

## CORPORATE GOVERNANCE, RISK MANAGEMENT DISCLOSURE, AND FIRM PERFORMANCE: A THEORETICAL AND EMPIRICAL REVIEW PERSPECTIVE



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### ABSTRACT

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The purpose of this study is to empirically and theoretically review the relationship between Corporate Governance (CG), risk management, and firm performance by suggesting future research agenda in this promising area. The study suggests the use ex-post facto research design to collect data on board characteristics (board size, board composition, board meeting, and board expertise), and quantitative content analysis to collect data on risk management disclosure from the annual reports and accounts of financial service firms quoted on the Nigerian Stock Exchange (NSE). The study also proposes the use of multivariate statistics in analyzing the data to be collected. Albeit, the study did not carry out any statistically analysis, yet, the review and theoretical evidences have shown that board characteristics (board size, board composition, board meeting, and board expertise) and risk management disclosure have positive relationship with firm performance. The outcomes from literature and theoretical review will be of paramount importance to the interest of firms that sought to know how board characteristics and risk management disclosure relate to their performance. This may in a long way aid them in making various business decisions.

**Contribution/ Originality:** Extant findings from literatures have shown that most prior studies engrossed mostly on corporate governance mechanisms and firm performance (FP), and risk management disclosure (RMD) without integrating the two components with FP. Thus, this paper will be a pioneering in establishing a link between board characteristics, RMD, and firm performance.

## 1. INTRODUCTION

Today's business environment has been highly competitive and often volatile in nature due to frequent changes and rapid advancement in technology. However, the 2008 and 2009 global economic crisis alongside several financial scandals by the managements of Enron, WorldCom, and Parmalat have increased the interests of multiple stakeholders to the effectiveness of Corporate Governance (CG) in organizations (Kyereboah-Coleman, 2008; Benjamin, 2009; Gill and Mathur, 2011; Fallatah and Dickins, 2012; Marn and Romuald, 2012; Shahwan, 2015). In like manner, the International Monetary Fund (IMF) Report (2009) reports that the issue of corporate failures resulting from global financial crisis have become severe because it is related to financial institutions which are the

main pillars in capital market stability serving as financial intermediaries for mortgage, government securities, corporate debt, equity markets, and derivatives among others. Relatively, several large financial institutions worldwide no longer exist or have been taken over precisely because they neglected the basic rules of risk management and control.

Afterwards, the financial reliability and stability, and profitability of a business solely depends on the process and practice of its CG, and with effective CG in operation, it is expected that the long-term value of stakeholders will be enhanced (Cohen *et al.*, 2002). Fairly, having the right boards ensure effective CG which influences related organizational outcomes (Carpenter and Westphal, 2001). In the opinion of Topal and Dogan (2014) the main duty of board of directors is to direct the overall activities of the corporation in a more cautious and proactive way because they are the apex authority in decision making process, and their directive to the corporation enables a continuous profit to the shareholders in the long-run. Board of directors is considered as the most important mechanism of organizational governance that is responsible for overseeing the decisions of the executives (Al-Manaseer *et al.*, 2012).

Nevertheless, the issue of corporate failure and its associations with weak governance that leads to poor performance is also experienced by Nigeria. In this regard, the Nigerian capital market has been shocked from the global financial crisis which leads to loss of jobs and investor confidence in the capital market, alongside, doubt in the effectiveness of existing CG practice (Mmadu, 2013; Ironkwe and Ade, 2014). The Central Bank of Nigeria (CBN) (2010) reports that the failure of some firms in the financial institution was due to weak CG and inadequate disclosure and transparency in reporting, and inadequate risk management frameworks for identifying, measuring and controlling the risks associated with their activities. These leads to the revision of old and reissuing of a new code of CG in Nigeria in 2011 by the Securities and Exchange Commission (SEC), which requires all listed companies in the Nigerian Stock Exchange (NSE) to disclose full information about their activities including those on risk management and its associates. As this will help investors, regulatory authorities, financial analysts, and other stakeholders in decision-making processes.

Therefore, the objective of this study is to empirically and theoretically review the relationship between CG concentrating on board characteristics (board size, board composition, board meetings, board expertise), risk management disclosure, and performance. Hence, suggesting a future research agenda on this promising area of research.

## 2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

### 2.1. Board Characteristics

Companies' boards are charged with the responsibility of overseeing the activities of corporate managers on shareholders' behalf (Uadiale, 2010). Agency theorists believed that corporate managers possessed substantial power and freedom to manage and control shareholders' resources. Consequently, for board of directors to perform their functions effectively, some features like board size, board composition, board meetings, board expertise, to mention but a few, must be in place (Kakanda *et al.*, 2016). Whereas Brennan (2006) concludes that the effectiveness of board of directors' oversight function is influenced by some factors like board size, board composition, CEO duality, board culture, information asymmetries, and board diversity. Therefore, for the purpose of this study, characteristics of board like, board size, board composition, board meetings, and board expertise are considered.

#### 2.1.1. Board Size and Firm Performance

Board size as an important characteristic of the board is refer to as the degree of board of directors of a company (Kakanda *et al.*, 2016) or the total number of directors serving on a company's board (Vafeas, 1999; Ogege and Boloupremo, 2014). In line with agency theory, a larger board size ensures an effective and efficient monitoring of management which reduces the power of the CEO on corporate board of directors, and therefore enhances firm

performance (Singh and Harianto, 1989). Again, based on resource dependence theory which aims at provision of intangible resources by board of directors to the firm (Hillman and Dalziel, 2003) so as to enhance firms' performance (Kiel and Nicholson, 2003) the size of board is expected to contribute to better operations and performance of companies.

Notwithstanding, some prior studies have found board size to be positively related with firm performance. For instance, Afrifa and Taurigana (2015) examined the impact of CG mechanisms on performance of listed Small and Medium Enterprises (SMEs) in UK and found that board size is positively related with performance. Others that found positive relationship include; Larmou and Vafeas (2010) and Saibaba and Ansari (2011; 2013) Whereas, others found a negative relationship between board size and firm performance (for instance, (Guest, 2009; O'Connell and Cramer, 2010; Chang and Duta, 2012)). Therefore, this study hypothesized that:

*H1. Board size has positive relationship with firm performance*

### **2.1.2. Board Composition and Firm Performance**

Board composition is the number of non-executive directors on board of a company (Kakanda *et al.*, 2016). It is the ratio of non-executive directors to total directors (Marn and Romuald, 2012). Fama and Jensen (1983) argued that non-executive directors' representation on the board increases board independence, directors' objectivity, and enhances directors' expertise. On the basis of agency theory, a corporate board that is dominated by a large number of non-executive directors are in a better position to serve in the best interest of the shareholders, and improve firm performance via effective oversight functions on the management (Hermalin and Weisbach, 1988).

Similarly, as an assumption of resource dependence theory, companies that invite and appoint powerful community members into their boards acquired vital resources from the external environment which may leads to performance increase (Provan, 1980). Some prior related studies found a positive relationship between board composition and firm performance. For instance, Harvey *et al.* (2015) investigate the association between CG mechanisms and performance of firms in South Africa, and the result shows that composition of board of directors (non-executive directors) is positively related with firm performance. Some studies that belong to this group include; Abdurrouf (2011); Agrawal and Knoeber (1996) and Ali and Nasir (2014). While others have found a negative relationship (for instance, (Marn and Romuald, 2012; Narwal and Jindal, 2015)). Hence, this study hypothesized that:

*H2. Board composition has positive relationship with firm performance*

### **2.1.3. Board Meeting and Firm Performance**

Board meeting is viewed as "the gathering of directors on the board to discuss issues regarding the company" (Kakanda *et al.*, 2016). Equally, board meeting serves as a means or an avenue for making effective decisions of a firm. Based on agency theory perspective, with frequency meetings, boards exhibit significant abilities in terms of counselling, penalizing, and overseeing management actions, hence enhancing performance of firms (Vafeas, 1999).

Some prior studies have found a positive and significant relationship between board meeting and firm performance. For instance, Liang *et al.* (2013) found that board meeting has positive and significant effect on asset quality and performance of 50 largest banks in China covering periods from 2003 to 2010. In the same vein, using 81 firms listed on the Muscat Security Market (MSM) in Oman for two years' period (2011 and 2012), Al-Matari *et al.* (2014) found that board size is positively related with performance (proxied by return on asset). Other studies relating to this group are; Kang and Kim (2011); Mangena and Pike (2005) and Sahu and Manna (2013). On the contrary, Vafeas (1999) found that board meeting is negatively related with performance in Cyprus. Harvey *et al.*

(2015) investigate the association between CG mechanisms and performance of firms in South Africa and found a negative association between board meeting frequency and performance. Therefore, this study hypothesized that:

*H3. Board meeting has positive relationship with firm performance*

#### **2.1.4. Board Expertise and Firm Performance**

Board expertise is imperative in ensuring that the oversight function of the board is successfully carried out (Yatim, 2010). Nadarajan *et al.* (2015) argued that directors that sit on the board of more than one company will acquire more skill, knowledge, and become more expertise in carrying out their oversight functions on managers' activities. Theoretically, resource dependence theory argues that directors holding multiple positions on several boards, rely on external resources that assist the firm in having access to external linkages, and resources that can ensure effective and efficient business operations, which finally enhances firm performance (Kiel and Nicholson, 2003).

Likewise, Yatim (2010) contends that board expertise is imperative in ensuring that the oversight function of the board is successfully carried out. By using a sample of 33 maritime firms quoted in the US for 12-years period (1999-2010), Andreou *et al.* (2014) established that the proportion of directors sitting on the boards of other companies have positive association with firm performance and financial management decisions. Moreover, Dass *et al.* (2014) found that directors from other related industries have significant impact on performance/value of US firms. On the other hand, using a sample of eight (8) firms in the Nigerian food and beverages industry, Nwonyuku (2016) finds that there is significant negative relation between board skill and competence, and financial performance. Hence, this study suggests the following hypothesis:

*H4. Board expertise has positive relationship with firm performance*

#### **2.2. Risk Management Disclosure and Firm Performance**

Reporting via annual accounts and reports by corporate entities is a means of disclosing their business activities including risk management practices. For the reason that annual reports of companies are a dependable medium for shareholders and other stakeholders to assess information on risk management regarding a company (Lang and Lundholm, 1993; Holland, 1998). Wong (2012) opines that risk management practices of companies particularly financial institutions are disclosed in their annual published accounts and reports, which (the reports) are subject to scrutiny by professional auditors and prepared in accordance with rules and regulations governing financial reports. In addition, Holland (1998) and Lang and Lundholm (1993) agreed that annual reports of companies are a dependable medium for shareholders and other stakeholders to assess information on risk management regarding a company. In Nigeria, the code of CG has made recommendations to the publicly traded companies that the board of directors should make adequate disclosure on the company's procedures and practices on risk management.

On the basis of agency theory, one of the best way of enhancing CG is to lessen the conflicting interests among various stakeholders (Shleifer and Vishny, 1986; 1997). Consequently, since corporate directors are in a better position to acquire information on the firm's future expectations than their shareholders, enhancing the flow of information between "investor" and "investee" company will help to cushion for information asymmetry and enhance investor-relations and practice of CG (Solomon *et al.*, 2000).

Albeit, there are number of studies on risk management disclosure, yet, pay less attention on linking risk management disclosure and firm performance. For instance, Nahar *et al.* (2016) report that there is significant relationship between risk disclosure, existence of risk management committee, and number of risk committees and performance of banks in Australia. Likewise, with the use of primary data collected from 722 managers of 21 banks and their branches in Nigeria, Dabari and Saidin (2015) found that enterprise risk management (ERM) is

implemented by some banks in Nigeria, but yet to be implemented by others. As a result, this study suggests the following hypothesis:

*H5. Risk management disclosure has positive relationship with firm performance*

### 3. METHODOLOGY AND THEORETICAL FRAMEWORK

Since this study is a review perspective, it therefore suggests that the Nigerian financial services sector should be the domain due to the significant role they usually play in the economy and due to the nature of their services, as they are highly exposed to risk. Accordingly, failure in the financial sector may be contagious to other sectors of the economy, because it serves as financial intermediary, and as an auxiliary in enhancing growth of an economy (IMF, 2009). Therefore, financial institutions are considered as the key economic players of every nation. Moreover, this study suggests that multivariate analysis should be carried out using STATA to analyze data if collected because it will help to empirically explore the relationship between the selected variables in this study.

Concisely, literatures have suggested various mechanisms of CG that affect firm performance. However, based on the foregoing prior studies' review, alongside theoretical review concerning the relationship between board characteristics, risk management disclosure, and firm performance, the study establishes a framework as thus:

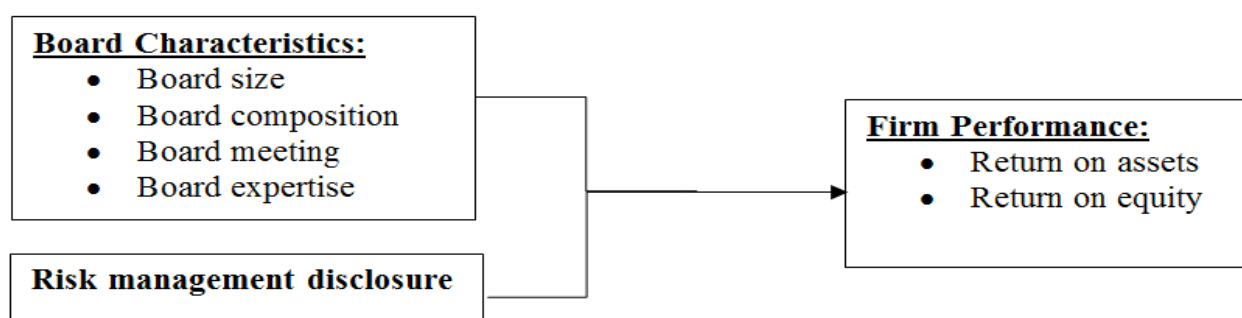


Fig-1. Research framework

Source: Developed by the authors for this study

### 4. VARIABLES DESCRIPTION AND MEASUREMENTS

#### 4.1. Dependent Variables

This study utilizes two measurements for firm performance, that is, return on asset (ROA) and return on equity (ROE). Numerous prior studies have considered market-to-book-value ratio in measuring performance (including (Best, 2004; Gentry and Shen, 2010)). Others used dividend per share, earnings per share, return on asset and return on equity (together with, (Vance, 1978; Yasser *et al.*, 2011; Marn and Romuald, 2012; Amba, 2013)). In line with prior studies, we will measure ROA as profit after tax divide by total assets, and ROE as profit after tax divide by total owners' equity.

#### 4.2. Independent Variables of interest

As earlier stated, prior studies have used various mechanisms of CG to examine their relationship with firm performance. Therefore, this study uses board size, board composition, board meeting, board expertise, and risk management disclosure as independent variables to empirically and theoretically review their relationship with firm performance. Herein, board size will be measured as the number of directors serving on a company's board (Vafeas, 1999). Board composition will be measured as the number of non-executive directors to total directors on a board of a firm (Marn and Romuald, 2012). However, board meeting will be determined as the number of meetings by a company board in a year (Vafeas, 1999; Al-Matari *et al.*, 2014) while board expertise will be measured as the number of directorship held by a non-executive director in different firms (Fich and Shivdasani, 2006; Elyasiani and Zhang, 2015).

More importantly, risk management disclosure has no specific measurement, but mostly measured based on risk management related elements or category as used by scholars like, Abraham and Shrives (2014); Wong (2012) and Abdullah *et al.* (2015). To follow the like of previous studies, this study develops a risk management disclosure index based on the provision of the Nigerian code of CG issued by SEC in 2011. The suggested risk disclosure category to be considered are provided in Table 1 as thus:

Table-1. Risk Disclosure Categories

S/n	Item Category	Explanation
1.	Governance structure related to risk management.	Risk management committee availability.
2.	Risk management committee responsibility and function explanations.	Explanation to responsibilities and functions of risk management committee.
3.	Description of risk management policies and objectives.	Availability of explanations to risk management policies and objectives of the firms.
4.	Audit committee responsibility and function explanations.	Availability of audit committee structure and explanations to their responsibility.
5.	Capital/Market risk disclosure.	Interest rate, Exchange rate, commodity, liquidity, and credit.
6.	Environmental risk disclosure.	Health and safety, erosion of brand name, and corporate social responsibility.
7.	Operational risk and other risks disclosure.	Customer satisfaction, product development, sourcing, product and service failure, stock obsolescence and shrinkage.

Source: Developed by the authors for this study based on the Nigerian Securities and Exchange Commission [SEC] (2011) code of CG.

However, in collecting data on risk management disclosure, various studies have used content analysis in counting “sentences” or “words” in the annual reports of firms (for instance, (Deegan *et al.*, 2000; Elshandidy *et al.*, 2013; Abdullah *et al.*, 2015)). Nevertheless, to collect data on the foregoing risk disclosure categories developed in Table 1, this study suggests that words and sentences counts should be extended in the contents of annual reports of any identified sampled firms by concentrating on the category of risk management disclosure based on the requirement of the Nigerian code of CG issued by SEC (2011). Consequently, there are studies that used categories in analyzing contents of firms (e.g., (Linsley and Shrives, 2005; Wong, 2012)). In essence, the risk categories will be coded as “0” if no disclosure, “1” if fairly disclosed, and “2” if strongly disclosed. The coding should encompass all the quoted financial service firms in the Nigerian Stock Exchange for a specified selected period.

## 5. RESEARCH LIMITATIONS/IMPLICATION

Despite the comprehensive evidences gathered from literature and theories, and the framework developed by this study on the relationship between CG (board characteristics), risk management, and firm performance, yet, the study fails to provide statistical evidences on the relationships established. Moreover, the study flops in providing a comprehensive explanation to several types of risk, although not in the scope of this study. By considering board characteristics and risk management, the study dwells only on internal mechanisms of CG, while there are other external factors that may influence the performance of firms.

## 6. CONCLUSION

This study review and theoretically examine the relationship between CG; concentrating on board characteristics (board size, board composition, board meeting, and board expertise), risk management disclosure, and firm performance. Based on the extant literature, board characteristics (board size, board composition, board meeting, and board expertise) have significant positive relationship with firm performance. Moreover, the review

has shown that risk management disclosure has positive relationship with firm performance, because investors will like to invest in a firm that discloses investment related information including the risk management practices of the firm.

Therefore, there is need for further research on CG, risk management, and performance in the Nigerian financial sector, since it has become apparent that there is scarceness of research in the area especially on risk management disclosure as it is enrolling on a fundamental level in Nigeria. After all, having understanding on how board characteristics and risk management disclosure relate with firm performance, various parties like management of financial service firms, board of directors, and regulatory authorities (e.g., SEC) can formulate policies and make appropriate decisions with ease and precision.

More so, intended scholars in this promising area of research can empirically provide evidence(s) on the established relationship between the variables selected in this study, add other additional variables especially on external mechanisms of CG, and can even elucidate risk management by considering the different types of risk. Likewise, other performance variable(s) like net profit margin, earnings management, economic value added etc. can be considered by future researchers.

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