

Can Governance Independence Determine Bank Efficiency?: Evidence from Nigerian Banking Industry

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Abstract: Banking industry is considered as the back bone of the any economy because many sectors rely on banking services. Independence governance mechanisms can influence the management to perform their activities effectively and efficiently. The present study investigates the effect of independent governance mechanisms on the efficiency of Nigerian banks. The study uses data of fifteen quoted banks as at 31st December 2014 for the period (2012-2014), using multiple regression analysis. The study finds that board independence, auditor independence and audit committee independence are significantly associated with the efficiency while independence chairman is not significantly associated with efficiency. The study concludes that independent governance mechanisms determine efficiency in Nigerian banks. The study recommends that policies (corporate governance code and external auditors' role) should be revisited for better control of the efficiency and transparency in banking industry.

Key words: Independence, corporate governance, efficiency, banking industry, Malaysia

INTRODUCTION

Financial institutions (Banking Industry) in Nigeria have been contributing a lot to the Nigerian economy for intermediation and supply of resources for long. In fact, it is seen as the backbone of the economy because many institutions including private and government agencies partly rely on the money institutions to finance their activities. In return, the institutions get back returns for their own sustainability as part of their incomes earns.

In spite of the importance of banking institutions, the sector is characterized with several governance failures that put a number of banks either out of business, forced into merger and acquisition or bailed out by the Central Bank Nigeria (CBN). For example, Central Bank of Nigeria conducted audit of financial good of 24 banks registered in 2009, the investigation revealed that most of the banks were at the threshold of collapse. The CBN had to inject N420 billion (\$2.8 billion) to bail out the first five banks (Afribank, Finbank, Intercontinental bank, Oceanic bank and Union bank). Then, two months later, additional N200 billion (\$1.33 billion) was injected to stimulate the liquidity of four other banks (Bank PHB, Equitorial Trust Bank, Spring Bank and Wema Bank). All these CBN intervention were done in order to save and stabilize the banks to be efficient (Njanike *et al.*, 2009).

Another issue that affects the financial activities of Nigerian banking is the issue of efficiency. Efficiency in

financial activities deals with the minimization of cost, reporting true and transparent financial figures at the due time. The lower the cost of the financial activities and the higher the efficiency and returns of the firms. The lesser the transparency and the bigger the risk of the financial reporting process, the larger the demand for monitoring of the financial reporting process by the stakeholders (Engel *et al.*, 2010).

For firms to be efficient depends on a number of characteristics of the firm, its environment and external forces (Engel *et al.*, 2010). This study considers some mixed mechanisms of internal and external forces as determinant of the firm efficiency. The relationship between independence control mechanisms (board independence, independent chairperson, auditor independence and audit committee independence) and managers' abilities to utilize the best resources and report transparent figures provide signals to the market.

Independence of the board and its committees can influence the firm monitoring mechanisms. Monitoring mechanism is the most appropriate term used by the firms that employ cost efficiency strategies (Govindarajan and Fisher, 1990). Monitoring mechanisms are also seen as part of corporate governance activities that facilitate the achievement of the organizational objectives. Corporate governance was introduced to regulate the business environment for the firms' long-term business success. Some studies have examined the relationship between corporate governance and profitability/efficiency of

business firms and come up with mixed findings (Bathala *et al.*, 1995; Hossain *et al.*, 2000; Lee *et al.*, 1992; Gani and Jermias, 2006; Park and Shin, 2004; Prevost *et al.*, 2002a; Rosenstein and Wyatt, 1990; Singh and Davidson, 2003; Young, 2003). Some studies use accounting-based performance measures such as returns on asset, returns on equity (Park and Shin, 2004; Singh and Davidson, 2003) while others use market-based performance measures such as stock return or market value of equities (Baysinger and Butler, 1985; Coles *et al.*, 2001).

In addition, outside directors in the board will put the boards in a better position to challenge management and negotiate with it and, in extreme cases, enable boards to terminate managers' employment (Dallas, 2003). Also, outside directors tend to rely on outcome measures or financial control in evaluating management due to their lack of specific, insider information about the firm (Baysinger and Hoskisson, 1990; Zahra and Pearce, 1989). This study differs from previous studies because the study uses different various independents at the board, audit committee and external auditors mechanisms to investigate governance independence mechanisms effect on the efficiency of Nigerian banks using accounting-based measurement.

Literature review: There are several theories that linked principal and agent issues but Agency theory has been the most dominant approach that links the relationship between board independence and efficiency. The theory explains that asymmetry information between the principal (shareholders) and the agent (management) enforce accounting costs on monitoring the agent (Gani and Jermias, 2006). According to the theory, firms might minimize agency costs by establishing appropriate monitoring systems through board of directors to supervise managers effectively (Byrd and Hickman, 1992; Fama and Jensen, 1983). This movement of having independent chairperson including more outsiders and independent directors on the board and audit committee has aimed at making boards and audit committee more independent from management. Gulati and Westphal (1999) propose that for managers are under considerable pressure to conform to the wishes of corporate insiders, firms need to provide effective supervision on managers, Berger and Humphrey (1997) report that 130 studies that apply frontier analysis to determine financial institution efficiency; 116 were published from 1992-1997. There are now enough frontier analysis studies to draw some tentative comparisons of average efficiency levels both across measurement techniques and across countries.

There are many frontiers analyses methodologies used to compute financial institution efficiency and there is no consensus among researchers on which method is the best. Some of these approaches include the Stochastic Frontier Approach (SFA), the Thick Frontier Approach (TFA), the Distribution-Free Approach (DFA), Market-Based Measurement and Accounting-Based Measurement. This research will use Accounting-Based Measurement (returns on asset) to measures the efficiency because it has direct relationship between what is realized as income and the resources invested.

Board independence and efficiency: Board independence play vital role in controlling and supervising the general activities of managers in a corporation (Westphal, 1999). The empirical findings regarding effect of board independence and firm efficiency/profitability have been inconclusive. For example, Hossain *et al.* (2000) posit that the value of outside directors is transmit their ability to judge firm efficiency objectively and inside director inside director may lack this quality which limit their effectiveness as corporate monitors. Chung *et al.* (2003) examine whether board independence improve firm performance through capital and R&D expenditures. They find that capital and R&D expenditure have positive impact on firm performance/efficiency, for only firms that have a high proportion of outside directors. Hossain *et al.* (2000) use data from New Zealand also find a positive relationship between higher levels of board independence and firm profitability/efficiency. Akhigbe and Martin (2006) show that SOX influence on market valuation in financial service firms with majority with independence board. Benkel *et al.* (2006) and Osma and Noguer (2007) find that boards with higher independence are associated with lower miss statements of account. Gani and Jermias (2006) find that the relationship between board independence and cost-efficiency is positive and strong.

In contrast, Bathala *et al.* (1995) find a negative correlation between board independence and performance/efficiency. Other studies like Vafeas and Theodorou (1998) and Prevost *et al.* (2002) do not find significant relationship between the board independence and efficiency/performance.

Independent chairperson and efficiency: Separate independent person as the chairperson of the board of directors can give a chance to the board of directors to control the affairs of management effectively. Rechner and Dalton (1991) find that the financial returns of firms with independent chair of the board consistently outperformed those with duality. Anderson *et al.* (2003) find that

earnings informativeness is positively related to firms with separated CEO and chair positions. Abdul Rahman and Haniffa (2005) supported that by saying companies with CEO duality did not perform well. Dey (2008) also finds partial support that the duality of CEOs is negatively related to the credibility of earnings announcements. Chang and Sun (2009) find a negative relationship between dual-role of CEOs and earnings informativeness after SOX. Murhadi explore the result indicate that CEO duality have significant effect on manipulation of account. Mohamad *et al.* (2012) find that separation of chairperson and chief executive officers in the companies have negative impact earnings management activities in the post-transformation period.

In order hand, several studies argue that CEO duality bring benefits in the form of reduced information costs and enhanced command of leadership (Anderson and Anthony, 1986; Brickley *et al.*, 1997). Baliga *et al.* (1996) find only weak evidence that CEO duality affects a firm's long-term performance/efficiency.

Auditors Independence and Efficiency: Researchers have been studying the possible for non-audit fees to damage auditor independence for quite moment of periods (Barkess and Simnett, 1994; Simunic, 1984). The basis underlying this alarm is the addition to the monetary bond between auditor and client created by the audit, the provision of non-audit services to audit clients can lead to yet another financial bond (DeAngelo, 1981; Simunic, 1984) which can affect auditors' independence related to transparency and efficiency issues.

Code of corporate governance requires that listed firms that are operating in a regulated market for shares or bonds must disclose both audit and non-audit fees. This rule is planned to provide financial statement stakeholders with full information about the type and level of both audit and non-audit services. The ratio of non-audit fees to audit fees can serve as an indicator of the degree of auditor-client (financial) independence.

Previous studies find mixed result for example, it was find no significant relationship between non-audit fees and auditors' reporting behavior for the U.S. audit market (Callaghan *et al.*, 2009; Geiger and Rama, 2003). Geiger and Rama (2003) find a positive relationship between the level of audit fees and auditors' reporting behavior but no relationship is documented in other earlier U.S. studies, regardless of the type of fees considered. However, the most recent US research finds a negative relationship between the level of non-audit fees and the likelihood that a company receives a going concern (Blay and Geiger, 2013).

Studies in Australian audit market, Sharma and Sidha (2001) and Sharma and Sidhu (2001) document a negative relationship between non-audit fees and auditors' reporting behavior; however, Barkess and Simnett (1994) find no significant relationship between non-audit fees and auditors' reporting behavior. For the UK audit market, Lennox (1999) finds that the level of non-audit fees is not significantly related to auditors reporting behaviors. In contrast, Firth (2002) and Basioudis *et al.* (2008) find non-audit fees are significantly negatively related to auditors' reporting behavior in the United Kingdom.

Audit committee independence and efficiency: The audit committee's independence allows the committee to review of the adequacy and compliance with internal accounting controls. For the audit committee to be fully independent and effective committee, the majority of the members must be independent directors or non-executive directors (Firth, 2002). Post SOX studies have found that an effective audit committee is positively associated with high quality financial reports (Lennox, 1999).

Empirical studies such as Barkess and Simnett (1994) find that audit committee independence has a negative relationship with misstatement. Bryan *et al.* (2004) find that an effective independent audit committee improves the credibility of reported earnings. Jenkins finds independent audit committee mitigates the income increasing. Goh (2009) show favorable SOX influence on the market valuation in financial service firms with majority independent audit committee. Benkel *et al.* (2006) and Osma and Noguer (2007) similarly, observed the situation whereby they find that audit committees with higher independence are associated with lower income misrepresentation. Chang and Sun (2009) find that the markets react positively to the disclosure of a fully independent audit committee after SOX.

In order way round, Fodio and coauthors in their study revealed that audit committee independence have a positive relationship with earnings manipulation, which implies that these variable might not reduce the extent of earnings manipulation by managers.

MATERIALS AND METHODS

This study is limited to the banks listed in Nigerian Stock Exchange (NSE). The population of the study consists of all fifteen (15) quoted banks operating in Nigeria as 31st December 2014. The study covered 3 year (2012-2014). The sample size is the same as the population given, since the population is not >20. The data were gathered from secondary sources.

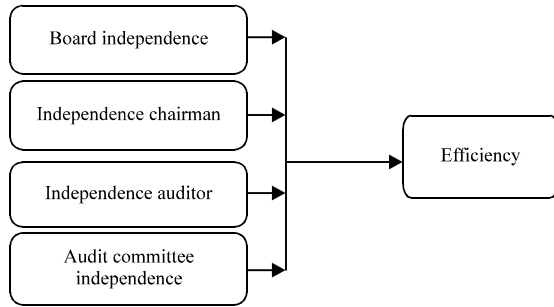


Fig. 1: Research framework

Conceptual framework: In this Fig. 1 above shows that efficiency as dependent variable of the study, board independence, independent chairperson, auditor independence and audit committee independence as the independent variables and firm size and financial leverage as control variables of the study.

Model specification:

$$Eff_{it} = \alpha_{it} + \beta_1 BOIN_{it} + \beta_2 CI_{it} + \beta_3 AI_{it} + \beta_4 ACIN_{it} + \beta_5 FSIZE_{it} + \beta_6 FLV_{it} + \mu_{it}$$

Where:

α = The intercept

β_{1-4} = The various slope coefficient

Efficiency (Eff) is measure using profit before tax divided by total asset. Board Independence (BOIN) is measured as the ratio of non-executive directors to the total directors in the board; independent Chairman (CI) is measured using dummy “0” = Independent chairman, CEO and chairman = “1”, Auditorindependence (AI) is measured using non-audit fee divide by the audit fee; Audit Committee Independence (ACIN) is measured as ratio of non-executive directors in audit committee to the total directors in the audit committee; firm size is measured as natural log of total asset and financial leverage is measured as total debt divide by total asset.

RESULTS AND DISCUSSION

Empirical evidence: The regression results of the model specification of the study are as follows: Table 1 shows that efficiency the mean of 0.016 which ranges from -0.059 to 0.499. Board of directors’ independence average is 0.693 which fall between 0.250-1.000 indicates that majority of the board members are independent directors. Chairman independence shows that almost 95% firms separated their CEO with the chairman of the board. Auditors’ independence shows the average of

Table 1: Descriptive Statistics

Variables	Mean	SD	Min.	Max.
ROA	0.016	0.017	-0.059	0.499
BOIN	0.693	0.207	0.250	1.000
CI	0.833	0.478	0.000	1.000
AI	0.323	0.176	0.196	0.964
ACIN	0.799	0.141	0.500	1.000
FSIZE	9.110	0.333	8.347	9.645
FLV	0.871	0.042	0.757	0.994

0.323 ranges between 0.196-0.964 indicates that majority of the auditors are independent auditors. Audit committee independence shows the average of 0.799 which ranges from half to full independent directors. Firm size average 9.110% ranging from 8.347-9.645% and financial leverage ratio average is 0.871 which falls between 0.757-0.994 shows that there are a lot of debts in the sector.

Table 2 shows the correlation of the explanatory variables use in the study. The result indicated that the ROA is positively correlated with BOIN, CI, AI and FSIZE. While is negatively correlated with ACIN and FLV. The highest with ROA is FLV which is -0.494. The highest correlation between the dependent and control variables are FSIZE and AI with the value of 0.671. The result indicates that there is no tendency of multicollinearity of all variables if included in the regression model. Furthermore, we tested for multicollinearity using variance inflation factors.

The result reported in Table 3 indicates that the mean of variance inflation factor of all the variables is 1.36 which is considered <10. This confirms the absence of multicollinearity in between the explanatory variables. We tested for the Heteroscedasticity, the result chi is 3.50 which is significant at 10% indicates that the variances are Heteroscedasticity. Therefore, we go ahead to estimate the coefficients of the determination using robust in order to take care of heteroscedasticity.

Table 4 shows the coefficient of determination of the model (R^2) is 0.330, this indicates that 33% of the changes in the dependent (efficiency) are explained by the predictors which fall within the accepted region and the remaining 67% is control by the other factors.

The result in Table 4 indicates that there is a positive relationship between board independence and efficiency which is significant at 1% level. It indicates that every 1 unit increase in non-executive director in the board leads to the 0.389 increases in the efficiency. This is consistent with the findings by Lindawati and Johnny which reveals that board independence leads to higher level of efficiency and also contradict the findings by Vafeas and Theodorou (1998) and Prevost *et al.* (2002a, b) who do not find significant relationship between the board independence and efficiency/performance. The result support the expectation of this study that firms with more independent board members are likely to monitor managers over efficiency in their activities.

Table 2: Correlation matrix

Variables	ROA	BOIN	CI	AI	ACIN	FSIZE	FLV
ROA	1.000						
BOIN	0.037	1.000					
CI	0.140	-0.291***	1.000				
AI	0.211	-0.176	0.130	1.000			
ACIN	-0.008	0.091	-0.109	-0.056	1.000		
FSIZE	0.464*	-0.299**	0.079	0.671*	-0.100	1.000	
FLV	-0.494*	0.003	0.044	-0.081	-0.068	-0.086	1.000

Table 3: Multicollinearity

Variables	VIF	1/VIF
FSIZE	1.970	0.508
AI	1.850	0.540
BOIN	1.200	0.833
CI	1.120	0.893
ACIN	1.030	0.973
FLV	1.020	0.984
Mean VIF	1.360	-

Table 4: OLS regression Analysis (Robust)

Variables	Expected Sig	Coefficients	t-Statistics
BOIN	+	0.389	2.040**
CI	+	-0.083	-1.260
AI	+	0.374	1.330*
ACIN	+	0.366	1.670*
FSIZE	-	-0.392	-2.330**
FLV	+	1.682	1.940**
R ²			0.330
f-Statistics			4.080
Sig.			0.003

*, **, ***significant at 10, 5 and 1 percent respectively (at one tail)

The study also provides evidence that chairman independence negatively and not significantly associated with efficiency. The result shows that every 1 unit increases in chairman independence leads to -0.083 decrease in the firm efficiency. This indicates that too much chairman independence leads to poor performance in monitoring for efficiency. This result is consistent with the finding by Mohamad *et al.* (2012) saying that separation of chairperson and chief executive officers in the companies have negative impact in management activities. However, it is contrary to the finding by Murhadi which indicates that CEO duality have significant effect on manipulation of account.

The association between auditor independence and the efficiency was found positive and significant at 10% showing that every 1 unit increase in auditor independence leads to 0.374 increase in efficiency. This is consistent with Geiger and Rama (2003) who find a positive relationship between the level of audit fees and auditors' reporting behavior. The result supports the expectation of the study that firms with more independent auditors are likely to monitor managers over efficiency. The present study provides evidence that audit committee independent is positively associated with firm efficiency and it is significant at 10% level. The result indicated that every 1 unit increase in audit committee independence

leads to 0.366 increase in the firm efficiency. This shows that audit committee independent yield good monitoring of the efficiency. This is inconsistent with Fodio and coauthors which reveals that audit committee independence increase accounting manipulations. Similarly, it is supporting the findings by Osma and Noguer (2007) which said out that audit committees with higher independence are associated with lower income misrepresentation.

This result provides that firm size is having negative relationship with efficiency which is significant at 5% level indicating that any 1% increase in the capital of the company leads to -0.392 decrease in efficiency. Financial leverage is positively and significantly at 5% related to efficiency indicating that any 1 unit increase leads to 1.682 increases in efficiency showing that the more company employed debt which will increase carefulness which enhances performance in the firm.

The overall result in Table 4 shows that the f-statistic explains the aggregate impact of the explanatory variables on the dependent variable (efficiency). The f-statistic 4.080 is significant at 1% level. This highlighted that the independence variables in this study have a significant aggregate impact on the efficiency of the quoted Nigerian banking industry. This indicated that if all the explanatory variables can work together to achieve maximum efficiency.

CONCLUSION

Independence of governance mechanism believes to enhance the control of managers' activities in organization. The study find that board independence, auditor independence, audit committee independent are significantly associated the efficiency while independence chairman is not significantly associated with efficiency. But the overall t-statistic is significant which signifies that governance independence lead to the bank efficiency in Nigeria. The study concludes that governance independence determined efficiency in Nigerian banking industry. The study recommends that policies (corporate governance and external auditors) should be revisited for better controls in the efficiencies and transparency in the activities of Nigeria banks. The relationship between

governance independence and efficiency is in conclusive area of research which needs more research, especially in the major area of the limitation of this study such as population, measurement of the efficiency.

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