

**RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND FINANCIAL  
PERFORMANCE OF MICROFINANCE BANKS IN KENYA**

**BY**

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## DECLARATION

### Declaration by Student

This research project is my original work and has not been presented in any other university for award of a degree.

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This project report has been submitted for examination with my approval as the appointed University supervisor.

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Despite all this able assistance, I accept full responsibility for any flaws in the writing of this paper. It has been a joy to craft it and I hope it will help to advance the field of Microfinance banking.

## **DEDICATION**

I dedicate this paper to my family; you all stood by me throughout this programme and inspired me immensely. God bless you so much.

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## **ABBREVIATIONS**

<b>ACH</b>	-Automated Clearing House
<b>ADB</b>	-Africa Development Bank
<b>ANM</b>	-Agency Network Model
<b>CBK</b>	-Central Bank of Kenya
<b>CEO</b>	-Chief Executive Officer
<b>CG</b>	-Corporate Governance
<b>CRR</b>	-Cash Reserve Ratio
<b>MD</b>	-Managing Director
<b>FSD</b>	-Financial Sector Deepening
<b>KBRR</b>	-Kenya Banks Reference Rate
<b>KEPSS</b>	-Kenya Electronic Payment and Settlements System
<b>MFBs</b>	-Microfinance Banks
<b>ROA</b>	-Return on Assets
<b>ROE</b>	-Return on Equity
<b>SME</b>	-Small and Medium Enterprises
<b>UK</b>	-United Kingdom
<b>US</b>	-United States

## ABSTRACT

Prudential corporate governance is important in promoting investors' confidence in banking sector. Therefore, the objective of this study was to evaluate the relationship between corporate governance and financial performance of microfinance banks in Kenya. The study used board size, board composition, cost of compliance and ownership concentration as measures of corporate governance while financial performance was measured by return on assets. A descriptive research methodology was adopted in this study. The target population considered in this study is made up of 9 MFBs which were licensed by the CBK between 2012 and 2015. The secondary data was obtained from published audited financial statements of the MFBs. These statistics covered the period 2012 to 2015. Data was described using the descriptive statistics while correlation and regression analysis was the one used to measure the relationship between corporate governance structures and financial performance. The study revealed that there is a strong correlation between performance and good corporate governance. There is a strong positive marginal effect of independent variable - corporate governance (measured by board size, cost of compliance) and financial performance (measured by the return on assets). This means that corporate governance mechanism measured by board size have a positive relationship on the financial performance proxied by return on assets. However, results reveal that board composition and ownership concentration don't have any relationship with financial performance and therefore do not affect the firm return on assets. From the study the conclusion is that there exists positive relationship between institutionalization of good corporate governance mechanisms and performance for the microfinance banks studied. Therefore, the study concludes that there is no financial burden in institutionalizing corporate governance. From the study it is evident that good corporate governance increases the agency costs. On the basis of the result of this study, it is recommended that firms should institute appropriate corporate governance mechanism that does not lead to financial burden to the company. There is need therefore the microfinance banks to reduce their board sizes in order to address high board remuneration. It is further recommended that all microfinance banks should have outside board members who have no shareholdings in the firms. This will institute good corporate governance in order to mitigate agency costs and hence increase the performance of their companies.



# **CHAPTER ONE: INTRODUCTION**

## **1.1 Background of the Study**

Corporate governance is mainly concerned with separation of owners from managers so as to ensure that managers come up with measures that protects the interests of all stakeholders Oman (2003). Corporate governance also addresses the agency problems arising from action of selfish managers and other insiders impose on stakeholders including investors due to lack of prudential corporate governance. Despite overwhelming literature on corporate governance there is lack of consensus on how to deal with the agency problem Oman (2003).

However, studies have shown importance of corporate governance in influencing performance of firms. There is empirical research on effectiveness of corporate governance measures on the stability and performance of microfinance banks. But whether these lessons apply to microfinance banks is not clear. Last decade, Kenya witnessed collapse of a number of financial institutions where investors have incurred tremendous losses following the collapse of these firms. According to Wambua (1999) among the causes of the collapse of these firms was weak corporate governance. To address agency problem in the deposit taking microfinance institutions, Central Bank of Kenya introduced corporate governance mechanisms to help reduce agency problem. This study therefore seeks to find out the existing relationship between the corporate governance and financial performance of micro finance banks in Kenya.

### **1.1.1 Corporate Governance**

Corporate governance is set of measures that ensure that there is separation of managers and ownership in terms of their decisions so as to protect shareholder's interests. According to Cremers & Nair (2005) a poorly governed firms experiences low profits, are bankruptcy riskier, pay less dividends to their shareholders and have low valuations. On the other hand, properly governed firms have higher profits, high dividend payouts to their shareholders, and experience less bankruptcy and are highly valued. This explains that sound corporate structures benefit firms through lower financing cost, unlimited access to financing and investors support occasioned by favorable stakeholders' confidence and support.

Market regulators are required to institute corporate governance which is expected to stimulate the performance of companies. Corporate governance is underlying forces behind economic growth in a society. It creates a business atmosphere that inspires managers and shareholders to optimize firm's return on investment and operational efficiency. This leads to long term firm productivity and growth Oman (2003). Due to the fact that owners and managers of firm are mostly separated, Oman (2003) said corporate governances need to focus on the agent relationship that exists thereof.

### **1.1.2 Financial Performance**

There have been a many definitions of financial performance that have been proposed in the literature. Performance in organization is a measure of how organization's goals and objectives are realized efficiently and effectively manner Wanjau (2007). Performance

can be defined as the ability to sustain growth and income stability. Financial performance indicates relativity of a company profits to its total assets, which according to Hassan et al. (2011) is measured broadly by investor returns and accounting returns. While investor returns are returns that are measured from the perspective of shareholders such as dividend yield and price earnings ratio, accounting returns measures focus on how firm earnings relate to managerial policies such as sales growth, operating income growth return on assets, total assets and asset growth. The mostly used financial performance measures include; ROA, ROE and return on sales Ngatia (2012). In microfinance institutions, Wanjau (2007) identified four main measures of financial performance namely market share, return on assets, turnover, portfolio quality and profits. Return on assets is mainly an authentic measure of financial performance Berman et al(1999).

### **1.1.3 Governance Structure and Financial Performance**

There is no conclusive literature on the relationship between corporate governance and financial performance. Corporate governance reduces agency costs; Chen, Chen & Wei, (2004) said that firms with lower agency costs have good corporate governance that results to higher valuation of the firm and increased returns. On the other hand, where agency related costs are higher, the corporate governance has no relationship with expected returns. Bebchuk, Cohen & Ferrell (2004) showed that in an agency risk cost environment, there is no positive relation between corporate governance and expected stock returns. They identified main characteristic of corporate governance as;how the board is composed, board size and separation of MD and board chairman functions.

Laing & Weir (2009) found that there is little evidence to support that board characteristics leads to higher performance. However, they said that presence of remuneration and audit board committees improves. Oman (2003) states that their institutions and structures mainly set up to address the agency problem and constitute monitoring costs that ultimately add to the agency costs; while the boards of directors' role is the governance shareholders' role is to appoint the directors and the auditors. Yakhou & Dorweiler (2004) argued that bigger boards are good for corporate performance because the wide expertise that help them make better decisions. In situation of a powerful CEO, Jensen (1993), argues that bigger boards might be less effective. He argues that when a board is too big, it becomes more difficult to process problems and also to co-ordinate. On the other hand smaller boards reduces the possibility of individual directors having a free ride which improves and fasten decision taking processes Eisenberg *et al* (1998). Ching-Yi (2008) studied the relationship between how banks performed and structure of the management and found that no significant relationship between the two. He argued that there is no relationship between how banks performed and structure of the management in China due to the reason that owners gave benefit packages and bonus and not equity shares to align incentives, and that the level of amount of bonus was independent with the managerial equity stakes contracted.

#### **1.1.4 Microfinance Banks in Kenya**

The concept of Microfinance has gained popularity in the developing countries, owing to the peculiarity of small enterprises, the role such enterprises play in poverty alleviation and economic development, and the reluctance of mainstream commercial banks to offer credit facilities to Micro, Small and Medium Enterprises. Microfinance services and products offered in this banking segment include savings, credit, insurance and money transfer to lower-income households or those at the bottom of the pyramid and Small and Micro Scale Enterprises (SMEs). Micro finance uses innovative delivery channels and methodologies to reach their customers and offers services to them FSD( 2013).

The coming into force in Kenya of the Microfinance Act (2006) transformed the microfinance landscape by creating two distinct groups of institutions namely the microfinance banks and non-deposit taking microfinance institutions. In this study microfinance is restricted to lending activities of microfinance banks (MFBs) which were formally called the deposit taking microfinance institutions. Central Bank of Kenya licenses supervises and regulates microfinance banks (MFBs) in Kenya. As at July 2016, they were twelve microfinance banks with 96 branches and 67 marketing offices in Kenya. In total, they had 1.47 million accounts with total deposits of kes 41.04 billion and an outstanding loan book of kes 45.77 billion (CBK, 2016). In July 2016, the number of MFBs clients' deposit accounts stood at 1.47 million compared to 2013 when the accounts stood at 1.12 million deposit accounts. The sub-sector's net loan portfolio also increased from KES 34 billion in 2014 to KES 45 billion in 2016.

The Microfinance Act, 2006 and Regulations 2008 were operationalized to provide an enabling corporate governance environment for microfinance banks to thrive. The Finance bill (2011) amended the Microfinance Act to allow sharing of customers' credit information among the sector players. Other regulations made mandatory to publish for MFBs to publish their financial quarterly so as to improve corporate governance.

In 2015, the microfinance banks' total assets comprised 66% of net advances and 9% fixed assets. This improved financial performance of the MFBs has led to increased financial inclusion many people in Kenya. However, lessons from the corporate collapses and losses in the last few years demand the need for prudential corporate governance practices so to ensure viable entities and maintain stakeholders' interests. Some of corporate failures were in MFB segment illustrating risks posed by corporate governance breakdowns.

## **1.2 Research Problem**

Prudential corporate governance is important in promoting investors' confidence in banking sector. It offers the investors a promise of a good return on their financial investment through improved efficiency. It also helps in the improvement of the firm performance; stakeholder interest is safeguarded and encourages investment in the financial markets. Both are associated with improved macroeconomic growth. However, Kenya has experienced a collapse of microfinance institutions in the recent past. Lessons from the corporate collapses and losses in the last few years demand the need for heightened corporate governance practices so as maintain viable entities and safeguard stakeholder's interests. Most of the corporate failures that were recorded in the Kenya

MFB industry are examples of the risks posed by corporate governance breakdowns. For example, the collapse of Akiba Micro Finance and the current fraudulent activities by Pyramid organization masquerading as MFIs. The report by the Task force on Pyramid Schemes (2008), found that Kenyans lost more than Sh34 billion to these fraudulent schemes such as Developing Enterprise Community Initiative (DECI).

Among the causes of the collapse of these institutions were weak corporate governance mechanisms which result to self-dealing and insider trading. Wahome (2009) explains that the corporate failures witnessed confirmed that many directors put their own interests before those of the company and shareholders/investors. Other reasons that lead to collapse were inadequate enforcement by regulators, inadequate capitalization and limited information disclosure Wahome (2009). There has been growing demand for effective corporate governance and in particular the deposit taking micro finance banks so as to ensure that the depositors' funds are safeguarded and also ensure investors get good returns on their investment. While new governance measures have been essential it has been observed that some regulatory requirements for MFBs are very stringent FSD (2013). Also, despite the regulatory prescriptions on prudent corporate governance, the implementation process has always been a challenge for most microfinance banks.

Several studies have previously been done to establish whether there is a relationship between CG practices and the financial performance of firms. Nam et al. (2002) in his study found that good corporate governance had a positive relationship with the financial performance of the firm since managers have clear objectives and agency costs are

reduced. Lack of good corporate governance is a fertile ground for poor financial performance and misuse of firm's resources. Brown and Marches (2003) in their study they found that those firms that had weak corporate governance performed poorly relative to those that had stronger corporate governance; in terms of profitability, stock returns dividend payment and the level of risks. Mwasi (2011) in her study found out that there were hardly challenges among the MFIs that were targeted in regard to CG practices; this is a good indication that MFIs in Kenya are on track with regards to implementation of corporate governance practices. Most recent researchers have delved more on the effect of CG on financial performance of MFIs which consist of NGOs, SACCOs, MFBs, credit Unions and other capacity building institutions. There is little research analyzing the effect of good corporate governance practices and the financial performance of MFBs in Kenya. This study therefore fills this research gap.

### **1.3 Objectives of the Study**

The main objective of this study is to establish if there exists a relationship between corporate governance and financial performance of the microfinance banks operating in Kenya.

### **1.4 Value of the Study**

To the policy makers including CBK it is within our interest that this evidence would offers important quantitative information into the cauldron of policy. The finding can help CBK to come with policy to protect investors and promote market growth. By



helping to promote good performance of the firm and the protection of interest of various stakeholders, corporate governance encourages more investment and banking sector development.

To deposit taking microfinance bank the evidence of this work can help them to initiate good corporate governance. Evidence have suggested that the level of firm corporate governance provisions has more impact in those countries that have weak legal (or regulatory) requirements, implying that companies can partly compensate for weak rules and regulations by establishing effective corporate governance and provision of credible investor protection mechanisms. To the board of directors of microfinance banks this study is intended to make the board more effective and efficient in their activity that leads to the achievement of its objectives such as to deliver value to the customers and returns to the shareholders' investment. The board may become more aware of how its activities affect the return on shareholders' value. To the shareholders the study is intended to sensitize them on the importance of ensuring that the board practice good corporate governance for the sake of maximizing their share value. This helps them to understand how the activities of the board determine the returns on their investments.

To the academicians it is hoped that this study will add to the existing body of empirical literature on corporate governance in microfinance institutions in Kenya. Hence, the study will contribute to the existing body of knowledge on good corporate governance and also make some recommendations which will arise from its findings which further research can be conducted or other related areas of study.

## **CHAPTER TWO: LITERATURE REVIEW**

### **2.1 Introduction**

In his chapter the literature on corporate governance and financial performance is reviewed. Literature review therefore refers to the analysis of the existing body of knowledge on a certain line of study. Literature review focuses on the already existing studies which were done by other researchers and scholars. These studies thus provide the researcher with some basic knowledge of the topic under research.

### **2.2 Theoretical framework**

Freeman (1984) defined a theory as a set of concepts that are interrelated, propositions and definition which present a view of an issue through specifying the relations among various variables with an aim of predicting that particular issue.

#### **2.2.1 Agency theory**

Agency theory by Berle and Means (1932) explored about the corporate revolution. They argued that that at inception corporations are managed by the owners but as they grew, the founders sought external expertise and support in terms management and finances. Consequently, due to this support corporation became owned by external shareholders. This support demand for the need to separate decision of founders (ownership) and managers (control). This separation of management and ownership has also resulted in various types of interests between managers and the shareholders.

According to Jensen and Meckling (1976) the agency theory tries to identify the agency relationship between the principal who delegates to another party which is the agent.

Managers who act as the agents might always fail act for the best interest of the owners thereby resulting to an agency problem. This happens if the interests of ownership and management as parties to this engagement are not aligned. The agency theory is concerned with reducing the agency problem which will lead to increase value maximization by parties in this engagement. To minimize agency problem and protect shareholder interests, Davis et al. (1997) proposes two important mechanisms of governance that is the compensation schemes to align the interests of both the agent and the principal and the board of director's characteristics

### **2.2.2 Stakeholder Theory**

This theory is anchored on the interest of stakeholders in a corporation. The theory underscores the need for a corporation to balance the interests of all stakeholders Freeman, (1984). Freeman said that the theory expands the scope of interested parties in the agency theory to factor all the stakeholders i.e. the internal and the external. Thus the theory tries to bring together the various interests of all stakeholders of the corporation, hence the name stakeholder theory by Freeman (1984).

Jensen (2001) advocates for stakeholder theory but did not specify how the necessary trade off among competing stakeholder's interests was to be made. He said the managers are left to make decision for each stakeholders with no check; without a way to keep scores, thus this theory makes managers not to be fully accountable in regards to their actions. It would seem clear that this theory could be attractive to the manager and the directors for their own self interests. Jensen proposed more value maximization of the stakeholders which he equates to stakeholder theory. He stated that 'more value

maximization should utilize as much of the stakeholder theory structure but still accepts that maximization of value of a firm in the long run as the single criterion for making prerequisite tradeoffs among its various stakeholders and therefore tries to solve the problems that usually arise from many objectives that go hand in hand with the traditional stakeholder theory'. Based on this stakeholder theory the study seeks to address the following research questions: Is there a direct correlation between good corporate governance and financial performance of microfinance banks?

### **2.2.3 Irrelevancy Theory**

Irrelevance theory by Modigliani and Miller (1958) states that the firm's Weighted Average Cost of Capital (WACC) and overall market value is independent of capital structure in a perfect market without taxation. However, perfect market which is tax free does not exist in the real world. In 1963 Modigliani and Miller modified the capital structure relevance theory, and they now analyzed how the present value of interest tax shields affected the value of the firm at the corporate level and they found out that the higher the debt ratio of a firm the higher value.

Miller (1977) extended the Modigliani and Miller model to include both the personal and the corporate taxes, and this led the introduction of the Miller theory which compared the relative tax advantage of debt over equity. However, they noted that over borrowing led to financial distress and in some instances resulted in bankruptcy. The tradeoff theory balances the tax advantage associated with borrowing vis-vis the costs of financial distress and concludes that there exists an optimal capital structure. The trade-off theory

clearly states that every value-maximizing firm always opt for optimal capital structure through consideration of marginal costs and the benefits of every additional unit of debt, and thereafter choose the form of debt that will equate the marginal costs and benefits. Debt has several advantages which include tax advantage and also the reduced cost of agency as a result of free cash flows; other costs include increased level of risk of financial distress, it can lead to bankruptcy and increased contracting and monitoring costs which usually increase with the levels of debts.

### **2.3 Determinants of Financial Performance**

The corporate governance cost can be defined as a measure of firm's managerial performance, based on the fact that institutionalization of corporate governance measures is likely to lead to good decisions that give results to improved firm performance. Higher director remuneration is seen as an incentive for the directors to act in the very best interests of all stakeholders as a means of retaining their jobs and continuing to access these benefits, and especially if these benefits represents a bigger component in relation to their total wealth portfolio. Thus, the higher director benefits are expected to lead to lower agency costs. Also, engaging compliance and external auditors, in efforts to enforce governance will force manager to act in manner that would increase firm value.

In contrary, corporate governance institutions and structures are mainly set up to address the agency problem and constitute monitoring costs that ultimately add to the agency costs adversely affecting firm performance Oman (2003). In the context corporate governance, financial performance can be influenced by several factors. These are inside

shareholders, ownership concentration, board size, agency costs and firm's capitalization. The section below explains how these factors affect the financial performance.

### **2.3.1 Ownership Concentration**

One of the element of good corporate governance mechanism measured in this study is the level of ownership concentration, this refers to the number of a firm's shares which are owned by a certain number of the board. Wruck (1989) argued that high level of concentration of shares to the board tends to have more pressure on the board and at low levels of shareholding concentration an adjustment upward in concentration leads to an increase in the level of firm performance, but that after a certain point of concentration, the resultant is negative relationship.

Njuguna (2013) found out that MFBs financial performance could be determined to capital invested and injected to the institutions. It was found that increase in capital invested in lead to improved performance of the MFBs as which is measured by return on assets (ROA). Poor economic conditions can worsen the capital adequacy of the MFBs and thereby quality of loan portfolio, thereby reducing profitability.

### **2.3.2 Board Size**

The board size has an influence on firm performance. There are various arguments in favor of smaller board size to deal with the agency problem. Yermack (1996) argues that large boards are slow in decision making, and thus can be a challenge to change. Further, small board size rarely criticizes the decision of top management, a problem that tends to vary with the board members number Yermack (1996).

Maranga (2014) investigated the corporate governance affects the financial performance of Small and Medium Enterprises in County of Nairobi, Kenya. The study found that there is a significant strong relationship between the SME's financial performance and board size. The number of board sub committees, number of board meetings, and the size/age of the SMEs were found to significantly affect the financial performance of SMEs in a positive direction.

### **2.3.3 Composition of Board Members**

Composition of members of the board also influences the firm performance with a positive firm performance expected depending on the number of outside directors who sits on the board Weisbach (1988). He said that outside directors are in a better position to question the CEOs unlike the inside directors which help to reduce the agency problem. There is enough Empirical evidence produced in support for outside directors' positive role on firm performance.

John and Senbet (1998) found significant evidence on existing positive relationship between how the firm performs and the number of external directors who sits on the board. Mori and Olomi (2012) in the study, how the board affects the performance of MFIs in Tanzania and Kenya, failed to find a significant difference in the performance between boards with internal board members versus those with external members. However, the study observed that local board members are associated with higher ROA and higher OSS.

### **2.3.4 Capital Adequacy**

Laing and Weir (1999) argues that firm aspire to establish a corporate governance structure that ensures firm is highly capitalized. The high capitalized firms are mostly large and better performing firms. They are able to dispose of their debt and so their debt to asset ratio is lower, this will in store confidence to the existing shareholders and potential investors.

Capital structure theory states that the cost of capital determines the way to refinance. Where we have capital market that are developed the top managers are restricted by creditors and shareholders, facing the pressure to service debts and also pay dividend. The empirical results indicate that firms will obtain capital from internal sources first and from equity. The literature present unanimous position on how capitalization affects the performance, which is adequate capital would protect owner, managers, shareholder and creditor interests, hence increased firm value.

### **2.3.5 Cost of Compliance with Corporate Governance**

Compliance with set regulation and prudential management guidelines also improves firm performance Yermack (1996). The board and management should ensure that their organization complies with all regulations, relevant laws, good governance practices and the accounting and auditing standards. There should be regular review of the systems, processes and the procedures. This will ensure the effectiveness of the internal control



systems thus making decision capability easier and also ensure accurate reporting of financial results at all times.

Cost of compliance with governance refers to those cost that a company incur when institutionalizing the corporate structures. Dimsdale (1994) says that these are cost of holding ceremonial Annual General Meeting which is held only once a year, board of allowances and other perks they draw from being on the board, management fees, auditors' fees and cost of publications financial report of the company. This view sees cost of compliance as externally imposed and is thus unrelated to how the firm's broader operation and financing arrangements are carried out.

## **2.4 Empirical Literature**

Ching-Yi (2003) investigated whether there existed a relationship between the performance of the banks and structure of the management between the year 1912 and 1937 in Shanghai. The panel data econometric technique was used and no significant relationship was found between banks performance and the management structure. It was found that, other factors like the bank lines of business, its portfolio quality influenced performance. Chung-Yi, explained that the lack of a direct connection between performance of the bank and the management structure in China could have resulted from the fact that banks gave benefit packages and bonuses and rather than equity shares in order to align the management incentives, and that any level of managerial equity stakes which was contracted was totally independent of the bonus amount they were to get. This study found out that performance depended more on factors like the quality of the

portfolio, access of information by the management, ability of the bank to adjust to changing business dynamics and management prudence and tech-savvy rather than the implications related to the principal and the agent.

Dean and Andreyeva (2001) in their study tried to investigate existence of any link between the governance mechanism and the regulatory environment. In their study they argued that firms in the countries which have weak overall legal systems usually have an average lower ranking in terms of governance. They also found that good corporate governance has a positive relationship with the firm's market valuation, share prices and operating performance which in turn implies a positive relationship between the performance of the firms and effective regulatory environment. They also observed in those countries which have weak laws, the level of flexibility of companies to affect their own corporate governance tends to be lower. They report that the kind of governance structure that emerge is highly dependent on the regulatory environment that exist. In their study they also found out that weak regulations and legal environment of Ukraine tended to work against diffused ownership structures against concentrated ownership. Effective regulatory encourages mandatory full disclosure of all relevant information concerning firms and this enhances investor participation.

Dimmesdale (1994) however says that the shareholders have little contact with the board members except during the purely ceremonial Annual General Meeting which is held only once a year. According to observation, the directors are elected in the Annual General Meeting and in turn appoint a Chairman. Most corporations have a large board with directors who have little interest in the company except for the influence, allowances

and other perks they draw from being on the board. This view sees cost of compliance as externally imposed and is thus unrelated to how the firm's broader operation and financing arrangements are carried out.

Goergen and Renneboog (2001) argued in their study that if there are inadequate mechanisms to monitor in firms such as the ones that have diffuse ownership structure, this may lead to high top management discretion thus increasing the agency costs. They argued that the level of monitoring depended on the technology in place to assess and monitor the manager and forecast profit gain derived as a result of the monitoring, the level of ownership by the outsiders. They suggested that effective monitoring by the block holders can lead to control of the level of degree of the moral hazard. This can be described as the proportion of the firm's residual cash flows that is diverted for manager's consumption.

Klapper and Love (2002) studied performance and corporate governance which contained a sample of firms from 14 countries, and most of them were from the developing economies. They found out that good corporate governance is related to performance of the firm in the form of Tobin's  $q$  and Rangoon level of governance is more important in the countries where the legal environment does not adequately provide protection for the investors. They said institutions with good corporate governance ensure that there is corporate conformance with all stakeholders' expectation and interest by limiting abuse of power, misuse of the corporate assets, unnecessary use of corporate resources arising from the self-serving behavior of managers and other insiders and

address the agency problem. Corporate governance majorly focuses on the relationship that exist between the principal and the agent which results from the separation between management and ownership especially in large firms.

Laing and Weir (1999) studied the level of how Cadbury complied and its effect on corporate performance in the UK between the year 1992 to year 1995 and found little relationship to suggest that the type of the board recommended by Cadbury resulted to any improvement in the performance or trying to adopt them led towards improved performance. Good remuneration and audit committee were mechanism found to positively affect the performance of the firm.

Tenev and Zhang (2002) said that corporate governance is usually like a set of mechanism and instruments which are at the disposal of the shareholders for ensuring managers maximize value for the shareholders and other stakeholders such as financial institution and employees, by limiting or eliminating the agency costs on equity. There is therefore need to address the issue of agency problem to reduce its impact. In order to deal with agency problems, additional expenditure would be required. The issue of agency costs could arise when the company wants to fund a project and the agents involved have different interests. Debt-holders, old shareholders, new shareholders and the company's management, all are involved in a costly negotiation process, which may lead to a second-best solution. Agency costs can be seen as the value loss to the principal, arising from divergences of interests which arise between the agent and the principal.

Weisbach (1988) in his investigation found out that there exists a positive relationship between the performance of the organization and the proportion of external directors who sits on the board. Outside director are able to challenge the CEO as compared to inside directors. It is in recognition of this fact that three outside directors are required to be on the board in UK and in the US they are supposed to constitute two thirds of the board. Unlike the previous argument which supported the board structures, he downplays their importance, instead stressing on the importance of entrepreneurship and business experience. In his view, dynamic CEOs tend performs better compared to other firms. On this assumption that foreign owned firms have more experienced CEOs. He suggested that board size should also be considered as a mechanism to deal with the agency problem. He provided arguments which favors small board size. He argued that large board are usually slow in making decisions, and thus can be a challenge where change is required urgently. A second reason why he supported small board sizes is because directors rarely criticized the policies of the top management and this problem increases as the number of director's decreases.

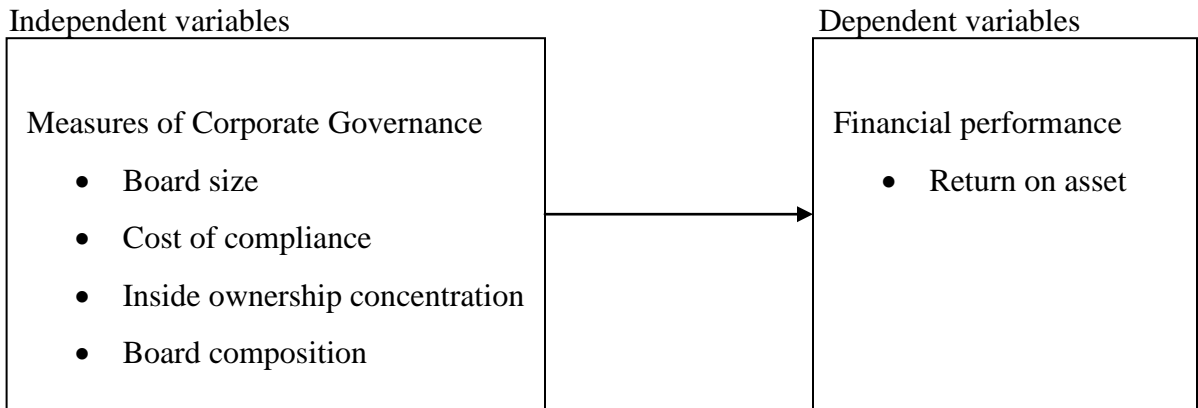
Yakhou and Dorweiler (2004) analyzed how the Sarbanes-Oxley Act of 2002 affected the principal management and control functions in the business environment. They said that during in the last ten years, there have been introduction, or review, of the corporate governance code across many countries. The main consideration in these countries has been the f legal backgrounds (e.g., common law in the United Kingdom,), political and cultural contexts and share ownership. In their views there is dire need for harmonization between the objectives of the firm managers and shareholders, there has been argument

on the size of the board. Some argue that larger boards are good for corporate governance because they have wide range of expertise to that help them make good decisions, and the powerful CEO are not able to dominate.

## **2.5 Conceptual Framework**

The conceptual framework is created to demonstrate relationships between the corporate governance and financial performance in MFBs. Financial performance is the dependent variable. The proxy used for financial performance is the Return On Assets(ROA). USAID Microenterprise Development Office in its, “Financial Reporting Standards” recommends that ROA and ROE are used as measures of MFB profitability. According to Berman et al. (1999) ROA has consistently been claimed to the authentic measure of financial performance. Corporate governance is independent measured by board size (proxied by the natural logarithm of the board member number); number of outside directors of the total directors, ownership concentration by inside/executive directors and corporate compliance costs. Compliance cost will be measured by annual cost of hiring external auditors and publishing financial reports. A control variable (Size of the Firm) will be included. Total number of assets was used as proxy for the firm size. The size of the MFB was measured using the natural logarithm of its total assets.

**Figure 2.1: Conceptual framework**



## 2.6 Summary of Literature Review

There is extensive literature on corporate governance and financial performance, especially empirical studies conducted to test the theories in different economies. Governance is synonymous in organizations and the corporate world. This term has extensively been used and is very important to the business organizations, especially with the recent misconduct that have been taking place in some organization. MacMillan and Downing (1999) stated that corporate governance is becoming mandatory for a firms to be able to perform competitively and also increase their returns as they focus to enter into new capital markets. Therefore, it is necessary to apply good corporate governance that is driven by the market and is also sensitive to the surroundings. There is empirical evidence which supports the internal governance mechanisms which play a very important role as it is used as monitoring tool in limiting or restricting agency costs.

Agency costs are as a result of conflict of interest which arises between the shareholders and the managers. Sloan (2001) found that good corporate governance would lower the agency costs and that good internal governance and positive external shareholding

influences are alternatives agency-mitigating mechanisms that lead to higher financial performance. However, this has not been the case in Kenya. Even with institutionalization of good corporate mechanisms in companies we have witnessed collapse of some of these companies Wambua (1999). In the recent past, there have been various changes happening in the financial sector in Kenya on the governance structure which might affect the financial performance of these institutions. There has been increased competition which is resulted from the entry of international commercial banks, mergers of others and acquisitions of multinational banks as the seek to enter the Kenyan market, and the recent conversion of non-deposit taking micro finance institution to microfinance banks. These recent changes on the governance of the microfinance banks raise very critical policy research questions. The basis of such questions is how these changes in governance structures will affect microfinance banks performance?

Previous studies are on evaluation of the relationship between agency cost control mechanisms and firm performance results, and there is a positive performance effects of agency attributes associated with lowering agency costs. Others have looked at corporate governance mechanisms influence firm performance. However, there has been no study on corporate governance mechanisms such as ownership concentration, board size, internal/external director composition and the cost of compliance and ownership effectiveness in controlling observed agency costs and problems. Further, there are few studies covering the relationship between corporate governance and financial performance in microfinance banks in Kenya. In addition, local studies have delved more on the effect of CG on financial performance of MFIs which consist of NGOs, SACCOs,



MFBs, credit Unions and other capacity building institutions. There is little research analyzing the how corporate governance practices affects the financial performance of MFBs in Kenya. This study therefore fills this gap through determining whether there exists a relationship between corporate governance and financial performance of microfinance banks in Kenya.

## **CHAPTER THREE: RESEARCH METHODOLOGY**

### **3.1 Introduction**

Research is concerned with how the problem is defined, how possible solutions are formulated how data is collected and organized and methods of evaluating it. The research methodology is an operational framework that is used to empirically solve a research problem. This chapter clearly outlines the general methodology that was used to conduct this study. The steps that were followed include specifying research design, identifying the target population, data collection procedure and instruments, data analysis and how to interpret it.

### **3.2 Research Design**

Study design is a plan of how data will be collected and utilized so that expected information can be obtained with some sufficient precision or so that the researcher can be able to test the hypothesis properly. A research design therefore is a plan, structure and a strategy which is conceived in order to obtain answers to the question under research Cooper and Emory (1995). It provides a framework for planning and conducting a study. The research design therefore captures both the structure of the research problem and the plan of investigation which is to be used to obtain empirical evidence on relations of the problem Cooper & Schindler (2003). This study used a descriptive research design. Descriptive design was preferred because the study used quantitative statistical data to describe the corporate structure mechanisms and performance of the microfinance banks in Kenya as they exist at the time of carrying this research.

### **3.3 Population of the Study**

The study population is the full set of cases from which a sample is taken. Cooper and Emory (1995) defined population of the study as collection of elements which the study wishes to make inferences from which are subject that measurement are to be taken from. The target population of interest in this study consists of all 9 microfinance banks in Kenya. (See appendix I). The study covered the period 2012 to 2015.

### **3.4 Sampling Design**

Sampling design can be defined as the determination of the number of people to interview, the number of events to observe or the number of records to inspect. The sample size is the part of the target population that was selected by the researcher for the purpose of data collection. The study adopted multistage sampling design. Since the population of study was few there was no need of sampling and therefore the study focused on all 9 microfinance banks. Hence, the study sample was 9 banks, and one can conclude that census sampling was used.

### **3.5 Data Collection Methods**

Data collection involves gathering of empirical evidence so as to gain new insights about a certain situation and try to answer questions that prompted undertaking of the research. The study has used secondary data in order to analysis the relationship between financial performance and corporate governance. Secondary data was obtained from financial statements of the 9 microfinance banks also published by CBK. These statistics were for the period 2012 to 2015. A data collection guide was prepared to guide data gathering.

Secondary data collected included returns on assets (measured as net profit expressed as a percentage of firms total assets), inside shareholding (total shares held by the directors on the board of the firm as a percentage of the total outstanding shares of the firm), ownership concentration (the number of shares held by the CEO/managing director divided by the total number of the shares) and cost of institutionalization of CG of publishing accounts in newspaper, hiring external audits and compliance officer and management fees) and capital adequacy (measured by the firm capitalization as a ratio of total asset of the firm).

### 3.6 Data Analysis

Descriptive statistics was used to describe the data. Descriptive statistics that is mean score, frequencies and percentages for all the variables were calculated and tabulated using the frequency distribution tables and bar charts. The analyzed data was presented in tables, pie charts and graphs. Regression analysis and Pearson Product-Moment Correlation Analysis were used to measure the relationship between corporate governance and financial performance of micro finance banks. The study used a regression model specified as follows;

$$Per = \alpha + \beta_1 e\text{-tax} + \beta_2 ted + \beta_3 tpn + \beta_4 ts + \beta_5 tre + ei$$

Where:

*Per* = Financial performance measured by return on assets

*bd* = Board size

*act* = Number of outside directors of the total directors

*sof* = Share of ownership by inside/executive directors

*cpb* = Corporate compliance costs

The regression model was used to predict the values of  $\alpha$  and  $\beta_i$ , which explains the association between the independent and dependent variables. This method is preferred due to its predictive power of multivariate association  $\beta$ , estimated coefficient of correlation  $R$ . The coefficient of determination  $R^2$  was used to explain the relationship between the dependent and independent variable; the T-test to assess the significance of individual betas and standard b-coefficients were compared (beta weights) to explain the relative predictive power of independent variables and the overall model. This analysis was carried out using the Statistical package for social scientists (SPSS, version 23).

## CHAPTER FOUR: DATA ANALYSIS AND FINDINGS

### 4.1 Introduction

This section presents the data analysis and findings of the study. There are two main parts in this section. The first part presents the descriptive statistics of the data of variables used in the study, while the other part deals with the broad objective of the study: examination of the relationship between the corporate governance and financial performance of microfinance banks in Kenya. The following section provides the response rate of the study.

The questionnaire and interview methods were used in data collection. The response rate is the ratio between the number of questionnaires received and those administered expressed in form of a percentage. The study targeted nine MFBs, questionnaires were dispatched to them and in total, only 7 responded. Hence the response rate was 75% as presented in Table 4.1 below;

Table 4.1: Respondent covered in this study

Name of the organization	Target	Response	Response rate
MFBs	9	7	75%

Source: Author (2016)

### 4.2 Description of Statistics Used

First the researcher sought to describe the data used structure of corporate governance existing in MFBs. This description covered the following: board size, ownership

structure, the number of directors categorizing them as executive directors and non-executive directors, the existence internal audits and their associated costs, and the management fees associated with directorships of the companies. The findings of the analysis are clearly summarized in the table 4.2 ;

Description of variable	2012	2013	2014	2015
<b>Dependent variable: Financial Performance</b>				
• Net Profit after Tax (in Mn)	9,910	11,975	10,890	12,975
• Total Assets (in Mn)	157,928	172,480	163,076	174,480
• <i>Return on Assets</i>	6%	7%	7%	7%
<b>Independent variables: Measures of Corporate Governance</b>				
<i>Board size</i>				
• Board members in 3 MFBs				10
• Board members in 4 MFBs				8
<i>Board Composition</i>				
• Ratio of inside board members in 3 MFBs				5/5
• Ratio of inside board members in 4 MFBs				3/8
<i>Inside ownership concentration</i>				
• % of share owned by inside directors				70%
<i>Cost of compliance with corporate governance</i>				
• Directors Fees	2,353.00	1,922.00	2,495.00	2,922.00
• Management fees	2,562.00	3,186.00	3,469.00	3,186.00
• Audit Fees	1,515.00	2,108.00	2,964.00	3,108.00
• Other related fees	820	1,432.00	2,989.00	3,232.00
• Total cost associated with good governance	7,250.00	8,648.00	11,917.00	12,448.00
• Compliance cost /Total assets	5%	5%	7%	7%

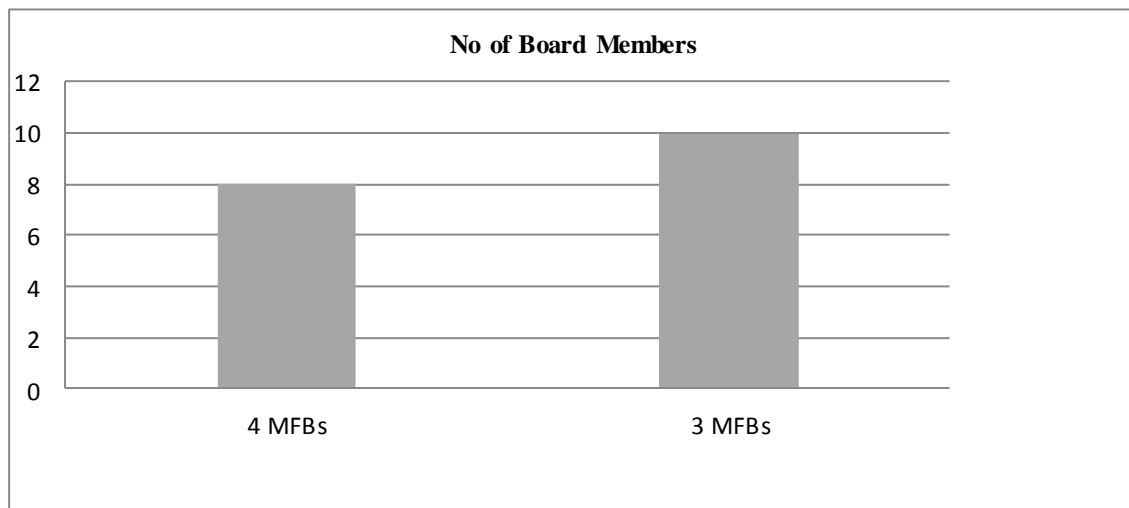


The following section explains the data used;

#### 4.2.1 Board Size

The researcher studied board size and composition of MFBs. The results of board size are contained in Graph 4.1 below;

Graph 4.1: Board size among the companies studied



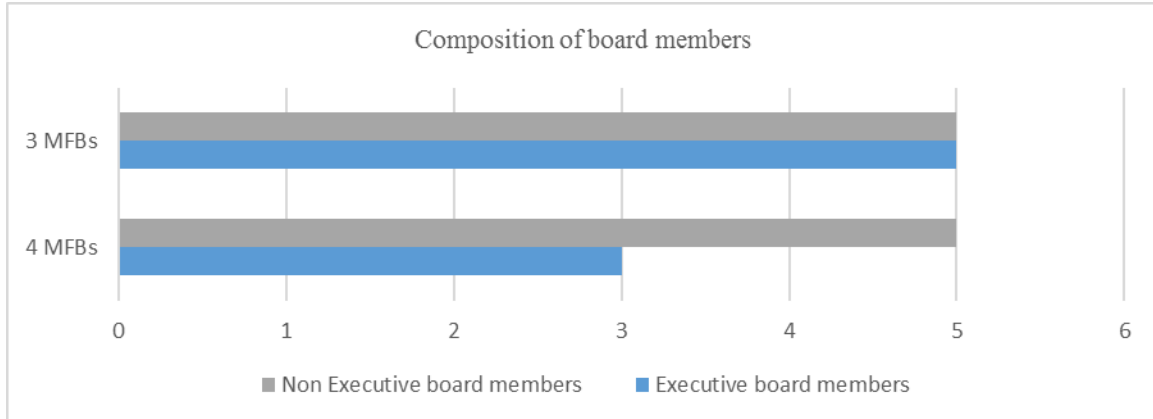
Source: Author (2015)

Graph 4.1 above indicates that board size in 4 MFBs is 8 board members while 3MFBs have 10 board members.

#### 4.2.2 Board Composition

Board composition in terms of the Number of Executive Directors and Non-Executive Directors was explored. The details of the finding on the board composition are contained in graph 4.2 ;

Graph 4.2: Board composition in MFBs studied



Source: Author (2015)

Graph 4.2 shows that the four MFBs with 8 board members, 60 percent of them were non-executive directors while 40 percent were executive directors. Among the 8 board members in 3 companies, 5 are executive directors and 5 are non-executive directors. These findings are in line with Jensen (1993) findings that directors who are non-executive promote shareholders interest and they are perceived as the governance measure that helps to monitor the agency problem.

The established committees of Board were explored. The MFBs indicated the number of committees of boards that have been established. The findings of the Established committees of Board are represented in the table 4.3 below.

Table 4.3: Committees of the Board members that have been established by microfinance banks

	Number of Firms	Percentage
Audit Committee	7	100%
Strategy and HR Committee	5	70%
Risk Management Committee	7	100%

Source: Author (2015)

Table 4.3 above show that all the 7 firms (100%) have established audit committee, 100% (7 firms) of the respondent companies have established Risk Management Committee and 70% (5 firms) have of Strategy and HR Committee. These findings are in line with Hampel Report (1998) who states that the boards of directors and their committees are responsible for the governance in companies they oversee. The report said that these board institutions and structures are mainly set up to address the agency problem and constitute monitoring costs that ultimately add to the agency costs.

The study sought to establish the frequency of the full board meeting in a year. The results of the analysis are as shown in the table 4.4 below.

Table 4.4: Frequency of full board meeting

	Frequency of Full Board Members	
	Companies	Percentage
Four Full board meetings	5	71%
Three Full board meetings	2	29%
Two Full board meetings	0	0%
Total	7	100%

Source: Author (2015)

Table 4.4 above shows that 5 (71%) companies hold four full board meetings in a year. 29% companies hold three full board meetings while none of MFBs hold two full board meetings.

### 4.2.3 Ownership Concentration

This study seeks to establish the main shareholders of the firms and ownership structure of MFBs. The results of the analysis are as shown in the table 4.5 below.

Table 4.5: Firms ownership by nationality

Ownership	Percentage
Inside (executive directors) shares	70%
Outside (non-executive directors) shares	30%
Total	100%

Source: Author (2015)

The table 4.5 above shows that 70% of the firms are owned executive directors while 30% of firms are owned by outside directors. In addition, this study tries to establish the ownership structure of the firms and its implication on the firm performance. The result of share capital of the firm is reported in the table 4.6

Table 4.6: Share capital of Firms Studied

Share capital in Kshs Million	Frequency	Percentage
50 -100	1	14%
100 -200	3	43%
200 and above	3	43%
Total	7	100%

Source: Author (2015)

Table 4.6 above shows that majority of firms (43%) have share capital between Kshs 100 million and 200 million, 43% of firm has share capital above Kshs 200 million and 14% have share capital below 100 million.

#### 4.2.4 Financial Information Audit and Disclosure

In regard to disclosure of financial information, the study tries to find the existence of audit function in the MFBs. It was apparent from the findings of the analysis that all the seven companies have an internal audit department. Similarly, the seven companies hire external auditor who annually audit the books and records. The results of the analysis are shown in the table 4.7 below.

Table 4.7: Existence of audit functions

	Companies	Percentage
Existence of internal audit department	7	100%
Outsourcing external auditors	7	100%
Auditors reporting to the boards	7	100%

Source: Author (2015)

Table 4.7 reveals that 100 percent of the respondent companies indicated that there existed adequately resourced external and internal audit functions. The audited accounts are reported to the board. All MFBs were found to have audited accounts and submit returns to regulator and revenue authority. The study sought to establish the type of returns that the companies make to the CMA, NSE and KRA, and from the results of the analysis all the companies indicated that they make tax returns to the KRA which are mainly the Income Tax and the Value Added Tax (VAT). The tax returns are done annually. Similarly, analysis established that 100 percent of the respondent companies indicated that the Balance Sheet and profit and Loss Account are done annually, and reported to CMA and NSE.

#### **4.2.5 Cost of Compliance with Corporate Governance Structures**

The study tries to establish whether there exists a relationship between cost of compliance with corporate governance on financial performance of MFBs. First, this section analysis the cost of institutionalization of good governance among the firms studied. Therefore, the study sought to verify whether there exists a direct correlation between the cost of good corporate governance and financial performance. The cost of corporate governance by director's emoluments, management fees and audit fees and other related CG costs such as publishing annual returns in the newspaper. All statistics covered period 2012 - 2015. From the audited accounts of respective companies amounts of director's emoluments, management fees and audit fees and other related CG costs such as publishing reports were obtained. Others which were obtained are net profit after tax and total firms asset. The total costs of CG were compared against the return on

assets for the four years. The average industry director’s fees, management fees, Audit fees and other related fees as proxies for cost of good governance , total assets and return on asset for the nine companies were summarized in the table 4.7 below;

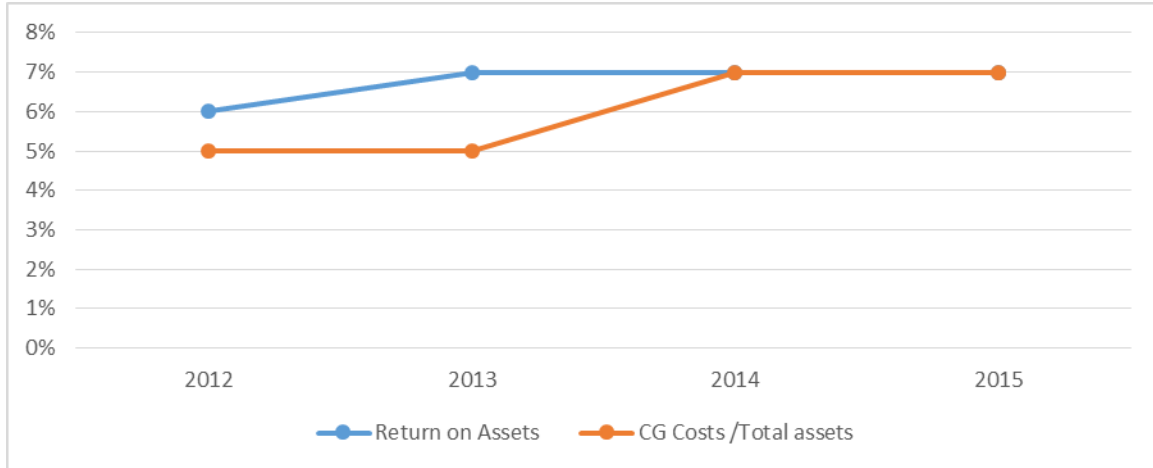
Table 4.7: Cost of good governance versus financial performance (000’s)

Account Explanation	2012	2013	2014	2015
Directors Fees	2,353.00	1,922.00	2,495.00	2,922.00
Management fees	2,562.00	3,186.00	3,469.00	3,186.00
Audit Fees	1,515.00	2,108.00	2,964.00	3,108.00
Other related fees	820	1,432.00	2,989.00	3,232.00
Total cost of compliance with good governance	7,250.00	8,648.00	11,917.00	12,448.00
Return on Assets	6%	7%	7%	7%
Compliance cost /Total assets	5%	5%	7%	7%

Source: MFBs Annual Returns, Various Issues, Central Bank of Kenya

First, all firms studied, the research established cost of good corporate governance measured as governance costs/Total Assets is less than the performance measured as return to asset ratio as shown in table above. The following section reports graphical representation of variables in Graph 4.3.

Graph 4.3: Graphing Cost of good governance versus financial performance



The finding of this analysis reveals that the cost of good governance rose steadily throughout the four-year period while performance rose between the years 2012 to 2013, before dropping between 2013 and 2014 rising again between 2014 and 2015. This finding therefore means that there is evidence of a direct relationship between good corporate governance and performance for the companies studied especially in years 2012, 2013 and 2014. In these years the cost of good governance seems to rise with the increases performance. For the year 2014, the cost of good governance seemed to rise while the performance in the same period was decreasing. Analysis of this year depicts that that the cost of good governance alone does not determine performance but there exist other influencing factors which are beyond the scope of this study.

### **4.3 Relationship between Corporate Governance and Firm Performance**

In order to empirically determine whether there exists a relationship between corporate governance and the performance of microfinance banks under review correlation and regression analyses was used. The following section shows the results of the analysis of the data.



### 4.3.1 Correlation Analysis

The correlation matrix is a very important indicator that is used to test the linear relationship, between the variables. The matrix also assists to determine the strength of the various variables i.e. strength of the relationship between the dependent variable i.e., performance (return on assets) and the independent variable corporate governance mechanism measured by ownership concentration, size of board, board composition, cost of compliance. Correlation coefficient between the two variables range from 1 (highly positively correlated) and -1 (highly negatively correlated). The results are reported in table 4.8 below;

Table 4.8: Pearson correlation between return on assets and corporate governance mechanisms

	Return on assets	Directors Remuneration	Management fees	Ownership concentration	Board size	Board Composition
Return on assets	1					
Directors Remuneration	-.926(**)	1				
Management fees	-.690(*)	.937(**)	1			
Ownership concentration	-.319	.522	.690(*)	1		
Board size	-.721(**)	.997(**)	-0.011	.507	1	
Board composition	-.349	-.426	-.429	-.152	-.395	1

\*\* Correlation is significant at the 0.01 level (2-tailed).

\* Correlation is significant at the 0.05 level (2-tailed).

Table 4.10 above shows that there is negative correlation between return on assets as a measure of performance and the cost of governance proxied by directors' remuneration, management fees, auditors' fees, size of the board and board composition. However, the correlation between return on assets as a measure of performance and the cost of governance proxied by directors' remuneration, management fees, and size of the board is strong as shown as indicated by correlation coefficients were 0.926, 0.690 and 0.721 respectively.

However, ownership concentration and composition of board are weakly related with return on assets profits as shown by correlation coefficients of 0.319 and 0.349 respectively. This indicates that cost of good corporate governance measured by management fees and directors' remuneration influences the performance of the studied firms studied. In addition, the size of the board has an influence on the firm performance.

The correlation coefficients of corporate governance mechanism measured by size of the board, management fees and director's remuneration are statically significance. This means that the variables affect performance proxied by returns on assets. However, results reveal that auditor fees and board composition are not statistically significance and therefore there no relationship between both variables and performance (proxied by return on assets).

The coefficient of size of board is 0.721. The coefficient is negative and statistically significant; implying that the probability that size of the board has an effect on the

performance of the firm. If the board size increases by 1%, then the net profit reduces by 0.721%. This can only be associated to increased costs associated with large board size.

The coefficient of management fees is 0.690 which is positive and significance. This indicates that increase in management fees reduces firms' net profits. The coefficient of directors' remuneration is 0.926, negative and statistically significant; implying that the probability that presence of active board member with ownership interest in firm running daily operations of the firm influences increase firm costs and reduces its net profits. Thus, there exist relationship between good corporate governance mechanisms (large size of board, management fees and remuneration by directors) and performance (measured by return on assets for the firms studied). Institutionalization of good corporate governance among firms, increases the firms' costs and hence affects the firm performance.

#### **4.3.2 Regression Analysis**

In order to establish the relationships between corporate governance and performance of MFBs regression analysis was conducted. Directors Remuneration, Management fees, Auditor fees, Size of Board, Composition of the Board were used as measures of corporate governance and returns on assets were used as proxy for performance for MFBs.

Table 4.9 below shows regression results. The adjusted R squared was 0.64 implying 64% variations from the predictability of the output (dependent variable: performance) are explained by the independent variable (corporate governance). These show a good fit

of the regression model. ANOVA shows that analysis co-efficient of the regression clearly shows that there exists a relationship between financial performance and corporate governance.

**Table 4.9: Summary of Regression Analysis Results**

<i>Dependent variable Return on Assets</i>				
<i>Regression Co-efficient</i>				
<i>Predictor- Independent Variable</i>	<i>Coefficients</i>	<i>Standard Error</i>	<i>t -Statistics</i>	<i>P-value</i>
Constant	3.336	1.154	2.891	.052**
Board size	4.209	2.175	1.935	.040**
Composition of the Board	-5.313	-7.836	0.678	0.412
Management fees	1.435	0.716	2.004	0.002*
Ownership concentration	0.738	0.443	2.34	0.426
Directors remuneration	0.102	-0.12	0.85	.001*
<b>Model Summary</b>				
R Squared			0.7204	
Adjusted R Squared			0.6409	
Observations			5	
<i>ANOVA (Analysis of Variance)</i>				
<i>Calculated F</i>		2.577		
<i>Significance F</i>		0.2286		

Note: \* significance at 1%, \*\* significance at 5%

#### **4.4 Discussion of Findings**

Table 4.9 above shows that the coefficients of board size, management fees and director remuneration have the correct sign and are statically significance. This means that these variables have a positive relationship on MFBs performance. However, the variables board composition and ownership concentration have no relationship with performance as the coefficients are statically insignificance.

The estimated equation shows that there is a strong positive marginal effect of independent variable - corporate governance (measured by board size, management fees and director remuneration) and financial performance (measured by the return on assets). This means that corporate governance mechanism measured by management fees, board sized and directors' remuneration has an effect/impact on the financial performance proxied by return on assets. However, results reveal that board composition and ownership concentration don't have any relationship with financial performance and therefore do not affect the firm return on assets.

The coefficient of management fees is 1.435. The coefficient is positive and statistically significant; implying that the probability that management fees and their work in advising the company mitigates agency costs. If management fees increase by 1%, then the return on assets increases by 1.435%. This can only be associated to reduction of costs associated to agencies costs mitigated by managers. This is in line with Tenev and Zhang (2002) who said that corporate governance is seen as a set of instruments and any mechanisms (contractual, legal and market) which are available to shareholders (as

residual claimants) for influencing managers. The coefficient of the board remuneration is 0.102, positive and also statistically significant; implying that the probability that presence of active board member with ownership interest in firm running daily operations of the firm influences mitigates agency costs and increase returns on assets. Hiring managers address the issue of agency problem to reduce its impact. In order to deal with agency problems, additional expenditure would be required which is the management fees. These costs rise the company overall cost and sometimes managers might be involved in projects that different of company hence reducing firm value. In addition, management/Agency costs can be seen as the value loss to the principal, arising from divergences of interests between the principal and the agent (McColgan, 2001).

The coefficient of board size is 4.208 which is positive and significance. This indicates that increase in board size mitigates the agency costs. The result indicates that if the board size increase with one members it will lead to increase in return on assets by 4.208. This is supports the argument that large board size increase returns on the firm. This finding is in agreement with those of Laing & Weir (1999) who analyzed the extent of board composition impact on corporate performance and found evidence to suggest that the large board size lead to improved performance or that moving towards them improves performance.

Regression result findings show that there is positive relation between corporate governance (measured by board size, management fees and director remuneration) and financial performance (measured by the return on assets). This means that corporate

governance mechanism measured by management fees, board sized and directors' remuneration have an effect/impact on the financial performance proxied by return on assets. This finding is in line with the views of Chen, chen and Wei (2004). They study established that respondents indicated ominously that introduction of structures of good governance leads to increased costs related to the directors, and hence low profits. However, results reveal that board composition and ownership concentration don't have any relationship with financial performance and therefore do not affect the firm return on assets.

## **CHAPTER FIVE: SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS**

### **5.1 Introduction**

This chapter presents the summary of the findings of the study, conclusion and suggests some recommendations. In particular, discussions of key findings with the prescriptions of academic literature form the gist of the chapter. At the end of the chapter, recommendations for further research are made.

### **5.2 Summary of the Findings**

This study examined the relationship between corporate governance mechanism and performance cost for MFBs in Kenya. Specifically, the study sought to established if there is relationship that exists between dependent variable i.e., financial performance measured by the return on assets and independent variable corporate governance mechanism measured by ownership concentration, director's remuneration and size of board, cost of compliance and board composition. To achieve this objective, two data analysis techniques were used namely graphical presentation, correlation and regression analysis.

Graphical presentation of variables revealed that, first, as the cost of institutionalization of corporate governance seems to raise the firms' net profit. This is in line with earlier



finding that 80 percent indicated that requirements for good corporate governance had increased their cost of operation. This finding is in line with the views of Chen, chen and Wei (2004). They study established that respondents indicated ominously that introduction of structures of good governance leads to increased costs related to the directors, and hence low profits.

Both correlation and regression analysis showed that there is a strong correlation between performance and good corporate governance. There is a strong positive marginal effect of independent variable - corporate governance (measured by board size, management fees and director remuneration) and financial performance (measured by the return on assets). This means that corporate governance mechanism measured by management fees, board sized and directors' remuneration have an effect/impact on the financial performance proxied by return on assets. However, results reveal that board composition and ownership concentration don't have any relationship with financial performance and therefore do not affect the firm return on assets.

The coefficient of the board remuneration is 0.102, positive and also statistically significant; implying that the probability that presence of active board member with ownership interest in firm running daily operations of the firm influences mitigates agency costs and increase returns on assets. The coefficient of board size is 4.208 which is positive and significance. This indicates that if the board size increase with one member it will lead to increase in return on assets by 4.208. This is supports the argument that large board size increase returns on the firm.

The coefficient of management fees is 1.435, positive and statistically significant, implying that if management fees increase by 1%, then the return on assets increases by 1.435%. With regards to management fees, the study finds increase in management fees decreases firms' net profits. This is in line with Tenev and Zhang (2002) who said that corporate governance is seen as a set of instruments and any mechanisms (contractual, legal and market) which are available to shareholders (as residual claimants) for influencing managers. Hiring managers address the issue of agency problem to reduce its impact. In order to deal with agency problems, additional expenditure would be required which is the management fees. These costs rise the company overall cost and sometimes managers might be involved in projects that different of company hence reducing firm value. In addition, management/Agency costs can be seen as the value loss to the principal, arising from divergences of interests between the principal and the agent McColgan (2001).

However, board composition and ownership concertation were weakly related to performance. The estimated coefficients show that there is no marginal effect of board composition on return on assets. From the analysis of the 9 MFBS, a conclusion can be drawn that there exists no relationship between the board composition and micro finance banks performance. This finding is in agreement with those of Laing & Weir (1999) who analyzed the extent of board composition impact on corporate performance and found evidence to suggest that the large board size lead to improved performance or that moving towards them improves performance.

### 5.3 Conclusions

The findings in this study shows that there is a strong positive marginal effect of independent variable - corporate governance (measured by board size, management fees and director remuneration) and financial performance (measured by return on assets). This means that corporate governance mechanism measured by management fees, board sized and directors' remuneration have an effect/impact on the financial performance proxied by return on assets. However, results reveal that board composition and ownership concentration don't have any relationship with financial performance and therefore do not affect the firm return on assets.

The following conclusions were made from the study. Institutionalization of good corporate governance measured by management fees, having large board size and director remuneration have strong and significance negative marginal effects on firm profits and hence they were found to mitigate corporate agency cost that increase firm performance. Thus, there exists negative relationship between institutionalization of good corporate governance mechanisms and performance for the microfinance banks studied.

The board remuneration was statistically significant and an increase of board remuneration by one Kshs will lead increase in return on assets by 0.102. This imply that the probability that presence of active board member with ownership interest in firm running daily operations of the firm influences mitigates agency costs and increase returns on assets. If management fees increase by 1%, then the return on assets increases by 1.435%. If the board size increase with one members it will lead to increase in return

on assets by 4.208. This supports the argument that large board size increase returns on the firm. This implies that the probability that presence of active board member with ownership interest in firm running daily operations of the firm influences mitigates agency costs and increase returns on assets. The study concluded that there is positive relation between corporate governance (measured by board size, management fees and director remuneration) and financial performance (measured by return on assets).

From the study, it can be concluded that the institutionalization of good corporate governance has mitigates the agency costs resulting to higher profits for the microfinance banks. The study also reveals that good corporate governance does increase the agency costs. Therefore, the study concludes that there is no financial burden in institutionalizing corporate governance.

#### **5.4 Recommendations**

From the study it is evident that good corporate governance increases the agency costs. The study concludes that there is financial burden in institutionalizing corporate governance. On the basis of the result of this study, it is recommended that firms should institute appropriate corporate governance mechanism that does not lead to financial burden to the company. There is need therefore the microfinance banks to reduce their board sizes in order to address high board remuneration. It is further recommended that all microfinance banks should have outside board members who have no shareholdings in the firms. This will institute good corporate governance in order to mitigate agency costs and hence increase the performance of their companies.

The researcher also recommended that companies need to have a moderate board of directors who serve the interest of the companies, who also serve in key board committees. There must be a separation between company and personal interest. Having separation of power between a Chief Executive Officer (CEO) and the Chairman of the company is emphasized. In addition to having competent internal auditors, there is need to engage external auditors in order to provide the company with professional independent advice on the company performance and strategic goals. Compliances with regulators guidelines and observation of prudential management practices is recommended.

### **5.5 Suggestions for Further Research**

This study was conducted only on the microfinance banks in Kenya. Further studies can also be conducted to other companies in Kenya such as listed companies in the Nairobi stock exchange and on stake brakeage firms. Further, similar studies can also be done for MFBs in other countries.

The study was confined to board size, cost of compliance, ownership concentration and the board composition. Similar study can be done to cover all the corporate governance costs. Whereas there are many players in the banking and financial sector, this study only targeted the 9 MFBs, similar study can be extended to cover only one of the microfinance bank.

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## APPENDICES

### Annex I: List of Microfinance Bank in Kenya

Microfinance Banks	Registration Date
Kenya Women Microfinance Bank Ltd	April 2010
Faulu Microfinance Bank Ltd	May 2009
Rafiki Microfinance Bank Ltd	June 2011
SMEP Microfinance Bank Ltd	December 2010
REMU Microfinance Bank Ltd	December 2010
Century Microfinance Bank Ltd	September 2012
Sumac Microfinance Bank Ltd	October 2012
Uwezo Microfinance Bank Ltd	November 2010

Source: Central Bank Kenya, Bank Supervision Annual Report, 2015,  
[www.centralbank.com](http://www.centralbank.com), retrieved on 19 September 2016