Effects of Board Composition on Financial Performance of Banking Institutions Listed at Nairobi Securities Exchange

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Abstract: CEO duality refers to a board leadership structure in which the Chief Executive Officer (CEO) is the Chairman of the Board (COB). The general objective of this study was to determine the relationship between board composition and financial performance of listed financial institutions at the Nairobi Securities Exchange. The specific objectives of the study were to: establish extent to which the size of the board affect the performance of listed financial institution in Kenya; determine the extent to which the proportion of independent non-executive directors affect the performance of listed financial institution in Kenya; and to establish the extent to which the CEO duality affect the performance of listed financial institution in Kenya. The study sought to investigate the relationship between board composition and financial performance of listed Banking companies in Kenya. The study made use of descriptive research study design and data was extracted from the institution through questionnaire administration. Correlation and multiple regression analysis were used for analysis. The results of the study were analyzed to see whether there is any effect of board composition on financial performance. The study also determined whether board composition have effect on financial performance of the firm by considering the board size, board independence and CEO duality and how they will be related to Return on Assets (ROA), at determined significant level.

1. Introduction

Companies have long recognized that good governance generates positive returns to a firm and boost confidence. Thus, the nature of corporate governance structures of a firm has critical impact on the responsive ability of a firm to external factors that impinge on its performance. One must point out that the concept of corporate governance has been a priority on the policy agenda in developed market economies for over a decade especially among very large firms. Further to that, the concept is gradually warming itself as a priority in the African continent. Indeed, it is believed that the Asian crisis and the relative poor performance of the corporate sector in Africa have made the issue of corporate governance a catchphrase in the development debate. Berglof & Von Thadden, (2002). A number of recent studies show that good corporate governance increases valuations and boosts the bottom line. For example, a study by Gompers et al, (2003) showed that companies with strong shareholder rights yielded annual returns that were 8.5 percent greater than those with weak rights. Related to that, it was also observed that the more democratic firms also enjoyed higher valuations, higher profits, higher sales growth, and lower capital expenditures. Again, poorly governed firms are expected to be less profitably, have more bankruptcy risks, lower valuations and pay out less to their shareholders, while well-governed firms are expected to have higher profits, less bankruptcy risks, higher valuations and pay out more cash to their shareholders. Claessens, (2003) argues that better corporate frameworks benefit firms through greater access to financing, lower cost of capital, better performance and more favourable treatment of all stakeholders. The position has been stated that, weak corporate governance does not only lead to poor firm performance and risky financing patterns, but are also conducive to macroeconomic crises like the 1997 East Asia crisis. Other researchers contend that good corporate governance is important for increasing investor confidence and market liquidity, (Donaldson, 2003).

An argument has been advanced time and again that the governance structure of any corporate entity affects the...
corporate governance systems may be thought of as mechanisms for establishing the nature of ownership and control of organizations within an economy. In this context, corporate governance mechanisms are economic and legal institutions that can be altered through the political process - sometimes for the better (Shleifer & Vishny, 2005). Empirical studies have provided the nexus between corporate governance and firm performance. Bebchuk et al., (2004) indicate that well-governed firms have higher firm performance.

1.1 Board Composition

Board composition refers to the number and the type of board members, board demographics, board structure, board education and evaluation, and board leadership (Zahra & Pearce, 2001). Board composition denotes the fraction of non-executive directors on the board as compared to their executive counter parts (Udiale, 2010; Lawal, 2012.). The non-executive directors are normally referred to as outsiders and the executive directors are referred to as insiders. Board composition is considered an important factor in the performance of three board roles (Hilman, Keim & Luce, 2001). They stated that the relationship between the composition of the board of directors and firm financial performance has been extensively studied in terms of insider and outsider. In addition to the oversight function, some board members may contribute to strategy development, while others are involved in service, or provide technical expertise, or a combination of the above (Markarian & Parbonetti, 2007). They argued, for example, that an independent director can perform a monitoring function, and can simultaneously provide other valuable resources to the company, such as providing expertise and knowledge in specific areas, expertise on decision making processes, legitimacy making process and access to information. The board of directors needs to have the appropriate structure and this involves several dimensions, (Van den Bergh & Levrault, 2004). According to their research the most frequently reported dimensions are diversity and complimentary. The other dimension relates to the proportion of inside directors and outside directors, experience and knowledge of directors and size of the board. They argued that board should comprise a mix of people having different personalities and educational, occupational and functional backgrounds, but they must be complementary. The impact of board composition on overall financial performance is not at all clear, (Davidson & Rowe, 2004). According to their study, one problem with measuring the relationship between board of director composition and financial performance could be that their relationships are endogenously determined, (Hermalin & Weisbach, 2000). A second problem may be that due to fixed board terms and periodic reporting, the relation may be inter-temporal (Davidson & Rowe, 2004). They developed a theory of inter-temporal endogeneity of board composition and financial performance. Inter-temporal endogeneity is the idea that board composition in one period influences financial performance financial performance in later periods, and financial performance in one period influences board composition in later periods. Thus, board composition and financial performance influences each other but the effect is delayed, (Davidson & Rowe, 2004).

In Kenya board composition is prescribed under Section 11(3) and 12 of the Capital Markets Authority Act, (CMA Act, 2000) that empowers the Capital Markets Authority to make rules and regulations to govern capital markets in Kenya. The CMA guideline on corporate governance practices (2002) has proposed that a balanced board constitutes an effective board. It therefore requires that the board of directors of every listed company should reflect a balance between the independent non-executive directors and executive directors. The independent and non-executive directors should form at least one-third of the membership of the board to ensure that no individual or small group of individuals can dominate board decision making processes.

1.2 Financial Performance

For a long time, financial performance has been perceived only through its ability to obtain profits. This changed over time. Today the concept of performance has different meanings depending on the user perspective of financial information. A company can be categorized as global performance if it can satisfy the interests of all stakeholders: managers are interested in their welfare and to obtain profit, because their work is appreciated accordingly; owners want to maximize their wealth by increasing the company’s market value (this objective can only be based on profit); current and potential shareholders perceive performance as the company’s ability to distribute dividends for capital investment, given the risks they take; commercial partners look for the solvency and stability of the company; credit institutions want to be sure that the company has the necessary capacity to repay loans on time (solvency); employees want a stable job and to obtain high material benefits; the state seeks a company to be efficient, to pay its taxes, to help creating new jobs, (Valentin, 2013). Companies’ management use financial indicators to measure, report and improve its performance. It has been proved that in order to obtain a global situation of an economic entity at a specific moment it’s necessary that the evaluation to be based on a balanced multidimensional system which includes both financial ratios and non-financial indicators.

Analysis of the determinants of corporate financial performance is essential for all the stakeholders, but
especially for investors. The Anglo-Saxon corporate governance focuses on maximizing shareholder value. This principle provides a conceptual and operational framework for evaluating business performance. The value of shareholders, defined as market value of a company is dependent on several factors: the current profitability of the company, its risks and its economic growth essential for future company earnings (Branch & Gale, 2003). All of these are major factors influencing the market value of a company.

Other studies by Brief and Lawson, (2004) argue the opposite, that financial indicators based on accounting information are sufficient in order to determine the value for shareholders. A company’s financial performance is directly influenced by its market position. Profitability can be decomposed into its main components: net turnover and net profit margin. Ross et al, (2008) argues that both can influence the profitability of a company one time. If a high turnover means better use of assets owned by the company and therefore better efficiency, a higher profit margin means that the entity has substantial market power.

Risk and growth are two other important factors influencing a firm’s financial performance. Since market value is conditioned by the company’s results, the level of risk exposure can cause changes in its market value (Fruhan, 2005). Economic growth is another component that helps to achieve a better position on the financial markets, because market value also takes into consideration expected future profits (Varaiya, Kerin& Weeks, 2003).

1.3 Relationship between Board Composition and Financial Performance

Many institutional investors perceive corporate governance as a tool for extracting value for shareholders from underperforming, undervalued companies. Targeting companies that are under performing and analyzing their corporate governance practices can lead to improvements that unlock a company's hidden value. These improvements often include replacing poorly performing directors and ensuring that the companies comply with perceived best practice in corporate governance, Fosberg, (2004).

MacAvoy and Millstein, (2005), in their study found that corporations with active and independent boards appeared to perform much better than those with passive, non-independent boards. Majority of investors prepare to pay a premium to invest in a company with good corporate governance. Frequently scheduled meetings generate opportunity costs in the form of management time consumed, and cash costs in the form of traveling allowances and fees for board members. Yet real benefits can be derived from such meetings as directors have the opportunity to confer, set strategy and monitor management. Vafeas (2004), for instance found that meeting frequency was influential in improving operating performance in a manner consistent with agency theory.

Bhagat and Black, (2005) examined the effect of board composition on long-term stock market and accounting performance. Once again, they do not find any relationship between board composition and firm performance. Overall, there is little to suggest that board composition has any cross-sectional relationship to firm performance. However the work of Dalton, Daily, Ellstrand and Johnson, (2006) showed that board composition has virtually no effect on firm performance, and that there is no relationship between leadership structure and firm performance. Shareholder activism is the key to ensuring good corporate governance and without this there is less accountability and transparency.

1.4 Objective

The objective of the study was to establish the extent to which board composition affect financial performance on financial institutions listed at the Nairobi Securities Exchange. The specific objectives are:
1) To establish extent to which the size of the board affect the performance of listed financial institution in Kenya.
2) To determine the extent to which the proportion of independent non-executive directors affect the performance of listed financial institution in Kenya.
3) To establish the extent to which the CEO duality affect the performance of listed financial institution in Kenya.

2. Literature Review

2.1 Introduction

This chapter aims to provide the theoretical background to the research through a literature review. The literature review provides evidence of the relationship between Board composition and performance. It also looks at empirical studies between corporate governance and performance. The literature is based on the corporate governance mechanisms of: board, ownership, and CEO duality and control variables.

2.2 Theoretical Framework

This research provides a new framework that is summarized basing on the drawings from the theories of agency by Berle and Means, (2002) assertion that the modern public corporation had separated ownership from the control; the owners of the firm were no longer also the managers. Stewardship theory by Donaldson 1990; Donaldson and Davis, (2002) disputes agency theory’s portrayal of managers as economic rationalists seeking to maximize their own wealth shareholders’ expense, they argue that rational action by managers need not disadvantage shareholders because managers are professionally motivated to improve the value of the firm.

2.2.1 Agency Theory

According to agency theory, the separation of ownership and control, which as noted above, is one of the hallmarks of the modern corporation, will lead in many instances to firm managers using their firm-specific knowledge and managerial expertise to gain an advantage over the firm’s owners, who are absent from the day-to-day affairs of the firm. Since the managers are “in control” of the firm, the risk is that they will pursue actions in their own self-interest, and not in the interest of the owners. Agency theory
recognizes specific roles for the main actors in corporate governance, stipulating that it is up to top management to take strategic decisions, and that shareholder have the power to hold management accountable according to firm results obtained. It could be said that agency theory became the main theory of corporate governance in the 1980s, and that it defined corporate governance in terms of balancing the interests of the firm’s principals, the shareholders, with the responsibilities and expertise of the firm’s top managers.

Agency theory is equally important to corporate governance, since it forms the backbone of any successful corporate governance policies and regulations, (get the agency theory framework right and the corporate governance principles will more than likely be right) especially in the 21st century where there have been some of the major corporate collapses and lots of talk with regards to strengthening the corporate governance reporting by companies to make sure that it is effective and efficient in protecting the interest of shareholders and all other stakeholders. Given the problems in mitigating agency problems through the use of contracts, scholars have suggested various governance mechanisms to address the agency problems. Agency theory thus provides a basis for firm governance through the use of internal and external mechanisms (Weir et al., 2002; Roberts et al., 2005). The governance mechanisms are designed to protect shareholder interests, minimize agency costs and ensure agent-principal interest alignment (Davis et al., 2007.).

2.2.2 Stewardship Theory
This theory postulates that managers are motivated by the desire to achieve and gain intrinsic satisfaction by performing challenging tasks. Proponents of this theory argue that managers need authority and desire recognition for performing challenging tasks. Unlike agency theory in which the managers are working for the shareholders, the stewardship theorists suggest that managers in organizations have a network of relationships to serve – this include the suppliers, employees and business partners. The stakeholders are the people who assist or hinder the achievement of organization’s objectives. Stewardship theory is equally important to corporate governance, since it assist the organization in its supply chain management and in the process help in resource management, allocation and management decision making (Jensen, 2001).

2.2.4 Conceptual Framework
Board duality is a corporate leadership structure that merges the position of board chair and CEO (Charan, 2008). The measurement variable for board duality will be a dummy, which takes a value of 1 if the CEO and chairman are the same person and 0 if the CEO is separated from the board chairman. Boards are traditionally composed of only male members. The presence of women on the board leads to gender diversity. It is generally accepted that female board members are more independent because they are not part of the “old boys” network (Carter, Simkins, & Simpson, 2003). The ratio of the number of women to total board size is used as measure of board gender. Higher level of educational qualification like PhD will function as a strategic resource. These educational qualifications such as PhD act as a mix of competencies and capabilities that help in executing the governance function, (Carpenter & Westphal, 2001). We shall proxy board skill as a ratio of board members with the qualification to board size. Hambrick and Mason, (2003) suggests that the age of directors can play on the value created by the enterprise. The post/ job tenure is an important criterion in analyzing the contribution of directors to the creation of value of the enterprise.

2.3 Research Gaps
Much of literature quoted relates to research work done on firms operating in developed Western countries. There is a conspicuous lack of literature relating to corporate governance on the African continent and especially within the Kenyan context. Information relating to governance of Kenyan financial institutions is scanty. Widely available information relating to corporate governance is made up of newspaper articles and annual reports and accounts published by public companies.

Those that have researched in the area in Kenya like Naibo, (2006) on CG structures and practices in insurance underwriting sector in Kenya, Ademba, (2006) on CG system in savings and credit co - operatives (SACCO’S) front office savings entities (FOSA), and Murithi, (2004) who studied the relationship between corporate governance mechanisms and performance of firms quoted on the NSE have not exhausted studies in corporate governance. These sources still have areas left out since corporate governance is practiced everywhere in all economy generating sectors, hence the available studies yet give little insight into specific governance processes and their effects on financial performance and shareholder value. Thus, it is necessary to investigate and report on the impact of corporate governance structures on performance of Kenyan commercial financial institutions which the researcher sought to study.

3. Methodology

3.1 Data Analysis and Presentation
Data collected for the study was compiled, sorted, edited, classified, coded and analyzed using a computerized data
analysis package known as SPSS 20.0. Descriptive statistics was used to depict the characteristics of the population. The mean and the variance were calculated using SPSS. This study used multivariate linear regressions where return on assets will be regressed against board size, non-executive directors and CEO duality of a firm from time 1+…….n. The model can be mathematically represented as follows:

$$\text{ROA}_i = \beta_0 + \beta_1 (\text{Log BZ})_i + \beta_2 \% (\text{NED})_i + \beta_3 \text{(DUALITY)}_i + \varepsilon$$

Where:
- ROA = Return on Asset of Firm i at time t
- BZ = Board size
- NED = Non-Executive Directors calculated as the proportion of non-executive directors to total number of directors
- DUALITY = CEO/Chair Duality taken as 1 if CEO is chairman; otherwise it is taken as 0
- $\varepsilon$ = Error Term
- $\beta_0$ = Intercept of the equation
- $\beta_1$ = Marginal effect of variable on debt to equity ratio

The model helped in determining if there is a relationship between board composition and financial performance of listed financial institutions in Kenya, collected data was subjected to the analysis tools SPSS version 20.0. The data was collected from the primary sources to analyze the data; the ANOVA test was used to determine the impact independent variables have on the dependent variable in a regression analysis. ANOVA provides a statistical test of whether or not the means of several groups are equal. ANOVAs are useful in comparing (testing) three or more means (groups or variables) for statistical significance.

### 3.2 Data Presentation

The data findings were presented using tables, charts, percentages, means and other central tendencies. Tables were used to summarize responses for further analysis and facilitate comparison. This generated quantitative reports through tabulations, percentages, and measures of central tendency. Data was presented using tables and graphs among other data presentation tools.

### 3.3 Design

The study used descriptive research design. Research design refers to the arrangement of conditions for collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in the procedure. Mathoko et al. (2007) describes a research design as a set of decision that make up the master plan specifying the methods and procedures for collecting and analyzing the needed information. The study was designed to provide information on potential relationships. Kothari, (2004) observed that research design is a blue print which facilitates the smooth sailing of the various research operations, thereby making research as efficient as possible hence yielding maximum information with minimal expenditure of effort, time and money. Descriptive analysis shows the mean, and standard deviation of the different variables of interest in this study. It also presents the minimum and maximum values of the variables which help in getting a picture about the maximum and minimum values a variable has achieved.

### 4. Data Analysis and Interpretation

#### 4.1 Response Rate

The study targeted 33 respondents but managed to obtain responses from 29 of them thus representing 88% response rate. This response rate is considered satisfactory to make conclusions for the study. Mugenda and Mugenda (2003) observed that a 50% response rate is adequate, 60% good and above, while 70% rated very good. This collaborates with Bailey (2000) assertion that a response rate of 50% is adequate, while a response rate greater than 70% is very good. This implies that based on this assertion, the response rate in this case of 88% is therefore very good.

The recorded high response rate can be attributed to the data collection procedures, where the researcher pre-notified the potential participants (Branch managers) of the intended survey, utilized a self-administered questionnaire where the respondents completed and these were picked shortly after and made follow up calls to clarify queries as well as prompt the respondents to fill the questionnaires.

#### 4.2 Board Size

Respondents were required to indicate the extent to which they agreed to various aspects on board size and their effect on performance. Items that were measured on a five point Likert-Type scale ranging from 1 being “Strongly Disagree” to 5 being “Strongly Agree”. Means of between 1.9250 - 4.4375 and standard deviations of between 0.03497- 0.95239 were registered. The study findings therefore revealed that majority of the respondents agreed that dialogue and meetings between the board and senior management is held outside formal board meetings for a great extent (4.4375). They further agreed that board members usually availed themselves to support management on areas of their expertise (4.0500). However, it was clear from the research findings that the board undertook self-evaluation and review of its performance to a small extent (1.9250).

#### 4.3 Board Composition

Respondents were further required to indicate the extent to which they agreed to various aspects on the composition of independent and executive directors and its effect on financial performance of commercial banks listed at the NSE. Items that were measured on a five point Likert-Type scale ranging from 1 being “Strongly Disagree” to 5 being “Strongly Agree”. Means of between 3.9250 - 4.7250 and standard deviations of between 0.03497- 0.95239 were registered. The study findings therefore revealed that majority of the respondents agreed that an expatriate CEO has superior knowledge and is likely to improve the performance of the firm to a great extent (4.7250). They further agreed that outside directors are better able to challenge and discipline the CEO and management to a great extent (4.5897). However, it was clear from the research findings that majority of the respondents were of the opinion...
that the selection of top management staff should not be a reserve of the board (2.9250).

4.4 CEO Duality

Respondents were further required to indicate the extent to which they agreed to various aspects on CEO duality and its effect on financial performance of commercial banks listed at the NSE. Items that were measured on a five point Likert-Type scale ranging from 1 being “Strongly Disagree” to 5 being “Strongly Agree”. Means of between 2.6176 - 3.9706 and standard deviations of between 0.03497 - 0.95239 were registered. The study findings therefore revealed that majority of the respondents agreed that the roles of chairman of the board and CEO should be clearly defined and not vested in the same person to reduce conflict of interest to a great extent (3.9706). They further agreed that the CEO tenure was fixed and that his salary was linked to performance though to a moderate extent (3.8676). However, it was clear from the research findings that majority of the respondents were of the opinion that the CEO duality did not promote effective business execution and planning (2.6176).

4.5 Financial Performance

Respondents were finally required to indicate the extent to which they agreed to various aspects on financial performance of commercial banks listed at the NSE. Items that were measured on a five point Likert-Type scale ranging from 1 being “Strongly Disagree” to 5 being “Strongly Agree”. Means of between 2.4559 - 3.8971 and standard deviations of between 0.54374 - 0.76968 were registered. The study findings therefore revealed that majority of the respondents agreed that checks and balances influenced the financial performance of commercial banks listed at the NSE to a great extent (3.8971). They further agreed that CEOs who are paid well perform better that their counterparts who are not paid well (3.8676). On the contrary, it was clear from the research findings that majority of the respondents were of the opinion that the size of the board of directors did not significantly influence the performance of commercial banks listed at NSE (2.4559).

5. Results and Discussions

5.1 Conclusions

The objective of this study was to evaluate the board composition factors affecting financial performance of commercial banks listed at the NSE. Based on previous studies, the aspects were expected to have a positive effect on financial performance. The study findings indicate that there is a significant positive relationship between the factors under study and financial performance of commercial banks listed at the NSE namely: board size, proportion of independent and non-executive directors and CEO duality and it indicated that they influenced financial performance of commercial banks listed at the NSE. The importance of corporate governance cannot be overemphasized since it enhances the organizational climate for the internal structures and performance of a company. Indeed, corporate governance brings to bear through external independent directors, new dimension for effective running of a corporate entity thereby enhancing a firm’s corporate entrepreneurship and competitiveness. The study examined the relationship between some measures of corporate governance such as board size, proportion of independent and non-executive directors, CEO duality and firm performance of listed financial institutions in Kenya. It was evident from the sample that most financial institutions in Kenya adopt the two-tier board structure where the positions of board chairman and CEO are occupied by different personalities thereby reducing agency cost. The findings of the study support the fact that a two-tier board structure enhances firm’s performance.

The separation of board chairman and chief executive officer positions minimizes the tension between managers and board members thus influencing positively the performance of financial institutions in Kenya. It is obvious therefore that board composition have an impact on the performance of firms in Kenya. Indeed within the governance structures the two-tier board structure is seen to be more effective compared to the one-tier system. However, for efficient performance of firms, the adoption of the two-tier board structure and maintaining smaller board sizes is critical.

5.2 Recommendations

Based on the findings of this study, there is a need to improve corporate governance of board composition, in terms of board size, proportion of independent and non-executive directors and CEO duality so as to improve the financial performance of listed financial institutions in Kenya as well as to protect the minority shareholders from being expropriated by dominant shareholders. Thus, there are some practical recommendations for possible reform on board composition in order to better improve the corporate governance in listed financial institutions in Kenya.

The study recommends that there should be separation of the positions of chairperson of the board and the CEO. Further the executive directors should have regular, frequent meetings without the CEO or other non-executive members of management present. In addition the board size and composition be considered since they affect the financial performance of the listed financial institutions in Kenya. The number of non-executive directors needs to be selected well since they affect financial performance of the listed financial institutions in Kenya. The board needs to comprise of well-educated people since they are actively involved in shaping listed financial institutions strategy.

Therefore, all board of directors must behave and act professionally, ethically and honestly. In this regard, they must take a long-term perspective as a high compliance standard can only be fostered over time. Further the study result indicates a negative correlation but significantly positive relationship between outside directors and firm financial performance. Clearly, the presence of outside independent directors alone will not solve the deficiencies exposed in corporate boardrooms and in extension, firm performance. What needs to be done is strengthen corporate boards beyond increasing the presence of outside
independent directors. The environment in which corporate boards operate needs to be changed.

5.3 Suggestions for Further Research

As the research objectives stated, this study sought to find out whether board composition has a relationship with financial performance of listed financial institutions with regards, to board size, proportion of independent and non-executive directors and CEO duality. However, the research did not exhaust everything and therefore suggests that independent variables like the age of the directors should also be tested to find out if it has significance to performance. A related study also could be carried out to find out board compositions aspects in non-listed financial institutions. Since the study covered only listed financial institutions in Kenya, further comparative studies could be appropriate between Kenya and other developing countries and even developed countries which act as a benchmarking analyzing the domestic companies' achievement in areas of board composition.

References


