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**THE EFFECT OF CORPORATE GOVERNANCE
MECHANISMS ON COMMERCIAL BANKS FINANCIAL
PERFORMANCE IN ETHIOPIA**

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ABSTRACT

Now a day's issue of corporate governance is becoming the popular agenda and getting attentions of our world as a general due to essentiality of corporate governance structure on firm's financial performance. The essence in corporate governance mechanisms is to vigorously demise agency costs in order to ensure that firm's capital is allocated and deployed only on profitable activities. It plays a key role in deterrence of agency problems which would be created between managers and shareholders. The work of scholars confirms that, firms with pertinent corporate governance structure are firm with appreciative financial performance than firms with flaw corporate governance. To reach on an authentic finding from the study, we used return on asset, return on equity and operating profit margin as dependent variables; board size, board independence, frequency of board meetings, audit committee and board ownership as independent, and financial leverage and firm growth rate were used as control variables.

The researchers used both correlation analysis and pooled panel time series data with cross-sectional nature. The econometric regression result shows that, board size is negatively and significantly associated to all the three indicators of financial performance: return on asset return on equity and operating profit margin. Both Board independence and Board ownership have positive relationships and significant effects on the three indicators of commercial banks financial performance. The result shows that Audit committee negatively and significantly correlated to return on asset and return on equity with negative and insignificant impact on operating profit margin. Frequency of board meeting remains positive in terms of its direction of connection and immaterial in its affiliation with the three financial performance indicators of commercial banks under investigation.

Keywords: Corporate Governance Mechanisms; Financial Performance; Commercial Banks

INTRODUCTION

Background of the Study

Shleifer and Vishny, (1997), defined corporate governance mechanisms as a ways to reduce the agency costs, which could come from managers and stakeholders.

The need for corporate governance arises from the potential conflicts of interest between stakeholders such as chief executive officers, board members and shareholders within the business organizations.

Imam and Malik (2007) recognized difference in interest, preference and information asymmetry across the participants as potential reasons for conflict. Therefore, corporate governance used to scale back agency issues in every business firm to confirm that shareholders' investment is not expropriated on unprofitable activities.

Maria & Thomas, (1999) recommended different theories such as, Agency theory, shareholders' theory and stakeholders' theory, on corporate governance which remain deterministic in influencing firms' financial performance.

According to Hsiang-tsui (2005), firms which apply best practice of corporate governance systems provide more useful information to investors and its others stakeholders to reduce agency problem.

There are different mechanisms of which corporate governance used to reduce agency cost, by which corporate governance is measured in a business firm. These are board size, board independence, frequency of board meetings, chief executive officer duality, audit committee, board ownership and so on. Those mechanisms are essential issue to the efficient use of investments invested by corporate business firms. Poor corporate governance is becoming critical issue in a corporate business firm as it has a critical negative impact on its financial performance (Klein et al. 2005).

The effect of corporate governance mechanisms on firms' financial performance have been substantially studied by different researchers, (Hiraki et al. 2001; Zunaidah & Fauzias, 2010; Sanda et al. (2005).

Jensen & Meckling, (1976) evidenced that companies with better corporate governance have better financial performance than those companies with poor corporate governance. Therefore, the baseline of this study is relied on the assessment of the effects of corporate governance on financial performance of selected commercial banks in Ethiopia.

LITERATURE REVIEW

Corporate governance mechanisms have been identified as one of the important tools needed in managing any organization including corporation. There are different mechanisms that reduce agency cost by which corporate governance can be measured in an organization. Most empirical studies used board size, board independence, frequency of board meetings, chief executive officer duality, and audit committee and board ownership as a mechanism of corporate governance.

Board Size and Firms' Financial Performance

As it is found by Babatunde and Olaniran (2009), bigger board size is likely to show evidence of a good spread of monitoring skills of the board and enhance its effectiveness. On the other hand, the board may be too big and compromise the quality of communication within the board.

Yermack (1996) examined the relation between board size and firm performance, concluding that the smaller the boards size the better the performance, and proposing an optimal board size of ten or fewer. This is due to nimbleness, cohesiveness, less communication and coordination costs as well as less 'free-riding' director problems with smaller boards.

Adusei (2011) concluded that a small board size increases the performance of a bank. Xiaojun and Zhenhong (2005) stated that the company's board of directors is an executive institution, elected by shareholders and accountable to shareholders.

Board Independence and Firms' Financial Performance

Fleming (2005) argued that the board must be made up of internal and external directors.

Independent directors are believed to be better monitors of managers as independent directors' value maintaining reputation in the directorship market as important.

Pearce and Zahra (1992) suggested that, firms with a higher proportion of independent directors on the board of directors are associated with better performance. A balanced board composition is important

for the board to function effectively. Nahar, (2001), balanced board means that the composition is not dominated by board members with executive power, and consists of members who are independent from the management and shareholders

Frequency Of Board Meetings And Firms' Financial Performance

Frequency of Board meeting is the board meetings held per year by the board members of a firm. Cohen et al. (2004) argued that the frequency of board meetings held should be evidence of effective monitoring activity. Accordingly if the board does not meet regularly, it is unlikely that effective monitoring of management will occur, even if the board is the appropriate size and has a high percentage of independent directors.

The board must ensure that the overall meeting is properly used as a sufficient channel to communicate with shareholders and foster their participation.

Audit Committee and Firms' Financial Performance

Audit committee acts as the internal auditors for the board for the company's operations, management systems, and general financial control and reporting. Carcello and Neal (2000) confirmed that audit committee members who are independent of the management are better monitors of the firms' financial accounting process. However, Klein (2002) reports a negative correlation between firms' financial performance and audit committee independence. As it stated by Robert (2006), Audit committee as an institution, along with other standing committees, provides for detailed specialization within the board.

Board Ownership and Firms' Financial Performance

Rose (2005) argued that managers who control a substantial part of the firm's equity may be able to have sufficient influence to secure the most favorable employment conditions, including an attractive salary. Sulong and Nor (2010) conclude that board ownership role as moderator variable of corporate governance acts to the shareholders' best interests and its effectiveness in controlling the agency conflicts with other governance mechanisms available to firms.

STATEMENT OF THE PROBLEM AND RESEARCH OBJECTIVES

Shleifer and Vishny (1997) proposed that both chief executives and shareholders should equally and necessarily share the same objective of how to capitalize firms' financial performance. However, for the smooth functioning of financial operations, the system needs chief executives to work independently as an autonomous organ without shareholders pressure. Conversely, what will devastate the industry is separation of shareholders from chief executives with the absence well-defined corporate governance mechanisms.

It is plausible that, the absence of corporate governance principles desperately affect the interest of organization. Because, executives will pursue their personal objectives than prioritizing that of the shareholders which deepen the root cause of agency costs or problems. It is ought that any organization with the problem of agency cost is an organization characterized with poor financial performance. Therefore, if corporate governance mechanisms are not properly structured and practiced with business firms, it will highly damage the financial performance of a firm. There are different mechanisms by which corporate governance can be measured and governed in an organization. Some of these variables are board size, board independence, frequency of board meetings, chief executive officer duality, audit committee and board ownership.

Addressing corporate governance issues of Ethiopian banking sector should be given due importance for the following reasons. Firstly, Ethiopian banking sector take deposits from the public and any mismanagement of assets and resources will result in ruining of the public savings. Secondly, the banking sector in Ethiopia has significantly increased in the last recent years which forced them to give loans, transfer funds and mobilize huge amount of resources across the country. Thirdly, the banking sector in Ethiopia operates in a difficult and risky environment which requires their boards to regularly assess the risks and provide proper oversight to manage them.

Thus, managing the significant growth of banking sector in Ethiopia will require effective corporate governance which involves active participation of both the board and management committee. Financial sector is the most sensitive sector of economy which requires strong monitoring and excellent regulation. Hence, the researchers were interested in diagnosing association between corporate governance and financial performance of commercial banks in Ethiopia.

Particularly, the researchers tried to address vigorously the following specific objectives;

1. To examine whether corporate governance mechanisms have a significant effect on banks' financial performance.
2. To identify the possible determinant factors of corporate governance mechanisms that affect banks' financial performance.

METHODOLOGY OF THE STUDY

Research Design

The researchers used an explanatory research design with which direction and magnitude of correlation among dependent and independent variables were clearly differentiated and defined.

Data Source and Collection Methods

Data for this study were collected from both primary and secondary data sources. Secondary data available from the year 2004 up to 2010 were gathered from banks' audited financial statements including balance sheet and income statement related to each selected banks. Furthermore, primary data were collected through conducting focus group discussion with selected staffs of banks under question.

Sampling Technique

In our case, the target population of this study was commercial banks in Ethiopia. Purposive sampling technique was used, because some banks were established recently, for the selection of representatives. Currently, 15 banks are operating in Ethiopia. From fifteen the total private commercial banks nine banks were selected. The sampled banks are Commercial Bank of Ethiopia, Dashen Bank, Awash International Bank, Bank of Abyssinia, United Bank, Wegagen Bank, Construction and Business Bank, Cooperative Bank of Oromo and Nib International Bank.

Data Analysis

Collected data were analyzed using both descriptive statistics and econometric model. The degree of association among variables was examined by Pairwise correlation analysis. Stata software version 10.0 is used for data analysis.

Model Specification

The following general econometric model was used for the estimation purpose;

$$Y_i = \beta_0 + \sum \beta_i X_i + \epsilon_i$$

Where:

- Y_i = are the i th observation of dependent variables (ROA, ROE and OPM)
- β_0 = is the constant or intercept term
- β_i = are the coefficients of the X_i variables
- X_i = are the i th observation of the explanatory variables (BSIZE, BINDP, FBM, CEOD, AUDCM, BOWN, FS, FL and FGR)
- E_i = is the error term of the models

Specifically,

$$\text{ROA} = \beta_0 + \beta_1 (\text{BSIZE}) + \beta_2 (\text{BINDP}) + \beta_3 (\text{FBM}) + \beta_4 + (\text{AUDCM}) + \beta_5 (\text{BOWN}) + \beta_6 (\text{FL}) + \beta_7 (\text{FGR}) + \varepsilon \text{-----} \quad (1)$$

$$\text{ROE} = \beta_0 + \beta_1 (\text{BSIZE}) + \beta_2 (\text{BINDP}) + \beta_3 (\text{FBM}) + \beta_4 + (\text{AUDCM}) + \beta_5 (\text{BOWN}) + \beta_6 (\text{FL}) + \beta_7 (\text{FGR}) + \varepsilon \text{-----} \quad (2)$$

$$\text{OPM} = \beta_0 + \beta_1 (\text{BSIZE}) + \beta_2 (\text{BINDP}) + \beta_3 (\text{FBM}) + \beta_4 + (\text{AUDCM}) + \beta_5 (\text{BOWN}) + \beta_6 (\text{FL}) + \beta_7 (\text{FGR}) + \varepsilon \text{-----} \quad (3)$$

Where:

- ROA= Return on Asset
- ROE = Return on Equity
- OPM = Operating Profit Margin
- BSIZE = Board Size: Number of directors setting on the board
- BINDP = Board Independence: Number of independent directors sitting on the board (no significant connection with the bank)
- FBM =Frequency of board meetings: The number of board meetings held per year
- AC = Audit Committee: The composition of the audit committee, that is, independent as a proportion/ percentage of the total member for banks audit committee.
- BO=Board Ownership: Number of board members, who has share contribution for the bank
- FL= the total amount owed by the bank divided by its total capital
- FGR= Firm growth rate: Change in annual revenue of the bank

RESULTS AND DISCUSSIONS

Descriptive Statistics for the Study Variables

Table 1: Descriptive Statistics for the Study Variables

To measure the impact of selected independent and control variables on financial performance of sampled commercial banks in Ethiopia, return on asset, return on equity and operating profit margin are used as dependent variables.

VARIABLE	OBS	MEAN	STD. DEV.	MIN	MAX
ROA	60	4.901167	1.427432	2.3	8.1
ROE	60	22.03067	14.28484	2.2	65.1
OPM	60	72.0345	29.87834	-11	177
BS	60	9.133333	1.779989	6	12
BI	60	7.6	1.575232		10
FBM	60	2.716667	1.657972	1	7
AC	60	8.783333	3.517952	3	17
BO	60	5.116667	1.88744	1	8
FL	60	5.526	2.889656	1.5	12.6
FGR	60	.73	1.339956	-3.9	5.7

These variables are summarized as follows: The mean value of return on asset for the sampled commercial banks is about 4.9 percent and the standard deviation is 1.4 percent from the average value

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among the sampled commercial banks. The minimum value of return on asset is 2.3 percent while the maximum value is 8.1 percent.

Measure of return on equity indicates 22 percent of the mean value of financial performance of the sampled commercial banks as measured by return on equity and for operating profit margin is 72 percent on average.

The descriptive statistics of these explanatory variables are summarized as follows:

The average value of board size for the sampled commercial banks in Ethiopia is 9.13 with the standard deviation of 1.78. The mean value of board independence is 7.6 percent and the standard deviation from the mean value is 1.56. The more independent the board is the more effective it becomes and firms' financial performance position will be affected positively.

It is shown there is a wide variation in frequency of board meeting held annually which remain significant in affecting positively or negatively firm's position of financial performance.

On the other hand the descriptive statistics of control variables is also summarized as follows:

Both; financial leverage, to show the proportion of total amount owed by the banks under investigation; and firm growth size, to demonstrate the change in annual revenue of the commercial banks were used as control variables.

Pearson Correlation Analysis Results

Correlation analysis of ROA as a firm financial performance proxy

As it is depicted in table 2, frequency of board meeting is significantly correlated at 1% with negative direction of relationship. Board size is negatively and insignificantly correlated to return on asset, and the remaining; board independence, audit committee and board ownership are positively and insignificantly associated with return on asset.

Table 2. Correlations (Pearson) analysis- ROA as a firm financial performance proxy

	ROA	BS	BI	FBM	AC	BO	FL	FGS
ROA	1.0000							
BS	-0.0227 (0.8231)	1.0000						
BI	0.0825 (0.5308)	0.8777 (0.0000)	1.0000					
FBM	-0.4052 (0.0013)	0.0302 0.8185	0.0013 0.9921	1.0000				
AUDC	0.1121 (0.3939)	-0.0115 0.9302	0.0942 0.4740	0.0765 0.5614	1.0000			
BO	0.2010 (0.1236)	0.4998 0.0000	0.8198 0.0000	-0.0597 0.6506	0.2183 0.0938	1.0000		
FL	-0.1102 (0.4021)	-0.3428 0.0073	-0.6210 0.0000	0.0558 0.6719	-0.2004 0.1247	-0.7326 0.0000	1.0000	
FGR	0.1258 (0.3381)	0.0674 0.6091	0.2360 0.0695	0.1531 0.2428	0.0044 0.9732	0.2627 0.0426	0.2704 0.0367	1.0000

On the other hand, both control variables, i.e. financial leverage and firm growth rate, have no significant correlation, and their direction of relationship is that financial leverage is with opposite direction and firm growth rate took the corresponding direction with return on asset.

The values of correlation coefficients of the variables shows the presence of softly strong association of frequency of board meeting with return on asset in contrast with board size, board independence,

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audit committee and board ownership respectively. In case of control variables, both are weakly correlated to return on asset.

Correlation analysis of ROE as a firm financial performance proxy

Table 3. Correlations (Pearson) analysis- ROE as a firm financial performance proxy

	ROE	BS	BI	FBM	AC	BO	FL	FGS
ROE	1.0000							
BS	-0.0659 0.6171	1.0000						
BI	0.3514 0.0141	0.8777 0.0000	1.0000					
FBM	-0.3255 0.0112	0.0302 0.8185	0.0013 0.9921	1.0000				
AC	-0.2527 0.0514	-0.0115 0.9302	0.0942 0.4740	0.0765 0.5614	1.0000			
BO	-0.4635 0.0002	0.4998 0.0000	0.8198 0.0000	-0.0597 0.6506	0.2183 0.0938	1.0000		
FL	0.6960 0.0000	-0.3428 0.0073	-0.6210 0.0000	-0.0558 0.6719	0.2004 0.1247	-0.7326 0.0000	1.0000	
FGR	-0.1370 0.2967	0.0674 0.6091	0.2360 0.0695	0.1531 0.2428	0.0044 0.9732	0.2627 0.0426	0.2704 0.0367	1.0000

From table 3, Pearson correlation result reveals, independent variable; board independence is positively and significantly correlated at 5 percent level of significance with return on equity.

However, frequency of board meeting, audit committee and board ownership are negatively and significantly correlated at 5 percent, 10 percent, 1 percent level of significance respectively. But, board size is insignificantly correlated to return on equity.

It is depicted that, the values of correlation coefficients of board size, board independence, frequency of board meeting, audit committee and board ownership with return on equity shows relatively poor association among all the independent variables and return on equity, the association between board independence and board ownership with return on equity is strong compared to others independent variables.

Furthermore, it is shown in the table that, both control variables are correlated to return on equity. According to the correlation analysis results, financial leverage is perfectly correlated to return on equity with maximum level of positive association at 69.6 percent. Whereas, firm' growth rate has no significant association with return on equity.

Correlation analysis of OPM as a firm financial performance proxy

The foregoing table shows, the correlation matrix that predicts the likely relationship of the operating profit margin with board size, board independence, frequency of board meetings, audit committee and board ownership as independent variables, and financial leverage and firm growth rate as control variables of the study. Beside to this, it is exhibited in the table about the existing linear relationships among each independent variables and control variables used in this study.

According to the results of Pearson correlation analysis, independent variables; board independence and board ownership are positively and significantly correlated at 5 percent and 1 percent level of significance with operating profit margin respectively. On the other hand, board size is negatively and significantly correlated at 10 percent level of significance. But, frequency of board meetings and audit committee are insignificantly correlated.

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Table 4. Correlations (Pearson) analysis- OPM as a firm financial performance proxy

	OPM	BS	BI	FBM	AC	BO	FL	FGS
OPM	1.0000							
BS	-0.0573 0.06637	1.0000						
BI	0.2899 0.0247	0.8777 0.0000	1.0000					
FBM	-0.1188 0.3658	0.0302 0.8185	0.0013 0.9921	1.0000				
AC	0.0903 0.4926	-0.0115 0.9302	0.0942 0.4740	0.0765 0.5614	1.0000			
BO	0.3420 0.0075	0.4998 0.0000	0.8198 0.0000	-0.0597 0.6506	0.2183 0.0938	1.0000		
FL	0.3537 0.0056	0.3428 0.0073	-0.6210 0.0000	-0.0558 0.6719	-0.2004 0.1247	-0.7326 0.0000	1.0000	
FGR	-0.1384 0.0915	0.0674 0.6091	0.2360 0.0695	0.1531 0.2428	0.0044 0.9732	0.2627 0.0426	-0.2704 0.0367	1.0000

As it is exhibited in the table, it can be seen that the correlation coefficients of board size is -5.73 percent, board independence is 28.99 percent and board ownership is 34.2 percent with operating profit margin. According to the coefficient values of significantly correlated independent variables, board independency and board ownership have relatively strong association with operating profit margin in comparison with other variables used in this study.

With regard to control variables, the correlation result shows both control variables; financial leverage and firm growth rate are significantly correlated at 1 percent and 10 percent level of significance with operating profit margin.

The coefficient values of control variables given in the table shows, financial leverage has maximum percentage of association with operating profit margin in comparison with firm growth rate at 35.37 percent and -13.84 percent respectively.

Across all the Pearson correlation tables, the relationship between independent and control variables are not more than nearly 80 percent. These results confirm that there is no multicollinearity problem in the models, because multicollinearity will be a serious problem with value exceeding 80 percent

Summary of Econometrics Analysis

Econometric regressions were conducted for three of the models separately. The data sets were tested for the classical linear regression model assumptions for pooled OLS estimation in panel data analysis since the data analysis technique was pooled cross sectional analysis.

Table 5 indicates that, Board size has a coefficient estimate of .0442024, 4.745789 and 28.07762 and it is statistically significant at 10 percent level of significance for both return on asset and return on equity and 1 percent level of significance for operating profit margin.

Table 5. Summary of Regression Analysis for the Study Variables

Variables	ROA		ROE		OPM	
	Coef. (Std.Err.)	t-value (p-value)	Coef. (Std.Err.)	t-value (p-value)	Coef. (Std.Err.)	t-value (p-value)
BS	-.0442024 (.2502871)	0.18 (0.0861)	-4.745789 (2.506939)	1.89 (0.064)	-28.07762 (7.448316)	3.77 (0.000)
BI	.2239713 (.3878505)	-0.58 (0.0566)	5.305672 (4.124681)	-1.29 (0.0204)	44.49517 12.19506	-3.65 (0.001)

Table 5.Summary of Regression Analysis for the Study Variables (Contd....)

Note: ***, **, and * shows 10%, 5% and 1% level of significance respectively

Source: stata regression result

The coefficients of board size imply that commercial banks' financial performance is negatively related with the number of board members. The empirical findings of Yermack (1996), Adusei (2011) and Sanda et al. (2005) support this result.

Board independence has positive association along with the three dependent variables used has an indicator of financial performance of commercial banks. It is significantly affiliated to return on asset, return on equity and operating profit margin at 10%, 5% and 1% levels of significance. The empirical work of Fleming (2005), Abu- Tapanjeh (2006), Sulong and Nor (2010) and Adusei (2011) support the finding of our study.

Frequency of board meeting has significant association with return on asset and return on equity at 1% level of significance with both dependent variables and irrelevant with operating profit margin. Based on the statistical estimation it can be concluded that, annual frequency of board meeting held in sampled commercial banks in Ethiopia could significantly affects financial performance of return on asset and return on equity of the banks and it has no any predictive power on operating profit margin.

Audit committee as an independent variable influencing financial performance of the sampled commercial banks remains significant with the three indicators of financial performance of commercial banks under investigation- return on asset, return on equity and operating profit margin at 10%, 1% and 10% respectively. The finding has an implication of degree and size of independent audit committee in corporate governance has positive influence on financial performance of commercial banks under question.

According to our findings, Board ownership is positively and statistically has remarkable affiliation only with operating profit margin at 1 percent level of significance among the three financial performance indicators. Even if the coefficient values of dependent variables are represented positively, the variable has no any worthy effect on return on asset and return on equity.

Besides this, the direction and magnitude of the effects of control variables on the three indicators of financial performance of commercial banks operating in Ethiopia which are under our investigation is clearly stipulated through the regression made. Accordingly, it is shown that there is positive and significant association between financial leverage and return on asset and return on equity. The variable significantly affects return on asset and return on equity at 10% and 1% levels respectively. But, it has no any significant association with operating profit margin.

The second control variable has significant relationship with return on equity and operating profit margin by equal percentage i.e., 10 percent, and the result confirm that firm growth rate has no meaningful influence on return on asset. The direction of association between firm growth rate and return on asset and operating profit margin is positive linkage.

CONCLUSIONS

The central theme of this study is to explore the effect of corporate governance mechanisms on firms' financial performance with selection of sampled commercial banks in Ethiopia using three financial performance indicators (return on asset, return on equity and operating profit margin) as dependent variables and five corporate governance mechanisms (board size, board independence, frequency of board meetings, audit committee and board ownership) as independent variables. Along with this, two control variables were also used (financial leverage and firm growth rate).

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Panel data with multiple regression method as data analysis and the pooled OLS method of estimation is used. Return on asset, with the exception of board ownership all independent variables have significant effects upon it.

Concerning return on equity, the only variable which is insignificantly associated to it is board ownership whereas; the remaining of them maintained significant association at different level of significance.

With the exclusion of frequency of board meeting, the remaining independent variables i.e., board size, board independence, audit committee and board ownership are significantly correlated to operating profit margin.

Regarding to the control variables used, financial leverage is significantly linked to return on asset and return on equity, but it has no relationship with operating profit margin, Whereas, firm growth rate is significantly associated to return on asset and operating profit margin.

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