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Agency theory and corporate governance: A comparative study of Board diversity and financial performance in Nigeria

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Abstract

Using panel data, the paper looked at the impact of agency theory and board diversity in corporate governance on the financial performance of money deposit banks and a few chosen manufacturing enterprises in Nigeria over a five-year period from 2015 to 2020. As a dependent variable, the study employed Return on Asset and Return on Equity as a ratio versus board diversity of male to female, foreign members to non-foreign members, and age range of board members as explanatory variables. Data was gathered from annual reports, the Nigeria Stock Exchange, and the Bureau of Statistics, and it was determined that board diversity has a considerable impact on return on assets, but little or no impact on return on equity for banks.. Meanwhile, there is high significant of return on equity to the composition of board and little influence of return on asset on the board diversity in the case of manufacturing firms.

Keywords: Profitability Performance, Return on Asset, Return on Equity, Board diversity, Foreign directors, Male-Female directors.

1. Introduction

Ross, one of the oldest and most widely codified kinds of social interaction is the agency connection (2015). In both the financial and non-financial industries, agency is a significant issue in corporate governance Separation of ownership and control in a professionally managed corporation may lead to managers putting in insufficient effort, indulging in perquisites, selecting inputs or outputs that suit their own tastes, or failing to optimize firm value in general. In fact, the value lost as a result of professional managers maximizing their personal utility rather than the firm's value is offset by the agency of outside ownership. The family of Pareto-efficient fee schedules is defined by the assumption that the principal and agent work together to select a schedule that maximizes a weighted sum of utility.

The performance of a company's management reveals how well it adapts to changing situations. A company's quality is defined by its management's ability to respond quickly and correctly to changes in the business environment. The firm's ability to develop and implement tailored planning strategies for the business's environment is required under the agency hypothesis. Campbell and Underdown are a team (2017). If a corporation is to survive and grow, it must consider both the potential and the impact of environmental changes on future corporate performance.

Agents or managers may not always act in the best interests of shareholders when a company's control is separated from its ownership. Managers may be "satisfiers" rather than "maximisers," according to Simon Herbert (quoted in Baysinger and Hoskisson, 2015), who

are more concerned with protecting their own survival than increasing the firm's value to its shareholders, prefer to play it safe and seek an acceptable level of growth. When participating on a board, all directors must preserve their independence of thought, which demands probing questions until adequate answers are received that they and other board members can comprehend. Their primary goal should be to prioritize the company's interests. The ability of directors to run a successful corporation, as well as their competency and independence of vision and thinking, will determine the success of an organization.

However, according to Agency theory, in today's organization, when share ownership is widely held, managerial actions differ from those required to maximize shareholder returns, which are depending on management's composition in relation to the board of directors. Board diversity as a corporate governance concept based on agency theory has recently piqued the interest of policymakers, managers, directors, shareholders, and academia.. Many research have been conducted in order to discover the link between board diversity and firm success as a result of these diverse interests. Many findings, particularly in non-financial sector studies, have been ambiguous, according to Randoy, Thomsen, and colleagues (2006), owing to geographical variances, legal and cultural disparities, and temporal discrepancies in company performance metrics.

The competitive behavior of an organization has a significant impact on the financial performance of the organization as measured by revenue earned. A diverse board may hinder decision-making because the chances of obtaining consensus are lower, especially if the board members are not of like mind, as is often the case due to gender inequalities. As a result, a less efficient decision-making body will emerge, which may prove to be a significant impediment to a firm's competitive behavior. Chen, et al. (1996). In an organization, age diversity and the presence of financial experts on the board are critical because of the impact they have on the board members' risk-taking behavior and experience. According to Hambrick and Mason (1984), young managers are more likely to engage in risky methods, and firms with young managers will expand faster than firms with senior managers.

Recently, several formal models based on the performance of the board of directors in establishing efficient corporate governance control mechanisms have recently been devised. However, to accommodate the uncertain character of the agency problem, an updated model incorporating uncertainty in model parameters is required for a multi-level decision system like corporate governance. In addition, modeling studies of monitoring board diversity are being undertaken with real data in order to tackle the agency's problem in a more quantifiable way. This study proves the presence of agency theory by comparing the financial and non-financial sectors of Nigerian listed companies.

2. Literature Review

The agency theory characteristic of board composition (board independence) has conflicting results in terms of business success. Booth et al. (2002), Husonet al. (2014), Sinha (2016), Charitouet al. (2017), Coles et al. (2018), Sandaet al. (2018), Eklundet al. (2019), Zainal-Abidinet al. (2019), Dimitropoulos and Asteriou (2010), Kim and Lim (2010), Olayinka (2010), Sandaet al. (2018), Musa, Ifurueze, and Success (2013). Eklundet al. (2019), Zainal-Abidine (2010). He (2008), on the other hand, discovers a clear negative link between independent boards of directors and firm performance. The relationship between the two variables, however, is complicated, according to Duchinet al. (2010), because the nature of the association between board composition and business success is contingent on the cost of collecting information.

Donaldson and Davis (2016), Adams and Mehran (2018), Erickson et al. (2015), and Pathan and Skully (2016), on the other hand, found no evidence of a link between board independence and business success (2010). Foreign directorship is another facet of board diversity that may have an impact on corporate success. There is a considerable positive association between the participation of foreign directors on boards of directors and the financial success of firms, according to Oxelheim and Randoy (2001), Sandaet al. (2008), and Tornyeva and Wereko (2012). According to Schwizer et al., the factors have a substantial

negative association (2012). Depending on the cost of obtaining information.

In addition, the findings of a study on the relationship between board size and corporate success are contradictory. For example, Adams and Mehran (2018), Zainal-Abidinet al. (2019), Olayinka (2010), Tornyeva and Wereko (2012b), and Najjar (2013) and Musa, Ifurueze, and Bernard (2013) ,all find a strong link between board size and business success. Despite this, both Bennedse et al. (2008) and Cheng (2018) find a strong negative relationship between board size and firm performance. In contrast, Pathan and Skully (2010) found no link between board size and business performance. A nonlinear negative link between board size and business success was also observed by Sandaet al. (2010) and Musa, Success, and Nwaorgu, (2015).

Similarly, research into the link between director equity holding and corporate success has yielded varied results. According to Bhagat and Bolton (2008), there is a significant positive relationship between directors' stock holdings and corporate success. Despite the fact that Olayinka (2010) and Sanda et al. (2010) show a strong negative relationship between directors' stock ownership and performance, Mehran (2014) finds none. On the other side, Bhabra (2017) discovers a nonlinear association between directors' equity holdings and firm performance. The results are unclear in light of these circumstances.

The family-controlled board is another issue related to board qualities that may influence corporate success. There is a substantial correlation between family-controlled boards and business performance, according to Lausten (2012), Maury and Pajuste (2015), Villalonga and Amit (2006), and Sandaet al. (2018) and Musa, Success and Iyaji, (2014).

Basic Agency Theory

The basic agency paradigm was developed in the economics literature during the 1960s and 1970s to determine the appropriate degree of risk-sharing among different individuals (Spence and Zeckhauser, 1971; Ross, 1973; Jensen and Meckling, 1976; Harris and Raviv 1976, 1978; Holmstrom, 1979). However, the domain of agency theory was gradually extended to the management field for determining collaboration between distinct persons in the organization with diverse goals, as well as goal congruency (Eisenhardt, 1989). Agency theory was widely employed in managerial accounting in the 1980s to find optimal incentive contracts among various staff and design appropriate accounting control mechanisms to monitor their behaviors and actions (Demski, 1980; Biaman, 1982; Namazi, 1985). The last function of the agency theory will be the focus of this research.

In its most basic form, agency theory refers to circumstances in which one person (referred to as the agent) is hired by another person (referred to as the principal) to act on his or her behalf based on a set of fees. Because both individuals are supposed to be utility maximizers who are driven by both monetary and nonmonetary items, incentive difficulties may occur, especially when there is uncertainty and information asymmetry.

That is, the principal's and agent's objective functions may be incompatible, causing the agent to take activities that threaten the principal's benefits. Furthermore, an agency operates in a risky and uncertain environment. Essentially, the basic agency theory presupposes that both parties are risk averse.

The quantity and nature of created accounting information and other information sources would become a key concern in risk sharing and managing the agent's behavior in this situation (Namazi, 1985; Baiman, 1982, 1990).

However, the fundamental agency model has been extended to include numerous agents (Holmstrom, 1979; Antle, 1982; Radner, 1981), private information (Penno, 1984), multiple period performance (Radner, 1981), and multi-objective models (Holmstrom, 1979; Antle, 1982; Radner, 1981). (Namazi, 1983). Furthermore, the impact of different cultures on the assumptions of the agency theory has been studied (Osterman, 2016; Kren and Tyson, 2019).

A corporation can be described as a nexus of contractual agreements among distinct individuals, according to the agency theory paradigm, and according to Alchian and Demsetz (1972), Jensen and Meckling (1972), and Kaplan (1984), among others. Contracts, in this view, are an appropriate mechanism of allocating resources and revealing the scope of a firm's activity.

They can also be used to create a strong framework for successful management accounting control procedures. Performance metrics, relevant control variables, and exogenous and endogenous aspects affecting the control process can all be quantified using the "agency theory" framework in this context. As a result, this study employs agency paradigms to evaluate the effect of agency theory in influencing corporate financial performance.

Concept of Board Composition

The degree of variety in a board's composition is measured (Akhalumeh, et al. 2011). The board of directors is in charge of the company's long-term success. A chairman (who may be an executive director but is more often a non-executive director), sometimes a deputy chairman, a chief executive officer (who is an executive director), other executive directors, and other non-executive directors make up the (unitary) board of a major company in many countries.

To properly fulfill their separate roles, the board and its committees should have a right balance of talents, experience, independence, and corporate expertise. All directors should be able to devote enough time to the company in order to properly carry out their duties. The board should not be too big

i) The code of corporate governance in Nigeria specifies that the size of the board should not be less than five (5) and should not exceed fifteen (15) persons.

ii) The UK Corporate Governance code states that ‘the board should not be so large as to be unwieldy.

iii) The Singapore code of Corporate Governance states: ‘The Board should examine its size and, with a view to determining the impact of the number upon effectiveness, decide on what it considers an appropriate size for the Board, which facilitates effective decision making.’ In deciding what a suitable size of board is for a particular company, ‘the Board should take into account the scope and nature of the operations of the company.

The board's functions, according to Garrat (1997), are to: i. determine the company's purpose and "ethics"; ii. select the company's direction, or strategy; iii. plan; iv. monitor and control managers and the CEO; and v. report and make recommendations to shareholders.

Individual directors are personally liable if the company was trading "wrongfully" (operating while insolvent), continuing to trade while there was no reasonable possibility of it being able to pay its obligations, illegally (e.g. Emron, AWB), or in violation of laws and regulations.

3. Methodology

This study used multiple regression analysis and panel data to determine and detect any significance of agency theory using board diversity of gender diversity, ethnic diversity, and age diversity with control variables (firms size, leverage, and board size) for proper management of it on the financial performance of commercial banks and manufacturing firms in Nigeria. Since we must take into account the firms' specific characteristics in the sample, the data used in the empirical analysis are from the firms' audited and published annual financial-year-end reports of the selected commercial banks and manufacturing firms observed from 2012 to 2020. The sample consists of ten (10) commercial banks and ten (10) conglomerate manufacturing firms.

Model Specification

Return on Equity (ROE) as a dependent variable: The ratio of Net Income After Taxes to Total Equity Capital is known as return on equity capital. It is the rate of return earned by the bank's stockholders on their funds invested in the bank (derived from Marimuthu and Koladaisamy, 2009b; 2009c; Sandaet al., 2010). The return on equity (ROE) measures how well a bank's management uses its shareholders' money. The ROE of a company is influenced by its ROA as well as the bank's financial leverage (equity/asset) (according to the works of (Cheung et al., 2005; Marimuthu, 2008; Marimuthu and Koladaisamy, 2009c).

However, the board diversity activities at any firms in Nigeria which have direct or indirect effect on the financial performance are categorised into board gender diversity, For the purposes of this study, board ethnic diversity and board age diversity were considered. The ratio of female directors on the board of directors is used to measure gender diversity

(borrowing from the works of (Williams, 2000; Swartz and Firer, 2005). Swartz and Firer (2005), on the other hand, define ethnic diversity as the proportion of individuals of color on the board compared to the entire board size. Oxelheim and Randoy (2001) use a dummy variable to measure ethnic diversity, with a value of 1 if the firm contains one or more Anglo Americans and 0 otherwise.

This measure by Oxelheim and Randoy (2001) is adapted but with modification. Ethnic diversity is measured as a dummy variable taking the value of 1 if the board consists of both Northerners and Southerners in Nigeria, and 0 otherwise. Age can be considered as a proxy for the extent of experience and risk-taking manner (Herrmann and Datta, 2005). Hambrick and Mason (1984) suggest that youthful managers are more inclined to undertake risky strategies, and firms with young managers will experience higher growth than their counterparts with older managers. Age diversity shall be measure with the proportion of members less than 50 years of age. Oxelheim and Randoy's (2001) measure has been modified, although with several changes. Ethnic diversity is measured using a dummy variable that takes the value 1 if the board is made up of both Northern and Southern Nigerians, and 0 otherwise. Age can be used as a proxy for a person's level of experience and willingness to take risks (Herrmann and Datta, 2005). According to Hambrick and Mason (1984), young managers are more likely to engage in risky methods, and firms with young managers will expand faster than firms with senior managers. The fraction of members under 50 years old will be used to measure age diversity.

The model used for the study was:

$$ROE_{it} = \alpha_i + \alpha_1 logBGD_{it} + \alpha_2 logFDR_{it} + \alpha_3 logFINEXP + \alpha_4 logBS_{it} + \alpha_5 logFS_{it} + \alpha_6 logLV_{it} + \varepsilon_{it} \quad (1)$$

$$ROA_{it} = \gamma_i + \alpha_1 logBGD_{it} + \gamma_2 logFDR_{it} + \gamma_3 logFINEXP + \gamma_4 logBS_{it} + \gamma_5 logFS_{it} + \gamma_6 logLV_{it} + \varepsilon_{it} \quad (2)$$

4. Result and Analysis

Correlation Analysis

The summary of the expected association and relationship between the explanatory variables and firms' returns is disclosed in Appendix 1a & b. The result indicates that returns on equity and asset are positively but insignificantly correlated. The insignificance relationship between them could result from the systematic and stochastic patterns dominant in each bank and in each period. The result could also stem from inconsistent relationship between equities and assets over time. The result shows that the returns on asset of banks is positively related to leverage ratio and number of financial expertise within boards and negatively related to firm size, board composition (both female-male ratio and foreigners-national ratio) though the returns on asset for manufacturing companies is positively related to firm size. On the other hand, for banks and manufacturing companies, returns on equity seem to have a positive relationship with firm size, leverage ratio, board composition (both female-male ratio and foreigner-national ratio) and a negative relationship with number of financial expertise. However, leverage ratio and number of financial expertise are not significantly correlated with returns on equities but maintains a significant relationship with returns on asset, whereas, on the other hand, board composition in terms of gender (i.e. ratio of female to male) and nationality (i.e. ratio of foreigners to nationals) tends to correlate significantly with returns on equities only. Meanwhile, although firm's size has a negative (positive) relationship with returns on asset (returns on equities), this relationship is significant even at 1% significance level for manufacturing companies whereas it is redundant in banks.

Regression analysis

Bank estimation

The result shows that apart return on asset is positively related with leverage ratio, firm size, foreign dominance in board and level of

financial expertise whereas it is negatively related with large female dominance in board. On the other hand, return on equity is negatively related with all except for firm size and foreign dominance in board. The result depicts that a 1% increase (decrease) in leverage ratio, ratio of foreigners to nationals in board, level of financial expertise and firm size leads to a 0.007%, 0.03%, 0.014%, 0.06% increase (decrease) in returns on asset respectively, while a 1% increase (decrease) in ratio of female to male board members leads to a 0.2% decrease (increase) in returns on asset. Whereas, on the other hand, a 1% increase (decrease) in leverage ratio, ratio of female to male in board and level of financial expertise leads to a 0.002%, 0.85% and 0.06% decrease (increase) in returns on equity and a 1% increase (decrease) in the ratio of foreigners to nationals in board and the firm size will lead to a 0.17% and 0.31% increase (decrease) in returns on equity respectively. However, among all these predictors of returns on asset and equity, only firm is shown to be significant (even at 10%). Hence, this implies that under the fixed effect model, only firm size significantly affects returns on asset and equity.

The table also shows the relationship between returns and aforementioned explanatory variables using the random effect model. From the result provided, returns on asset has positive relationship with leverage ratio, level of financial expertise and firm size and a negative relationship with both female to male ratio in board and ratio of foreigners to nationals' ratio, whereas, all the predictors (except level of financial expertise) are positively related to returns on equity. Explicitly, for returns on asset, a 1% increase (decrease) in leverage ratio, level of expertise and firm size leads to a 0.012%, 0.019% and 0.02% increase (decrease) in returns on asset respectively while a 1% increase (decrease) in the ratio of female to male and ratio of foreigners to nationals among board members leads to a 0.04% and 0.07% decrease (increase) in returns on asset respectively. However, among the highlighted predictors, only leverage ratio and level of financial expertise are classified as being significant. Thus, given the random effects model, leverage ratio and level of expertise of board members significantly determines the level of returns on asset.

On the other hand, for returns on equity, it is significantly explained by only the ratio of female to male in board and firm size i.e. when female members in board increases (decreases) by 1% in relation to the male members, returns on equity increases (decreases) by 0.87%, while a 1% in the size of banks leads to an approximately 0.15% increase (decrease) in returns on equity on average.

Manufacturing Estimation

The regression result for manufacturing enterprises is presented in the appendix table. Return on asset is positively connected to leverage ratio, company size, foreign majority on the board, and level of financial knowledge, and adversely related to big female dominance on the board, according to the findings. Return on equity, on the other hand, is adversely related to everything except firm size and foreign board dominance. The result depicts that a 1% increase (decrease) in leverage ratio, ratio of foreigners to nationals in board, level of financial expertise and firm size leads to a 0.002%, 0.03%, 0.0006%, 0.23% increase (decrease) in returns on asset respectively, while a 1% increase (decrease) in ratio of female to male board members leads to a 0.03% decrease (increase) in returns on asset. A 1% increase (decrease) in the leverage ratio, the ratio of female to male on the board, and the level of financial expertise, on the other hand, results in a 0.006 percent, 0.01 percent, and 0.01 percent decrease (increase) in returns on equity, respectively, and a 1% increase (decrease) in the ratio of foreigners to nationals on the board and the firm size, respectively, results in a 0.02 percent and 0.49 percent increase (decrease) in returns on equity However, the gender ratio in the board of directors and firm size are important in the return on asset model, whereas the gender ratio and leverage ratio are significant in the return on equity model, even at the 1% level. As a result, the gender ratio, leverage ratio, and firm size have fixed effects in the fixed effect model.

The adjusted R squares of 0.441 and 0.836 suggest that leverage ratio, firm size, gender ratio in board, nationality ratio in board, and financial experience explain about 44.1 percent and 83.6 percent of the variations in returns on asset and returns on equity for the manufacturing company fixed effect model, respectively. The relevance of the models is further verified by the F-probability Statistic's threshold, which is less than 1%.

The relationship between returns and aforementioned explanatory variables using the random effect model. From the result provided above, returns on asset has positive relationship with leverage ratio, level of financial expertise and firm size and a negative relationship with both female to male ratio in board and ratio of foreigners to nationals' ratio, whereas, all the predictors (except level of financial expertise) are positively related to returns on equity. Explicitly, for returns on asset, a 1% increase (decrease) in leverage ratio, level of expertise and firm size leads to a 0.004%, 0.01% and 0.02% increase (decrease) in returns on asset respectively while a 1% increase (decrease) in the ratio of female to male and ratio of foreigners to nationals among board members leads to a 0.04% and 0.02% decrease (increase) in returns on asset respectively. However, among the highlighted predictors, only gender ratio and firm size are classified as being significant. Thus, given the random effects model, leverage ratio and firm size significantly determines the level of returns on asset.

On the other hand, for returns on equity, it is significantly explained by only the ratio of leverage ratio i.e. when leverage ratio increases (decreases) by 1%, returns on equity increases (decreases) by 0.008%.

The adjusted R squares of 0.462 and 0.412 suggest that leverage ratio, firm size, gender ratio in board, nationality ratio in board, and financial experience explain about 46.2 percent and 41.2 percent of the variations in returns on asset and returns on equity in the manufacturing company random effect model, respectively. The relevance of the models is further verified by the F-probability Statistic's threshold, which is less than 1%.

Hausman test

Hausman test on Returns on Asset

Test	**Banks**	**Manufacturing**
Chi square statistic	8.97 (0.11)	6.43 (0.27)

Hausman test on Returns on Equity

Test	**Banks**	**Manufacturing**
Chi square statistic	16.79 (0.005)	21.86 (0.0006)

The Hausman test result shown above provides information as whether to adopt the fixed effect or the random effect. The null hypothesis of this test is that the random effect is equally good as the fixed effect, thus we chose the random effect because it is more efficient if the null hypothesis is not rejected. The null hypothesis cannot be rejected based on the test results for returns on assets for banks and manufacturing enterprises because the probability value is greater than the crucial level of 5%. As a result, this study uses the random effect model for the returns on asset model since it is more efficient. The null hypothesis is rejected in the Hausman test for bank and manufacturing company returns on equity, and the conclusion is that the fixed effect model is better for returns on equity in both cases.

However, because the results of the two heterogeneous models are so dissimilar, the study integrates the findings of the fixed and random effect models. Thus, business size, leverage ratio, gender ratio, and level of competence are all important determinants of returns on assets, whereas firm size, board gender composition, and leverage rate are all major determinants of returns on equity.

5. Conclusion

All of the explanatory variables (excluding the ratio of foreigners to nationals in board) had substantial effects on company returns, according to the data. To begin with, bank returns (as demonstrated in the data) tend to climb as the firm's board of directors includes more females than males. As a result, female board members are demonstrated to be more efficient and capable than male board members; in this situation, the gender gap has a considerable impact on the firm's performance. Women are thought to be better at business (profit) management than men in this scenario.

Furthermore, data show that as a company grows, it becomes more efficient, increasing its profits over time. In other words, as businesses grow larger, they benefit from economies of scale, as large transactions can be completed at a cheaper cost than before. As a result, as a bank grows, it becomes more profitable.

However, the results from the manufacturing industry provide a different perspective on the

subject, as return on asset is positively related to leverage ratio, firm size, foreign dominance in the board, and level of financial expertise, while return on equity is negatively related to large female dominance in the board. Given that the agency theory couldn't make a significant difference in the manufacturing industry, one could conclude that the agency theory couldn't make an absolute difference.

The conclusion on leverage ratio also revealed that as companies become more risk-averse, profit increases. This means that risk tends to obstruct effective bank performance, i.e., as a bank is exposed to more risk, its operations are negatively impacted, and profit suffers as a result. Meanwhile, organizations that are assured that they are risk-free run effectively because they are optimistic about the future. Similarly, as the level of competence of board members improves, organizations' operations and performance improve. This implies that when board members' education and understanding improves, they become more diplomatic in dealing with managerial challenges, which improves the firm's performance.

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