Effect of Corporate Governance on Return on Equity in Nairobi Securities Exchange

Philip Kiprotich Bii

Abstract

In Kenya, over the last decade there has been a dramatic shift in the stance of corporate governance among academia and practitioners with the prescription and contribution of corporate governance on firm performance. But, the crucial questions are: Does Firm performance depends on corporate governance? And is there conclusive evidence that corporate governance has significantly improved the firm performance in Kenya? To answer these questions, this study examined the effects of corporate governance on return in equity among companies listed in Securities Exchange. The data set used in the analysis consists of yearly observations from 2001 to 2010. Both descriptive and inferential statistics were used. The study adopted causal study design and had a sample of 35 companies that continuously traded in Nairobi Securities Exchange. Secondary data was collected from audited annual financial statements. Both descriptive and inferential statistics were applied. The study found that board independence had a positive and significant relationship, Board size had a negative and insignificant relationship and the study further found a positive and significant relationship on CEO duality and return in equity. The study concluded that there is need to enhance board independence and customize board size to meet company specific needs.

Keywords: Corporate Governance, CEO duality, Board Size, Firm performance, Board Independence

I. Background of the Study

Effective corporate governance has been identified to be critical to all economic transactions especially in emerging and transition economies (Dharwardkar *et al.*, 2000). Likewise, corporate governance has assumed the center stage for enhanced corporate performance. According to Fohlin, (2008) corporate governance is the formal system of accountability, oversight and control aimed at removing the opportunity of employees to make unethical decisions. A more inclusive approach to cooperate governance has been defined, as one that creates governance systems that consider stakeholders welfare in tandem with cooperate needs and interest thus promoting the development of long-term relationships (Capital Markets Authority, 2002).

Therefore, at the core of corporate governance is the manner in which the power of a corporation is exercised in the running of the corporation's total portfolio of assets and resources with the objective of maintaining and increasing shareholder value and satisfaction of other stakeholders in the context of its corporate mission (Private Sector Initiative for Corporate Governance, 2009). Integrity is highly emphasized in good cooperate governance. Kenya has witnessed the collapse of many business enterprises and incurred tremendous costs due to weak corporate governance structures within the organizations. Despite the good laws that exist in theory, there is still a window for senior managers to misappropriate shareholders wealth. This came in the height of Nairobi Stock Exchange report of low investor confidence levels due to weak corporate governance structures that cost investors billions in losses as traders irregularly traded in clients' shares.

II. Literature Review

The issue of structure of the board of directors as a corporate governance mechanism has received considerable attention in recent years from academics, market participants, and regulators. It continues to receive attention because theory provides conflicting views as to the impact of board structure on the control and performance of firms, while at the same time the empirical evidence is inconclusive. To date, the relationship between board structure (as opposed to board processes) and company performance has been the most studied aspect among all board investigations (Bhagat and Black, 1999). In these studies, it is often assumed that a company's financial performance is mainly determined by board characteristics.

John and Senbet (1998) argue that a board is more independent if it has more non-executive directors. As to how this relates to firm performance, empirical results have been inconclusive. In one breath, it is asserted that executive (inside) directors are more familiar with a firm’s activities and, therefore, are in a better position to monitor top management. On the other hand, it is contended that non-executive directors may act as “professional referees” to ensure that competition among insiders stimulates actions consistent with shareholder value maximization (Fama, 2000). Cotter *et al.,*(1997) support this view underscoring the important role of outside directors in protecting shareholders’ interest through effective decision control.

Some authors have also found that there is no significant relationship between proportion of non-executive directors and return on equity (Bhagat and Black, 2002). It has been shown that the effectiveness of a board depends on the optimal mix of inside and outside directors (Baums, 1994). However, available theory is scanty on the determinants of optimal board composition (Weisbach, 2002). As for the relation between board independence and firm performance, if outside directors are independent and have professional ability, they could be more objective to make decisions and monitor managers.

A review of the empirical evidence on the impact of board size on performance shows mixed results. Dehaene*et al*. (2001) found that board size is positively related to company performance. However, the results of Haniffa*et al*., (2006) are inconclusive. Using a market return measure of performance, their results suggest that a large board is seen as less effective in monitoring performance, but when accounting returns are used, large boards seem to provide the firms with the diversity in contacts, experience and expertise needed to enhance performance. Yermack (1996) finds an inverse relationship between board size and firm value; in addition, financial ratios related to profitability and operating efficiency also appear to decline as board size grows. Finally, Connelly and Limpaphayom (2004) find that board size does not have any relation with firm performance.

Studies on this board tenure shows that, there is relationship between board tenure and firm value, which is reflected in M&A performance, financial reporting quality, corporate strategies and innovation, executive compensation, and CEO replacement. The results indicate that, for firms with short-tenured boards, the marginal effect of board learning dominates entrenchment effects, whereas for firms that have long-tenured boards, the opposite is true. For long-tenured boards, transaction costs could take the form of agency costs. For instance, board tenure choice may reflect the extent to which CEOs have influence over the board selection process. Further, firms with staggered boards can only replace a portion of board member each year, in which case the use of a staggered board itself introduces agency problems (Bebchuk and Cohen, 2005). For short-tenured boards, transaction costs could take the form of frictions in the labour market for directors.

Empirical analysis on studies on this area shows that board tenure matters as it is related to firm value and corporate policies above and beyond other commonly examined firm and board characteristics. The results highlight a time-varying trade-off between knowledge and entrenchment for board effectiveness, which should be taken into account when designing board structure (Bebchuk and Cohen, 2005).

The question of whether the chairman and CEO positions should be separated has been controversial. The advantages and the drawbacks of separating the chairman and CEO positions have been studied extensively for instance: Combining the positions of chairman and CEO confers greater power to the CEO, Brickley, *et al*. (1997) finds that in most companies, CEOs gain the title of chairman after having outperformed their peers. They argue that the chairman title serves as a reward to a new CEO who has demonstrated superior performance and represents an implicit vote of confidence by outside directors. In their view, requiring companies to separate the positions of CEO and chairman would deprive boards of an important tool to motivate and reward new CEOs.

On the other hand, other researchers believe that since the CEO and chairman is the same person, the company will: (i) achieve strong, unambiguous leadership; (ii) achieve internal efficiencies through unity of command; (iii) eliminate potential for conflict between CEO and board chair, and (iv) avoid confusion of having two public spokespersons addressing firm stakeholders (Davis, Schoorman and Donaldson, 1997). Consistent with these arguments, Cannella and Lubatkin (1998) report a positive link between a dual leadership structure and financial performance, Brickley, Coles, and Jarrell (1997) find a negative market reaction upon the announcement of splitting roles, while Dedman and Lin (2002) find no evidence of significant abnormal returns upon the announcement of splitting roles in the post-Cadbury period, and Simpson and Gleason (1999) report that companies that combine the roles the CEO and chairman are less likely to be financially distressed. A closer look at the empirical evidence reveals that the relationship between CEO-chairman duality and company performance is mixed and inconclusive.

However, other studies also suggest that too many directorships lower directorial effectiveness. Dedman and Lin (2002) reports that busy directors provide excessive compensation for their CEOs, which results in lower firm performance. Shivdasani and Yermack (1999) argued that that busy directors cater to the CEO, thus compromising their monitoring role. If this indeed is the case, busy directors may not fully represent shareholder interests. Dedman and Lin (2002) found that firms with busy directors exhibit lower book-to-market ratios as well as weaker operating profitability. They also present results that suggest that if directors are busy, the rate of CEO turnover (in response to performance) is significantly lower than otherwise. Finally, if busy directors take on another appointment, the firms where they already serve exhibit negative abnormal returns.

III. Statement of the Problem

The East Asian crisis and the recent corporate scandals around the world coupled with the seemingly poor performance of corporate Africa have given prominence and impetus to corporate governance on the continent. The extant literature on corporate governance, which is generally about large and listed firms in the US and UK, considers the relationship between corporate ownership structure, boards of directors composition and corporate performance. One of the few comprehensive studies done on the continent with regards to corporate governance was by Ayogu (2001). That study concentrated on regulations, legalities and governance practices across selected African countries. Again, Akinboade and Okeahalam (2003) followed up on the study by Ayogu (2001) by doing a cross-country study on selected African countries. The study by Akinboade and Okeahalam was essentially a review of corporate governance in Africa and highlighted issues and challenges. Sanda*et al*. (2005) looked at corporate governance and financial performance of firms in Nigeria. Furthermore, Kyereboah-Coleman *et al*. (2006) conducted a study on corporate governance and performance of listed firms in Ghana whiles Kyereboah-Coleman and Biekpe (2006) did a comparative study by looking at corporate governance and performance of listed and non-listed banks in Ghana thus, the point must be made that linking corporate governance and return on equityon listed firms in Kenya has never been attempted and this is our primary motivation for carrying out this study. In Kenya, corporate governance matters are driven by Companies Codes, Nairobi Stock Exchange regulations, Capital Market Authority, Central bank of Kenya, and the stock exchange listing requirements. However, though corporate governance in Kenya is off on a good start, insufficient empirical research limit the basis for comparison of the Kenya's corporate governance experiences and listed return on equity. This study seeks to fill the apparent gap in literature.

IV. Theoretical Framework

Jensen & Meckling (1976) proposed the agency theory so as to understand how ownership structure influences the behavior of an organization. In a situation where owners hire the series of managers to manage the affairs of a firm, principle agent relationship develops. According to Jensen and Meckling (1976), there are a few kinds of conflicts of interests, namely, conflict of interest between shareholders and mangers on one hand and conflict of interest between shareholders and debt holders on the other hand. The agency theory which posits that in the presence of information asymmetry the agent (in this case, the directors and managers) is likely to pursue interests that may hurt the principal, or shareholder (Fama, 2000). At first the theory was applied to the relationship between managers and equity holders with no explicit recognition of other parties interested in the well-being of the firm. Subsequent research efforts widened the scope to include not just the equity holders but all other stakeholders, including employees, creditors, government, etc. This is the first theory that underpinned this study.

The stakeholder theory, the second theory for this study, has been a subject of some investigation. Jensen (2001) provides a comprehensive review of corporate governance, with a particular focus on the stakeholder theory. The authors note the presence of many parties interested in the well-being of the firm and that these parties often have competing interests although equity holders might welcome investments in high yielding but risky projects, for example, such investments might jeopardize the interests of debt holders especially when the firm is teetering on the edge of bankruptcy. The review also emphasizes the role of non-market mechanisms, citing as an example the need to determine an optimal size of the board of directors especially in view of the tendency for board size to exhibit a negative correlation with firm performance. Other non-market mechanisms reviewed by Young (2003) include the need to design a committee structure in a way that allows the setting up of specialized committees with different membership on separate critical areas of operations of the firm. Such a structure would allow, for example, productivity-oriented committees and monitoring-oriented ones.

Hypotheses

The following null hypotheses were tested in the study:

$H0_1$: There is no significant effect of board independence on return on equity among listed companies in NSE.

H0$_2$: There is no significant effect of Board size on return on equity among listed companies in NSE.

H0$_3$: There is no significant effect of CEO duality on return on equity among listed companies in NSE.

H0$_4$: There is no significant effect of board tenure on return on equity among listed companies in NSE.

H0$_5$: There is no significant effect of multiple directorships on return on equity among listed companies in NSE.

V. Methodology

The study adopted a causal study design as it was found to be appropriate because according to Dedman and Lin (2002) it explores and establishes the causal relationship between the independent variables and the dependent variables. It also predicts accurately the effect of dependent variables on the dependent variable. To predict the causal relationship between dependent and independent variable, a panel data analysis was used. The population of this study comprised of a census of all firms listed in Nairobi Stock Exchange. The sample that was used was obtained from the firms listed over a period of ten years from 2001-2011. According to Nairobi Stock Exchange handbook (2012), there are 55 listed firms in Nairobi Stock Exchange; however the research conducted a survey of 35 firms as the sample. This is because the financial and insurance firms were omitted owing to repatriation through the use of Banking Act and Insurance Act. The study used secondary source of data. Secondary data was collected from annual reports and audited financial statement of the listed companies and fact books of Nairobi stock exchange. The study used quantitative data analysis approach.

VI. Results

Results in Table 1 show descriptive statistics of the study variables. The study reveals that the average board independence is 0.68 with a minimum of 0.5 and a maximum of 0.90. This implies that on average 68% of the board members are independent directors. It was found that the average board size was nine members with a maximum board of 17 directors. A close scrutiny of standard deviation revealed a wider deviation on board size among listed companies as accounted by three (2.56). The study found that on average 74% of the board of directors served in more than listed company board. The average return on assets was 17% with a minimum of 0.01 and a maximum of 1.14. This implies that there were some companies which earned more than 100% return from their asset base. In addition, the average board tenure was 6 years within the minimum term of service being three years and maximum term eight years. This implies that the board of directors is composed with experienced and qualified members which can be attained through continued service in an organization.

Results in Table 2 shows the regression results with return on equity as the dependent variable. According to the coefficient of determination 43.5% of the changes on return on equity can be explained by board independence, board size, CEO duality, board tenure and multiple directorships. Since the F statistics of 8.35 had a p value of 0.00, it implies there was a significant relationship between return on equity and board characteristics and one the slope coefficient was non-zero.

There was a positive but insignificant relationship between board independence and return on assets (Coefficient β=1.029, P value =0.851). Since the P value >0.05, there was no enough evidence to reject the null hypothesis which stated board independence had no significance effect on firm performance. Thus the findings support the null hypothesis.

Table 1: Descriptive Statistics

	Minimum	Maximum	Mean	Std. Deviation
Board Independence	0.5	0.9	0.68	0.12
Board size	5	17	8.68	2.56
CEO_Duality	0	1		
Board Tenure	3	8	5.77	1.69
Multiple Directorship	0	1	0.74	0.44
ROA	0.01	1.14	0.17	0.20
ROE	0.01	6.58	1.96	1.68

The second hypothesis stated that board size had no significant effect on return on equity. Results supported the prediction since p> 0.05 thus we could not reject the null hypothesis (β= -0.005, P value =0.958), though there was a negative relationship between board size and firm performance.

Hypothesis three stated that board tenure had no significant effect on return on equity. Results of the study revealed a negative though insignificant relationship between board tenure and return on equity (β=-0.392, P value =0.355). This implies that board tenure had no significant effect on return on equity.

The fourth hypothesis stated that CEO duality had no significant effect on firm performance. Results of the study found that there was a positive significant relationship between CEO duality and return on equity, (β=-0.781, P value =0.34). Thus there was no enough evidence to warrant rejection of the null hypothesis and it can be concluded that CEO duality had no effect on return on equity.

The fifth hypothesis stated that multiple directorships had no significant effect on return on equity. Results of the study though there was a negative relationship they supported the null hypothesis since they were not significant, (β=-0.358, P value = 0.537). This implies that multiple directorships have no effect on return on equity among listed companies in Kenya

Table 2 Regression Model Dependent Variable ROE

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	4.342	5.704		0.761	0.454
Board Independence	1.029	5.406	0.073	0.19	0.851
Board size	-0.005	0.102	-0.008	-0.053	0.958
CEO Duality	-0.781	0.802	-0.226	-0.973	0.34
Board Tenure	-0.392	0.416	-0.394	-0.941	0.355
Multiple Directorship	-0.358	0.572	-0.095	-0.626	0.537
R	0.66				
R Square	0.435				
Adjusted R Square	0.322				
F	8.35				0.000

VII. Conclusion

Based on the current findings the study attained the main objective of examining the effect of corporate governance on return on equity in Nairobi Securities Exchange. Since there was a positive and significant relationship between return on equity and independent directors there is need to increase the number of independent directors as such to benefit fully from their heterogeneous skills composition. Although, there was an inverse and significant relationship between board size and return on equity there is need for listed companies to match their board size with companies specific needs. The inverse relationship can be associated with agency cost which may increase as the board size increases.

Although, there was a positive and significant relationship between CEO duality and return on equity there is need to evaluate the relevant agency costs which may increase when an organization is being run by one person serving multiple roles. Listed companies ought to be encouraged to refrain from this practice which may hinder the ultimate power separation as stipulated in agency theory. There is need to ensure there is consistent board rotation as such to increase the benefits associated with board leadership.

VIII. Recommendations

There is need to improve on the board independence so as to foster increase in organization performance. This will minimize the agency costs associated with board management. The listed companies should intensify in the use of independent directors as such to benefit from their skills networking and expatriate which they can provide to listed companies by the virtue of positions which they currently hold.

There is need to match the corporation board size with the company specific characteristics as such to eliminate the chances of duplication of responsibilities and over exploitation of the available skills as provided by the board members.

There is need for separation of responsibilities between the board chairman and the CEO responsibilities as such to minimize the agency costs and consequently improve on organization profitability. Even though, there was a significant positive relationship a cost benefit analysis should be carried out to ensure that there is full benefit achieved from the corporate governance.

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Author

Philip Kiprotich Bii
Lecturer, School of Business and Economics, Garissa University College, Garissa, Kenya, pbiisoimo@gmail.com