In any organization, corporate governance is one of the key factors that determine the health of the system and its ability to survive economic shocks. The health of the organization depends on the underlying soundness of its individual components and the connections between them. According to Morck, Shleifer and Vishny (1989), the main factors that support the stability of any country's financial system include: good corporate governance; effective marketing discipline; strong prudential regulation and supervision; accurate and reliable accounting financial reporting systems; a sound disclosure regimes and an appropriate savings deposit protection system.

Corporate governance has been looked at and defined variedly by different scholars and practitioners. However, they all have pointed to the same end; hence, giving more of a consensus in the definition. Coleman and

Nicholas-Biekpe (2006) defined corporate governance as the relationship of the enterprise to shareholders or in the wider sense, as the relationship of the enterprise to society as a whole. However, Mayer (1988) offers a definition with a wider outlook and contends that corporate governance is the sum of the processes, structures and information used for directing and overseeing the management of an organization. The Organization for Economic Corporation and Development (1999) has also defined corporate governance as a system-based on which companies are directed and managed. It is upon this system that specifications are given for the division of competencies and responsibilities between the parties included (board of directors, the supervisory board, the management and shareholders) and formulate rules and procedures for adopting decisions on corporate matters. In another perspective, Arun and Turner (2002) contend that there exists a narrow approach to corporate governance, which views the subject as the mechanism through which shareholders are assured that managers will act in their interests. However, Shleifer and Vishny (1997), Vives (2000) and Oman (2001) observed that there is a broader approach which views the subject as the methods by which suppliers of finance control managers in order to ensure that their capital cannot be expropriated and that they can earn a return on their investment.

2.2 Insurance Business

Insurance business is a promise of compensation for specific potential future losses in exchange for a periodic payment. Insurance is designed to protect the financial well-being of an individual, company or other entity in the case of unexpected loss. Some forms of insurance are required by law, while others are optional. Agreeing to the terms of an insurance policy creates a contract between the insured and the insurer. In exchange for payments from the insured (called premiums), the insurer agrees to pay the policy holder a sum of money upon the occurrence of a specific evident.

In most cases, the policy holder pays part of the losses (called the deductibles), and the insurer pays the rest (Davis, 2000). The amount of the

premium is determined by the operation of the law of averages as calculated by actuaries. By investing premium payments in a wide range of revenue-producing projects, insurance companies have become major suppliers of capital, and they rank among the nation's sub sector of the capital market. It is pertinent to state that in the complex field of risk management, insurance business has become universally recognized and accepted as the most efficient response to rescue risk related issues. The position today is that no modern economy can survive or prosper without the active support of a disciplined and viable insurance company. Within the last decade, certain factors have made unprecedented positive impact on global growth and development of insurance, which include Liberalization of world trade, increasing efficiency, advances in information technology and the integration of world financial system which now provide unparallel economic, cultural, and recreational opportunities (Daniel, 2008).

2.3 Nexus between Corporate Governance Mechanisms and Corporate Financial Performance

To be able to achieve the objective of this paper, there's need to look at studies on the relationship between corporate governance mechanisms and corporate financial performance

2.3.1 CEO Status and Corporate Financial Performance

Several studies have examined the separation of CEO and the chairman of the Board, positing that agency problems are higher when the same person occupies the two positions. Jensen (1993) voices his concern that a lack of independent leadership makes it difficult for boards to respond to failure in top management team. Fama and Jensen (1983) also argue that concentration of decision management and decision control in one individual reduces board's effectiveness in monitoring top management. Relating CEO duality more specifically to firm performance, researchers however find mixed evidence. Daily and Dalton (1992) find no relationship between CEO duality and performance in entrepreneurial firms. Yermack (1996) shows that firms

are more valuable when the CEO and the chairman of the board positions are occupied by different persons. However, Liang and Li (1996) do not find a positive relation on the separation of the position of CEO and Board Chair. Brickley et al. (1997) also show that CEO duality is not associated with inferior performance. Rechner and Dalton (1991), however, report that a sample of Fortune 500 companies with CEO duality has stronger financial performance relative to other companies. Goyal and Park (2002) examine a sample of U.S. companies and find that the sensitivity of CEO turnover to firm performance is lower for companies when CEO and chairman duties are vested in the same individual, implying that board monitoring of top management is less effective in firms with CEO duality. Faleye (2003) perhaps presents an interesting proposition. He argues that no "one hat fits all" and board leadership structure depends entirely on individual firm characteristics such as organizational complexity, availability of other controls over CEO authority and CEO reputation and power. Using a sample of 2,166 U.S. companies, he finds that companies with complex operations (implying need for CEO to make swift actions), alternative control mechanisms and sound CEO reputation are more likely to have CEO duality.

2.3.2 Board Composition and Corporate Financial Performance

Board composition refers to the number of independent non-executive directors on the board relative to the total number of directors. An independent non-executive director is defined as an independent director who has no affiliation with the firm except for their directorship (Clifford and Evans, 1997). There is an apparent presumption that boards with significant outside directors will make different and perhaps better decisions than boards dominated by insiders. Fama and Jensen (1983) suggest that non-executive directors can play an important role in the effective resolution of agency problems and their presence on the board can lead to more effective decision-making. However, the results of empirical studies are mixed. A number of studies, from around the world, indicate that non-executive directors have been effective in monitoring managers and protecting the interests of shareholders, resulting in

a positive impact on performance, stock returns, credit ratings, auditing, etc. Dehaene et al. (2001) find that the percentage of outside directors is positively related to the performance of Belgian firms. Connelly and Limpaphayom (2004) find that board composition has a positive relation with profitability and a negative relation with the risk-taking behavior of life insurance firms in Thailand. Bhojraj and Sengupta (2003) and Ashbaugh-Skaife, Collins and Kinney (2006) also find that firms with greater proportion of independent outside directors on the board are assigned higher bond and credit ratings respectively. Furthermore, O' Sullivan (2000) examines a sample of 402 UK quoted companies and suggests that non-executive directors encourage more intensive audits as a complement to their own monitoring role while the reduction in agency costs is expected. However, there is also a fair amount of studies that tend not to support this positive perspective. Some of them report a negative and statistically significant relationship with Tobin's Q (e.g. Agrawal and Knoeber, 1996; Yermack, 1996) while others find no significant relationship between accounting performance measures and the proportion of non-executive directors (e.g. Vafeas and Theodorou, 1998; Weir, Laing and mcKnight, 2002; Haniffa and Hudaib, 2006). Furthermore, based on a large survey of firms with non-executive directors in the Netherlands, Hooghiemstra and van Manen (2004) conclude that stakeholders are not generally satisfied with the way non-executives operate. Haniffa et al (2006) summarize a number of views expressed in the literature which may justify this non-positive relationship, such as that high proportion of non-executive directors may engulf the company in excessive monitoring, be harmful to companies as they may stifle strategic actions, lack real independence, and lack the business knowledge to be truly effective (Baysinger and Butler, 1985; Patton and Baker, 1987; Demb and Neubauer, 1992; Goodstein, Gautum and Boeker, 1994).

2.3.3 Board Size and Corporate Financial Performance

This is considered to be a crucial characteristic of the board structure. Large boards could provide the diversity that would help companies to secure critical resources and reduce environmental uncertainties (Pfeffer, 1983; Pearce and Zahra, 1992; Goodstein et al., 1994). But, as Yermack (1996) said, coordination, communication and decision-making problems increasingly impede company performance when the number of directors increases. Thus, as an extra member is included in the board, a potential trade-off exists between diversity and coordination. Jensen (1993) appears to support Lipton and Lorsch (1992) who recommend a number of board members between seven and eight. However, board size recommendations tend to be industry-specific, since Adams and Mehran (2003) indicate that bank holding companies have board size significantly larger than those of manufacturing firms.

A review of the empirical evidence on the impact of board size on performance shows mixed results. Dehaene et al. (2001) find that board size is positively related to company performance. However, the results of Haniffa et al. (2006) are inconclusive. Using a market return measure of performance, their results suggest that a large board is seen as less effective in monitoring performance, but when accounting returns are used, large boards seem to provide the firms with the diversity in contacts, experience and expertise needed to enhance performance. Yermack (1996) finds an inverse relationship between board size and firm value; in addition, financial ratios related to profitability and operating efficiency also appear to decline as board size grows. Finally, Connelly and Limpaphayom (2004) find that board size does not have any relation with firm performance.

There is a view that larger boards are better for corporate performance because they have a range of expertise to help make better decisions, and are harder for a powerful CEO to dominate. However, recent thinking has leaned towards smaller boards. Jensen (1993) and Lipton & Lorsch (1992) argue that large boards are less effective and are easier for the CEO to control. When a board gets too big, it becomes difficult to co-ordinate and process problems.

Smaller boards also reduce the possibility of free riding by, and increase the accountability of, individual directors. Empirical research supports this. For example, Yermack (1996) documents that for large U.S. industrial corporations, the market values of firms with smaller boards more highly. Eisenberg Sundgren and Wells (1998) also find negative correlation between board size and profitability when using sample of small and midsize Finnish firms, which suggests that board-size effects can exist even when there is less separation of ownership and control in these smaller firms. Mak & Yuanto (2003) echo the above findings in firms listed in Singapore and Malaysia when they find that firm valuation is highest when board has five directors, a number considered relatively small in these markets.

3.0 Methodology

The data used in this study where obtained from the annual reports and accounts of the selected Insurance companies and other statistical documents/ records maintained by the Nigerian stock exchange.

3.1 Sample Size and Sampling Techniques for the Study

The statistical technique recommended by Yamane (1967) was used to carve out a sample from the working population. In particular, the following formula was used to arrive at the size of the sample for the study:

$$n = \frac{N}{[3 + (N)e^2]} = \frac{62}{3.155} = 17.1 \approx 17$$

Where:

n = the desired sample size

N = 62 - the working population size

e = 10 per cent - level of significance.

The sample size of 17 companies constituted about 27 per cent of the entire insurance industry and 50 per cent of licensed and listed operators in the insurance business in the country.

Having determined the sample size, a simple random sampling, using the Random Numbers Table, was employed to identify the specific sampling units (companies) to concentrate on, after the sampling frame (list of licensed and quoted companies) was arranged alphabetically.

3.2 Model Specification

The Economic model used in the study is given by

$$Y = \beta_0 + \beta f_{it} + e_{it} \text{ --------------------------------------- } (1)$$

Where Y is the dependent variable

β_0 is constant,

β is the co – efficient of the explanatory variable (corporate Governance Mechanism)

f_{it} is the explanatory variable and

e_{it} is the error term (assure time period).

This study employed two important financial ratios ROE and ROA to measure performance in a defined period of time.

$$PERF = \beta_0 + \beta_1 BSize + \beta_2 Comp_{+} \beta_3 CEO_{+} e_{it} \text{ ------------------------- } (2)$$

Based on the model above, the following null hypotheses were tested: Board size has no significant impact on the financial performance of listed insurance firms in Nigeria, board composition has no significant impact on the financial performance listed insurance firms in Nigeria, Separation of CEO and the Board Chair has no significant impact on the financial performance of listed insurance firms in Nigeria.

Variable Specification:

There are two types of variable

i. Dependent, ii. Independent

The dependent variable are the financial performance proxies return on asset (ROA) and return on equity (ROE).It is measured by :

Return on Equity (ROE) = Net profit after tax / equity value

Return on Assets (ROA) = Net profit after tax / net assets.

Independent variables are the corporate governance mechanisms and are measured as stated below.

VARIABLE	DEFINITION/MEASUREMENT
BSIZE = Board Size	Total members on the Board
B.COMP = Board Composition	Proportion of Non executive Directors on the board
CEO = Chief Executive Status	Value 0(zero) for CEO/Chairman duality and 1(one) if CEO and Chairman are different head.

Based on the model above, the following null hypotheses were tested: Board size has no significant impact on the financial performance of listed insurance firms in Nigeria,

Board composition has no significant impact on the financial performance listed insurance firms in Nigeria, Separation of CEO and the Board Chair has no significant impact on the financial performance of listed insurance firms in Nigeria.

4.0 Results and Discussions

Based on the analysis of the results as contained in the appendix, in Table 4.2, the corporate governance variables such as CEO status (CEOSTATUS), Board composition (BCOM) and Board size (BSIZE) are

negatively correlated to return on assets (ROA) while BCOM, CEOSTATUS and BSIZE are negatively correlated with returns on equity (ROE) respectively. In addition, the positive sign in the variables coefficient indicates a positive relationship between these corporate governance variables and firm's performance as measured by ROA and ROE. Other variables that show a negative correlation indicate that, at a combine level, there is a negative relationship between these variables and firm's financial performance.

A Positive correlation also exist between CEO status and Board composition (BCOM) and it is significant at 5%,while Board size (BSIZE) is negatively correlated with CEO status and Board composition (BCOM) and it is significant at 1% . In terms of the regression result in Table 4.7 and 4.8, a significant negative relationship exist between CEO status, Board composition (BCOM), Board size (BSIZE) with Returns on assets (ROA), also Board composition (BCOM) has a positive significant relationship with returns on equity (ROE), while CEO status and Board size (BSIZE) shows no relationship with returns on equity (ROE). It is clear from this findings that, there is a significant relationship between Board composition(BCOM) and the two firm's performance measures (ROA and ROE). This result is consistent with previous findings of (Yemack, 1996; and Kyereboah- Coleman, 2007). The relationship between Board size and returns on assets (ROA) was negative and significant, while no relationship exist between Board size and returns on equity (ROE).

The result of BSIZE and ROA is in agreement with Yermack (1996) who found a significant negative relationship between board size and returns on asset (ROA).The result of the relationship between CEO status is clear with the two performance measures, CEO status is found to be negatively related to ROA, while no relationship exist between CEO status and ROE which is consistent with (Najjar, 2012 and Bolbol, et al, 2003) suggesting that firms performance is not affected by the separation or unification of the CEO and chairperson positions. The negative relationship between CEO status and ROA is consistent with the findings of Kyereboah - Coleman (2007) who found that large and possible independent boards increase firm's value.

5.0 Conclusion

This paper took a cursory look at the relationship that exists between three corporate governance mechanisms (CEO status, Board size and Board composition) and financial performance of listed insurance firms in Nigeria using two firm performance measures (ROA and ROE) . It was found that some of the corporate governance variables used for the study had positive and some had negative relationship, while others had no relationship with the firm performance as measured by ROA and ROE. Specifically, the status of the CEO of a firm has a remarkable influence particularly in financial related firms, for proper check and balance is arguably difficult when there is CEO duality, since most of the CEO's always possess the large part of the firm information, as a result they easily engaged in information asymmetry of vital information from the non - executive directors. Board size is important in the performance of the oversight function on executive management. The nature of the firm business should determine the size that is appropriate for its operations, mean while since most of the board members simultaneously sit on boards of other firms or are also full time executive managers of other organizations, the extent of commitment payable by each director is somewhat limited, as such the findings of this study with regards to board size is considerable. Therefore, the larger or smaller the board size, does not significantly influence the performance of the insurance companies in Nigeria. Although several studies have examine the relationship between firm performance measures and corporate governance mechanisms, but the conclusions of this study is entirely different from others. A sample size of 17 listed insurance firms between 2001 and 2010 is used, the method of analysis is multiple regressions. The study reveals the following results:

1. There is significant negative relationship between returns on assets (ROA) and CEO status, Board composition (BCOM), and Board size (BSIZE).

2. There is a positive and significant relationship between returns on equity (ROE) and Board composition (BCOM).

3. CEO status and Board size (BSIZE) shows no relationship with returns on equity (ROE).

Arising from the conclusions, we recommend that the code on board composition of listed insurance companies should be sustained and encouraged so that corporate governance could be strengthened to allow room for enhanced financial performance of the listed insurance companies in Nigeria. Regarding future line of research, efforts should be put at incorporating new corporate governance variables with regards to listed insurance companies in the country, for this will make the outcome of the research to be more robust.

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