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Influence of Corporate Governance Practices on Financial Distress of Firms Listed at the Nairobi Securities Exchange, Kenya

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Abstract

Corporate governance has gained global prominence owing to increasing collapse of major corporations across the world as a result of their financial distress which is a major cause of shareholders' wealth loss, diminishing confidence of investors in the economy and socioeconomic problems. This study sought to establish the influence of corporate governance practices on financial distress of companies listed at the Nairobi Securities Exchange in Kenya for a ten-year period from 2008 to 2017. The effects of three components of corporate governance practices namely board composition (measured by boards independence and diversity), board structure (whose constructs were boards size, tenure and activity) and ownership structure (measured by block, managerial and institutional ownerships) on financial distress of the listed firms was assessed. The study utilized an ex-post facto explanatory research design and analyzed secondary data derived from the audited financial statements and annual reports of the companies. Panel regression analysis techniques and descriptive statistics were used to analyze the relevant data. The study established that board independence had a significant inverse influence on the firms' financial distress while board diversity had a significant direct influence on financial distress. Further, the study established that board activity had a significant direct influence on the firms' financial distress while board tenure had an insignificant influence on financial distress and board size had significant negative effect on financial distress the firms' financial distress. Finally, the panel regression results reveal that the firms' ownership structures namely institutional ownership, block ownership and managerial ownership had a significant negative influence on the financial distress of the firms. The findings of the study provide significant managerial recommendations and valuable insights for further study on the concept of corporate governance.

Keywords: Financial Distress, Corporate Governance, Ownership Structure, Board Structure and Board Composition



1. Introduction

Corporate governance is the process and structure used to direct and manage businesses and affairs of a firm towards enhancing prosperity and corporate accountability with the ultimate objective of realizing the long-term value of shareholders while taking into account the interest of other stakeholders (Capital Market Authority, 2016). It includes a system of structuring, operating and controlling a corporation with a view to achieving long term strategic goals so as to satisfy a wide range of stakeholders and also complying with the legal and regulatory requirements as well as meeting environmental and immediate community needs (Bairathi, 2009). Rezart (2016) perceives corporate governance as a set of rule-based processes of laws, accountability and policies that define the relationship between shareholders and corporate managers. The main concern in the corporate governance framework is the accountability of key persons in corporations (Abdullah et al., 2016).

On the other hand, financial distress refers to a situation where the company experiences failure and in which the rate of return is less than the cost of capital (Lakshan & Wijekoon, 2012). It occurs when a company's cash flows are not sufficient to repay the principal and interest of debt and ensues when the firm's equity becomes negative (Lee & Yeh, 2004). Agrawal (2015) describes financial distress as the inability of an entity to meet its financial obligations as and when they fall due or do so with difficulties. Ching-Chun *et al.* (2017) argue that financial distress is not limited to a firm's ability to repay its debt obligations but a sequence of other events that may occur before a firm default. Such events reduce performance and eventually eat into equity of a firm to the extent that it's not able to service debt obligations.

The economic cost of financial distress is significant and impacts adversely on the shareholders, suppliers, investors, creditors, management and the work force (Montserrat *et al.*, 2016). The major stakeholders in a company tend to lose most of their investment. Creditors may receive partial or no repayment of their initial loans depending on whether it was secured or unsecured, the government collects less corporate and personal taxes and social problems may abound (Hafiz & Desi, 2017). Many firms in financial distress downsize their work force, resulting to households losing income vital for livelihood. In some instances, the government spends millions of public funds in bailouts. Stock prices of distressed firms decline leading to a reduction in the wealth of shareholders. Firms in the financial turmoil may not pay dividends and may not honor their debt obligations as and when they fall due. According to Abdullah and Valentine (2009), when companies go through financial distress, they have a contagion effect and could negatively affect economic stability of other sectors.

1.1 The Status of Financial Distress Facing Firms in Kenya

Financial distress is a global problem that has afflicted both developed and developing economies (Baimwera & Muriuki, 2014). Over the past two decades, the world



economy has witnessed numerous cases of corporate failures among some of the globally reputed firms such as the Pacific Gas and Electric Ltd in 2001, Delta Airlines in 2005, Parmalat in 2003, Enron in 2001, WorldCom Ltd in 2002; among others. These corporate and systemic failures have generated a lot of interest on the concept of corporate governance (Martin, 2017). According to Alexandru and Iulia (2011), most corporations in the world have collapsed because of poor governance practices such as inflated earnings, expenses booked as capital expenditure, looting by management and improper share deals.

Kenya has also witnessed a number of corporate collapses. These include Lonhro East Africa Ltd in 2009, Uchumi Supermarkets Ltd in 2006, Kenya Planters Cooperative Union in 2006, East African Packaging in 2003 and Dunlop Kenya in 2001 (Capital Markets Authority, 2000-2017). Further, corporations in Kenya continue to experience financial distress as verified by the delisting of firms and the placement of some under statutory management. A case in point is Kenya Airways Plc, which after thirteen years of steady profitability, has reported billions of losses since 2013. The decline in the Kenya Airways Plc performance followed a series of questionable corporate governance practices such as the fuel hedging scandal. In addition, Cooper Motors Corporation Plc, whose shares had been suspended from trading at the Nairobi Securities Exchange in 2011 was eventually delisted in 2015 due to continued poor performance arising from non-adherence to the best corporate governance practices. Other companies such as Mumias Sugar Company Ltd, Uchumi Supermarket Ltd and National Bank Ltd continue to be plagued by operational and cash flow challenges (Maina et al., 2017). Most recently in 2018, the Athi River Mining Company and Deacons East Africa shares were suspended from trading by the regulator when the companies were put into administration owing to their status of financial distress (Capital Markets Authority, 2018).

1.2 Objective of the Study

This study sought to establish the influence of corporate governance practices on financial distress of companies listed at the Nairobi Securities Exchange for a ten-year period from 2008 to 2017. In particular, the study analyzed the influence of board structure, board composition and ownership structure on financial distress of firms listed at the Nairobi Securities Exchange.

2. Theoretical Framework

Three theoretical perspectives expounded in the following sections namely the agency, resource dependency and stewardship theories were considered useful in explaining the relationship between corporate governance practices and the likelihood of financial distress in organizations and informed the study.

2.1 The Agency Theory

The agency theory posits that the separation of ownership and control in corporations result in agency costs (Eisenhardt, 1989). The theory, formulated by Jensen and



[Meckling \(1976\)](#), perceives the firm as a set of contracts between different agents, who have self-interest and at the same time depend on each other in order to perform better and survive in the market. According to [Felix \(2017\)](#), theoretically and practically, perfect alignment of interest between the parties is impossible and therefore each party will always try to maximize his own interest to the disadvantage of the other party. The theory hypothesizes that managers create agency costs by not creating value for shareholders. Though managers are assumed to be rational, the theory argues that they can't be trusted to always act in the best interests of shareholders and could possibly draw private benefits. It therefore proposes that managers must be controlled to check on their deviant behaviors. The principal can decide to control divergences from his interest by incurring agency costs which are the sum of monitoring, bonding costs and the residual loss ([Zogning, 2017](#)).

To increase the effectiveness of the board in their supervision and monitoring of management, the agency theory advocates for high board independence, more diverse boards and boards with large number of directors ([Carter et al., 2003](#); [Mahadeo et al., 2012](#)). Independent boards, large board size and diversified boards may diligently watch over management and align their interest with those of the firm. Besides, board meetings and board tenure determine the quality of board monitoring and effectiveness and the theory recommends for increased board activities and board tenure ([Vefees, 1999](#)). Further, proponents of the theory suggest that the ownership structure plays a significant role in reducing the agency costs. Block owners and institutional investors provide a role of active monitors of management and help in reducing agency costs, thereby aligning the interest of owners and management ([Shleifer & Vishny, 1997](#); [La Porta et al., 2000](#); [Claessens et al., 2002](#)). Nevertheless, agency theorists posit that board activity does not reduce agency costs as they are reactive and the agenda is often set by the chief executive officer, which reduces their monitoring effectiveness.

2.2 The Stewardship Theory

Emerging from the psychology and sociology literature ([Donaldson & Davis, 1991](#)), the stewardship theory describes a convergent relationship between the shareholders (and their proxies such as the board of directors) and management. The theory, developed by [Freeman \(1984\)](#), takes the view that there is no conflict of interest between corporate owners and corporate managers. It suggests that managers will act in good faith, since they realize that they are active players. Thus, managers are not opportunistic agents, but good stewards, who will act in the best interest of the owners. According to [Sundaramuthy and Lewis \(2003\)](#), the theory is based on a model of man where a steward perceives greater utility in cooperative, pro-organizational behavior than in self-serving behavior. It assumes a strong relationship between organizational success and a principal's satisfaction and hence, a steward overcomes the trade-off by believing that working towards organizational collective ends meet personal needs ([Stout, 2003](#)).



The Stewardship theory advocates for inside directors because of the reason that they understand the business of the firm better than outside directors and thus the interest of the owners is best safeguarded by board dominated by inside directors. Additionally, the steward theory is based on high levels of managerial trust and therefore advocates for high levels of managerial shareholding (Ntim et al., 2012). Since managers are naturally trustworthy there will be no major agency costs (Donaldson & Davis, 1994) and therefore increasing their shareholding will align their interest of the principal and agent (Donker et al., 2009).

2.3 Resource Dependency Theory

The resource dependency theory originates from the open system theory and was advanced by Pfeffer (1972). The theory postulates that organizations have a varying degree of dependence on the environment, especially for the resources they need to operate. It views the board of directors as the means to manage external dependency (Pfeffer & Salancik, 1978), reduce external uncertainty, (Pfeffer, 1972) and reduce the transactional costs associated with environmental interdependency (William, 1988). According to Pfeffer (1972) ownership structure and board size are not random or interdependent factors but are rational organizational responses to the conditions of the environment. The theory concentrates on the external role and linkages of each board member who come from diverse independent organizations and is supposed to play a critical role in securing essential resources for a firm (Abdullah & Valentine, 2009).

The Resource Dependency theory advances that the acquisition of external resources is vital for strategic management of any organization. Its proponents strongly emphasize the role of the board of directors in providing the much-needed resources relevant for the survival of the firm (Tricker, 2012). Like the agency theory, the resource dependency theory support boards dominated by independent directors, large sized boards and highly diversified boards. The theory perceives that these mechanisms as critical in linking the firm with the external environment, which brings in resources, board knowledge and expertise and this minimizes the uncertainty of the external environment.

3. Methodology

The study utilized an ex-post facto research design and targeted all the 65 firms listed at the Nairobi Securities Exchange from 2008 to 2017. Secondary panel data was obtained. However, firms with incomplete information were eliminated in the final analysis, leaving a sample of 41 firms.

Corporate governance practices were operationalized by board composition (whose indicators are board independence and diversity), board structure (measured by board size, board activity and board tenure) and ownership structure that was represented by the proportion of block, institutional and managerial shareholding. The study



controlled for the effects of firm size that was measured by the natural logarithm of total assets (Amato & Burson, 2007; Gonenc, 2005; Serrarsquerio & Nunes, 2008; Montserrat *et al.*, 2016). The study used the reciprocal of the distance to default to measure financial distress. As proposed by Laeven and Levine (2009), the study determined the distance to default as follows;

$$\text{Distance to Default Z score} = \frac{\text{CAR} + \text{ROE}}{\sigma (\text{ROE})}$$

Where:

CAR- is the firm's capital asset ratio, ROE is the return on equity, and σ (ROE) is the standard deviation of return on equity.

To achieve the objective of the study the regression model was estimated as follows:

$$Y_{it} = \alpha_i + \beta_1 SZ_{it} + \beta_2 BC1_{it} + \beta_3 BC2_{it} + \beta_4 BS1_{it} + \beta_5 BS2_{it} + \beta_6 BS3_{it} + \beta_7 OS1_{it} + \beta_8 OS2_{it} + \beta_9 OS3_{it} + \epsilon_{it}$$

where; i = number of companies sampled, t = time in years from 2008 to 2017, β_1 - β_9 are the slope coefficients, α_i -the intercept coefficient, ϵ_{it} – Error term, Y_{it} - Financial distress, SZ_{it} -Firm Size, $BC1_{it}$ -Board independence, $BC2_{it}$ - Board diversity, $BS1_{it}$ - Board size, $BS2_{it}$ - Board tenure, $BS3_{it}$ - Board activity, $OS1_{it}$ - Block ownership, $OS2_{it}$ - Managerial ownership, $OS3_{it}$ -Institutional ownership.

The study used the linear regression model that is based on the assumption of normality of errors, (Williams et al, 2013). This assumption was tested by Jarque-Bera test. The errors were found to be normally distributed as the probability values for each variable was greater than the significance level of 5%. Additionally, the study used panel data that requires testing for multicollinearity and stationarity (Field, 2009; Tabachnick & Fidell, 2001). To this end, the Augmented Dickey- Fuller unit root test (Dickey & Fuller, 1979) and Philips-Peron unit root test was used to determine whether a unit root was present in the panel data and the results indicated that the variables were stationery. To test for multicollinearity the study employed correlation analysis. The results in Table 1 show that the correlation coefficients were below 0.8, indicating the absence of multicollinearity.

Further, the study conducted the Hausman test to determine the appropriate model between the random effect and the fixed effects. Both the fixed and fixed models were initially estimated and the random effect model was found to be the appropriate model.

Data was analyzed using both descriptive and inferential statics. Descriptive statistics included measures of central tendency (mean) and the measures of dispersion (standard deviation, maximum and minimum measures), whereas panel regression analysis technique was used to establish the underlying relationships.



Table 1: Correlation Analysis Results

Variable	1	2	3	4	5	6	7	8	9	10
1 Financial Distress	1									
2 Firm size	0.036**	1								
3 Board diversity	0.018	0.184*	1							
4 Board independence	-0.061*	0.006	0.559**	1						
5 Board size	-0.017**	0.544**	-0.031	0	1					
6 Board Tenure	-0.108*	0.249	0.09	0.088	0.301**	1				
7 Board Activity	0.346	0.376**	0.188**	0.105*	0.211**	0.181**	1			
8 Block Ownership	-0.091*	-0.313	0.003	-0.055	-0.181	0.03	-0.129**	1		
9 Managerial ownership	-0.011	0.036	0.110*	0.332**	-0.154**	0.023	0.523**	0	1	
10 Institutional Ownership	-0.122*	-0.311**	0.066	-0.039	-0.199**	-0.127**	0.027	0.700**	-0.218**	1

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

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

4. Results and Discussions

The panel regression results in Table 2 show that that firm size had a significant and direct influence on financial distress. This implies that large firms, as measured by the magnitude of their assets, have a high likelihood to experience financial distress as compared with small firms.

These results concur with studies by [Amato & Burson \(2007\)](#) who established a direct relationship between firm size and financial distress. On the contrary, a study by [Donker et al. \(2009\)](#) document a statistically inverse influence of firm size on financial distress of firms listed on the Amsterdam Stock Exchange. Studies by other scholars such as [Turetysky and McEwen \(2001\)](#), [Yu \(2006\)](#) and [Rommer \(2004\)](#) did not find any evidence that firm size has a significant effect on the likelihood of financial distress.

Table 2: Panel Regression Results

Variables	Coefficient	P> t
Constant	0.8023 (0.750)	0.454
Firm Size	0.0335 (1.700)	0.040
Board Diversity	0.2519 (0.0256)	0.567
Board Independence	-2.0097 (-1.440)	0.049
Board Size	-0.0312 (-0.980)	0.028



Table 2: Panel Regression Results Conti...

Board Tenure	-0.0116 (-0.100)	0.918
Board Activity	0.1026 (2.600)	0.009
Block Ownership	-2.6403 (-2.330)	0.02
Managerial ownership	-0.5316 (-0.620)	0.0453
Institutional Ownership	-4.162 (-2.680)	0.007
Statistics		
R-squared	0.1529	
Wald-statistic	63.820	
Prob. (Wald-statistic)	0.000	

*The values in parenthesis are the t- statistics

Further, as the results in Table 2 reveal, board independence had a significant and inverse influence on financial distress, ($\beta = 2.0097$), $p = .0490$), implying that as the level of board independence increases, the probability of financial distress decreases. This finding is in agreement with studies by [Fathi and Jean-Pierre \(2001\)](#), [Manzaneque et al. \(2016\)](#) and [Luqman et al. \(2018\)](#) which support an inverse association between board independence and financial distress. On the converse, scholars such as [Bilal et al. \(2014\)](#) and [Ayoola and Obokoh \(2018\)](#) posit that the influence of board independence on financial distress is direct.

The regression results also show that board diversity has a significant and direct influence on financial distress, ($\beta = 0.2519$; $p = .0256$). This suggests that an increase in board diversity, as measured by the proportion of female board members, leads to an increase in financial distress. The result is consistent with studies by [Letting et al. \(2012\)](#) and [Carter et al. \(2003\)](#) who found a direct link between board diversity and financial distress. In contrast, [Charbel and Nehme \(2012\)](#) and [Donker et al. \(2009\)](#) found no significant relationship between female directors on the board and financial distress for sample of 276 Lebanese non-listed firms. Board size had a significant but inverse influence on financial distress, ($\beta = -0.0312$, $p = .034$). As board size increase, the chances of financial distress decline. Correspondingly, a small board size increases the probability of financial distress. Contrary to the stewardship theory that supports small boards, the result concurs with the agency and resource dependency theories that recommend large boards. In the context of empirical studies, some authors have recorded an inverse relationship between board size and financial distress ([Xavier, 2014](#); [Manzaneque et al., 2016](#); [Ching-Chun et al., 2017](#)). Nevertheless, some authors assert that board size has a direct influence on financial distress ([Lakshan & Wijekoon, 2012](#); [Nizar et al., 2016](#)).



In addition, the regression results in Table 2 indicate that the p value and coefficient of board activity is .009 and 0.1026 respectively, suggesting the variable has a significant and direct influence on financial distress. The findings of this study mirror prior studies by [Mangena and Taurigana \(2008\)](#), [Bilal et al. \(2014\)](#), and [Dissanayke et al. \(2017\)](#) who testament a direct relationship between board activity and financial distress. Board tenure had an insignificant influence on financial distress, ($p = .918$). The relationship between block ownership and financial distress is inverse and significant, ($\beta = -2.6403$, $p = .02$). In line with this finding, the agency theory proposes that high block ownership could provide the role of active monitors to limit the opportunism of corporate managers and therefore reduce the chances of financial distress ([Nizar et al., 2016](#)). Empirically, [Donker et al. \(2009\)](#) and [Miglani et al. \(2015\)](#) attest to an inverse association between block ownership and financial distress. Conversely, some scholars posit that block ownership does not reduce financial distress ([Montserrat et al., 2016](#); [Lee & Yeh, 2004](#)).

Managerial ownership has a significant but inverse influence on financial distress, ($\beta = -0.5316$, $p = .0453$), suggesting that an increase in managerial ownership could lead to a decrease in the probability of financial distress. On the empirical studies front, [Martin \(2017\)](#) and [Donke et al. \(2009\)](#) document an inverse association between managerial ownership and the likelihood of financial distress. On the converse, studies by [Ching-Chun et al. \(2017\)](#) and [Bilal et al. \(2014\)](#) assert that managerial ownership has a direct impact on financial distress. Based on the regression results shown in table 2, the study submits that the relationship between institutional investors and financial distress is significant and inverse, ($\beta = -4.162$, $p = .007$). This finding is in agreement with similar empirical studies. [Shridev et al. \(2016\)](#) and [Ching-Chun et al. \(2017\)](#) infer an inverse association between institutional ownership and financial distress. However, studies by [Matanda et al. \(2015\)](#) and [Manzaneque et al. \(2016\)](#) designate that institutional ownership has no significant impact on the probability of financial distress.

5. Conclusions and Recommendations

Based on the findings of this study, it can be concluded that firm size plays a critical role in influencing the likelihood of financial distress. Further, it may be argued that board composition that includes a high proportion of independent directors significantly reduces the likelihood of financial distress. This is based on the findings that board independence has a significant inverse influence on financial distress. Moreover, the research concludes that board composition that is diversified has a significant and direct influence on financial distress. The study further suggests that a board structure characterized by a large board size decreases the possibility of financial distress, which means that large boards are preferred in reducing the likelihood of financial distress. In addition, board structure that comprises of corporate boards with long tenures insignificantly influence financial distress while board structure that is



characterized by more board activities in terms of board meetings increases the likelihood of financial distress.

Another conclusion of the study is that an ownership structure that is premised on high proportions of block ownership could reduce the likelihood of financial distress. This was derived from the fact that both block ownership has a significant and inverse influence on financial distress. Similarly, based on the inverse but significant influence of institutional ownership on financial distress, the study concluded that an ownership structure characterized by a high percentage of institutional ownership reduces the occurrence of financial distress. Further, the study concludes that an ownership structure that includes a high percentage of managerial ownership could reduce the chances of financial distress. Based on these findings, the study recommends the adoption of the best corporate governance practices that will go a long way in alleviating financial distress. Improving corporate governance through having an appropriate board composition, board structure and ownership structure would reduce the likelihood of financial distress in firms.

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