ISSN 2349-7807

International Journal of Recent Research in Commerce Economics and Management (IJRRCEM)
Vol. 6, Issue 4, pp: (177-184), Month: October - December 2019, Available at: www.paperpublications.org

EFFECT OF CORPORATE GOVERNANCE ON FINANCIAL PERFORMANCE OF THE COMMERCIAL BANKS KENYA

[1]NOOR BASHIR HAMUD, [2]DR GORDON OPUODHO

Abstract: **The General objective of this research was to assess the effects of effect of corporate governance on finance performance of commercial banks in Kenya. The specific objectives of this project wereto establish the effect of board diversity, board independence, board size and ownershipon financial performance of commercial banks in Kenya. The study adopted secondary data analysis research design. The observations used dated from January the year 2014 to December 2018 and includes 48 monthly observations. The population composed of all the commercial banks in Kenya. The data was obtained from Kenya National Bureau of statistics, the central bank and audited financial statements of individual banks. Correlation and multiple regressions were employed as the analytical tools. The study was driven by the absence of laborious studies that address the dynamics of the financial performance in commercial banks in Kenya. The research is also motivated by the mixed results that various previous researchers got for the same types of the variables. The study also helps other researchers as a source of reference and as a stepping stone for those who want to make further study on the area afterwards. It also contributes to the understanding and stabilization of the financial sector of the economy and the society as a whole. It will also give all stakeholders in the sector an opportunity to gain deep. From the findings on the effects of Board Size on the financial performance of commercial banks in Kenya, the study found that various aspects of board size affect the financial performance of commercial banks in Kenya to a great extent. From the regression analysis, board size was found to positively affect the financial performance of commercial banks in Kenya. On the effects of board diversity on the financing performance of commercial banks in Kenya, the study established that various aspects of composition of the board affect the financial performance to a great extent. The study thus concludes that board diversity positively influence the financial performance of commercial banks in Kenya. From the findings on effects of ownership on the financial performance of commercial banks in Kenya, the study found that various aspect of ownership positively influenced the financial performance of commercial banks in Kenya to great extent. Thus the study concludes that separation of the role of CEO and Chair positively influenced the financial performance of commercial banks in Kenya. Finally, from the findings on effects of board independence on the financial performance of commercial banks in Kenya, the study established that board independence of the firm positively influenced the financial performance of commercial banks in Kenya. The study thus concludes that board independence of the firm positively influenced the financial performance of commercial banks in Kenya.**

Keywords: **board diversity, board independence, board size and ownership.**

1. INTRODUCTION

In today's business environment, shareholders in organizations are holding the board of directors to account for performance of the organization. The collapse of large corporations around the world has focused their attention on the performance and behavior of the board of directors of an organization. The board of directors as the top management of the organizations is held accountable for the strategic direction that the organization takes. Heracleous (2001) agrees that

ISSN 2349-7807
International Journal of Recent Research in Commerce Economics and Management (IJRRCEM)
Vol. 6, Issue 4, pp: (177-184), Month: October - December 2019, Available at: www.paperpublications.org

the importance of corporate governance in today's corporations has gained momentum owing to separation of ownership and management control in the firm. The shareholders' interests are in conflict with the manager's interest.Corporate governance refers to making such set of laws and motivation through which administration of company is bounded and administered for profit maximization which ultimately adds the value for shareholders as well as for management (Ilyas & Rafiq, 2012).

Statement of the problem

The issue of corporate governance has received prominence in the recent past especially among large and listed commercial banks in Kenya. In Kenya for example, the Central Bank of Kenya expects all commercial banks to subscribe to the corporate governance instruments such as a set code of conduct, establishment of an independent audit committee and board of directors. Most of the firms and commercial banks that have collapsed such as Enron, Layman Brothers, Mumias Sugar Company,Imperial bank and Chase bank have all been attributed to a lack of observance of the corporate governance tenets.

Empirical studies have mixed findings on the relationship between corporate governance and finance performance of commercial banks in Kenya.Chaganti and Damanpour (2001), Grier and Zychowicz (2004), Bathala et al. (2004) and Crutchley and Jensen (2006) find a negative relationship between corporate governance and financial performance. On the other hand, Leland and Pyle (2007), Berger et al. (2007) and Chen and Steiner (2009) show that corporate governance and financial performance are positively related.

Most of the studies on the relationship between corporate governance and financial performance

Have covered developed economies, whereas much less studies covered developing economies such as Kenya's economy. Some of these studies include Aburime (2008) in Nigeria, Al-Tamini (2010) in UAE, Clair (2004) in Singapore, Heffernan & Fu (2010) and Wong, Fong, Wong, & Choi (2007) in China. It is however important to note that countries differ in terms of the macro-economic conditions, the financial systems as well as the operating environment of these banks (Ongore and Kusa, 2013). This shows that corporate governance factors that influence financial performance in one country may not be the same as those in another country (Lipunga, 2014).

Studies that are close to effect of corporate governance on bank financial performance in Kenya include Njihia (2005), Mwania (2009), Okutoyi (1988), and Ndungu (2003). These studies were however designed to focus on each corporate governance factor of bank financial performance to the exclusion of the other factors while some only focused on listed commercial banks as in the case of Ndungu (2003). There is no study that has been done on a larger sample of commercial banks hence a gap that needs to be filled in by carrying out the present study. This study builds on the study by Njihia (2005) as the former study was limited by the scope as it only focused on one aspect of commercial banks financial performance. Given the passage of time and limitations of case studies as far as generalization of results to the population is concerned, there is need for the present study to be conducted. The study poses the following research question: What is the effect of corporate governance on financing performance of commercial banks in Kenya?

Objectives

i. To find out the effect of board diversity on the financial performance of the commercial banks in Kenya

ii. To establish how board independence affect the financial performance of commercial banks in Kenya

iii. To find out how board size affect the financial performance of commercial banks in Kenya

iv. To establish the effect of ownership on the financial performance of commercial banks in Kenya

2. THEORETICAL REVIEW

Agency Theory

Agency theory refers to a set of propositions in governing a modern corporation which is typically characterized by large number of shareholders or owners who allow separate individuals to control and direct the use of their collective capital

ISSN 2349-7807

International Journal of Recent Research in Commerce Economics and Management (IJRRCEM)
Vol. 6, Issue 4, pp: (177-184), Month: October - December 2019, Available at: www.paperpublications.org

for future gains. Agency Theory is based on the idea that in a modern corporation, there is a separation of ownership and management, resulting in agency costs associated with resolving the conflict between the owners and the agents (Berle & Means, 1932). Jensen and Meckling (1976) regarded corporate governance as a mechanism where a board of directors is a crucial monitoring device to minimize the problems brought about by the principal agent relationship. In this context, agents are the managers, principals are the owners and the boards of directors act as the monitoring mechanism (Mallin, 2004).

Stakeholder's Theory

The shareholder theory,posited in the early 20th century by economist Milton Friedman.Stakeholders' theory holds that corporations are social entities that affect the welfare of many stakeholders where stakeholders are groups or individuals that interact with a firm and that affect or are affected by the achievement of the firm's objectives (Donaldson & Preston, 1995). It is this interaction that Donaldson and Davis (1991) concludes that shareholder interests are maximized by shared incumbency of the roles of the various stakeholders in a company and according to them stewardship theory is superior to agency theory. Stakeholder theory argues that the parties involved should include governmental bodies, political groups, trade associations, trade unions, communities, associated corporations, prospective employees and the general public.

Stewardship Theory

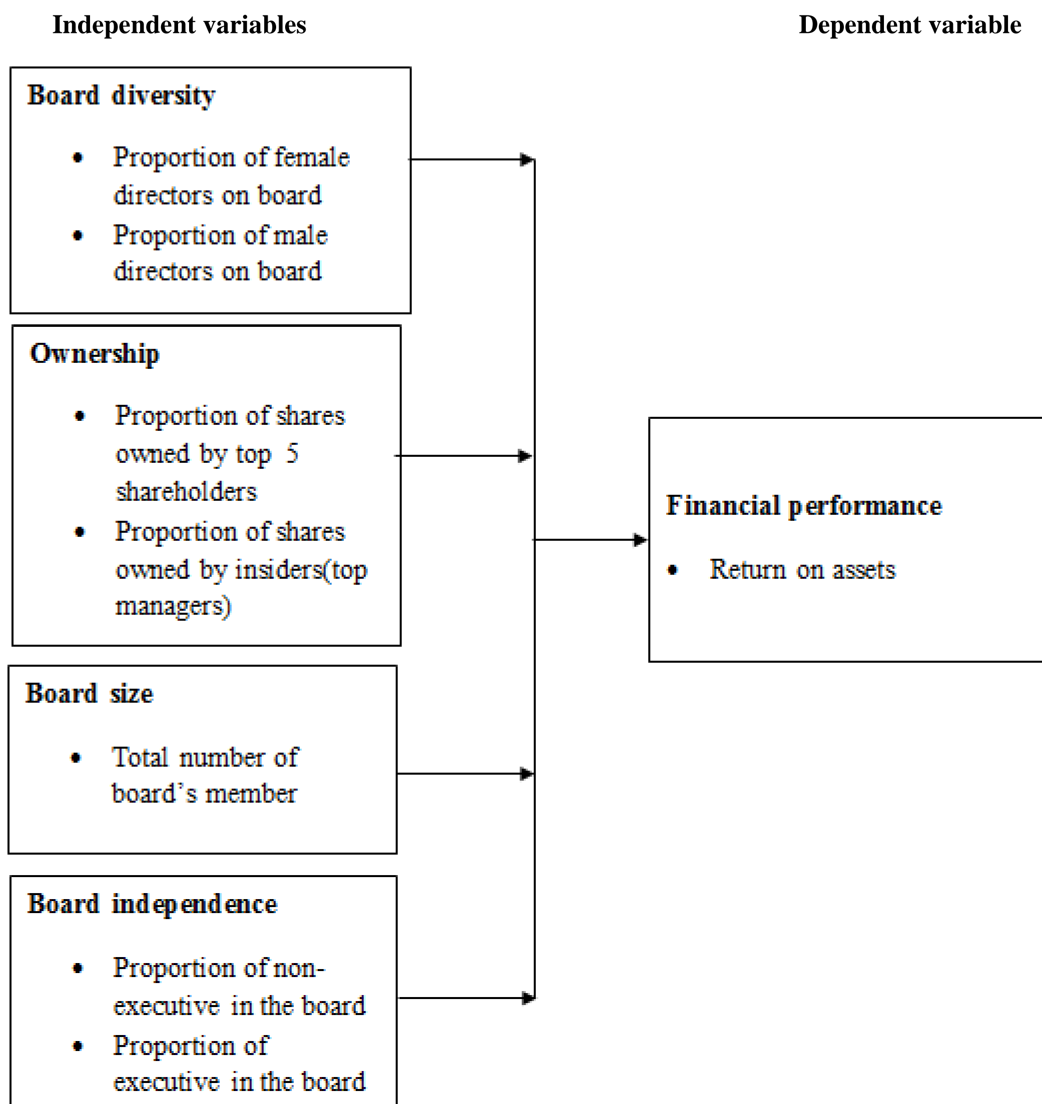
Stewardship Theory, developed by Donaldson and Davis (1991 & 1993) is a new perspective to understand the existing relationships between ownership and management of the company.In contrast to agency theory, stewardship theory presents a different model of management, where managers are considered good stewards who will act in the best interest of the owners (Donaldson& Davis, 1991).The fundamentals of stewardship theory are based on social psychology, which focuses on the behavior of executives.The steward's behavior is pro-organizational and collectivists, and has higher utility than individualistic self-serving behavior and the steward's behavior will not depart from the interest of the organization because the steward seeks to attain the objectives of the organization (Davis, Schoorman & Donaldson, 1997).According to Smallman (2004) where shareholder wealth is maximized, the steward's utilities are maximised too, because organizational success will serve most requirements and the stewards will have a clear mission. He also states that, stewards balance tensions between different beneficiaries and other interest groups. Therefore stewardship theory is an argument put forward in firm performance that satisfies the requirements of the interested parties resulting in dynamic performance equilibrium for balanced governance.

Resource Dependency Theory

Resource dependence theory is based on the notion that environments are the source of scarce resources and organizations are dependent on these finite resources for survival. A lack of control over these resources thus acts to create uncertainty for firms operating in that environment. Organizations must develop ways to exploit these resources, which are also being sought by other firms, in order to ensure their own survival. It argues that the key to organizational survival is the ability of the firm to acquire and maintain resources (Pfeffer & Salancik, 1978). Thus, boards of directors are an important mechanism for absorbing critical elements of environmental uncertainty into the firm. Environmental linkages could reduce transaction costs associated with environmental interdependency.

3. CONCEPTUAL FRAMEWORK

A conceptual framework is a set of broad ideas and principles taken from relevant fields of inquiry and used to structure a subsequent presentation (Reichel and Ramey, 1987). It is a tool intended to assist a researcher to develop awareness and understanding of the situation under scrutiny. It helps the research to explain the relationship among interlinked concepts such as the dependent and independent variables (Kombo, 2006).It will be conceptualized within the dependent-independent variable components and their indicators. The figure below shows a diagrammatic representation of the relationship between the dependent and independent variables.



Research gap

Melese (2015), noted that since financial performance is very crucial to the existence of banks, corporate governancefactors that affect it should be identified. The author note that further research on the area of corporate governancethat affect financial performance of commercial banks by incorporating any more relevant variables would enhance the understanding of the sector. The literature available on financial performance in relation to corporate governanceon Kenyan context is limited. The few papers that have been written on financial performance in Kenya have been supported mainly by reviews of papers from other countries.

4. RESEARCH METHODOLOGY

This study will adopt a secondary data analysis research design since the data to be used has been previously been collected and tabulated by other sources.The target population for this study is all the commercial banks in Kenya.This study will use census sampling since the population also constitute the sample that is the 2 commercial banks. The data that will be used will be dated from year 2014 January to 2018 December. Each year consists of 12 monthly observations for each variable so in total 48 observations which is a fairly large sample above the minimum acceptable small sample size of 30 for inferential analysis. This data is authentic since it is secondary data that has been collected by credible agents and published by the Republic of Kenya. The researcher will use secondary data in empirical analysis. The data will be obtained from the central bank of Kenya database, Kenya National Bureau of Statistics public website link, and the financial statements of all the commercial banks in Kenya. A schedule will then be used to organize the data that will be collected.

ISSN 2349-7807

International Journal of Recent Research in Commerce Economics and Management (IJRRCEM)
Vol. 6, Issue 4, pp: (177-184), Month: October - December 2019, Available at: www.paperpublications.org

Model

Specification of the regression model

Where:

Y= $\beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$

Where:

Y = **Financial performance**

β_0=Intercept term

β_i=coefficients of the independent variables

X_1= Board diversity

X_2= Board independence

X_3= board size

X_4= Ownership.

ε= error term

Table 4.1: Significance of Independent Variables

Variable	Coefficient	Standard error	t-statistic	p-value
Board diversity	0.1678	0.0413	4.0630	0.000
Board independence	0.2011	0.0377	5.3342	0.002
Board size	1.2071	0.2107	5.7290	0.001
Ownership	0.5523	0.1572	3.5134	0.003
Constant	1.000	0.3010	3.3222	0.000
F-statistic = 73 Prob>F = 0.0000		Adjusted R-squared=0.87		

The regression model is as follows:

$$\log Y = 1.00\log\beta_0 - 0.1678\log X_1 - 0.2011\log X_2 + 1.2071\log X_3 - 0.5523\log X_4 + \varepsilon$$

Standard Error 0.3010 0.0413 0.0377 0.2107 0.1572

t-Statistics 3.3222 4.0630 5.3342 5.7290 3.5134

p-value 0.000 0.000 0.0020.0010.003

F-statistic = 73

Prob>F = 0.0000 Adjusted R-squared=0.87

Where:Y =Financial performance, β_0 = Constant Term, β_1 = Beta coefficients, X1 = board diversity, X2 =board independence, X3 = board size, X4 = Ownership ε = Error Term

5. INTERPRETATION OF THE FINDINGS

Board Diversity

There was a positive relationship between the proportion of female board members and ROA. As the number of female board members increased the performance of the firm increased as it was measured byReturn on Assets (ROA).

Board Independence

Results obtained from correlation results showed that higher ratio of independent board directorswas positively related with ROA and ROE of financialperformance of commercial banks in Kenya.Regression results also showedthat increase in level of independency to board directors would promote ROA and ROE.

Board Size

Results obtained from correlation results showed that board size was found to be positivelyassociated with financialperformance of commercial banks in Kenya.Regression results also predict that a unitchange on board size would positively enhance return on asset and return on equity. In descriptiveinstances, the study established that board with a smaller number of members is more efficient, smaller board can efficiently monitor the, management.

Ownership

Regression results show that Results obtained on ownership show that various aspects of ownership positively influenced the financial performance of commercial banks in Kenya as measures in ROEand ROA. The findings are in line with the research by Yermack (2006) found that ownershipcould have a positive effect on stock returns.

6. CONCLUSION

Board Size

From the findings on the effects of Board Size on the financial performance of commercial banks in Kenya, the study found that various aspects of board size affect the financial performance of commercial banks in Kenya to a great extent. From the regression analysis, board size was found to positively affect the financial performance of commercial banks in Kenya.

Board diversity

On the effects of board diversity on the financing performance of commercial banks in Kenya, the study established that various aspects of composition of the board affect the financial performance to a great extent. The study thus concludes that board diversity positively influence the financial performance of commercial banks in Kenya.

Ownership

From the findings on effects of ownership on the financial performance of commercial banks in Kenya, the study found that various aspect of ownership positively influenced the financial performance of commercial banks in Kenya to great extent. Thus the study concludes that separation of the role of CEO and Chair positively influenced the financial performance of commercial banks in Kenya.

Board independence

From the findings on effects of board independence on the financial performance of commercial banks in Kenya, the study established that board independence of the firm positively influenced the financial performance of commercial banks in Kenya. The study thus concludes that board independence of the firm positively influenced the financial performance of commercial banks in Kenya.

REFERENCES

[1] Adams, R., B. and Ferreira, D. (2007), "A theory of friendly boards". *Journal of Finance*, 62(1), 217-250.

[2] Becker, B. et al (2011), "Estimating the effects of large shareholders using a geographic instrument". *Journal of Financial and Quantitative Analysis*, 46(4), 907-942.

[3] Bhabra, G., S. et al (2003), "Corporate Governance in Singapore: The Impact of Directors' Equity Ownership". *Advances in Financial Economics*, 8, 29-46.

[4] Brickley, J. and Smith, Jr., C. (1988), "Ownership structure and voting on antitakeover amendments".*Journal of Financial Economics*, 20, 267-291.

ISSN 2349-7807

International Journal of Recent Research in Commerce Economics and Management (IJRRCEM)
Vol. 6, Issue 4, pp: (177-184), Month: October - December 2019, Available at: www.paperpublications.org

[5] Vietnam Ministry of Finance (2012), “Circular No. 121/2012/TT-BTC dated on July 26, 2012 issuing the regulations on corporate governance which is applied to public companies”.

[6] Burkart, M. and Panunzi, F. (1997), “Large shareholders, monitoring, and the value of the firm”. *The Quarterly Journal of Economics*, 112(3), 693-728.

[7] Carlson, R., Karlsson, K. (1970), “Age, cohorts, and the generation of generations”. *American Sociological Review*, 35(4), 710-718.

[8] Chen, C., W., Lin, J., B. and Yi, B. (2008), “CEO Duality and Firm Performance: An Endogenous Issue”. *Corporate Ownership and Control*, 6(1), 58-65.

[9] Child, J. (1975), “Managerial and Organizational Factors Associated with Company Performance - Part II. A Contingency Analysis”. *Journal of Management Studies*, 12, 12-27.

[10] Chung, K., H. and Pruitt, S., W. (1996), “Executive ownership, corporate value, and executive compensation: A unifying framework”. *Journal of Banking and Finance*, 20(7), 1135-1159.

[11] Coles, J., L., Daniel, N., D. and Naveen, L. (2008), “Boards: Does one size fit all?”. *Journal of Financial Economics*, 87(2), 329-356.

[12] Dahya, J., Garcia, L., G. and van Bommel, J. (2009), “One Man Two Hats: What's All the Commotion!”. *The Financial Review*, 44(2), 179-212.

[13] Dalton, D., R. et al (1999), “Number of Directors and Financial Performance: A Meta-Analysis”. *The Academy of Management Journal*, 42(6), 674-686.

[14] Daily, C., M., Dalton, D., R. and Cannella, A., A. (2003), “Corporate Governance: Decades of Dialogue and Data”. *The Academy of Management Review*, 28(3), 371-382.

[15] Denis, D., K. and McConnell, J. (2003), “International Corporate Governance”. *Journal of Finance and Quantitative Analysis*, 38(1), 1-36.

[16] Dutta, P. and Bose, S. (2006), “Gender Diversity in the Boardroom and Financial Performance of Commercial Banks: Evidence from Bangladesh”. *The Cost and Management*, 34(6), 70- 74.

[17] Elloumi, F. and Gueyié, J., P. (2001), “Financial distress and corporate governance: an empirical analysis”. *Corporate Governance*, 1(1), 15-23.

[18] Fama, E., F. (1980), “Agency problems and the theory of the firm”. *Journal of Political Economy*, 88(2), 288-307.

[19] Fama, E., F. and Jensen, M. C. (1983), “Separation of ownership and control”. *Journal of Law and Economics*, 15(2), 301-325.

[20] Fairchild, L. and Li, J. (2005), “Director Quality and Firm Performance”. *The Financial Review*, 40(2), 257-279.

[21] Gedajlovic, E., R and Shapiro, D., M. (1998), “Management and Ownership Effects: Evidence from Five Countries”. *Strategic Management Journal*, 19(6), 533-553.

[22] Heidrick & Struggles (2009), “*Corporate Governance Report 2009 - Boards in turbulent times*”. Heidrick and Struggles International, Inc.

[23] Hewa-Wellalage, N. and Locke, S. (2011), “Does CEO Duality is Really Matter? Evidence from an Emerging Market”. *Corporate Ownership and Control*, 8(4), 112-122.

[24] Jensen, M., C. (1993), “The Modern Industrial Revolution, Exit, and The Failure of Internal Control Systems”. *The Journal of Finance*, 48(3), 831-880.

[25] Jensen, M., C. and Meckling, W., H. (1976), “Theory of the Firm Managerial Behavior, Agency Costs and Ownership Structure”. *Journal of Financial Economics*. 3(4), 305-360.

ISSN 2349-7807

International Journal of Recent Research in Commerce Economics and Management (IJRRCEM)
Vol. 6, Issue 4, pp: (177-184), Month: October - December 2019, Available at: www.paperpublications.org

[26] Jensen, M., C. and Murphy, K., J. (1990), "Performance Pay and Top-Management Incentives". *Journal of Political Economy*, 98(2), 225-264.

[27] Klein, A. (1998), "Firm Performance and Board Committee Structure". *Journal of Law and Economics*, 41(1), 275-303.

[28] Lipton, M. and Lorsch, J., W. (1992), "A modest proposal for improved corporate governance". *Business Lawyer*, 48(1), 59-77.

[29] Mehran, H. (1995), "Executive Compensation Structure, Ownership and Firm Performance". *Journal of Financial Economics*, 38(2), 163-184.

[30] Myers, S., C. (2000), "Outside Equity". *The Journal of Finance*, 55(3), 1005-1037.

[31] Nicholson, G., J. and Kiel, G., C. (2004), "Breakthrough board performance: how to harness your board's intellectual capital". *Corporate Governance: The International Journal of Business in Society*, 4(1), 5-23.

[32] Pfeffer, J. (1972), "Size and Composition of Corporate Boards of Directors: The Organization and its Environment". *Administrative Science Quarterly*, 17(2), 218-228.