

Board Independence and Financial Sustainability of Corporate Firms in Kenya: Does Independent Directors Matter in Times of Financial Distress?

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Abstract: The purpose of this paper was to examine the effect of whether independent directors matter in times of financial distress. The research design used in this study was exploratory design. The study employed panel regression analysis and simultaneously used pooled regression and random effects on sample size of 39 listed firms in Kenya during the period of 2004-2013. The study established that board independence is negatively and significantly related with financial distress ($\beta=-0.044$; $p<0.05$). This study adds value to theory by empirically analyzing the effect of independent directors on financial distress. This study fills a significant gap in academia by providing insights into the effect of independent directors in times of financial distress by focusing an emerging economy. This study supplements similar studies focusing in China and Middle East. In addition given the increasing collapsing of companies in emerging economies, this paper provides policy makers with evidence on the implications of board independence for financial sustainability.

Keywords: Board independence, financial distress, Sustainability, independent directors.

1. INTRODUCTION

Research on financial distress has attracted a lot of attention in academic literature (Cruz *et al.*, 2014). Financial distress is defined as the inability of a firm to meet its financial obligations as and when they fall due (Grice and Dugan, 2001; Davydenko, 2005; Mumford, 2003). Other researchers view financial distress as a condition when the firm is faced with negative cumulative earnings for at least a few consecutive years (Gilbert, 1990). Indeed there is consensus that a firm is deemed to be in financial distress when it is unable to meet its financial obligations.

An analysis of many corporate failures indicates that the causes of corporate financial distress are financial factors such as leverage (Amoa-Gyarteng, 2014), profitability (Zulkarnain and Hasbullah 2009) and assets turnover (Zulkarnain and Hasbullah, 2009). Furthermore, non-financial factors such as lack of consistent policies (Milton, 2002), control procedures, guidelines and mechanisms (Jimming and Weiwei, 2011) also play an important role in financial distress.

Studies have also indicated that most of the causes of financial distress are dependent on the quality of the decision makers who are the board of directors (Argenti, 1986; Daily and Dalton, 1994; Cheng *et al.*, 2009). The board is the internal corporate governance mechanism that aligns the shareholders' interests with those of the management (Norwahida *et al.*, 2012; Fama and Jensen, 1983). Jensen (1993) argues that the board of directors is crucial for an effective internal control system. Jensen further contends that the problems associated with corporate internal control systems start with the board of directors.

The board composition and its role has been studied by scholars and practitioners in the recent times (Kosmidis and Stavropoulos, 2014). According, to Kosmidis and Stavropoulos (2014) the recent collapse of multi-national firms were as a result of failure of the board to detect questionable practices which management engaged in. Mohd-Mohid *et al.*, (2004) argue that the failure of big companies to continue their business is often associated with weak controlling and monitoring mechanism over the strategic decision making process of the board of directors. Salloum and Azour (2012) are of the opinion that poor governance and agency problems are among the reasons for financial distress that is spread among several companies in different industries and countries across the globe. The failure of the world international companies has therefore resulted in search for ways to eliminate these failures and as a result the concept of corporate governance has arisen.

According to La Porta *et al.*, (2000) weak corporate governance increases the probability of opportunistic behavior of management to act for their interest thus increasing the likelihood of financial distress. Argenti (1986) argue that corporate failures are associated directly with boards of directors. In addition agency theorists opine that poor corporate governance is as a result of management acting in self-interest manner at expense of shareholders. The actions of management to safe guard their interest may lead a firm to end in financial distress. The board that aligns managements' interest and shareholders goals has been linked with independent directors (Argenti, 1986).

1.1 Theory and Hypotheses Development:

Agency theory is founded on the assumption that managers are opportunistic and that they pursue selfish interests to the detriment of shareholders (Jensen and Meckling, 1976). This divergence of interests precipitates conflicts between shareholders and management, which results in agency cost. One of the major costs incurred by shareholders is the need to monitor management through the introduction of a layer of scrutiny in the form of a board of directors (Fama, 1980; Fama and Jensen, 1983). The board of directors is charged with the responsibility of monitoring the decisions and actions of management, thereby reducing opportunistic behavior. According to Jensen and Meckling (1976) the shareholders are assured that the managers will make optimal decisions only if appropriate incentives are given and only if the agent is monitored.

While Agency theory assumes that principals and agents have divergent interests and that agents are essentially self-serving and self-centered, stewardship theory takes an opposite perspective. It suggests that agents are essentially trustworthy and good stewards of the resources entrusted to them (Donaldson and Davies, 1991). Stewardship theory defines situations in which managers are not motivated by individual goals rather are stewards whose motives are aligned with the objectives of their principals (Davies *et al.*, 1997). Organisational role-holders are conceived as being motivated by a need to achieve, to gain intrinsic satisfaction through successfully performing inherently challenging work, to exercise responsibility and authority, and thereby to gain recognition from peers and bosses (Davies *et al.*, 1997).

The stewardship perspective views directors and managers as stewards of the firm and as stewards, directors are likely to maximize the shareholders' wealth. Stewards derive a greater utility from satisfying organisational goals than through self-serving behavior (Davies *et al.*, 1997). The steward realizes the tradeoff between personal interests and organizational objectives and believes that by working toward organizational, collective ends, personal needs are met (Davies *et al.*, 1997). According to Davis and Donaldson (1991) the attainment of organisational success also satisfies the personal needs of the stewards. Stewardship theory therefore suggests that managers should be given autonomy based on trust, which minimizes the cost of monitoring and controlling.

Boards of directors have different characteristics, which all contribute to firms' corporate governance mechanisms, although some characteristics provide more controlling mechanisms than others. In this study, we examine some of the variable facets of board composition that are commonly discussed in the literature, such as board independence, board size, board tenure, multiple directorships and financial expertise of directors.

2. CONCEPT OF FINANCIAL DISTRESS

Financial distress is a situation where a firm's operating cash flows are not sufficient to satisfy current obligations and the firm is forced to take corrective action (Ross *et al.*, 2005). According to Altman (1968) Whitaker (1999) and Mumford (2003) financial distress arises when a company is unable to meet its debts. The first signals of distress are usually violations of debt covenants coupled with the omission or reduction of dividends. According to Whitaker (1999) and

Wruck (1990) firms enter financial distress as a result of economic distress emanating from decline in industry operating income and poor management arising out of persistent negative operating income over a period of five years.

Usdin and Bloom (2012) identified nine signs of financial distress being the company untimely payment of creditors; the firm being sued in collection matters; the firm suffering a significant event that will not recur; the firm's bank or secured lender threatening to shut down business operations; a union threatening some type of action against the firm; a major supplier threatening to terminate supplying services to the firm; the firm not being able to perform its contracts on time or cannot perform at all; the liabilities of the firm being greater than its assets; and the company's business model no longer being viable.

Prior studies relate financial distress to financial factors, such as leverage, profitability, liquidity and assets turnover (Zulkarnain and Hasbullah, 2009). Amoa-Gyarteng (2014) argues that highly leveraged firms may face bankruptcy if they are unable to meet repayment schedules, though it may also increase shareholder return on investments. Profitability and liquidity are direct determinants of a firm's ability to endure periods of distress. These ratios are expected to be negatively associated with likelihood of financial distress (Parker *et al.*, 2002).

Research has also indicated that other factors that may cause the firm to be out of operation due to financial distress can be viewed from macroeconomics aspect. Economists have believed that the macroeconomic phenomenon such as, a tight monetary policy (Altman 1971), high interest rates (Charitou *et al.*, 2004) and high inflation (Liou and Smith, 2007) are also attributed to the failure of firms. Even though the impact of macroeconomic conditions on the firm's failure has not been examined popularly, comparing to those studied on the ratio analysis or corporate governance, it seems likely that the macroeconomic factors can influence the firm's financial distress.

Another main cause of the firm's failure investigated from the prior financial scandals is perhaps the firm's mismanagement which is the consequence of the management decision heavily reflecting self-serving behavior (Sengupta and Faccio, 2011; Johnson *et al.*, 2000). In general, the action of management could be seen through the firm's corporate governance practices. Daily and Dalton (1994) have provided evidence that the likelihood of bankruptcy is related to corporate governance characteristics by comparing healthy firms against firms who have already entered into bankruptcy. According to Mohd-Mohid *et al.*, (2004) and Mitton (2002) companies experience financial distress when they lack independent control and monitoring over the management resulting from CEO-duality practices or lower equity ownership among members of board of directors. Altman and Hotchkiss (2005) argue that managerial incompetence is the most pervasive form of financial distress.

Extant literature indicates that there are a number of competing empirical models by employing different explanatory variables and methodology to predict financial distress. The accounting-based models developed by Altman (1968) and Ohlson (1980) have emerged as the most popular distress prediction models and are often used by empirical accounting researchers as indicators of financial distress. Altman's Z-Score formula is a multivariate formula used to measure the financial health of a company and to diagnose the probability that a company will go bankrupt within a two-year period. The prediction of distress arising from financial difficulties has been of interest to many researchers. The use of financial ratios as predictors of financial distress was first given a serious thought by Beaver (1966) who used a number of financial ratios from failed and non-failed firms and concluded that some ratios are more predictors than others.

Financial ratio analysis has been regarded as indicator of business health (Green, 1978) supported by the fact that the right interpretation of ratios help assessing the liquidity, profitability and debt position. Moreover, Gardiner (1995) found that financial ratios were significant in evaluating financial distress of a company. Bhunia (2011) also opine that ratio analysis continues to represent one of the financial world's most powerful and versatile tools in determining financial distress of the firms.

Altman (1968) employs multivariate discriminate analysis (MDA) on a list of financial ratios to identify those ratios that are statistically associated with future distress. Ohlson (1980) uses a logit model, which uses less restrictive assumptions than those taken by the MDA approach. Ohlson chose his default predictor based on the frequency of appearance in the literature and identifies four basic factors which are statistically significant in assessing the probability of default within one year: the size of the company, a measure(s) of the financial structure, performance measure and liquidity. Ohlson found that size of the company appears to be the most significant predictor of financial distress.

Agarwal and Taffler (2008) found that the Z-score model outperforms other statistical models. Moreover, Altman and Saunders (1998) report that multivariate discriminant analysis models are by far the most widely used statistical models. Altman's Z-Score has also been used to explore the potential for distress in hospitals and the study revealed that both discriminant analysis and logistic regression models are able to predict service organizations' success or failure, with the latter being more predictive in a sample of 65 hospitals (Al-Sulaiti and Almwajeh, 2007).

According to Hayes *et al.*, (2010) Z" score accurately predicted distress filing 94% of the time and accurately predicted financial distress over 90% of the time for firms in retail specialties. Carton and Hoffer (2006) argues that Altman's Z-score is more than a financial distress predictor; it is also efficacious as a performance management tool. The study done in Kenya by Maina and Sakwa (2008) looked at the financial distress among listed firms in Nairobi stock exchange. Their study made use of the Altman Z-score to determine the financial distress in the listed firms in Kenya. The study concluded that financial position of listed firms differs on the basis of sector.

2.1 Independent Directors:

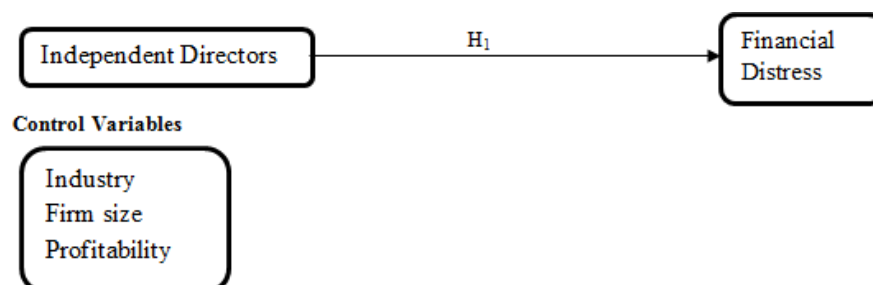
Independent director is a member of the board who has no affiliation with the firm other than the affiliation derived from being on the firm's board of directors (Beasley, 1996). The Kenyan Capital Market Authority Act, Cap. 485A defines an independent director as a director who has not been employed by the company in the last five years, who is not related to a senior member of management, who has no contract with the company, and who is not a member of the immediate family of senior managers. Thus, a director is deemed independent if he/she is independent of management and free from any business or other relationships that could interfere with the exercise of independent judgment.

Independent directors provide a unique monitoring function Jensen and Meckling (1976) and Fama (1980) due to external markets that reward and punish non executive directors. Hence, independent directors are likely to be diligent in constraining practices that deteriorate financial statement quality or violate securities laws. Byrd *et al.*, (2001) states that companies' rescue from financial crisis depends on the independent directors' role in the board. It therefore indicates that financial distress could be due to insider dominated board (Pfeffer, 1972). According to Weisbach (1988) independent directors are in a better position to monitor the actions of the CEO.

Several empirical studies argue that a high number of independent directors can produce better performance (Daily and Dalton, 1994). Weisbach (1988) argues that as a result of their position in the firm and the existence of possible inherent contracts with the CEO, internal directors would not be as fair as independent ones. Daily and Dalton (1994) argue that a dependent board of directors would exacerbate the rigidity of the company and limit the organization's adaptive abilities, and thus, its ability to respond to crises. Uzun *et al.*, (2004) argues that companies with more independent directors are less probable to malfunction and the financial crisis would be less likely to occur. Darrat *et al.*, (2010) also found that those companies with high representation of independent directors on their boards are more likely to remain solvent. According to Chen *et al.*, (2006) when independent directors are more, frauds are less and so financial distress would be less probable.

However, Harris and Raviv (2008) differ in opinion by arguing that in reality companies would prefer insider-controlled board of directors. The reason is explained in the information importance, that is available to insiders rather than to outsiders. If the cost of losing information is higher than the agency costs associated with inside control, the insider-controlled board is preferable (Harris and Raviv, 2008). This view is supported by stewardship theory Donaldson and Davis (1991) that superior financial conditions will be linked to a majority of inside directors. Thus, we hypothesize that

Hypothesis 1; Independent directors is not significantly related to financial distress



3. METHODS AND DATA

Exploratory research design was used in this study. Panel data was used in this study which was derived from publicly listed firms in Kenya during the period 2004-2013. The total number of firms listed on the Nairobi Securities exchange (NSE), as at the end of 2013, was 57: these firms fall under different sectors of the economy, such as agricultural, commercial and services industry, telecommunications and technology, automobile and accessories, investment, manufacturing and allied, and construction. We considered only those firms that traded throughout the period under study: thus, firms that were first listed after 2004 and those that were suspended during the period were excluded.

For the purpose of this study, companies were excluded if the relevant financial information was not available either in the company annual financial reports or on company websites. Therefore, total number of firms used in the study was 39, yielding a total of 390 firm year observations.

3.1 Measurement of Variables

Dependent Variable:

Financial distress was measured using Altman Z'' -Score (Altman, 2006). Altman amended the formula to allow its application to certain situations not originally included in the original sample set (Altman, 2006).

$$Z'' = 6.56 X_1 + 3.26 X_2 + 6.72 X_3 + 1.05 X_4 \quad Z'' < 1.10 \text{ bankrupted/distressed}$$

$$Z'' > 2.60 \text{ non distressed/ non-bankrupted (safe)}$$

$$Z'' = 1.10 \text{ to } 2.60 \text{ grey area}$$

Independent Variables:

Board independence was measured as the percentage of membership held by the independent directors, where independent directors are those with no affiliation to the firm which has been considered in prior studies (Morellec *et al.*, 2012; Bhagat and Bolton, 2008 and Zahra and Stanton, 1988).

Control Variables:

The study incorporates control variables into the analysis, especially variables known to affect financial distress. Firm size was measured, as a natural log of total assets as measured by Choi *et al.*, (2012). This was controlled because previous studies have found firm size to be significantly related with financial distress (Iskandar *et al.*, 2012).

Industry was measured as a dummy variable and controlled in the study, because firms in different industries adopt varied capital structures (Jensen, 1989) thus affecting financial soundness of a firm. According to Nwachukwu and Mohammed (2012) firms in the manufacturing industry have assets with a collateral value that improves their capacity to borrow which have a bearing on financial distress of firms. Following this observation, and consistent with the approach used by Barroso *et al.*, (2011) and Plambeck and Weber (2010), this study assigned "1" to firms in the manufacturing sector and "0" to the rest.

Consistently with previous studies, profitability was controlled in the study because of strong indications of its effect on financial distress. Thus, consistently with literature, profitability in this study was calculated as earnings before depreciation, interest, and tax (EBDIT), divided by total assets (Sirtaine *et al.*, (2005) and (Maere *et al.*, 2014).

3.2 Model Specification

$$Z_{it} = \beta_{0+} + \beta_1 I_{it} + \beta_2 FS_{it} + \beta_3 P_{it} + \varepsilon_{it} \dots \dots \dots \text{Model 1}$$

$$Z_{it} = \beta_{0+} + \beta_1 I_{it} + \beta_2 FS_{it} + \beta_3 P_{it} + \beta_4 BI_{it} + \varepsilon_{it} \dots \dots \dots \text{Model 2}$$

Where

Z_{it} = Financial distress of the firm i ($i=1, 2, \dots, 57$) in time t ($t=1, 2, \dots, 10$) BS =Board size of firm i in time t , BT =Board tenure of firm i in time t , BI= Board independent of firm i in time t , MD=Board Multiple directorship of firm i in time t , FE= Board Financial Experts of firm i in time t , FS_ Firm Size, I= Industry Dummy, P=Profitability, ε = the random error term.

4. RESULTS

4.1 Descriptive Results:

Table 1 indicates descriptive results. The descriptive statistics indicate that Kenyan firms have an average of .745 board independence. The average board size is 8.75 while the minimum number of board members was 4 and the maximum was 16. The average board tenure is 6.78 years. For the directors with financial related skills and experience the minimum was 1 while the maximum was 9 at an average of 3.78.

Table 1: Descriptive statistic

	N	Mean	Std. Deviation	Min	Max
Financial Distress	390	4.882	2.879	0.050	19.110
Profitability	390	0.759	0.248	-0.280	1.940
Firm Size (Log)	390	22.372	-0.429	15.660	26.540
Board Independence	390	8.746	2.243	4.000	16.000

Source Research data (2015)

The Pearson correlations results on board independence was found to be negatively and significantly correlated with financial distress (-.371; $p < 0.01$). The possible explanation to this could be that the independent directors aren't at the discretion of the managers. Hence, managing director's influence may not as much influence the decisions of independent directors.

Table 2: Pearson Correlation Coefficients

	1	2	3	4	5	
1. Financial distress	1					
3. Board Independence	-.371**	1				
3. Profitability	-.005	.152**	1			
4. Firm Size	.008	.199**	-.270**	1		
5. Industry	-.068	-.382**	-.286**	.097	1	

Source: Research Data (2015)

4.2 Empirical Results:

Data was subjected to several tests before the regression analysis. Firstly, we tested for the presence of multicollinearity using Variance Inflation Factors (VIF) and tolerance. Multicollinearity exists when two or more predictor variables are strongly correlated (Field, 2005). Hair *et al.*, (2006) suggested a threshold of VIF values of 10. Each of the variables used in this study, including the control variables, range from 1.201-3.269, suggesting the absence of multicollinearity. A tolerance of below 0.10 or a VIF greater than 10 or a correlation coefficient above 0.8 is regarded as indicative of serious multi-collinearity problems (Field, 2009).

Independence of error terms was tested using a Durbin-Watson statistic, and the results ranged between 1.53 and 1.737, which is within the threshold of 1.5-2.5 (Hair *et al.*, 2006). Outliers were checked using box plots, and the results indicated the absence of outliers in the sample. According to Gujarati (2003); Granger and Newbold (1974) data series must be primarily tested for stationarity in all econometric studies. In this study we conducted unit root test for the variables using the Augmented-Dickey-Fuller unit root test. The p-values for the ADF-Fisher Chi-square statistic were less than theoretical values of 0.05 for profitability and financial distress. This implies that these variables/ panels (had no unit roots) and therefore suitable for modelling and forecasting. To correct for non stationarity in board independence and firm size the first difference of the variables [D (var)] were used in the regression models.

We reported the results of the analysis using random effects regression. A Hausman test suggested that a random effects regression model would be preferable to a fixed effects model. Consistent with the approach used by Kim *et al.*, (2008), we tested the hypotheses using hierarchical regression analysis because it allows fitting of the model to individual measurements while accounting for systematic unexplained variations among firms.

Hypothesis 1 proposed a non-significant relationship between board independence and financial distress. The results exhibited a negative and significant relationship between board independence and financial distress ($\beta=-0.044$; $p<0.05$) therefore rejecting the hypothesis.

Table 3: Regression Analysis

Variables	Model 1	Model 2
Controls		
Constant	0.658(3.677)**	0.559 (3.967)**
Firm Size	-0.000(-0.058)	0.000(0.121)
Industry	0.007(0.239)	-0.016(-0.778)
Profitability	0.180(1.344)	0.311(1.012)
Board Independence	-0.044(-2.138)*	
R Squared	0.024	0.206
Adjusted R	-0.051	0.114
F-Statistic	0.056	4.671
Prob. of F-Stat.	0.956	0.000

** 1 percent significance level; * at 5 percent level Figures in parenthesis are t-statistics

Source: Research Data (2015)

5. DISCUSSION AND CONCLUSION

In this paper, we have examined the relationship between board composition and financial distress using data from firms listed on the Nairobi Securities Exchange. Specifically, we have investigated the effect of board composition variables; board size, director independence, board tenure, multiple directorships and financial expertise of directors on financial distress. Our analysis showed a number of findings; the findings indicated that higher representation of independent directors has a negative association with financial distress while, long tenure board is positively associated with financial distress. Our first finding backs the view that independent directors are effective monitors which is consistent with agency theory (Jensen and Meckling, 1976).

Overall, the study suggests that the board plays an important role in the decision making of the firm. Board independence was found to be having a negative and significant effect on financial distress. This study concludes that board directorship should have more independent directors as they reduce probability of facing financial distress. Board tenure was also found to be positively and significantly related with financial distress. This result confirms the hypothesis that long tenure boards tend to befriend management hence compromising their role of oversight. Therefore, this result implies that tenure of board directors should be reduced since seasoned directors tend to lose their objectivity and independence.

Notably, the findings of this study supported the prescriptions of agency theory that independent directors provide better control over management and that average tenured boards are beneficial to the firms than seasoned directors. The study therefore has boosted the existing literature on financial distress and board composition which provide a reference point for academic discourse and future reference.

As the corporate governance reforms are vigorously advocated in Kenya, this study provides insights into the roles of corporate governance in financial healthiness. As such the findings of this study provide valuable insights to authorities, managers and stakeholders on corporate governance. Specifically, these findings can be beneficial to authorities that formulate the policies, mainly the Capital Market Authority and Nairobi Securities Exchange.

Firstly, the study found the relationship between board independence and financial distress was negative and significant. Therefore, the composition of boards should take cognizance of members who are independent of management. Hence, the study recommends that the authorities should put structures that enhance the appointment of independent directors who have requisite skills and knowledge in the board.

It is essential to note the study's limitations. Firstly, the study has relied on archival data, especially information contained in financial statements. Secondly, while the study has considered several board variables, there are other important board measures that are particularly important in a Kenyan context, such as compensation, ownership structure, and audit committee. Thirdly, the study was based on a sample of firms listed on the Nairobi Securities Market, which may be considered a small sample. This may limit the generalizability of the findings. Future research using a larger sample size and different types of firms private non-listed firms may provide additional insights and enhance our understanding of the issues explored here.

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