Corporate governance, financial performance and firm Value: a case of commercial banks in Kenya

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Abstract

Firm value is dependent on corporate which leads to increased value. High valued firms attract more investors. Towards firm value protection, minimum capital requirements were raised by the Central Bank of Kenya from 250 million to 1 billion shillings on commercial banks to cushion bank shareholders value. Despite the increased oversight and regulatory efforts on corporate governance to protect and enhance firm value, some commercial banks have recorded low firm value. Hence, this study sought to investigate the mediating effect of financial performance on the relationship between corporate governance and firm value of commercial banks in Kenya. The study was anchored on Agency Theory. Explanatory research design was adopted. Target population was forty four Kenyan commercial banks, where a census was conducted. Secondary data was collected from published financial statements and bank websites for the period 2009 to 2018. STATA version 13.0 was used for data analysis. Descriptive and inferential statistics specifically panel regression was used in data analysis. The study findings established that there is a statistically significant effect between financial performance and firm value of commercial banks in Kenya. Therefore, the study concluded that firms with good financial performance have high firm value. And as such, these calls for the management of the commercial banks improve financial performance which will go a long way in improving firm value. There is also need for Central bank of Kenya, Capital Markets Authority and Nairobi Securities Exchange to emphasize on corporate governance and short term goals to enable achievement of long term goals.

Key Words: Corporate Governance; Financial performance; Firm Value; Commercial Banks

JEL Classifications: N20; 016

Introduction

Firm Value is a measure of financial performance in the long-term, and therefore improved financial performance improves firm value. (Samiloglou & Dermigunes, 2008). Profit maximizing organizations are actually concerned with maximizing value in the long term (Bay& Michel, 2006). Performance can be classified into two; non- financial and financial performance (Tudose,2012). Financial performance is regarded to be superior because it is the lifeblood of the company (Kaplan, 2016).

Improved corporate governance lowers cost of capital which improves share price which also impacts firm value positively (Yin,2013). Across board, corporate governance majorly aims at improving financial performance, shareholder value over a long period of time and firm value, which in the long run contributes towards a firm's sustainability (Meesiri, 2014).

Corporate governance regulations in Kenya are enshrined in the Capital Markets Act (cap. 485A) of 2002 which underpinned the importance of corporate governance (Markhan, 2006). In most developing nations which have different socio-economic and political contexts compared to western economic and financial systems, have adopted Organization of Economic Cooperation and Development(OECD) Corporate governance codes (Uddin, 2008; Wanyama et al., 2009).

Waweru (2014) noted that in the year 2000, the Private Sector Corporate Governance Trust (PSCGT) was published; Guidelines were on voluntary adoption by complying or explain approach. PSCGT contributed to the development of corporate governance guidelines that the Capital Market Authority (CMA) issued in 2002 and were made mandatory (Barako et al., 2006). The guidelines focus on performance and good governance, the board, rights of shareholders and maximization of value (Barako et al., 2006; Gakeri, 2013).

Musikali (2015) posits that there is a positive effect between corporate governance and value of the firm. Off-balance sheet items as observed in ICB and GBL where ICB had a six year old board member and GBL had two board members without say (Yunusu & Felix, 2001). Larger boards may enhance access to a variety of resources and improved executive supervision (Bredart, 2014). Large boards are more symbolic, but poor communication associated costs may be high than benefits (Habbash & Bajaher, 2014).

According to Capital Markets Regulations (2016) striking of a balance of skills, independence and company knowledge are important for corporate governance operations to be effective. Regulations by CBK are on single borrower limit, liquidity, board attendance, investment in land, buildings and insider lending (CBK, 2017).But,due to increased cases of agency conflict, fraud and insider dealings corporate governance has been emphasized (Enobakhare,2010)

Corporate governance was introduced to restore investors' confidence and to provide efficient and effective operations of the financial institutions which are key in any economic system (Soludo,2004). Recent collapse of banks as chase bank was associated with poor corporate governance. Weak corporate governance was associated with the collapse of organizations (Zahahria & Zaharia,2012).

Financial performance is the core of any business, it involves; maximization of profits and it is enhanced by operational performance as increase in market share also contributes to firm value (ACCA, 2015). Haque and Sharma (2011) proposed that to assess the health of an economy, there is need for a study around the financial performance of banks in that economy. Survival of a business is largely pegged on the financial performance of a firm because companies like Enron and WorldCom collapsed due to Andersen accounting related scandals, which reflected positive performance but liquidity unveiled scandals (Handley & Li, 2018).

Financial ratios are the most important methods that are used in the evaluation of a company's performance, and usually are based on different aspects of the firm (Kaplan, 2017). Mostly financial ratios are used to determine the firm's financial performance and besides, it is used for comparison purposes (Saleeem & Rehman, 2011). These ratios also help in forming a basis for financial analysis to establish the relationship between the income statement and the balance sheet (Innocent, Mary, & Mathew, 2013).

However there are distortions in financial performance ratios due to manipulation by management and fraudulent accounting scandals (Dinsmore, 2014). Cost of capital is at times treated as a financial performance measure by researchers (Campbell, Dhaliwal, & Schwartz, 2012). This study adopted the liquidity ratio to measure financial performance in testing the mediation effect of financial performance on the relationship between corporate governance and firm value.

Past studies adopted ROA and ROE for financial performance measurement and revenue growth. These ratios are popular though they have been deemed to be weak measures of firm financial performance (Du Toit & De Wet, 2007). Liquidity ratio was adopted as a critical short term ratio essential for survival of a bank to achieve its long term objective. Thus the current study adopted the same ratio of liquidity ratio. Therefore, this study sought to examine the effect of financial performance on the relationship between corporate governance and firm value. Consequently, a null hypothesis; financial performance does not have a significant mediating effect between corporate governance and firm value of commercial banks in Kenya.

Literature Review

This study is anchored on Agency Theory. The proponents of the theory Mitnick (1975) and Ross (1974) explained the separation of the principal who are the owners and agents who are managers of a firm. Jensen and Meckling (1976) stated that agency relationship is due to separation of owners of the firm and the management of the firm. The separation leads to managers who are agents to being entrusted the rights of making decisions by the shareholders who are the principals. Conflict of interest by the managers arises when they maximize on their own benefits at the expense of owners of the firm destroying shareholder wealth.

Management have been found to making funding decisions that are detrimental to firm value in achieving short term goals (Fatemi & Gift, 2002). Contracts between the management and owners of the firm should be those that encourage the management to be motivated to work and increase shareholders value (Dennis, 2003). Most studies on corporate governance have been anchored on agency theory due to the principal and agent relationship (Filatotchev & Wright, 2011). The theory helps explain the board structure role in the reduction of the agency principal conflict.

Karima (2016) established the influence of internal factor on performance and valuation in Indonesia. Findings were that there is no relationship between corporate governance and performance. Purposive sampling and data for 2011-2013 was used. Study was conducted on 18 real estate companies while the current study is on commercial banks. Purposive Sampling technique that was adopted is open to sampling error unlike a census. The current study had financial performance as a mediator.

Sucuahi and Cambarihan (2016) findings were that performance has a positive relationship on value. The study assessed performance and value of firms in Phillipines. Correlational research design was adopted while the current study adopted explanatory research design. Secondary data for one year 2014 was used which is not necessarily the same for all periods due to changes that continually take place in the business environment. Tobin's Q measured firm value while the current study adopted CAPE ratio which is a multiple-period measure. Correlation research design is best suited as a basis for experimental research and not testing of the causality.

Pascareno and Siringoringo (2014) findings were that financial performance does not affect firm value. The researchers examined the effect of financial performance, dividend policy on companies' value in Indonesia. Study was carried out in a different country with different economic and cultural differences. A short period of study was studied 2010-2013 while the current study considered a longer period of time of 2009-2018. This study sought to determine if financial performance explains firm value.

Sudiyanto, Puspitasari, and Kartika (2012) found out that firm performance and value of the company to have a positive relationship. Aspects of the study included company policy, firm performance and value on manufacturing firms at the Indonesian stock exchange. Purposive sampling was used and a period of 2008-2010 was covered. Purposive sampling technique used was non-random, and therefore, the findings cannot be generalized.

Ng'anga (2017) found out that ownership structure has a positive and significant effect on performance. Foreign and executive shareholding was found to have the highest effect. The study examined the effect of ownership structure and firm performance on firms listed at Nairobi stock exchange. Cross-sectional research design was adopted which is done at one point in time, which fails to capture business cycles. But the panel was adopted in the current study.

Mohamed (2017) results indicate that firm size has a significant negative effect on financial performance, and asset size has a significant positive effect on performance measured by ROA. The study investigated the influence of structure of ownership on performance of manufacturing firms listed at Nairobi securities exchange. The study used descriptive research design which has a low statistical rigor and cannot be used to test causality. The study was on manufacturing firms that are not highly regulated compared to the commercial banks.

Hypotheses for the study

Extant literature reviewed has indicated that board diversity, board structure and transparency are measures of corporate. However earlier studies have used the variables in isolation which the current study has combined. According to Anderson, Chagler, and Gellad (2011), higher academic qualifications possessed by board of directors can contribute diverse skills, knowledge, cognitive abilities and expertise. These study captured academic qualifications (educational level, professional qualifications), gender and industry experience under board diversity.

Large boards are more symbolic, but poor communication associated costs may be high than benefits (Habbash & Bajaher, 2014). This study adopted institutional investors, multiple bank boards and independence for board structure for they have been used by previous researchers. Corporate governance, board members personal details, rights of shareholders, attendance, ethics and corporate social responsibility are focused by transparency and disclosure in this study. This study adopted transparency measures based on mandatory and voluntary disclosures.

H01: Corporate governance does not have a significant effect on firm value of commercial banks in Kenya.

Sudiyanto, Puspitasari, and Kartika (2012) found out that firm performance and value of the company to have a positive relationship. Performance can be classified into two; non- financial and financial performance (Tudose, 2012). Financial ratios are the most important methods that are used in the evaluation of a company's performance, and usually are based on different aspects of the firm (Kaplan, 2017). Past studies adopted ROA and ROE for financial performance measurement and revenue growth. Survival of a business is largely pegged on the financial performance of a firm because companies like Enron and WorldCom collapsed due to Andersen accounting related scandals, which reflected positive performance but liquidity unveiled scandals (Handley & Li, 2018). Therefore the study adopted liquidity ratio for performance.

H02: Financial performance has no significant Mediating effect on the relationship between corporate governance and firm value of commercial banks in Kenya

Methodology

Research design therefore provides specific direction for a study (Creswell, 2014). Explanatory research design was adopted to enable test of the effect of board structure on firm value of Commercial banks in Kenya. When the researcher is concerned with identifying factors that cause change and explain the operation of a phenomena without manipulation then explanatory research design is deemed appropriate (Kerlinger & Lee, 2000).

The study adopted Panel linear regression analysis. As suggested by Greene (2008) a panel linear regression model was estimated since the data had cross-section and time dimension by Al Manaseer et al. (2012); Hassan et al. (2016). A regression model was adopted to test the relationship between financial performance and firm value. CAPE ratio was obtained by the current market price per share divided by average EPS for ten years. Empirical model:

$$Y_{it} = \beta_0 + \beta_1 X_{it} + \beta_2 X_{it} + \epsilon_{it} \dots \dots \dots 1..0$$

Where:

Y_{it} =Firm value, B_0 =constant, B =beta coefficient, X_{it} =Corporate governance X_{it} = financial performance, ϵ_{it} = error term.

Step 1: A panel regression analysis with corporate governance predicting firm value.

$$Y_{it} = \alpha + \beta_1 X_{it} + \epsilon_{it} \dots \dots \dots 1.1$$

Step 2: A regression analysis corporate governance predicting financial performance

$$FP_{it} = \alpha + \beta_1 X_{it} + \epsilon_{it} \dots \dots \dots 1.2$$

Step 3: A regression analysis financial performance predicting firm value

$$Y_{it} = \alpha + \beta_2 X_{it} + \epsilon_{it} \dots \dots \dots 1.3$$

Step 4: A regression analysis Corporate Governance and Financial Performance predicting Firm Value

$$Y_{it} = \alpha + \beta_1 X_{it} + \beta_2 X_{2it} \dots \dots \dots 1.4$$

Where:

Y_{it} = Firm value for bank i at time t , X_{it} =Corporate Governance index for bank i at time t financial performance (liquidity ratio) for bank i at time t , β_1 = Corporate governance coefficient for bank i at time t

β_2 =Financial performance coefficient for bank i at time t , α = Constant term

Empirical Results and Discussion

Findings indicate that corporate governance was a good predictor variable of firm value. This study findings concur with Koerniadi, Krishnamurti, Tourani-Rad, and Alireza (2014) who found that those organizations that have good governance have lower levels of risk in relation to composition of the board, rights of shareholder. Corporate governance accounts for up to 26.71% of the variation in firm value of commercial banks in Kenya other factors held constant ($R^2=26.71$).

Step 1: Test for Mediating Effect

Table 1: Results of hypothesis testing of corporate governance predicting firm value

Cape Ratio	Coef.	Std. Err.	Z	P> z	[95% Conf. Interval]
CG	0.001551	0.000682	2.27	0.023	0.000214 0.002888
_cons	4.59951	0.260906	17.63	0.000	4.088144 5.110877

In the step one, the model was fitted with corporate governance predicting firm value. Corporate governance composite index accounted for 48.10% of the variation in firm value ($R^2=0.4810$). Corporate Governance had positive and significant effect on firm value ($\beta=0.001551$, $p=0.023$).

Step 2: Corporate governance predicting financial performance

Table 2: Results of corporate governance predicting financial performance

Fin.Per.	Coef.	Std. Err.	Z	P> z	[95% Conf. Interval]
CG	3.45E-05	2.17E-05	1.59	0.112	-8.00E-06 7.69E-05
_cons	0.350798	0.007247	48.41	0.000	0.336594 0.365001

In the step two, the model was fitted with corporate governance predicting financial performance. Corporate governance composite index accounted for 15.86 per cent of the variation in financial performance ($R^2=0.1586$). The finding indicates that corporate governance was an insignificant predictor of financial performance as measured by liquidity ratio ($\beta=0.000003$, $p=0.112$). Therefore, corporate governance had a positive and insignificant effect on financial performance.

Step 3: Financial performance predicting firm value

Table 3: Results of hypothesis testing of financial performance predicting firm value

Cape Ratio	Coef.	Std. Err.	Z	P> z	[95% Conf. Interval]
Fin.Perf.	11.67834	1.018366	11.47	0.000	9.682375 13.6743
_cons	0.829517	0.46342	1.79	0.073	-0.07877 1.737804

The third model in the test for mediating effect of financial performance on the relationship between corporate governance and firm value of commercial banks was fitted with financial performance predicting firm value. Financial performance composite accounted for 28.58% of the variation in firm value (0.2858). The finding indicates that financial performance was a significant predictor of firm value ($\beta=11.67834$, ($p=0.000$). Financial performance had positive and significant effect on firm value.

Step 4: Corporate Governance and Financial Performance predicting Firm Value

Table 4: Results of corporate governance and financial performance predicting firm value

Cape Ratio	Coef.	Std. Err.	Z	P> z	[95% Conf. Interval]
CG	0.001702	0.000621	2.74	0.003	-0.00014 0.002295
Financial Performance	11.77378	1.045785	11.26	0.000	9.724081 13.82348
_cons	0.591491	0.451689	1.31	0.190	-0.2938 1.476785

In the final model for test of mediating effect, a model was fitted with corporate governance and financial performance predicting firm value. Corporate Governance and financial performance explained 27.88 per cent of the variation in firm value of commercial banks in Kenya ($R^2=0.2788$). The model was statistically significant (Wald $\chi^2=129.43$; $p=0.000$). The finding indicates that corporate governance and financial performance were significant predictors of firm value. The findings further indicates that both corporate governance ($\beta=0.001702$, $p=0.003$) and financial performance ($\beta=11.77378$, $p=0.000$) had positive and statistically significant effect on firm value of commercial banks.

Table 5: Summary of Test for Mediating Effect

Step	Result	Step
	Conclusion	
Firm value = $\alpha + \beta_1 CG_{it} + \epsilon_{it}$	$P < 0.05$	Significant
Financial Performance = $\alpha + \beta_1 CG_{it} + \epsilon_{it}$	$p > 0.05$	Insignificant
Firm value = $\alpha + \beta_1 FP_{it} + \epsilon_{it}$	$p < 0.05$	Significant
Firm Value = $\alpha + \beta_1 CG_{it} + \beta_2 FP_{it}$	$p < 0.05$	Significant

Since the regression between Corporate Governance (independent variable) and financial performance (mediating variable) was insignificant, the study concluded that financial performance partially mediates the relationship between corporate governance and firm value of commercial banks in Kenya. Findings shows that there is no relationship between corporate governance and financial performance. The study therefore rejects hypothesis number four that financial performance has no significant mediating effect on the relationship between corporate governance and firm value of commercial banks in Kenya. The study findings are in concurrence with those of Karima (2016) who notes the influence of internal factors on performance and valuation in Indonesia.

Conclusion

Corporate governance was found to have a significant positive effect on firm value of commercial banks in Kenya. The study concluded that commercial banks in Kenya with high firm value have Good corporate governance and better financial performance. This study recommends that policy makers from commercial banks should focus on corporate governance for enhanced firm value. Implementation of corporate governance should be in terms of board structure and transparency. Also, commercial banks management should focus on short term goals as financial performance which will lead to achievement of high long term goal of firm value.

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