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Proposed Corporate Governance System for Nigeria: Market-Based vs. Institutionally-Based Model

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Abstract

The purpose of this paper is to address the corporate governance system in Nigeria as to whether it is likely capable of mitigating the agency problem. Following an overview of both the market-based and the institutionally-based corporate governance models the authors propose the institutionally-based model for Nigeria considering the country's peculiarities. This is the first attempt to specifically suggest that the institutionally-based model would be preferred for Nigeria against the present market-based model that is in operation. This paper has implications for regulators as there is the need to provide adequate protection for investors in view of the weak enforcement and compliance mechanism that obtains in Nigeria.

Keywords: Corporate governance, single-tier board, dual-board, Nigeria.

1. INTRODUCTION

The conflict of interest that exists between shareholders and managers in firms resulting from the separation of ownership and control is addressed as an agency problem in the agency theory literature (Fama, 1980; Fama & Jensen, 1983; Jensen & Meckling, 1976; Munisi, Hermes, & Randøy, 2014). The literature argues that this agency problem requires a mechanism to mitigate it (Gillan, 2006; Simanjuntak, 2001). Besides, there are other company stakeholders whose interests must be synchronized with that of the overall organizational objectives. According to Freeman and Reed (1983), anyone that is a necessary contributor to the survival of the firm is deemed a stakeholder. This group includes but not limited to the host community, government, employees, creditors, suppliers, and customers who have different interests in the organization resulting in different agency problems (Gillan, 2006; John & Senbet, 1998).

Past studies suggest that strong and effective corporate governance mechanism is crucial for mitigating the agency problem (Connelly, Hoskisson, Tihanyi, & Certo, 2010; Core, Holthausen, & Larcker, 1999; Duffhues & Kabir, 2008; Jensen & Meckling, 1976; Munisi & Mersland, 2013; Ozdemir & Upneja, 2012; Reddy, Abidin, & You, 2015). Corporate governance issues have received increased attention in a number of countries as a result of corporate frauds and global financial crisis that have affected the fortune of many corporate organizations (Brown, 2008; Faleye, Hoitash, & Hoitash, 2011; Glick, 2002; Johnson, Boone, Breach, & Friedman, 2000; Walker, 2005). Empirical studies provide evidence that poor corporate governance practice by firms has association with increased executive compensation (Basu, Hwang, Mitsudome, & Weintrop, 2007; Core et al., 1999; Duffhues & Kabir, 2008; Murphy & Zabojnik, 2004). This is because of the perception that executive compensation is not related to company performance (Kaplan, 2012) and that it is also exacerbating the agency

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conflicts (Bebchuk & Fried, 2003; Harris, 2009; Murphy & Sandino, 2010; Tien, Chen, & Chuang, 2013). The implication is that poor corporate governance practice may likely exacerbate the agency problem.

In this paper, we address the corporate governance system in Nigeria as to whether it is likely capable of mitigating the agency problem. Although we do not claim to conduct any empirical analysis, we propose that Nigeria adopts the institutionally-based corporate governance system that suits the country's peculiarities. This is because the present market-based corporate governance system is described as inadequate (Adekoya, 2011), corruption laden (Adegbite, 2012), and weak (Okike, 2007). The remainder of this paper is structured as follows. Section 2 presents the associated benefits of good corporate governance practice by firms. Section 3 describes corporate governance practice from the international perspective. Section 4 discusses both market-based and institutionally-based corporate governance system. Section 5 describes the development of Nigeria's corporate governance system and section 6 provides the conclusion and recommendation.

2. BENEFITS OF GOOD CORPORATE GOVERNANCE IN FIRMS

The importance of effective corporate governance mechanism in any corporate organization cannot be overemphasized as it has been identified as an essential condition by institutional investors that desire to invest in emerging economies (Gibson, 2003). It is argued that adherence to the codes by companies signals their governance quality (Munisi et al, 2014). The Asian financial crisis and the collapse of Enron, Tyco, and WorldCom and other companies around the globe were all blamed on poor corporate governance practice (Brown, 2008; Glick, 2002; Johnson *et al.*, 2000; Walker, 2005). A rational investor will be very much concerned about the corporate governance practice of the firm he wants to add to his investment portfolio. Stanwick (2008) argues that foreign investors will be glad to invest in countries with good corporate governance structure at a premium. This is because such environment guarantees the safety of their investments.

3. INTERNATIONAL PERSPECTIVES ON CORPORATE GOVERNANCE

Different international organisations like the Pan African Consultative Forum on Corporate Governance, Organisation of Economic Cooperation and Development (OECD), Global Corporate Governance, and the Commonwealth Association of Corporate Governance are at the forefront of the campaign for good corporate governance practice by companies (Adekoya, 2011). The corporate governance landscape is a fairly well-researched topic spanning several countries from the Americas to Europe and Asia (Naciri, 2008). The results from the literature suggest that there cannot be a uniform corporate governance system because of the differences in legislation, national culture, and level of economic development. For example, Stanwick (2008) examined and compared the corporate governance system in the US and Europe and concludes that while there are certain standards that are universal in nature, some others are country specific.

After several decades of study there is no accepted universal definition of corporate governance because it has its roots in several academic disciplines as finance, economics, accounting, law, management, organizational behaviour (Balc, Ilies, Cioban, & Cuza, 2013; Durisin & Puzone, 2009; Rwegasira, 2000). In fact, Durisin and Puzone (2009) in their study had to investigate whether corporate governance is a discipline on its own or multi-disciplinary research area. They report that corporate governance has come of age in sophistication, depth and rigour, and consistency in the extent of its intellectual structure. Resulting from its root in different academic disciplines, there is bound to be diverse definitions from different authors depending on their perception on the subject. Claessens and Yurtoglu (2013) agree to the heterogeneous definition of corporate governance as they discussed the narrow and broad definitions of corporate governance. The narrow view definitions focus on the role of board of directors in protecting the interests of the shareholders while the broad view definitions centre on all inclusive corporate governance mechanisms by considering the interests of all the company's relevant stakeholders.

The literature points that corporate governance mechanism could either be internal or external to the firm (Baysinger & Hoskisson, 1990; Denis & McConnell, 2003; Gillan, 2006). For example, Denis and McConnell (2003) states that board of directors and ownership structure are internal corporate governance mechanisms while corporate control and legal system are external mechanisms. In another strand of literature, Rwegasira (2000) and Denis and McConnell (2003) classified corporate governance as either market-based or institutionally-based system. The market-based system takes after the Anglo-American model while the institutionally-based system takes after the Germany-Japan model of corporate governance. It is argued that firms are heterogeneous entities that have different governance problems that will require different approaches to tackle (Adams, Hermalin, & Weisbach, 2010). Therefore applying the same governance standards for all firms may not be suitable as it will sometime be counterproductive. It is also appreciated that different countries have developed different approaches to corporate governance system that is most suitable to their specific environment (see Naciri, 2008). In fact, Rwegasira (2000) suggests that African countries should adapt the institutionally-based model to suit their country specifics just as Ehikioya (2009) document that there is no one size fits all corporate governance system.

4. MARKET-BASED VS. INSTITUTIONALLY-BASED CORPORATE GOVERNANCE SYSTEM

Market-based corporate governance system is operational in US, UK because of their strong support for the free market economy. It is described as the Anglo-American corporate governance system (Rwegasira, 2000). This system is characterized by a single-tier board with large diffused shareholders, market for corporate control, and strong investor protection rights (Rwegasira, 2000). Denis and McConnell (2003) in their study identify board of directors and ownership structure as the internal corporate governance mechanisms of the firm while corporate control and legal system serve as external mechanisms. Gillan (2006) on his part identifies board of directors, managerial incentives, capital structures, bylaw and charter provisions, and internal control system as internal mechanisms while law/regulation, markets, and media are identified with external corporate governance mechanisms. The board of directors serves as the agent of the diffused shareholders whose duty is to monitor, discipline, hire and fire the manager whenever the need arises (Jensen, 1993). The alienable rights of the shareholders help them to dispose of their shares at will if they are not satisfied with the running of the company. This may in turn have adverse effect on the fortunes of the company and ability of the manager as there could be takeover bids from raiders.

There are however arguments that the board is not doing enough to protect the interest of the shareholders (Bebchuk & Fried, 2004; Jensen, 1993; Kaplan, 2012). Further, the expropriation hypothesis (La Porta, Lopez-de-Silanes, & Shleifer, 1999; Renders & Gaeremynck, 2012; Young, Peng, Ahlstrom, Bruton, & Jiang, 2008) argue that the presence of block shareholders would create what is addressed as the principal-principal agency problem where the block shareholders would be more prone to extract private benefits of control. Under this hypothesis, block shareholders will use their control rights and influence to their private advantage. It is in the light of the above that researchers have opined that the market-based corporate governance model may not be suitable for countries with weak investor protection rights (Rwegasira, 2000). Past studies suggest that the single-tier board is characterised by cronyism and directors' social network (Brick, Palmon, & Wald, 2006; Kirchmaier & Stathopoulos, 2008). All these are argued render the board ineffective in the discharge of its monitoring duties. It is argued that Nigeria's weak corporate governance system (Okike, 2007) has eroded the effectiveness of the board (Pierce, 2011). The implication is that the single-tier board may not likely act in the overall interest of the shareholders in Nigeria.

The institutionally-based system of corporate governance is also called the "bank-based" system because of the role of the bank in providing long-term fund for the company. Under this system the dual board structure comprising the management board and the supervisory board is operational (Rwegasira, 2000). This is the Germany-Japan system of corporate governance. Further, Bien, Délga, and Ged (2008) show that a country's legal system has strong influence in determining its corporate governance system. They argued that the Anglo-American corporate governance system is suitable for countries with "common law" origin like US and the UK but not for France with a "civil law" origin. Rwegasira (2000) offered Africa a choice to adapt the institutionally-based corporate governance system. Claessens and Yurtoglu (2013) report that voluntary and market corporate governance mechanisms are not suitable for a country with weak corporate governance system. Consistent with Claessens and Yurtoglu (2013), Rwegasira (2000) show that the Anglo-American model of corporate governance is suitable for countries with strong investor protection rights. It can therefore be inferred that the Anglo-American model of corporate governance may not be suitable for a country like Nigeria with weak investor protection rights (Okike, 2007; Yakasai, 2001). However, Nigeria's corporate governance code is patterned after the UK style of corporate governance even though the requisite attributes for its effective operation is absent in the country.

The institutionally-based corporate governance model has a dual board structure unlike the Anglo-American corporate governance model with a single-tier board. The dual board is categorised into the supervisory board and the management board. The inherent advantage under this arrangement is that the members of the management board are nominated by the supervisory board (Ross & Crossan, 2012). The supervisory board has representatives of various stakeholders such as the employees, financial institutions and shareholder representatives. These stakeholders that constitute the supervisory board may have the incentives to constrain the management from exhibiting opportunistic behaviour. The supervisory board may therefore be inclined to do proper monitoring of the management board and also free from managerial interference.

Table 1: Comparisons between market-based and institutionally-based corporate governance system

	Market-based corporate governance	**Institutionally-based corporate governance**
1.	Single-tier board	Two-tier board
2.	Shareholder oriented	Stakeholder oriented
3.	Anglo-American model	Germany-Japan model
4.	Diffused shareholders provide long-term fund for the company	Banks provide long-term fund for the company

5. DEVELOPMENT OF CORPORATE GOVERNANCE IN NIGERIA

With explosive research efforts across the globe on corporate governance, little is known about it in Nigeria except from some studies (Adegbite, 2012; Adekoya, 2011; Ahunwan, 2002; Ehikioya, 2009; Okike, 2007; Yakasai, 2001). Historically, it was the British colonialists that introduced company formation that recognised the separation of ownership and control into Nigeria and the subsequent promulgation of different companies' legislation prior to Nigeria's independence in 1960 (Ahunwan, 2002; Okike, 2007). It is specified in these legislations how a company is to be governed responsibly. During this period, majority of the companies were foreign owned. Before 1970, there was little concern for how corporate enterprises were run in Nigeria (Yakasai, 2001). This was because most of those companies were either foreign or government owned (Ahunwan, 2002).

It was the Institute of Chartered Accountants of Nigeria during its Annual Conference in 1998 that extensively discussed the issue of corporate governance in companies resulting from the allegations levelled against auditors by the public for not doing enough regarding the corporate scandals in Nigeria (Okike, 2007). These scandals involved Lever Brothers Nigeria Ltd. and some commercial banks (Ahunwan, 2002; Aina, 2013). It was aftermath of this that an exhaustive discussion of corporate governance in the Nigeria banking sector with its accompanying challenges was conducted by Yakasai (2001), while Ahunwan (2002) and Adegbite (2012) examined corporate governance in Nigeria and corporate governance regulation in Nigeria respectively.

In an attempt to enhance the corporate governance practice in Nigeria, section 359 (4) CAMA 1990 established the Audit Committee (not more than six members) to be comprised of an equal number of shareholders and directors. This committee is required to make its report to the shareholders at the Annual General Meeting. Section 1 of CAMA 1990 established the Corporate Affairs Commission (CAC) with accompanying functions contained in section 7 that empowers the Commission to have oversight functions over registered businesses in Nigeria. With the global corporate scandals and failures coupled with increasing emphasis on good corporate governance practice by developed and emerging economies, it was not long for Nigeria to decide on a standard corporate governance code for its listed companies if it must remain attractive to foreign and informed investors. The financial crisis in the banking sector in the 1990s added fervour to this pursuit. It was this line of reasoning that led the SECN on June 15, 2000 to constitute a seventeen member committee that has Atedo Peterside as chairman to draft a standard corporate governance code for listed companies in Nigeria.

The Peterside committee's recommendations were published as Code of Corporate Governance for Public Companies in Nigeria in October, 2003. The Securities and Exchange Commission Nigeria (SECN) code took after the UK code by adopting the single-tier board that is operational in the market-based system of corporate governance. In spite of the fact that the Nigerian code took after the UK code it fell short of international benchmark for standard corporate governance practice compared to that of South Africa, Malaysia, India and some other emerging economies. The inadequacy of the code was captured as the only code in Africa that does not adopt the all inclusive model of corporate governance (Rossouw, 2005). It adopted the narrow view classification of (Claessens & Yurtoglu, 2013).

The weaknesses of the code were not late in manifesting following the Cadbury Nigeria Plc financial fraud in 2006/07 and the banking sector crisis that cost the country about ₦2 Trillion (ROSC, 2008, 2011). The expectation was that the adoption of the code would deepen investors' confidence in the economy, provide protection for minority shareholders, make the capital market more liquid and encourage foreign investors into the country. This is because foreign investors will prefer making investments in countries with sound corporate governance practices (Stanwick, 2008).

As a means of improving the CG Code 2003, SEC Nigeria set up another committee in September, 2008 with M. B. Mahmoud as chairman to craft a new corporate governance code for Nigerian Listed Companies (NLCs) (SECN, 2011). Mahmoud's committee's final report was published in April, 2011 as Code of Corporate Governance for Public Companies in Nigeria. Adekoya (2011) discussed the inadequacy of corporate governance mechanisms in Nigeria as there are reported corporate scandals in spite of legal and regulatory framework put in place to ensure good corporate governance practice. Between 2008 and 2010 the country witnessed another series of banking crisis in spite of the code for banks issued by the Central Bank of Nigeria in 2006 after the banking consolidation exercise. This crisis was attributed to poor financial reporting by Nigerian banks (ROSC, 2011). Attention was once again focused on the effectiveness of the board of directors in performing its monitoring duty. Adegbite (2012) argued for a legal corporate governance regulatory framework in Nigeria in the short run given the corporate corruption that is deep in the country's corporate governance system. In addition, Sanda *et al.* (2011) argued for the need for NLCs to evolve better corporate governance mechanisms that will diminish the CEO's influence over the board and its committees and thus improve company performance. From the foregoing, it is evident that the market-based corporate governance system remains ineffective in the Nigeria setting considering country specifics as weak enforcement and compliance mechanism, weak investor protection rights, and weak market for corporate control. The existence of a supervisory board similar to what obtains in the institutionally-based corporate governance system may therefore be suggested for Nigeria to suit the country's specific environment. This is consistent with the suggestion by Rwegasira (2000) for African countries.

6. CONCLUSION AND RECOMMENDATION

In an era of globalization when countries are competing for global resources, it becomes imperative for a country to belong if it must have a place of reckoning among global participants. This paper has examined the development of corporate governance system that is operational in Nigeria after situating that from the external environment. Nigeria's corporate governance system is patterned after that of the UK where investor protection right and law enforcement mechanism is high unlike what obtains in Nigeria.

In the light of the inherent weaknesses associated with the market-based system of corporate governance that is in practice in Nigeria, we propose that institutionally-based corporate governance system be adapted for Nigeria to suit the country's specific environment. This is consistent with the suggestion by Rwegasira (2000) for African countries. This paper has shown that there are two major corporate governance models: the market-based and the institutionally-based models. This is the first attempt to specifically suggest that the institutionally-based model would be preferred for Nigeria against the present market-based model that is in operation considering Nigeria's peculiarities. This paper has implications for regulators as there is the need to provide adequate protection for investors in view of the weak enforcement and compliance mechanism that obtains in Nigeria.

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