

Effect of Board Characteristics on Financial Performance of Listed Firms at Nairobi Securities Exchange, Kenya

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Abstract

Financial performance of listed firms at Nairobi Securities Exchange are expected to be financially stable in order to build investors' confidence and contribute to economic growth. The poor performance of some firms at NSE resulted to some firms being suspended from trading at the NSE. A number of firms listed at the Nairobi Securities Exchange reported losses due to liquidity and corporate governance challenges. The general purpose of this study was to determine the effect of board characteristics on financial performance of listed firms in Kenya. The study specific objectives were; to determine the effect of Board activity, Board independence, and Board financial expertise on financial performance of listed firms in Kenya. The study was guided by Agency theory and Resource dependence theory. Explanatory research design was adopted and all listed firms at NSE were targeted from 2018 to 2022. Panel data analysis was conducted using Secondary data collected from audited financial reports to test the research hypothesis. Both descriptive and inferential statistics were used in data analysis. Descriptive involved standard deviation, mean, minimum and maximum while inferential statistics involved use of correlation and regression Analysis. The study results showed that firm size ($\beta = 0.4573$; $P = 0.000$), firm age ($\beta = 9.0449$; $P = 0.000$), board activity ($\beta = 0.0853$; $P = 0.004$), and board financial expertise ($\beta = 0.0672$; $P = 0.002$) had a positive and statistically significant effect on financial performance, but board independence had a negative and statistically insignificant effect on financial performance ($\beta = -0.0252$; $P = 0.081$). The study findings inform policy regulators, investors, managers and further researchers.

Keywords: Board, characteristics, finance, performance, Nairobi Securities Exchange

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Introduction

A company's ability to generate revenue from its primary mode of business and use its assets is measured subjectively by its financial performance (Okoye, Amahalu & Okoye). Financial performance is also used as a broad indicator of a company's overall financial health over a specific time period. It can be used to aggregate compare industries or sectors or to compare similar companies within the same industry (Ndolo, 2015). For businesses, increased and better financial performance is key (Pandey, 2009). It helps a company to easily compete in the market, hold onto and even increase market share and give investors consistent returns in the form of regular dividends and capital gains. Strong financial results give shareholders a return on their investment. Consequently, this stimulates more investment and results in economic expansion. However, subpar financial performance can result in crises and the collapse of listed companies, which can have a detrimental effect on economic expansion.

Around the world, listed companies are having trouble making money. Examples of this include the collapses of Enron, HIH, WorldCom, OneTel, and most recently, Wirecard, which was caused by problems with corporate governance and bad financial results. Due to subpar performance, investors suffered significant losses when Kenya National Bank, Mumias Sugar, Kenya Airways, ARM Cement PLC, and Deacons (E.A.) were suspended from the NSE (Kinyua, Gakure, Gekara, & Orwa, 2015). Due to the underwhelming financial performance of listed companies and markets in general, researchers have focused their attention on identifying the factors that influence listed company financial performance (Jesuka & Peixoto, 2022). The relevance of corporate governance issues to a company's financial performance has drawn the attention of numerous academics.

A US study by Alm and Winberg (2016) on the Gender and Ethnic Diversity of US Boards and Board Committees and Firm Financial Performance found no

evidence of a significant correlation between the financial performance of a sample of large US corporations and the gender or ethnic diversity of the board or significant board committees. Board size, directors' equity, and firm size significantly impact Nigerian banks' financial performance, according to an African study by Okoye, Olokoyo, Okoh, Ezeji and Uzohue, (2020) on corporate governance and financial performance on Nigerian banks.

Juster (2022) study on the relationship between listed firms' financial performance and corporate governance in Kenya found a direct correlation between financial performance and corporate governance components, including gender diversity, independence, experience, ownership, and size of the board. The financial performance of firms has been associated with corporate governance and an effective board. This study aims to examine the impact of three factors on the financial performance of Kenyan listed firms: board activity, board independence, and board financial expertise. They are essential to proper operation because they impact how well businesses perform. The poor financial performance of Kenyan listed companies in recent years has been ascribed to lax corporate governance (Puni & Anlesinya, 2020). Listed companies have failed as a result of limitations in the qualities of their boards. The collapse of Kenya's largest retailer, Uchumi Supermarket, was one of the most prominent financial catastrophes. Corporate failures continue to occur despite the Capital Market Authority's efforts to revolutionize corporate governance practices. Examples of these include the failures of Kenya Airways, Athi River Mining, Deacons EA, Mumias Sugar, Imperial Bank, and National Bank of Kenya, all of which have had their trading at the NSE suspended. The failures have

shown that most company boards do not promote the delivery of shareholder value; rather, some boards either perform poorly in their oversight capacities or directly contribute to the conflict of interest that arises between shareholders and their representatives (Chancharat & Chancharat, 2019). As a result of the majority of studies' inconsistent and ambiguous findings, this one aims to closely examine specific board traits and their impact on the NSE-listed companies' financial performance (Benton & You, 2019). The general objective of this study was to determine the effect of board characteristics on financial performance of listed firms at NSE Kenya and the specific objectives were to; determine the effect of board activity, board independence, and board financial expertise on financial performance of listed firms at NSE Kenya.

Theoretical Review

Agency Theory

Jensen and Meckling developed agency theory in 1976. According to their definition, an agency relationship is a type of agreement in which the managers of a company, acting as the owners' agent, are chosen by the owners as their principal to oversee the business. This theory states that principals hire agents to carry out specific tasks on their behalf (Jensen & Meckling, 1976). Additionally, according to this theory, managers or agents may choose to disregard the principal's interests in order to further their own, which could lead to agency costs.

In this study, the principal in this case, the shareholder sees maximizing the company's value as a top priority and assigns management to the agent, the manager, whose goals may conflict with those of the principal because the manager is presumed to be rational,

individualistic, and risk-averse. Despite the desire of a company's investors to see a return on their investment, managers typically have other interests, such as job satisfaction and other rewards or the status and power that come with running a large business. Due to their superior access to inside knowledge and the scattered and numerous shareholders' comparatively weak position, managers are likely to have the upper hand (Fama and Jensen, 1983). The fundamental idea of agency theory is that managers may behave in their own self-interest rather than the best interests of the shareholders.

Improved oversight and control systems that guarantee managers look out for shareholders' interests rather than just their own are necessary to lessen agency problems. According to Fama and Jensen (1983), To lessen the agency problem that arises from the separation of ownership and control, organizations need to have a structure in place that enables them to discern between the authority of decision management and decision control. This would minimize agency expenses and guarantee the optimization of shareholders' wealth through efficient regulation of management's authority and self-serving choices.

In order to prevent managers from taking advantage of shareholders and to effectively monitor them when they attempt to advance their own interests at the expense of the company's profitability, boards of directors are regarded as crucial tools. Scholars propose alternative governance mechanisms to address agency problems, given the challenges associated with using contracts to mitigate agency problems. One such governance mechanism that allows owners to directly influence managers to safeguard their interests is ownership concentration. Large shareholder activism,

which serves as an external governance monitoring role, is also supported by agency theory (Benton et al., 2019). According to Belinfanti et al. (2008), agents who do not act in the best interests of shareholders are mitigated by stricter oversight from more concentrated shareholder blocks.

Resource Dependence Theory

This theory was proposed by Pfeffer and Salancik in 1978. It describes how the environment of an organization affects its connections. It is based on the notion that an organization, such as a business enterprise, needs to conduct transactions with other actors and organizations in its surroundings in order to gain resources. According to this theory, different external resources can influence how an organization behaves, and different elements of corporate governance mechanisms can assist in facilitating the company's connection with external resources in order to enhance the performance of the organization (Pfeffer, 1973). For example, the extensive experience and knowledge of a board of directors, particularly its independent members, can improve a company's success (Foyel, 2021).

In addition, having these directors on the board can strengthen the company's network of contacts in the business world and improve its reputation. Lastly, the directors may personally know powerful individuals who can be contacted to secure critical information from other organizations and political elites. Garsia (2020) asserts that external resources and corporate performance are positively correlated. The resource dependency theory states that the board of directors is essential in ensuring that the company has access to the resources it requires. According to this theory, the board of directors' primary duty is to

provide resources for the business. Directors are thought to be a great addition to the business. Therefore, when directors are seen as resource providers, several features of director diversity such as gender, experience, qualifications, and subject matter expertise clearly take on greater significance. The agency theory concentrated on the board of directors' duty of monitoring and control, while the resource dependency theory focused on the advisory and counseling role of directors to a corporate management.

According to resource dependence theory, an organization needs to interact with the outside world in order to function because it has limited resources (Pfeffer and Salancik, 2003). According to the theory, the board of directors serves as the foundation for the organization's external environment because it has access to vital external resources like technology, pertinent information, and human and financial capital. These resources have the potential to boost the legitimacy of the company and enhance the efficacy of its strategic decision-making (Garsia, 2020).

The theory asserts that, a board that is independent, has women, skilled, and foreign directors on it, and has connections to the company's external environment is preferable (Ujunwa, 2021).

Methodology

The study used explanatory research design. This research design is suitable as the study intends to explain the cause effect relationship between the research variables. This study focused on listed firms at NSE which comprised of 61 firms. Panel data for 5 years starting 2018 to 2022 was analyzed. From the target population of 61 listed firms, firms included were those in operation from 2018 to 2022 and consistent for five years. Those with inconsistent, inadequate, merged, delisted or suspended due to poor performance and those that were listed later than year 2018 were excluded. The final sample after the exclusion criterion was 43 firms for firm years giving 215 firm year observations. Data was secondary in nature retrieved from annual published financial reports of firms listed at NSE.

Table 1: Measurement of variables

Variables	Measurement of Variables	Source
Dependent variable		
Financial performance	Net income over Total Assets	Oguda (2015)
Independent variables		
Board independence	Percentage of independent directors on the board	Wang & Young, 2010; Nguyen et al. (2014)
Board activity	Number of board meetings in a year	Mandala (2019)
Board Financial expertise	Percentage of financial experts on board	(Minton & Williamson, 2014)
Size	Log of total assets	Bwauma (2021), Li and Chen (2018)
Age	Difference between observation year and establishment year	(Oyekunkle Oyewobi et al.,2013);Doaei et al.,2014)

A panel data analysis was conducted using secondary data collected from the yearly audited financial reports of all listed firms at the Nairobi Security Exchange. Panel data was analyzed using descriptive and inferential statistics. Descriptive statistics involved standard deviation, mean, frequency, minimum and maximum. Inferential statistics involved use of Pearson correlation and regression analysis.

Results

The table 2 presents descriptive statistics for various variables related in the study on board characteristics, and financial performance. According to the table results financial performance of firms had a mean of approximately 0.0498, indicates that on average, the firms experience slightly positive financial outcomes. However, there is variability, as reflected by the standard deviation of about 0.143. The firm size variable had an average log-transformed value of approximately 10.081, suggests that the firms are generally of substantial size. The standard deviation of 0.928 indicates moderate variability in firm size among the 215

observations. The firm age had a mean of approximately 70.51 years, indicates that the firms are generally well established, with an average age reflecting long standing operations. The standard deviation of 31.25 years reveals significant variability in the ages of the firms. The board activity had a mean of approximately 5.35 meetings per year, indicates that, on average, the boards of the firms in the sample meet about five times annually. The standard deviation of 3.46 suggests considerable variability in the frequency of board meetings among the firms. The board independence had a mean of approximately 0.506, indicates that just over half of the board members in the firms are independent directors on average. The standard deviation of 0.185 signifies a moderate level of variability in board independence among the firms. The board financial expertise had a mean of 0.46, indicates that on average, 46% of the board members in the firms possess financial expertise. The standard deviation of 0.17 suggests a moderate level of variation in the financial expertise of board members among the firms.

Table 2: Descriptive statistics

Variable	N	Obs	Mean	Std. Dev.
FP	215	.049767	.1429473	-.694
FSIZE	215	10.08091	.927925	8.298351
FAGE	215	70.51163	31.2492	10
BACT	215	5.353488	3.463518	3
BIND	215	.5056074	.1846881	.0769231
BFE	215	0.46	0.17	0.09

FP: financial performance, FSIZE: firm size, FAGE: firm age BACT: board activity, BIND: board independence, and BFE: board financial expertise.

Source, (Research data, 2024)

The table 3 presents the Pearson's correlation matrix indicating the direction and strength of the association between two continuous variables. First, the

Pearson's correlation matrix indicates a positive correlation between firm size and financial performance ($r=0.4724^*$). This suggests a moderate statistically

significant and positive linear relationship between the two variables, implying that larger firms tend to have better financial performance. Second, firm age and financial performance reveals a statistically significant and positive relationship, with a Pearson correlation coefficient of $r=0.3481^*$. This coefficient suggests a weak positive linear association between the two variables, indicating that as firm age increases, there is a tendency for financial performance to improve slightly. Moving on to the third point, the analysis of the correlation between board activity and financial performance indicates a positive relationship, with a Pearson correlation coefficient of $r=0.6611^*$. This coefficient suggests a strong statistically significant and positive linear association between the two variables, implying that firms with more active boards tend to exhibit higher

financial performance. On the other hand, the fourth point highlights that board independence and financial performance reveals a statistically significant and negative relationship, with a Pearson correlation coefficient of $r=-0.4563^*$. This coefficient suggests a moderate negative linear association between the two variables, indicating that firms with higher levels of board independence tend to have lower financial performance. Lastly, board financial expertise and financial performance unveils a statistically significant and positive relationship, with a Pearson correlation coefficient of $r=0.4128^*$. This coefficient implies a moderate positive linear association between the two variables, indicating that firms with boards possessing greater financial expertise tend to exhibit higher financial performance.

Table 3: Pearson's Correlation Matrix

	FP	FSIZE	FAGE	BACT	BIND	BFE
FP	1.0000					
FSIZE	0.4724*	1.0000				
FAGE	0.3481*	-0.0349	1.0000			
BACT	0.6611*	0.3806*	0.2026*	1.0000		
BIND	-0.4563*	-0.3287*	-0.0932	-0.2980*	1.0000	
BFE	0.4128*	0.2332*	0.0377	0.2497*	-0.0864	1.0000

FP: financial performance, FSIZE: firm size, FAGE: firm age, BACT: board activity, BIND: board independence, and BFE: board financial expertise.

Source, (Research data, 2024)

The table 4 presents the regression results for the direct variables and financial performance. The results imply that firm size had a positive and statistically significant ($\beta= 0.4573$; $P=0.000$) effect on financial performance. This indicates that a unit change in firm size increases financial performance by 0.457. Firm age had a positive and statistically significant ($\beta= 9.0449$; $P=0.000$) effect on financial performance.

This indicates that a unit change in firm age increases financial performance by 9.045. Board activity had a positive and statistically significant ($\beta= 0.0853$; $P=0.004$) effect on financial performance. This indicates that a unit change in board activity increases financial performance by 0.085. Board independence had a negative and statistically insignificant ($\beta= -0.0252$; $P=0.081$) effect on financial performance. This indicates that a unit

change in board independence decreases financial performance by 0.025. Board financial expertise had a positive and statistically significant ($\beta = 0.0672$;

$P=0.002$) effect on financial performance. This indicates that a unit change in board financial expertise increases financial performance by 0.067.

Table 4: Regression results

Variable	coefficients	p-values
Constant	-10.0251	0.000
Firm Size	0.4573	0.000
Firm Age	9.0449	0.000
Board Activity	0.0853	0.004
Board Independence	-0.0252	0.081
Board Financial Expertise	0.0672	0.002

Dependent Variable: Financial Performance

Discussions

Board activity showed a positive and statistically significant effect on financial performance ($\beta = 0.0853$; $P=0.004$). This indicates that the frequency of board meetings significantly impacts financial outcomes, possibly because the quantity of meetings is more critical. This was consistent with the findings of (Abang'a, Tauringana, Wang'ombe, & Achiro, 2022) that board meetings significantly and positively associated with financial performance of state-owned enterprises in Kenya and (Prashar & Gupta, 2021) that there was a positive relationship between the frequency of board meetings and ROE among Nepalese state-owned firms. The finding was also consistent with the findings by (Al-Matari, 2020) that found a positive and significant relationship between frequency of board meetings and Tobin's Q, but inconsistent with (Bhatt & Bhattacharya, 2015) findings that reported negative but insignificant relationship between board meetings and Tobin's Q.

The negative and statistically insignificant effect of board independence on financial performance ($\beta = -0.0252$; $P=0.081$) suggests that higher levels of board independence may be associated with lower financial performance. This could be

due to challenges in decision-making dynamics or increased monitoring costs. This was consistent with the study in Bangladesh by (Sobhan, 2021) on Board Characteristics and Firm Performance: the evidence from the Listed Non-Banking Financial Institutions of Bangladesh indicated that proportion of independent directors, do not have any significant impact on firm performance. Also, in Turkey, a study by (Abdulsamad, Yusoff, & Lasyoud, 2018) on board characteristics and firm performance found insignificant relationship between independent directors and firm performance. This result was also consistent with the findings of (Arora & Sharma, 2016) that there was negative relationships between independent directors and firms' financial performance. Study in Egypt by (Wahba, 2015), on the joint effect of board characteristics on financial performance, demonstrated that increasing the proportion of non-executive members to the total number of directors has a negative impact on firm financial performance.

Board financial expertise had a positive and statistically significant effect on financial performance ($\beta = 0.0672$; $P=0.002$). This finding indicate that

financial expertise is valuable. This finding was consistent with the findings by (Nkundabanyanga, 2016) that board accounting/financial expertise are positively associated with firm performance (expressed by ROA) and (Adams & Jiang, 2020) that financial expertise has the most significant financial performance impact. The result was further consistent with (Osemene & Fakile, 2018) findings that financial expertise was identified as possibly having effects on financial performance, (Gafoor, Mariappan, & Thiyagarajan, 2018) that found significant relationship between larger number of financial experts on the board and bank performance.

Conclusions and Recommendation

The findings showed the significance of firm size and age in influencing financial performance among firms listed on the Nairobi Securities Exchange. Larger firms and those with greater age were associated with higher financial performance, indicating their pivotal role in shaping financial outcomes. These results emphasize the importance of considering firm size and age as critical factors when assessing and predicting financial performance in the context of the Nairobi Securities Exchange. The board activity revealed that more active boards might lead to better financial results, the frequency of board meetings did show a significant influence on financial performance. The board independence unveiled a notable finding regarding its impact on financial performance among firms listed on the Nairobi Securities Exchange. Higher levels of board independence were associated with lower financial performance. This suggests that while board independence is often considered a hallmark of good

governance, its negative impact on financial performance indicates complexities in its relationship with firm performance, possibly due to conflicts or slower decision-making processes. The board financial expertise yielded finding regarding its impact on financial performance among firms listed on the Nairobi Securities Exchange. An increase in board financial expertise was associated with an increase in financial performance. This suggests that board skillsets increases financial performance, highlighting the importance of financial expertise in increasing performance.

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