THE EFFECT OF CORPORATE GOVERNANCE ON THE FINANCIAL PERFORMANCE OF FINANCIAL INSTITUTIONS LISTED AT THE NAIROBI SECURITIES EXCHANGE.

BY

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DECLARATION

I declare that this is my original work that has not been submitted to any other institution of higher learning for the award of a degree.

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

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I thank God for gifting me with life and good health; I was able to undertake this research smoothly. I also appreciate my supervisor Dr. Ondigo immensely for he greatly supported and guided me throughout the research, May the Almighty God bless you.

DEDICATION

I am dedicating this project to my mother; Florence Ngina, I cherish your support, prayers and guidance. My uncle; Onesmus Kamau, I will forever be grateful for your support. My sister Yvonne Wambui, your love and encouragement played a great part in ensuring this project was successful.

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LIST OF ABBREVIATIONS

ANOVA	Analysis of Variance
CEO	Chief Executive Officer
CG	Corporate Governance
CMA	Capital Markets Authority
DY	Dividend Yield
EACSE	East African Community Securities Exchange
EPS	Earnings per share
MVA	Market value added
NSE	Nairobi Stock Exchange
OECD	Organisation for Economic Co-operation and Development
OP	Operating profit
ROA	Return on Assets
ROCE	Return on capital employed
ROE	Return on Equity
ROI	Return on investment
SPSS	Statistical Package for Social Sciences

ABSTRACT

Corporate Governance has taken centre stage in many organisations due to the important role it plays in these organisations and in the economic status of the nation. The intent of this study was to determine the effect it has on the fiscal output of listed financial institutions. The major elements that were focused are composition of the board, its size as well as CEO duality. A descriptive design was used with the sole purpose of reaching the objectives of this study .An analysis of the 11 banks and 6 insurance companies listed on the NSE was done, using five years financial information between 2012 and 2016 obtained from the financial statements of these institutions. The association between the different variables and the fiscal accomplishment of these institutions was determined using Linear Regression Model and the revelation was that there existed no outstanding correspondence between the various corporate governance variables and the firm's achievement financially as measured by ROA and ROE. This study unearthed that there existed no connection among the measures of Corporate Governance including CEO duality, Board Size, Age of Company and Board Composition and the financial performance of NSE-listed financial institutions. The study advocates that the firms adhere to regulations such as gender balancing, proportion of independent directors to dependent directors and splitting of role of CEO and Chair for efficient and effective running of the business.

CHAPTER ONE

INTRODUCTION

1.1Background of the study

Due to growing firms and economies, Corporate Governance (CG) has increasingly become very important. Berle and Means (1932) noted that once corporations increased, in size a system of control separate from the direct ownership could be established. Their pioneering work is regarded to as the foundation of CG.

Separating ownership and control has fuelled most governance problems. CG acts to a great extent in enhancement of the firm's, market and economic performance. Ongore and K'Obonyo (2011) associated Poor governance with poor economic performance in most developing countries. Corporations have a responsibility to their shareholders as well as other stakeholders such as the societies and its employees (Maher and Anderson, 1999). It is therefore very important for every corporation to maintain a good CG framework that will ensure that the interests of these parties are safeguarded.

Postulates of good CG recognise the need to protect the rights of shareholders, effectively monitor the management and also make accurate disclosures of all material matters regarding the corporation in a timely manner. This in the long run translates to business continuity as well as shareholder's wealth maximization.CG became more prominent in the 1980's and 90's due to crises in the stock market and corporate failures around the globe, thus different corporate structures were adopted across the world.

In Kenya in 1990's there was inefficiencies and lack of accountability in the public-sector due to lack of corporate governance framework and government officials influence on the organizations whose only interest was business and not regulation. These inefficiencies were also replicated in private companies. In 2002, CMA issued guidelines to be observed in order to enhance CG practices in listed companies. This move was fuelled by the great urge to standardize these concepts relating to CG in Kenya (Gakeri, 2013 and Musikali, 2014).

Recent financial institutions failures in Kenya such as Chase bank and imperial bank among others have negatively impacted on the shareholders and the economy. As a

result, sound corporate governance measures need to be taken more seriously to govern the internal operating controls and systems of organisations as well as give investors confidence that their wealth is being created, improved and maintained. Strong CG framework is aimed at monitoring the management who control the investors' resources in order to foster transparency and accountability.

1.1.1 Corporate Governance

There are various numbers of definitions for corporate governance (CG) with the traditional one relating to protection of shareholders interests (Tirole, 2001) and it stems from separation of management and control. Holmstrom and Kaplan (2001) defined CG as the tools for governing the running of corporations. According to La Porta et al (2000) CG is an aggregation of devices that protect investors from the harmful effects caused by selfish interests of the executives. On the other hand CG is a structure used to direct and guide corporations (Cadbury, 1992) with the common objective of protecting stakeholders and nature an favourable environment that promotes decent investment returns (Sullivan, 2009).

OECD defines CG as the approach for directing and controlling business organisations. This is the most accepted definition by a large number of countries and large reputable corporations including World Bank, United Nations etc. According to Edwards and Clough (2005) CG explains the coexisting ties between a company's different stakeholders which provide the framework for setting a firm's objectives and achieving them as well as tracking performance. This denotation incorporates performance which is an essential facet of this study. CG therefore seeks to create equilibrium between the socio-economic desires and between individual and community desires while at the same time encouraging effective resource use, to collaborate the interests of the various stakeholders (Okundi, 2011).

There are different measures of CG. The most commonly studied include board size, board composition structure as well as CEO duality. To understand CG, we need to grasp a very important aspect of the board members who execute a pivotal responsibility in CG. The number of members on the board has an influence on the corporate performance, though the exact relationship differs amongst different researchers. Coles et al (2008), Eisenberg et al. (1998) and Yermack (1996) found a

negative correlation between board magnitude and firm's fiscal success while Hans Van Ees et al. (2003) found no correlation at all.

The board is comprised of both executive and non-executive directors. According to Shah et al. (2011) executive and non-executive directors are the dependent and independent directors respectively. For the board to be effective, a composition of one third of the non-executive directors is required because they are unbiased. Dependent directors are well versed with inside information about the organization hence they are of great importance in the board. A higher composition on non-executive directors reduces agency costs (Kee et al, 2003). It also contributes to CG effectiveness due to their independence and pool of skills.

Duality occurs when one individual holds the two most influential roles of Chief Executive Officer and board Chairman, (Weir and Laing, 2001). Holding the two positions by the CEO could lead to serious consequences such as lack of independence in supervising management. Segregating the role of CEO and that of chairman has an impression on this performance. Separation creates a system of checks and balances hence bringing a positive impact on the firm's performance. This issue has also attracted contradicting opinions and findings from different authors and researchers. Studies by Chen et al. (2005), Aygun and Ic (2010), Gill and Mathur (2011b) concluded an unfavourable correlation between CEO duality and the performance of a firm. On the contrary Gill and Mathur (2011 b), Yu (2008), Baptista et al. (2011) found a favourable correlation between them. Abdullah (2004), Valenti et al. (2011) and Faleye (2007) found no relationship between the two.

1.1.2 Financial Performance

The major objective of the firm is to increase the value of the shareholders. In this doing, the firm is able to generate adequate cash flows to finance its operations and pay off its expenses as well as make favourable amounts of profits. The firm's performance is often used as a basis to determine the efficiency of its management and how effectively the assets of the firm are being utilised.

Financial performance refers to the degree of accomplishment of the financial objectives (Bourguignon, 1995). It involves gauging in monetary terms, the outcome of the actions and activities of a corporation to ascertain the financial well being

during a stated period. The performance of the company can be determined using the financial statement reported by the company. Financial statements provide important information which is a summary of all the activities of a firm. According to Oshisami (1992) reviewed financial reports represents the legitimate financial outlook of a corporation as at the stated period in time. There are a number of metrics used to gauge the financial accomplishment of the firm which are accounting based measurements and market based measurements.

Accounting based measurements that are used include ROA, ROE, ROI, EPS, OP, ROCE among others and Market based measurements include Tobin Q, DY, MVA among others. Hutchinson and Gul (2004) and Mashayekhi and Bazazb, (2008) argue that Accounting based measurements are highly favoured compared to the Market ones when investigating the association between CG and firm accomplishment as they present management actions outcome. However it is important to integrate both measurements to get a better view of the firm. This is because most accounting measurements like ROE determine short-term performance while the market measurements e.g. Tobin's Q depict future long-term performance.

1.1.3 Corporate Governance and Financial performance

According to Stanwick and Stanwick (2010) the importance of governance is dismissed in the viewpoint of managers and shareholders, if the altitude of CG doesn't affect the performance of companies. Bauer et al. (2008) examined the collaboration between CG and share price accomplishment by collecting data on market risk and size as well as book to market effect. The conclusion was that well governed companies did better than poorly managed ones by up to 15 percent annually.

The objectives pursued by the corporate managers have contradicted with the interests of the shareholders in different institutions worldwide which has seen a number of those institutions go on their knees. The overriding objective of the firm in the interest of shareholders is to maximize their wealth. When corporate managers pursue their own selfish interests, the firm is not able to make adequate and sustainable profits and reasonable cash flows from operations to keep the business on its feet. Due to these crises, a number of investors have been seen to shy away from organisations with questionable corporate governance measures.

Good CG has different aspects which includes ensuring management is committed to transparency, independence, accountability and prudence in the management of financial institutions without which corporate managers will be able to pursue their own interests without being caught to the detriment of the firm. It also attracts the interest and trust of investors, and is able to fulfil the interest of shareholders which revolves around improved shareholders wealth and dividend. A good CG will also protect the organisation from lawsuits and political interference. All these aspects work together in improving the financial accomplishment of the firm, thus CG has a consequential favourable effect on the performance of the firm and the economy in general. This is supported by Bebchuk, Cohen and Ferrell (2004) who indicate that properly governed firms report a more favourable performance.

1.1.4 Financial Institutions in Kenya

The major financial institutions in Kenya include banks, Sacco's and Insurance companies. These institutions are regulated by respective bodies that ensure integrity within the institutions. As at 31st December 2016, Kenya has 43 listed commercial banks, 164 licensed deposit taking Sacco's and 49 listed insurance companies. Banks are overseen by the Central Bank of Kenya which draws its mandate from the Banking Act. The Sacco's are monitored by the Sacco Societies Regulatory Authority which was formed through the Sacco Societies Act. The Insurance companies are regulated by Insurance Regulatory authority which was initiated through the Insurance Act.

CG in these financial institutions is of great importance in order to ensure stability in the economic and financial system of Kenya. Over the past years, the banking and insurance industries have faced challenges leading to collapse of a remarkable number of institutions. Some of those affected in the insurance industry include Blue Shield Insurance Company, Access insurance company and Kenya National assurance Company. The banking sector also been affected over the years and recently saw several banks such as Chase Bank, and Imperial bank suffer financial distress. A large number of Sacco's have also collapsed in the past leaving Kenyans in distress trying to recover their deposits. Most of these financial sector scandals have been caused by weak controls, dishonesty and poor management. In order to enhance investor

confidence, growth and stability within the financial industry, it is important to put in place strong CG mechanisms.

1.2 Research Problem

Despite the tight regulations surrounding the management of financial institutions, we still experience major corporate failures associated with weak corporate governance structures. Mukanyi (2011) indicates that corporate governance continues to deteriorate despite tight regulatory framework. An example is the 2008 global financial crisis which was attributed to weakness and failure of CG structures. According to Kirkpatrick (2009), the CG mechanisms failed to safeguard against excessive risk taking by many financial institutions and the main surrounding issues included risk management, board monitoring and accountability as well as disclosure of foreseeable risks.

Most recently in Kenya, 2016 saw several banks such as Chase bank and Dubai bank go through financial Scandals. One problem that was cited in these scenarios is that there were poor CG structures in place to mitigate financial loss. Due to the big losses experienced by investors and the economic instability resulting from these unfortunate occurrences there is need to do more research so as to prevent such happenings in future. The link between CG and firms' financial performance is however highly contentious issue as different researchers obtained differing results. Anusha Rambajan (2011) established a positive association between the firm's financial improvement and CG. Guze (2012) also scrutinized the impression of CG on fiscal achievement of public organizations in Kenya and established a positive relationship between the two. Insurance Regulatory Authority equally pointed poor CG in insurance companies to be one of its road blocks to attaining the key plan 2008-2012.

A number of studies however have not been able to identify a favourable link between CG and firm performance. Erkens, Hung, & Matos (2010) during the 2008 financial crisis established that firms with more independent boards realised worse returns on stocks during the crisis period. Due to the inconclusiveness and extreme findings from the studies that have already been done, there is need to do more research to ascertain the influence CG has on the fiscal achievement of financial institutions. The recent scandals facing financial services institutions in Kenya have put corporate governance

at the centre stage. This exploration works towards answering the following question; Does CG affect the performance of the firm?

1.3 Research objective

To determine the effect of CG on the financial performance of financial institutions in Kenya.

1.4 Value of the study

This study is of great importance to both researchers and academicians because it forms a basis of their research in this field. These two parties will be in a position to build on this body of knowledge so as to come up with relevant facts and meaningful conclusions. It will be a great source of reference and will give them more insights that will help in identifying any other existing gaps for future study.

Organisations in the financial services industry and other industries will be able to understand more, the role that CG plays in their financial performance for future decision making. This will assist them to make relevant decisions with regards to this issue. The findings and recommendations of this study will be used by in designing CG policies and regulations that better influence the financial performance of the firm and the economy as a whole.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This bit renders an all-inclusive synopsis of the theoretical framework and empirical studies relating to the effect of CG on firms, giving a sense of focus into the direction of this study.

2.2 Theoretical review

The theoretical analysis of this study involves three theories of CG namely; Stewardship, stakeholder and agency theory.

2.2.1 Agency Theory

Developed by Jensen and Meckling (1976), this theory explains the interdependence joining principals (shareholders) and agents (corporate executives) in a business. It seeks to address agency problem that arise due to conflicting interests of these two parties. According to Xie and Fukumoto (2013), this conflict leads to the sub-optimal performance of the firm. The interest of the principle is wealth maximization but on the other hand the agents may pursue self centred interests such as taking very high risks for shorter gain without considering the future and huge unjustifiable salaries. According to this theory, the aim of effective CG mechanisms is to align the interests of the agents with those of the principles by monitoring and controlling the actions of the executives and managers.

Some of the ways of managing this conflict to collaborate the interests of both the shareholders and management include compensating the top management adequately through share ownership, stock options, and profit sharing. This is supported by Baulkaran (2014) who stated that adequate compensation to executives leads to a much closer alignment between the interest of the shareholders and the top management. However, to completely eliminate the agency problem the principal would be required to monitor the actions of the agent perfectly which is not possible as it is very expensive. This theory is of great relevance to this study in that, it aids in understanding the relationship between the owners and the management of

organisations. It also helps us to understand the importance of having strong CG mechanisms in firms and how they impact their performance. Kenya's financial institutions are managed by executives on behalf of the shareholders. The agency problem is evident in most scandals that have faced some of the financial institutions under this study. This theory is therefore relevant in this study, as it informs us on the importance of managing this relationship between owners and managers which influences the performance of corporations to a great extent.

2.2.2 Stakeholder Theory

This theory was lodged into the management jurisdiction in 1970 and slowly grown by Freeman (1984).It addresses morals and ethical values in the management of a firm. It takes into mind the interests of a network of stakeholders. It values the relationship with this network more than the principle-agent relationship as in Agency theory. Managers need to consider all stakeholders who will be impacted by their decisions and actions according to Sendjaya et al., (2016).This theory focuses on the interest of all stakeholders where none has dominance over the other, they all have same value and managers have to put all these interests into account.

This theory argues that since the firm draws resources from the environment, it should be responsible for its preservation for the sake of current and future generations. Arenas & Rodrigo (2016) answered the question about the consideration of future generations as stakeholders of the firm, since it is difficult to identify and decide what fair allocation of resources to them is by indicating that they are direct descendants of the present stakeholders, out of whom the firm will get future employees, customers, and managers. This theory plays a great role in this study as it further puts emphasis on the importance of CG mechanism and firm's performance as they both have an impact on all the stakeholders of the firm. The relevance of this theory in this study is based on the attention it gives to the interests of the owners and other stakeholders.CG mechanisms should ensure that the desires of the owners which include maximizing their wealth are met and also meet their interests to other stakeholders.

2.2.3 Stewardship Theory

It was developed by Donaldson and Davis (1991 & 1993). It gives an alternative view to Agency theory by emphasizing that the manager is committed to the long-lived goals of the corporation instead of the steward's self-interests (El-Faitouri, 2014).It supports that managers and owners of a firm do not bear conflicting interests and that the endmost goal of CG is to find means that facilitate the highest degree of collaboration between them (Donaldson, 1990).In this theory top management are stewards unlike in agency theory where they are agents. Stewards' utility functions are maximized by maximizing and protecting shareholders' wealth. These executives therefore protect their reputations by using all rightful means to maximize shareholder' wealth as well as improve the firm's long-term performance as they are motivated by needs such as self-esteem and self-actualization.

The theory also recommends consolidation of the roles of the CEO and chairman so as to minimize expenses and foster greater responsibility as the corporation stewards. The savings on agency costs when managers adopt stewardship should therefore steer higher the firm's performance. The role of a steward is however oversimplified and unrealistic and this theory is yet to be accepted as a basis for analyzing organizational dynamics. This theory just like agency theory is important for this study. It shows a different perspective on the behaviour of managers in running a firm which greatly impacts its performance.

2.3 Determinants of Financial Performance

The financial performance of different financial institutions is dictated by several factors both internal and external. Capital availability is one important factor that affects the performance of a financial organization. Capital refers to the level of funds owned by the firm that are available to support the running of the firm. It increases liquidity and reduces the chances of the firm being exposed to financial stress. This also contributes positively to the performance of the firm, as it can venture into profitable projects as well as ensure business is not interrupted by lack of funds.

Liquidity management is another important factor affecting the performance of financial institutions. Liquidity enables these firms to meet their obligations to their

customers on a real time basis. This increases the level of their existing customers and becomes very attractive to potential customers and as a result better performance.

Management efficiency also determines the financial performance of the firm. The ability of the management to effectively deploy the resources of these firms leading to increased income and reduced costs shows the efficiency of the management. An efficient management leads to improved performance. There are also macroeconomic factors which are beyond the control of the business, such as inflation, GDP growth, interest rates and political factors which also affect the firm's financial performance. Political instability and declining economy for instance negatively affects the firm's performance.

2.4 Empirical Literature

Several studies have been carried with the aim of shedding light on the influence of CG on the firm's financial performance in different sectors and industries. This study expands on the Jensen and Meckling (1976) theory that assessed the Principal agent relationship. Shleifer and Vishny (1997) observed that firms that are effectively managed and controlled will potentially invest in exceptionally profitable projects which will in result lead to higher expected cash flows. CG both internal and external has a notable influence on firm performance (Cremers and Neir, 2005).

Anusha (2011) studied CG and financial performance of firms in South Africa. The key importance of the examination was to find the linkage amongst board characteristics of CG as quantified by board magnitude, independence ,composition, CEO duality and remuneration committee availability and fiscal accomplishment of companies in the goods sector that were listed on the South African exchange measured using net profit margin, ROA and ROE. Delphi technique was used to carry out interviews on four CG experts. This study discovered that independence of the board improved monitoring and a larger lead to better performance of the organisation.

Fratini and Tettamanzi (2015) sought to find out the intensity of the correlation between CG and performance in Italian listed companies. A sample of 182 companies that were listed was used and regression analysis applied. The exercise was done to affirm if there was indeed a favourable link amongst performance and board size and

audit committee. It also sought to clarify if there was an unfavourable association amongst performance and leverage. The exercise divulged that only board size had a favourable influence on the success of the firm. The conclusion was that there existed an ambiguous relationship between CG structure and performance.

Yilmaz and Buyuklu (2016) studied the footprint of CG variables on the achievement of firms in Turkey. This exercise deployed panel data in analysing different companies over a vast period. Board size and share of independent board members influence on a firm's performance was tested. The conclusion was that these CG variables had an impression on the performance of the firm.

Abdulazeez et al. (2016) studied listed deposit money banks in Nigeria to see the influence on financial performance by CG.15 deposit money banks listed in the Nigerian Stock Exchange were put under were used in the study. Quantitative data of a period of seven years was retrieved from annual reports and analyzed using regression model. It was deduced that larger board led to more favourable performance compared to smaller one, because it was difficult for an individual to dominate the board. This also led to better decisions coming from a large pool.

Erkens, Hung and Matos (2012) did an investigation on the impression that CG had on firm performance using 296 financial institutions that were affected in the financial crises of 2007. These institutions were listed as at the close of 2006 and we picked from thirty countries. Regression model of analysis was applied on data obtained from January 2007 when the weight of the losses started to be felt until September 2008. Stocks of corporations that had independent boards were discovered to produce worst returns during this period. A negative correlation between CG and performance was discovered.

Malik and Naushad (2015) unearthed a favourable association between CG and performance. This was after the examination of 24 Gulf Cooperation council banks, chosen based on their cumulative assets and cross sectional data gotten from their annual financial reports and websites. Tobin Q and ROA was used as the fiscal accomplishment measure while CG was quantified using size of board ,duality and cost of agency. This exercise also revealed that boards of a smaller size were able to monitor management more closely in this banking sector.

Kigotho (2014) also undertook a study on NSE listed firms to determine the link between CG and financial performance. Descriptive analysis on all 62 listed companies at NSE by December 2013 was used. Regression model discovered an existing positive correlation between CG and the performance of a firm due to the fact that various particulars of the board had an impression on its financial results.

Ndungu (2013) using a sample of 49 insurance companies in Kenya undertook a similar study. CG attributes used included sub-committees of the board, number of meetings held by the board, its independence, and duality among others. The result was that the number of board sub committees had a remarkable impact on the achievement of firms undertaking insurance business in Kenya. Large number of dependent directors as opposed to independent directors in the board positively affected the performance greately.The composition of the board and that of the sub committees had a great repercussion on the fiscal achievement of these firms.

Aduda, Okiro and Nixon (2015) studied the influence of CG and capital structure on the fiscal achievement of firms trading on the EACSE.98 firms listed on Uganda Securities Exchange, Rwanda Stock Exchange Nairobi Securities Exchange and Dar es Salaam Stock Exchange were put under the test. It was observed that a good CG enhances the performance of a firm. This study concluded that the contribution of external independent directors improved the effectiveness of running the corporation and its competitiveness. Mwangangi (2015) also researched on the effect of the profile of the board on the fiscal accomplishment of corporations trading at the NSE.64 companies trading at the NSE were studied and revealed that the board profile had little influence on their performance. The research concluded that only the board size had an outstanding effect on the fiscal accomplishment of these firms.

A study by Mang'unyi (2011) explored CG and ownership structure and the resulting effect of firm performance. This study was focused on 40 managers of banks selected using purposive sampling from both local and international banks. These managers responded to questionnaires and this data was analysed using ANOVA. It revealed significant differences between CG and performance. It recommended the reinforcement of CG mechanisms by both the government and the corporations in order to attract investors as well as to better the performance of the institutions.

2.5 Conceptual Framework

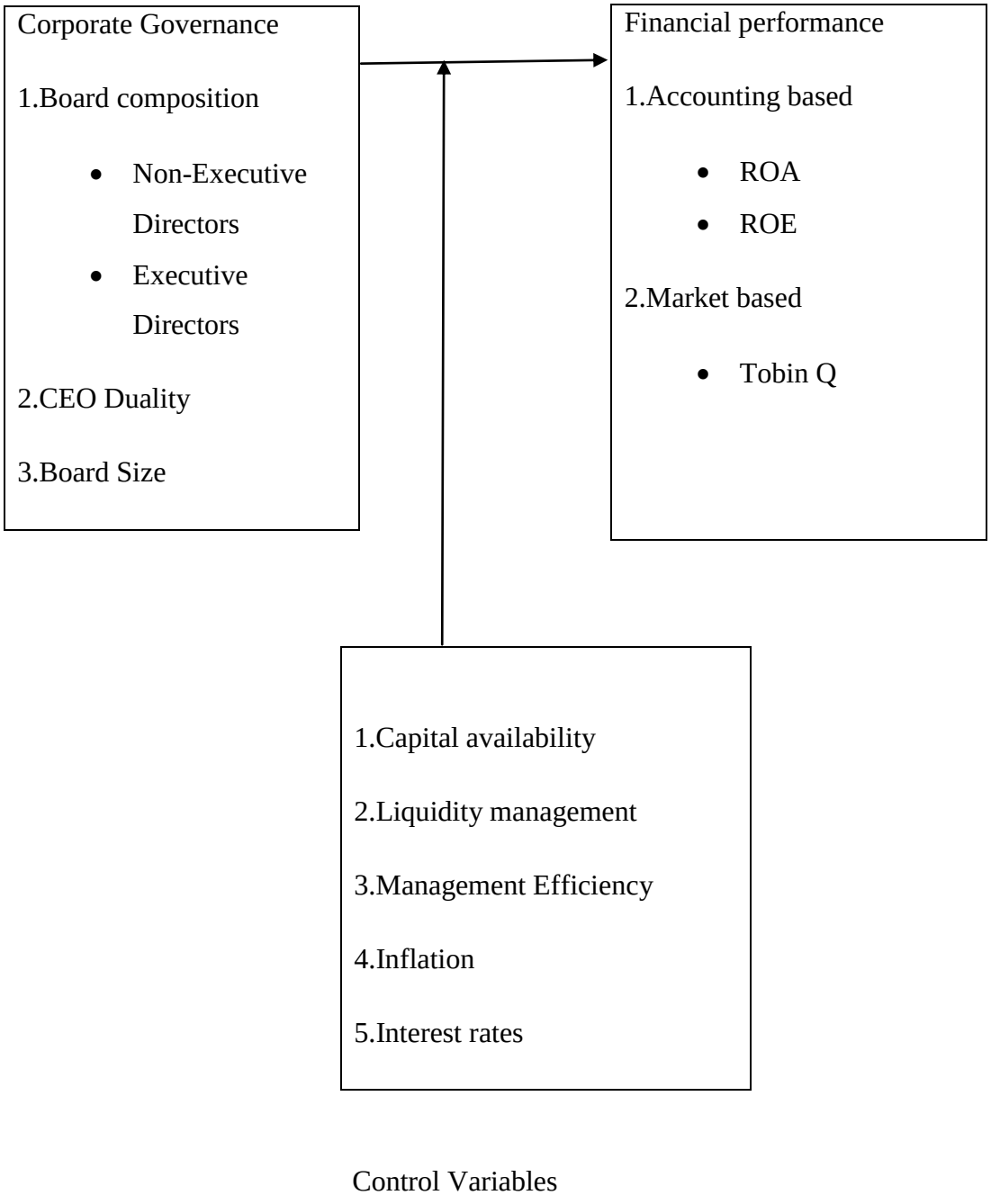
This section gives an outline of the conceptual framework with regards to the role played by CG on the firm's financial performance. A conceptual framework gives a road map of the researcher's conception of how different variables in the study interact with each other.

In this study the independent variables relating to corporate governance are CEO duality, board magnitude and makeup of the board while the dependent variables relating to financial performance are ROA and ROE.

Figure 2.1: Conceptual model

Independent variables

Dependent Variables



Control Variables

Source: Researcher.

2.6 Summary of Empirical Literature

Research has been carried out on the influence CG mechanisms have on the performance of firms. It is very clear from these studies that CG has many aspects and different researchers have come up with different findings some of which are contradictory. This is a major limitation of these empirical studies because it makes it difficult to make a final conclusion on the effect that CG variables have on performance.

Major corporate scandals and financial crises have happened across the world leading to large losses and economic instability. To manage these losses therefore, Strong CG mechanisms are required. Bhagat and Jefferis (2002) indicate that an effective CG guards a firm from susceptibility to future financial problems. Investors tend to shy away from firms that have a reputation for a weak management. For that reason, it is important to put in place and nurture strong CG mechanisms and policies by both the government and the institutions to boost investor confidence and as such attract them to the business.

In Kenya, recently several financial institutions experienced scandals that were closely linked to weak CG structures. Very few studies have been done focusing on CG in the overall Kenyan financial sector, and those that have been done are not conclusive due to their contradictory findings and the scope which has mainly focused on only a few variables of CG. More studies therefore need to be done focusing on different variables and different governance mechanisms in order to exhaustively give conclusions and recommendations that will assist in curbing the crises.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

The section explains the strategy for undertaking this study endeavouring to meet the established targets and fact-finding queries of the study. It reviews the different methods, approaches and designs for investigating the research question. The main subtopics to focus on are research design, population of interest, sample, data collection and analysis as well as validity and reliability.

3.2 Research Design

Research design is defined as a model for handling a study with utmost domination over elements that may thwart the results validity, (Burns and grove, 2003). Parahoo, (1997) also defines research design as a master plan that outlines how, when and where data is to be collected and analysed.

A descriptive design was used to determine and report things as they are. This choice stemmed from the fact that the study does not require any manipulation of the variables but desires to establish the state of affairs as they are. A descriptive study is the approach taken in collecting data with the intention of testing an assumption or answer queries regarding present status of objects under scrutiny (Mugenda and Mugenda, 2003).

3.3 Population and Sample

Parahoo (1997) defines population as the aggregate amount of elements from where figures can be obtained such as events, individuals or organisations.

The targeted population from which sufficient and reliable data was collected in order to draw conclusions from on this study included all 11 listed banks and 6 listed insurance companies in Kenya as at 31st December 2016 as illustrated in Appendix I. This study utilized all these 17 institutions.

3.4 Data Collection

This study utilized secondary data obtained from reported annual statements and websites of the specific organisations. The financial performance was obtained from year end statements including statements of income, statement of financial position and cash flow statements for period between 1st January 2012 and 31St December 2016.

The specific data collected included net revenue and total assets for each period. Also data on the exact figures of board members and those of dependent and independent directors, age of company and CEO duality was obtained from other company reports accompanying the annual reports.

3.5 Diagnostic Tests

3.5.1 Test for Normality

The study conducted normality test for independent variables, autocorrelation test and test for multicollinearity. This is done given that it is impractical to achieve accurate and reliable deductions about reality when the postulation that the population from which the sample is derived is normally distributed, is invalid (Ghasemi & Zahediasl, 2012). The study used Kolmogorov-Smirnov test of normality and the graphical method to assess whether the data is normally distributed.

3.5.2 Test for Multicollinearity

Multicollinearity happens when there is a great extent of correlation between independent variables in a study. Independent variables with collinearity of more than 0.8 is assumed to have severe multicollinearity and is removed from the model (Saunders, Lewis, & Thornhill, 2016).

3.6 Data Analysis

The acquired quantitative data was analysed through the application of descriptive analysis technique. Descriptive statistics usually spell out the fundamental traits of data in the study. To find out the link joining the dependent and independent variables i.e. the relationship between the financial performance and the CG aspects (board composition, size and CEO duality) multiple linear regression analysis was used.

ROA and ROE was used to represent the firm's performance (dependent variable) while the board composition, size and CEO duality will represent the independent variables of the study.

3.6.1 Analytical Model

The analytical method used in this study is as shown below.

$Y= \alpha + \beta_1X_1 + \beta_2X_2+ \beta_3X_3 +\beta_4X_4 + e$

Y represents financial performance measured using ROA and ROE

X_1 is the board size

X_2 is the board composition, measured based on the ratio of independent and dependent directors.

X_3 is the CEO duality determined as 0 if CEO is not the chairman and 1 if CEO is also the chairman

X_4 is the age of the company

e is the error term to cater for any other variables not captured by the model.

3.6.2 Test of Significance

F-test was used to test the overall significance of the model, while T-test was used to test the individual significance of individual variables.

CHAPTER FOUR

DATA ANALYSIS, FINDINGS AND DISCUSSION

4.1 Introduction

This component shows the end product from the data investigation. This study sought to inspect the effect of Corporate Governance on the financial performance of NSE-listed financial institutions in Kenya. Fiscal accomplishment was quantified using ROA and ROE whereas CG was measured by the board composition, board size, the age of the company and CEO duality.

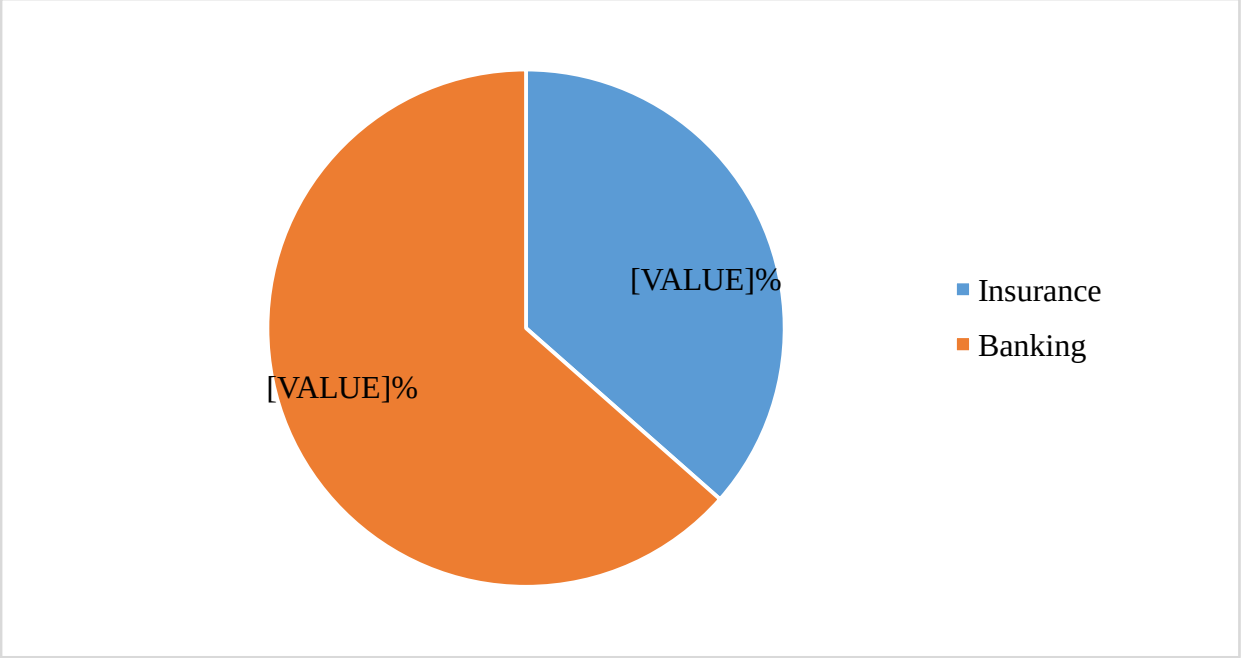
4.2 General Information

4.2.1 Sectors of the Listed Financial Institutions

The population of the study was 17 corporations listed by Nairobi Securities Exchange (NSE). Financial performance data and governance information was obtained from all (100%) of the companies.

Majority (63.5%) of the firms under study were from the banking sector whereas 36.5% were from the insurance sector of the Nairobi Securities Exchange. The results are as shown in figure 4.1. These findings that the study included all the categories of financial institutions that are NSE-listed imply that the study was representative.

Figure 4. 1: Sector of the firm



Source: Research Findings

4.2.2 Descriptive Statistics

Data analysis revealed that CEO Duality for all (100%) of the companies was the same since all the company chairs were not the respective CEOs or Managing Directors. The standard deviations of CEO Duality of both banking and insurance sectors were 0. Table 4.1 below summarizes the mean board size, board composition, age of company, ROA and ROE for both insurance sector and banking sector financial institutions. These results also are of the implication that the study was representative since companies with different ages, board sizes, sectors and board compositions were studied.

Table 4. 1: Group Statistics for the insurance and banking sector companies

	Sector	N	Mean	Std. Deviation	Std. Error Mean
Board Size	Insurance	31	9.35	2.153	.387
	Banking	51	9.90	1.781	.249
Board	Insurance	23	1.348	1.7513	.3652

Composition	Banking	44	1.875	1.3761	.2074
Age of Company	Insurance	31	55.52	12.447	2.236
	Banking	54	65.35	27.811	3.785
Return on Assets	Insurance	31	.051355	.0423191	.0076007
	Banking	54	.030148	.0130996	.0017826
Return on Equity	Insurance	31	.178385	.1405345	.0252407
	Banking	54	.184808	.0854679	.0116307

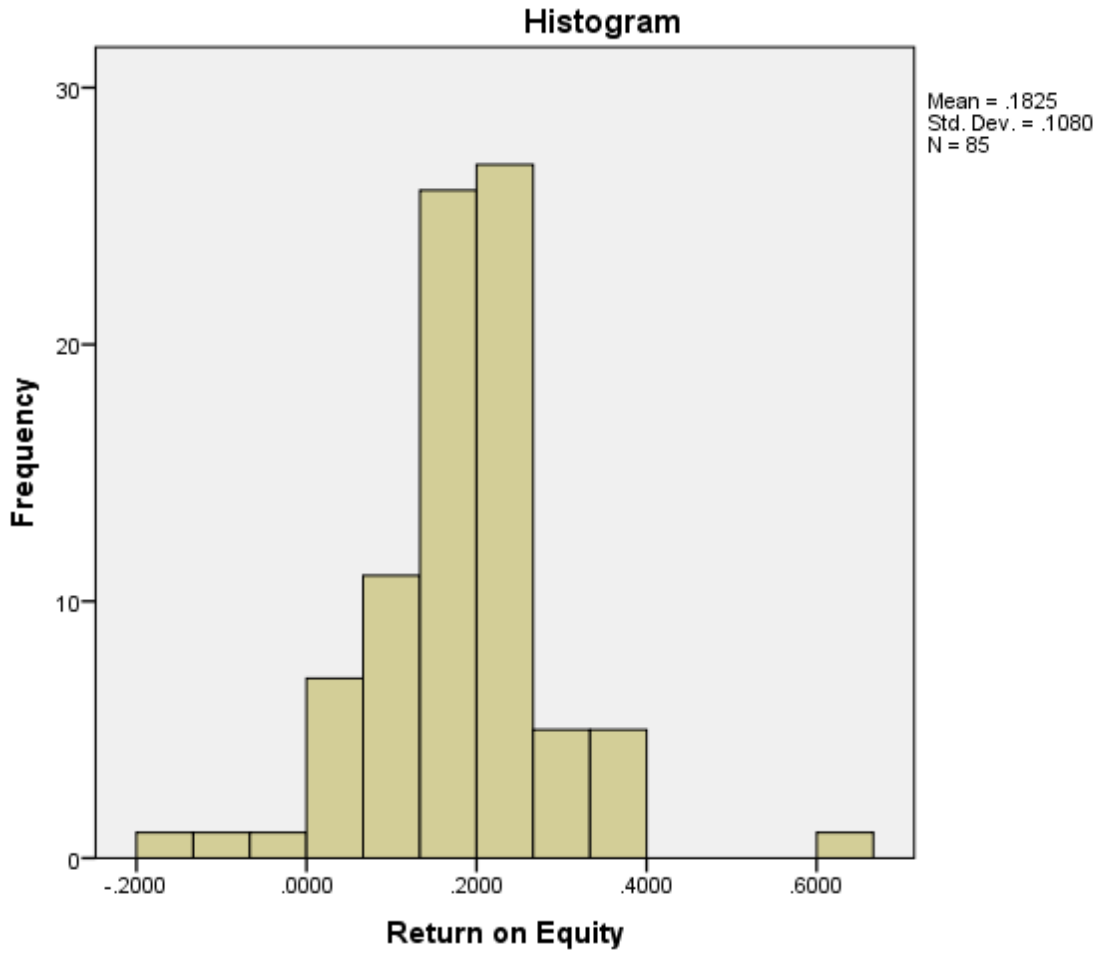
Source: Research Findings

4.3 Diagnostic Tests

4.3.1 Test for normality

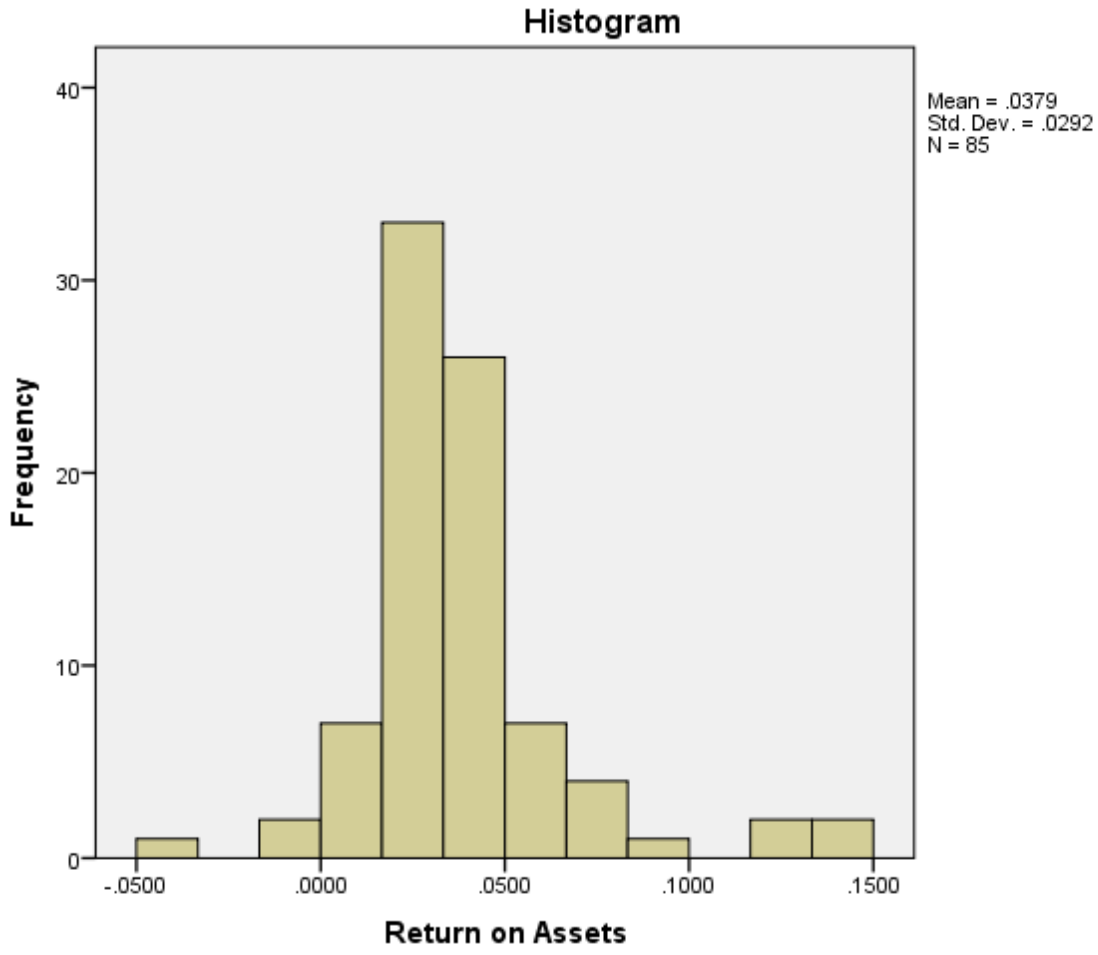
The study used both the graphical and numeric method to test for normality of the residuals for both ROE and ROA. The residuals for ROE (figure 4.2) and ROA (figure 4.3) were both normally distributed because the bell-shaped density curve is symmetrical and aligned around its mean with distribution determined by standard deviation.

Figure 4. 2: Normality Test for Return on Equity



Source:Research findings

Figure 4. 3: Normality Test for Return on Asset



Source: Research Findings.

Numerical test for normality was conducted and using Shapiro-Wilk, whereby the independent variable was statistically significant. The values of Shapiro-Wilk test were all less than 0.05, thus the data is normally distributed. Results are presented in table 4.2.

Table 4. 2: Tests of Normality for Independent Variables

	Kolmogorov-Smirnov			Shapiro-Wilk		
	Statistic	df	Sig.	Statistic	df	Sig.
Board Size	.154	67	.000	.957	67	.021

Board Composition	.198	67	.000	.857	67	.000
Age of Company	.182	67	.000	.872	67	.000
Return on Assets	.139	67	.002	.919	67	.000
Return on Equity	.130	67	.007	.952	67	.011

Source: Research Findings.

4.3.2 Test for multicollinearity

Multicollinearity was tested for using Pearson correlation coefficient. There was no multicollinearity since the Pearson correlation for all the independent variables were less than 0.8. The findings are presented in table 4.3.

Table 4. 3: Test for multicollinearity

		Board Size	Board Composition	Age of Company	Return on Assets	Return on Equity
Board Size	Pearson Correlation	1				
	Sig. (2-tailed)					
	N	82				
Board Composition	Pearson Correlation	-.277*	1			
	Sig. (2-tailed)	.023				
	N	67	67			
Age of Company	Pearson Correlation	-.067	.238	1		
	Sig. (2-tailed)	.548	.052			
	N	82	67	85		
Return on Assets	Pearson Correlation	.234*	-.237	-.099	1	
	Sig. (2-tailed)	.035	.054	.365		
	N	82	67	85	85	
Return on Equity	Pearson Correlation	.081	-.131	.183	.544**	1

	Sig. (2-tailed)	.470	.292	.093	.000	
	N	82	67	85	85	85

Source: Research Findings.

4.4 Corporate Governance and Financial Performance

4.4.1 Correlation Matrix

The study conducted Pearson correlation to investigate the relationship between CG variables and the two variables of financial performance namely, ROE and ROA.

The correlations between board composition and board size (r = -.277, p=0.023), Return on Asset and board size (r = .234, p=0.35) and between Return on Equity and Return on Asset (r = .544, p=0.000) were significant. This signifies that a significant association exists between board composition and board size, a relationship between Return on Asset and board size and also a relationship exists between ROA and ROE. These findings imply that any change in a single unit of board size of a NSE-listed firm will result to change in the board composition. A change in a unit of board composition will also result into change in a unit of ROA. Further, any change in ROA of a NSE-listed firm will result to a unit change in the ROE of the firm. Table 4.4 shows these results.

Table 4. 4: Correlations

		Board Size	Board Composition	Age of Company	Return on Assets	Return on Equity
Board Size	Pearson Correlation	1				
	Sig. (2-tailed)					
	N	82				
Board Composition	Pearson Correlation	-.277*	1			
	Sig. (2-tailed)	**.023**				
	N	67	67			

Age of Company	Pearson Correlation	-.067	.238	1		
	Sig. (2-tailed)	.548	.052			
	N	82	67	85		
Return on Assets	Pearson Correlation	.234*	-.237	-.099	1	
	Sig. (2-tailed)	**.035**	.054	.365		
	N	82	67	85	85	
Return on Equity	Pearson Correlation	.081	-.131	.183	.544**	1
	Sig. (2-tailed)	.470	.292	.093	**.000**	
	N	82	67	85	85	85

Source: Research Findings

4.4.2 T-test

The study carried out independent t-test to test the individual significance of individual variables. The two unrelated groups were banking and insurance sectors are equal. From the results there were statistically significant differences in Age of Company ($t_{16,\ 0.05}$ = -1.861, p= 0.000), ROA ($t_{16,\ 0.05}$ = 3.421, p= 0.000) and ROE ($t_{16,\ 0.05}$ = -.262, p= 0.024) between insurance and banking sectors (table 4.5). These results imply that return on equity, age of firms, and return on assets were all statistically different between the insurance and banking sectors.

Table 4. 5: Independent Samples Test (t-test)

		Levene's Test for Equality of Variances		t-test for Equality of Means					
		F	Sig.	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference
									Lower	Upper
Board Size	Equal variances assumed	2.001	.161	-1.246	80	.217	-.547	.439	-1.421	.327
	Equal variances not assumed			-1.189	54.473	.240	-.547	.460	-1.469	.375
Board Composition	Equal variances assumed	1.688	.199	-1.354	65	.181	-.5272	.3894	-1.3049	.2506
	Equal variances not assumed			-1.255	36.543	.217	-.5272	.4200	-1.3785	.3242
Age of Company	Equal variances assumed	20.818	**.000**	-1.861	83	.066	-9.836	5.284	-20.345	.674

	Equal variances not assumed			-2.238	79.367	.028	-9.836	4.396	-18.584	-1.087
Return on Assets	Equal variances assumed	31.664	**.000**	3.421	83	.001	.0212067	.0061994	.0088764	.0335370
	Equal variances not assumed			2.716	33.334	.010	.0212067	.0078070	.0053293	.0370841
Return on Equity	Equal variances assumed	5.282	**.024**	-.262	83	.794	-.0064234	.0244810	-.0551150	.0422682
	Equal variances not assumed			-.231	42.995	.818	-.0064234	.0277915	-.0624705	.0496237

4.4.3 Multiple Regression Result

Regression analysis was conducted on the study data to implore the impression of CG variables on the financial performance of NSE-listed financial institutions, as measured by ROE. From the results, 7.5% of variations in ROE are explained by Corporate Governance. The resolutions are availed in table 4.6. The outcomes are of the implication that Return on Equity explains a very marginal proportion of Corporate Governance.

Table 4. 6: The model Summary for effect of CG on financial performance (ROE)

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.273	.075	.031	.1039695	1.218

Source: Research Findings

Analysis of Variance test was carried out to investigate if the model significantly predicted Return on Equity. However, the study established that the model was not a good measure for the data ($F = 1.695$, $p = 0.177$). The findings mean that the model does not predict CG significantly. Results are presented in table 4.7.

Table 4. 7: ANOVA for effect of CG on performance (ROE)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.055	3	.018	1.695	.177[b]
	Residual	.681	63	.011		
	Total	.736	66			

Source: Research Findings

The coefficient for the regression models offers the essential information required to predict the outcome variable (ROE). The coefficients for the model were all statistically insignificant as shown in table 4.8, thus the model was insignificant in

predicting the values of Return on Equity. This result is of the implication that CG has no significant influence on financial performance as determined by ROE. Performance of NSE-listed financial firms as measured by Return on Equity is not influenced by Corporate Governance elements of board composition, age of firm and company board size.

Table 4. 8: Coefficients for effect of CG on performance (ROE)

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.066	.079		.833	.408
	Board Size	.007	.007	.139	1.103	.274
	Board Composition	-.010	.009	-.142	-1.094	.278
	Age of Company	.001	.001	.207	1.661	.102

Source: Research Findings

Further, regression analysis was conducted on the study data to find out the effect of Corporate Governance variables on financial performance of NSE-listed financial institutions, as measured by ROA. From the results, 7.4% of variations in ROA are explained by Corporate Governance. The outcomes are of the implication that Return on Assets explains a very marginal proportion of Corporate Governance. The findings are shown in table 4.9.

Table 4. 9: Model Summary for effect of CG on performance (ROA)

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.273[a]	.074	.030	.0233574	1.296

Source: Research Findings

Analysis of Variance test was carried out to investigate if the model significantly predicted Return on Assets. However, the study established that the model was not a good measure for the data ($F = 1.688$, $p = 0.179$). Results are presented in table 4.10.

Table 4. 10: ANOVA for effect of CG on performance (ROA)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.003	3	.001	1.688	.179[b]
	Residual	.034	63	.001		
	Total	.037	66			

Source: Research Findings

The coefficient for the regression models provided information needed to predict ROA which was the dependent variable. The coefficients for the model were all statistically insignificant, thus the model was insignificant in calculating the values of ROA. This result is of the implication that CG has no significant influence on listed financial institutions' financial performance as computed by ROA. Performance of NSE-listed financial firms as measured by Return on Assets is not influenced by Corporate Governance elements of board composition, age of firm and company board size. Table 4.11 shows these findings.

Table 4. 11: Coefficients for effect of CG on performance (ROA)

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.021	.018		1.201	.234
	Board Size	.002	.002	.130	1.031	.307
	Board Composition	-.003	.002	-.214	-1.654	.103
	Age of Company	0.00005128	.000	.056	.448	.656

Source: Research Findings

4.5 Interpretation of the Findings

This study's objective was to uncover the impression of CG on the financial performance of financial institutions in Kenya. Majority (63.5%) of the listed financial institutions were found to be from the banking sector whereas 36.5% were from the insurance sector. Additionally, the mean board size was 9.35 for the insurance sector firms and 9.90 for the banking sector firms. This indicates that baking sector firms had larger boards compared to insurance firms.

From the results, the study found that a relationship exists between board composition and board size, and between ROA and board size. Regression results showed that Board Composition, Board Size, Age of Company and CEO duality had no influence on the performance of NSE-listed financial institutions as measured by both ROE and ROA. This suggests that the number of board members, the ration of independent directors to dependent directors, whether the CEO is the board chair or not and the age of the listed financial instructions did not in any way impact the firms' financial performance irrespective of the measure used.

The study findings are in agreement with Fratini and Tettamanzi (2015) that there is vague association between a firm's performance and CG structure. Further, the results of this study confirm findings by Wambua (2011), who through a study focusing on board composition and its influence on Sacco's performance in Kenya also found that the size and makeup of the board did not have any influence on the performance of the institutions. These findings however contradict findings by Cremers and Neir (2005) that CG both internal and external has a notable influence on firm performance.

This study thus finds that none of the corporate governance measures influence operating performance and stock market performance of the NSE-listed financial institutions. The results of this study confirms the findings of other previous studies (Fratini and Tettamanzi, 2015; Wambua, 2011).

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

In this section, the discussion of the results, conclusions and recommendations in accordance with the results from the study are presented. The study limitations and areas that require further inquiry are also presented.

5.2 Summary

The intention of this paper was to establish the influence of Corporate Governance on the financial performance of financial institutions in Kenya. Secondary data on financial performance and CG from the year 2012 to 2016 was collected from 11 banking sector companies and 6 insurance sector companies listed at the NSE.

There were differences in mean age of firm, mean size of the board, Board Composition, ROA and ROE of the financial institutions from banking and insurance sector. The findings revealed that Board Composition, Board Size, Age of Company and CEO duality had no influence on the financial performance of NSE-listed financial institutions, as measured by both ROE and ROA.

5.3 Conclusions

As indicated by the results from the analysis, all the measures of Corporate Governance including CEO duality, Board Size, Age of Company and Board Composition had no effect on the financial performance of NSE-listed financial institutions listed as measured by both ROE and ROA. The study thus concludes that none of the determinants of Corporate Governance used in this study has effect on the operating income performance and stock market performance of the listed companies.

5.4 Recommendations For Policy and Practice

This study recommends that although aspects of CG including CEO duality, Board Size, Board Composition and Age of Company may not influence the financial performance of financial institutions, it is necessary that the firms adhere to regulations such as gender balancing, proportion of independent directors to dependent directors. The study also recommends the split-up of the positions of board chair and the CEO/MD as this may be necessary to enhance effective and efficient

operation of the business as well as its perpetuity as the CEO will focus on the management duties fully.

5.5 Limitations of the Study

Only specific aspects of CG such as Board Composition, Board Size, and CEO Duality were examined in this study. Further, the population of the study was constrained to financial institutions listed at the NSE. Thus, the study findings are not generalizable to the universal population of other listed companies or other companies in Kenya.

5.6 Suggestions for further studies

This paper was constrained to examining the influence of CG on financial performance of NSE-listed financial institutions listed. Corporate Governance aspects were just limited to Board Composition, Board Size and CEO Duality. Further research needs to focus on other elements of corporate governance such as board members tenure and education of directors.

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APPENDICES

Appendix I: Financial Instructions Listed at the NSE as at 31st December 2016

No	Banking Sector
1	Barclays Bank Ltd
2	CFC Stanbic Holdings Ltd
3	I&M Holdings Ltd
4	Diamond Trust Bank Kenya Ltd
5	HF Group Ltd
6	KCB Group Ltd
7	National Bank of Kenya Ltd
8	NIC Bank Ltd
9	Standard Chartered Bank Ltd
10	Equity Group Holdings
11	The Co-operative Bank of Kenya
	Insurance Sector
12	Jubilee Holdings Ltd
13	Sanlam Kenya PLC
14	Kenya Re-Insurance Corporation Ltd
15	Liberty Kenya Holdings Ltd
16	Britam Holdings Ltd
17	CIC Insurance Group Ltd

Source: NSE Website (2017).

Appendix II: Study Variables and Terms of Measurement

Variable	**Terms of Measurement**
Board Composition (BOARDCOMP)	Ratio of independent and dependent directors
Board Size (BOARDSIZE)	Size of the board
CEO Duality (CEODUAL)	Determined as 0 if CEO is not the chairman and 1 if CEO is also the chairman
Return on Assets (ROA)	Dividing a company's annual earnings by its total assets
Return on Equity (ROE)	Net Income/Shareholders' Equity
Age of the company (FIRMAGE)	Age

Appendix III

LETTER OF INTRODUCTION.

CATHERINE NGINA,
P.O BOX 64746-00620,
NAIROBI,
KENYA.

TO**:** .....
.....
.....

Dear sir/Madam.

RE: **INTRODUCTION LETTER FOR CATHERINE NGINA**

I am an MSC student at the University of Nairobi. I am conducting an academic research paper in partial fulfilment of the conditions for the award of the degree of Master of Science Finance. My topic of study is "**The effect of Corporate Governance on the Financial Performance of Financial Institutions listed at the Nairobi Securities Exchange".**

I Kindly request for your assistance in this fundamental part of my study which i will highly appreciate.

I will treat any information provided with utmost confidentiality and the results of this exercise will only be used for educational purposes.

Thanks in advance.

CATHERINE NGINA
REG: D63/87873/2016.