INFLUENCE OF BOARD COMPOSITION ON THE FINANCIAL PERFORMANCE OF MICROFINANCE INSTITUTIONS IN NAIROBI COUNTY

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ABSTRACT

The issue of corporate governance is still a debate across the world, with some emphasizing its role in their firm performance whereas others underplay its role in business. The purpose of the current study was to establish the influence that internal attributes of corporate governance have on the financial performance of microfinance institutions in Nairobi County. The specific objective of the study was to determine the influence of board composition on the financial performance of Microfinance Institutions in Nairobi County. The population of interest in the study was 351 board members, CEOs, and auditors in 25 MFIs in Nairobi County. Through the use of the Yamane formula, 187 respondents were sampled for the study to provide primary data. Primary data was collected through drop and pick methods of a questionnaire among the respondents, whereas secondary data was collected from financial newsletters and published financial statements among the 25 MFIs in Nairobi County. Data collected for the study was analyzed through descriptive analysis including determination of frequencies, percentages, standard deviation, and mean. Correlation analysis and simple linear regression were conducted to establish the nature of the relationship between independent and dependent variables. The presentation was tabulated and narrated. The findings of the study revealed that board composition was associated with (β=0.552, t=3.080, and a p-value associated with it was 0.003). The study concluded that board composition had a positive and significant influence on the financial performance of MFIs in Nairobi County. The study recommended an appropriate number of board members that were financially manageable and optimal in decisions making. Besides, the study recommended a good mix of directors, both executive and non-executive, gender inclusiveness, and also a good mix of professionals and experienced members to ensure better financial performance of MFIs in Nairobi County.

Key Words: **Board Composition, Corporate Governance, Microfinance Institutions, Financial Performance.**

INTRODUCTION

Internal controls of an organization refer to the practices, policies, and behaviors that an organization instills to respond to the operational, business, compliance, and other forms of risks that an organization needs to take care of to effectively and efficiently carry on its business and remaining a performing business. For the ultimate purpose of safeguarding a company's assets, an organization needs to instill discipline through policies and a regulatory framework that safeguards loss through loss or frauds (Ewert & Wagenhofer, 2016). The efforts include maintaining proper books of accounts and creating accountability for any particular transaction including incurring liability, these efforts ensure compliance with the standard internal control policies set up by the firm's management. Internal control is part of management that ensures that an organization is always steered towards achieving its goals and objectives. However, there are chances always that there is the risk of the company staff not adhering to the policies resulting in financial loss or a company failing to undertake some projects as a result of financial misappropriation (Ghafoor et al., 2019).

The concept of corporate governance (CG) has become a debate across the world due to the challenges affecting the performance of multinational corporations. Large companies including micro-financial institutions have changed their practices and legislation across public and private corporations to address the way these institutions and companies are managed and therefore enhance their performance. The challenge of corporate governance issues emanates from the agent to the principal relationship supported by the agency theory. In agent-principal relationship owners of the company funds projects and all other undertakings of business undertaking whereas the management carried out by managers who are employees of the company with great experience in running institutions to create value for investors/shareholders (Madison et al., 2017). A crisis in corporate governance comes in when the managers fail to decide on the best interest of the investors, therefore, causing investors financial losses (Shi et al., 2017).

Corporate governance has attracted so much attention across the globe due to the many benefits associated with it. Effective Corporate governance serves different purposes including management of all stakeholders' interests such as ensuring that customers are satisfied with the products and services that are offered by the company, the suppliers also benefit from being paid in good time, the employees of the company also get their compensations in good time. Besides, corporate governance plays a vital role in ensuring that the company remains compliant with the regulatory environment such as health and occupational safety, environmental regulations as well as meeting statutory submissions such as paying taxes (Edwin & Timothy, 2016).

In the international financial markets companies with good corporate governance practices have higher chances of attracting foreign financial investments due to investors' confidence in the internal operations, however, companies especially in developing countries, are finding it difficult to attract foreign support as a result of questionable corporate practices (Li et al., 2016).

Effective corporate governance is perceived to be the solution across the globe in the assurance of the survival of companies and great economies. The world's companies' giant's in the United States of America including; Enron, the Houston, Texas-based energy giant surprised many after their unethical and illegal operations came to light. These illegal operations involved allocating themselves hefty annual bonuses and luxurious allowances that ultimately led to the collapse of the companies. Other companies across the world were faced with similar challenges including Parmalat found in Italy where top management and directors of these companies collude to award themselves prestigious awards including luxurious cars and homes only for the shareholders to realize later that there had nothing left as earnings on their shares. Illegal actions included manipulating companies' books of accounts to make them attractive for external investors only for them to realize financial information given was misleading (Prosman et al., 2016).

The concept of corporate governance gained further predominance through the Cadbury report that recommended the adherence to corporate governance practices to cushion against fraud as a result of increased business globalization that steered for increased accountability and better financial performance of companies. In India, the concept of corporate governance started gaining root as early as the year 2000 as a result of demand for transparency among corporate executives which is the subject of corporate governance.

Africa companies have as well warmed up to the provisions of corporate governance to address the challenges facing their corporations. Issues of corporate governance have become a common catchphrase among African companies on debates affecting financial performance for prospective investors and partnerships by foreign investors. In Sub-Saharan Africa, microfinance institutions (MFIs) have a broad range of financial services to provide to low-income clients, cooperatives, savings financial institutions, non-bank financial institutions, rural banks, and non-governmental organizations (NGOs) as well as some commercial banks (Brown, 2017).

The economic development of many developing countries can be attributed to the growth of MFIs. The low-income community in these countries has greatly benefited from these institutions from financial services such as technical assistance as well as loans for the development of businesses (Hartungi, 2017). Besides, these institutions provide other services that commercial banks find difficult to provide to low-income clients in society. These services include savings, microloans, payment services, transfers and remittances, and other deposit products and financial services (Hoque & Chisty, 2017).

Several factors have promoted the growth of MFIs in Kenya. These factors include job creation, social welfare as well as the general economic improvement of the lives of the poor in the society. However, most MFIs find it difficult to be viable in the long term despite the growing interest in the sector and the subsidies offered to them. A survey found that 30% of locally initiated microfinance programs that were operating in 2001, could not lend capital after only two years of operation or they simply were not in operation (Bhatt et al., 2016). Moreover, most reports on microfinance programs and institutions indicate that without grants, subsidies, or external fundraising, most MFIs could not sustain their operations for long (Kimando, 2018). A key aspect that helps most MFIs to remain in business in a turbulent and ever-changing economy is by renewing their strategies to attain a competitive advantage. To achieve this, most MFIs have made the process of acquiring loans simple and quick as well as providing cheap loans. However, these institutions face several challenges when trying to implement strategies that will enhance their growth (Lafourcade, 2019).

In Kenya, the central bank got speed with the situation of corporate governance crisis and resolve the formation of audit committees in these companies to address financial risks faced by those corporations, also, the regulator of commercial banks in Kenya ordered for the lowering of the chief executive officers shareholding in these companies to control his influence all these attempts geared toward reducing financial risks (Wagana & Karanja, 2017).

In Kenya, like in any other part of the world, the concept of corporate governance has become very popular through the capital market authority and it is through this concept that Kenya has remained an official ally of the commonwealth association for corporate governance promotion. Both private and public companies have fallen victim to what corporate governance can cost a company. The wave of companies downsizing did not leave Kenya behind with major corporations including Blue shield insurance company coming to their knees with the main reason for collapse having to do with corporate governance issues.
Kenya having adopted the principles of corporate governance of the Organization of Economic Co-operation and Development (OECD) has boosted the strengthening of these principles in Kenya. The prepositions by the OECD were further taken up back in the year 2000 by the capital market authority which made it compulsory for all companies listed at the Nairobi stock exchange to adhere to best principles on board composition, duality nature of CEO (separation of roles of chair and executive), the board size, the rights of the shareholders and the function of the audit committee.

Kenya’s Economic survey (2017) has indicated that the performance of MFIs in Kenya has continued to decline from 2015 through 2017 which has been associated with high credit risks that result in high non-performing loans and MFIs borrowing at high-interest loans. The huge decline in profits among the MFIs has seen the central bank push for strict core-capital measures and laws as well as governance rules as some of the laws to cushion further losses. The main purpose of the proposed amendment was to promote a more resilient, transparent, and stable microfinance sector that can adapt quickly and efficiently to emerging challenges, risks, and opportunities.

Corporate governance remains instrumental in the achievement of the economic wealth of countries across the globe by ensuring that financial and non-financial checks, policies, and controls are upheld to sustain the growth of companies. However, this does not happen so easily because corporate governance calls for very high levels of ethical practices and transparency in the way businesses are managed (Bansal & Sharma, 2016). The Board of directors is also expected to act as a well-organized and coordinated team that helps in setting key strategies and ensuring that the management entrusted with managing the businesses does exactly that (Dam, 2018). One sensitive area that corporate governance needs special attention is in the financial sector due to the high number of stakeholders involved. MFIs are supposed to demonstrate financial health to build trust among investors/depositors, suppliers, employees, government, and other stakeholders (Bansal & Sharma, 2016).

However, MFIs are faced with a greater risk of financial fraud and losses. Kenya's financial sector witnessed the collapse of banks including Imperial Bank, Dubai Bank, and Chase Bank whose subsidiary was Rafiki microfinance. The collapse incidence of Chase bank brought panic over the fall of Rafiki microfinance and therefore resulting in customers overwhelmingly withdrawing their deposit during that period. According to the central bank of Kenya report (2017) on bank supervision report, the banking sector of Kenya’s micro-finance loss went as high as $7.31 million for the financial period that ended December 2017, the previous year 2016 the loss was $ 3.77 million. The sector that in the earlier year of 2015 had reported profits, instead saw a further increase in non-performing loans rise from $73.1million in 2016 to $99.1million in 2017, the customer deposits also went down to $394 in 2017 from the previous year 2016 deposit of $401.9. The huge decline in profits among the MFIs has seen the central bank push for tougher core capital laws and governance rules as some of the laws to cushion further losses. The main purpose of the proposed amendment was to promote a more resilient, transparent, and stable microfinance sector that can adapt quickly and efficiently to emerging challenges, risks, and opportunities.

Several studies have locally been conducted on CG however, none has considered the influence of internal attributes of CG on the performance of MFIs financially (Victor 2015 on CG and how the manufacturing firms listed in the Nairobi Stock Exchange perform financially; Opanga 2011 on CG and how insurance firms in Kenya perform financially). The study found contradicting results, the study by Victor noted that CG through corporate disclosure does not influence performance whereas Opanga noted that gender diversity is a significant factor that influences the financial performance of insurance companies. This study sought to establish the influence that corporate governance attributes have on financial performance by specifically seeking to answer the question: what is the influence of corporate board composition on the financial performance of MFIs in Nairobi County.

LITERATURE AND HYPOTHESIS

Manyaga et al. (2020) studied the influence of the composition of the board on the financial performance of commercial banks that are in operation in Kenya. The study involved 43 commercial banks that operate in Kenya. The study was a casual-effect study that intended to determine how the study variables related to each other. The study used a questionnaire for the correction of primary data and a data collection form for the correction of secondary data. The study revealed that a diverse composition of the board positively impacted financial performance. The study concluded that a board comprised of members with unique qualities and experience background, as well as disciplines including leadership, financial management, law, and compliance skills, had a lot to advise the CEO in ensuring that the company improves performance.

Dam (2018) studied how board diversity influences the firm's financial performance by comparing firms from the United Kingdom and the Netherlands. The study noted that there are non-executive board directors who are not part of the management of a company, normally appointed to ensure that they supervise the actions of the executive directors. They are chosen because of their vast experience with the external environment and also in the reduction of agency costs in the companies. The non-executive director, therefore, plays a vital role in making sure that they safeguard the interest of the shareholders because they have no selfish interest in the way the company is managed. The non-executive members are therefore supported to be people of high integrity and independence, they should also be professionals who can investigate, question, listen as well as constructively debating on the challenges facing the performance of the organization.

Ali (2020) studied to establish whether the relationship between a firms' performance and its corporate governance can be mediated by the use of corporate social responsibility. The study was conducted among 3400 firms listed with the shanghai stock exchange in china. The study was conducted through a panel regression and secondary data collected from 2009 to 2019. The results of the study revealed that including female directors positively impacted the financial performance of the firms with corporate social responsibility moderating the relationship. Therefore, the inclusion of female directors in strategic direction and policymaking had a positive influence on financial performance. Besides the study revealed that foreign investment in the firms had a positive impact on financial performance, with corporate social responsibility effectively moderating the relationship.

Muchemwa et al. (2016) carried out research to determine how the composition and size of a board affect the firm performance of companies listed in the Johannesburg stock exchange. The study focused on all firms listed in the Johannesburg stock exchange market from 2006 to 2012. An associative research design was adopted for this study. The study used published annual reports as the main tool for collecting data with data analysis being conducted using quantitative methods such as multiple regression analysis. The study revealed that there was an insignificant relationship between the firm performance and the size and composition of the board. It indicated that both the composition and size of the board were not significantly associated with performance measures such as Tobin’s Q and ROA in the South African context.

Atieno (2016) determined commercial banks' performance in Kenya from 2013 to 2015 was impacted by the composition of the board. A descriptive research approach was adopted in this study with the study targeting a population size of 42 commercial banks that were operational during this period in Kenya. However, only 25 banks were considered for this study. Secondary data was mainly used in this study with the data being collected from the published financial reports and statements. Data analysis was done using correlation and multiple regression analysis. The study revealed that the board composition, size, and independence had a significant and positive influence on the performance of commercial banks in Kenya. However, the gender diversity of the board had a negative influence on the performance of the commercial banks. The study proposed that the commercial banks in Kenya should not make hasty decisions in appointing their board members to ensure that factors such as gender diversity, independence, and size of the board are taken into consideration.

Cherotich and Obwogi (2018) conducted a study to determine how the financial performance of firms listed in the Nairobi securities exchange was influenced by the board composition. A quantitative and descriptive research approach was adopted for this study where published financial reports for the period 2010 to 2017 were used to obtain secondary data. The study targeted a total of 55 companies that were listed in the Nairobi stock exchange in 2010. The study revealed that the gender composition of the board and the independence of the board had significant effects on the financial performance of these companies. Besides, the study indicated that the size of the board had a non-significant effect on the financial performance of the companies. The study recommended that the firm should ensure that the same individual does not hold the CEO and board chair position but should rather appoint two different persons. Furthermore, the firms' female directors are included in the board and their proportion in the board should also be increased.

Awinja (2017) sought to assess how the performance of the banking industry in Kenya is influenced by the board composition. This study used an explanatory and descriptive research design with questionnaires being used as the main tool of data collection from a total of 127 respondents. The sample size comprised of CEOs, executive, and non-executive directors as well as company secretaries. The study focused on only 11 banks listed in the Nairobi stock exchange market. Data analysis was then done by use of Microsoft Excel and SPSS programs. The study revealed that a board that is comprised of members with high levels of experience positively influences the board’s effectiveness and in turn the performance of the banks. This study proposed that banks should appoint board members with a high number of experience years since they have a wider knowledge of the banking industry.

Hθ: Board composition has no significant influence on the financial performance of MFIs in Nairobi County.

DATA AND METHODS

The study was descriptive. All 25 MFIs in Nairobi County were considered for the study. The Kenya national bureau of statistics (2019) noted that there are 25 MFIS in Nairobi County. The target population for the study was 351 comprising: 251 board members, 25 CEOs, and 75 auditors working for the MFIs in Nairobi County. The study used the Yamane formula to determine sample size. According to Yamane (1967) with a margin error and the population, the following is applied in deriving a sample size.

Yamane Formula, n = $\underline{\quad\quad N}$

1+N (ἑ
^{2})…………………………………………….Equation 1

Where n is the sample size, N is the population for the study, and ἑ is the margin of error. The following was the sample size with a margin error of 5%.

n=351/ [1+351(0.05*0.05)] = 351/1.875= 186.66. The formula gave a sample size of 187 respondents. Data for the current study was both secondary and primary data. Primary data was collected by a questionnaire through the drop and pick method. The researcher followed up daily for three weeks to ensure that many respondents are reached due to the nature of top management and directors being busy. This helped in having a good response rate. The researcher also collected secondary data from the financial newsletters and also published annual financial statements. Collected data was on the profits made by the institutions and return on equity ratios. Data for the current study was analyzed through descriptive and inferential statistics because the data was purely quantitative. The descriptive analysis involved the use of percentages, frequencies standard deviation, maximum, minimum and mean. The study also used inferential statistics to establish the nature of the relationship that exists between financial performance and the board composition through a simple linear regression equation.

$Y = \alpha + \beta_1 X_1$……………………………………………………………………...Equation 2

Whereby: α represents a constant, Y represents financial performance of MFIs and X_2 was Board composition and β_1 was coefficient for the board composition.

RESULTS AND DISCUSSIONS

Response Rate

The study sought to collect data from a sample of 187 respondents on the influence of board composition and the performance of MFIs in Nairobi County. The response rate for this study was 93% as the total number of completed and returned questionnaires was 174 out of 187.

Descriptive statistics for board composition

The proportion of Non- Executive vs Executive Directors in the Board

Table 1 shows that there were many executive directors compared to non-executive directors. However, the table above revealed that 34.79% of the board comprised of non-executive directors which is a clear indication of the supervision role by the no-executive directors in the MFIs as required by corporate governance to have an independent outsider sitting in the board as a non-executive board director. The findings are in agreement with those of Dam (2018) that there are non-executive board directors who are not part of the management of a company, normally appointed to ensure that they supervise the actions of the executive directors. They are chosen because of their vast experience with the external environment and also in the reduction of agency costs in the companies. The non-executive director, therefore, plays a crucial role in making sure that they safeguard the interest of the shareholders because they have no selfish interest in the way the company is managed. The non-executive members are, therefore, supported to be people of high integrity and independence, they should also be professionals who can investigate and question, listen as well as constructively debating on the challenges facing the performance of the organization.

Table 4.1: Proportion of Non- Executive vs Executive Directors in the Board

Directors proportion	Frequency	Percent
Executive	60	65.21
Non-executive	32	34.79
Total	**92**	**100.0**

Gender Composition of the Board of Directors

Table 2 revealed that the majority of the board remembers are male directors as shown by 51.2%, 48.8% of the MFIs board members were female directors; this revealed that the MFIs were almost evenly distributed. The findings are in agreement with those of Ali (2020) that including female directors on a firm's board, positively influences the financial performance of the firm with corporate social responsibility moderating the relationship. Therefore the inclusion of female directors in strategic direction and policies making positively influenced financial performance.

Table 2: Gender Composition of the Board

Number of directors	Frequency	Percent
Male directors	47	51.2
Female directors	45	48.8
Total	**92**	**100.0**

Descriptive statistics on Finacial Performance

Net profits

Table 3 above revealed that the majority of the MFIs had net profits range between kshs 75 and 175 million, this was followed by firms whose profits ranged between kshs 76 and 275 million, this was followed by firms whose net profit was between kshs 276 and 375m only 4% of the MFIs had their profits average between 376 and 475 million. The profit for the MFIs was 191.94 million with the lowest firm registering a profit of 79.69 while the highest registered kshs 430.57 million, which indicates low profits compared to the banking sector and MFIs in developed countries. The findings are in agreement with those of Kenya's Economic survey (2017) who have closely observed that the net profits of MFIs in Kenya have been on a decline.

Table 3: Net profits

Profit range In 'M'	Frequency	Percent	Mean	Min	Max	Std. dev
75-175	15	60.0	191.9480	79.69	430.57	79.27075
76-275	6	24.0				

276-375	3	12.0
376-475	1	4.0
Total	**25**	**100.0**

Return on Equity

Table 4 above revealed that the majority of the firms had their REO range between 0.21 and 0.25 as shown by 32%, this was followed by firms whose average ROE was between 0.16 and 0.20 as shown by 245, which was followed by firms whose average RPE was between 0.31 and 0.35 as shown by 16% only 8% of the MFIs had their ROE between 0.26 and 0.30. The study findings also confirmed that the mean ROE was 0.2476 with the minimum ROE being 0.12 and a maximum of 0.37. The MFIs in Nairobi are therefore reporting average performance which needs to be increased through financial management practices such as through proper corporate governance practices. Kenya's Economic survey (2017) revealed that the financial performance of MFIs in Kenya had been in the decline.

Table 4: Return on Equity

ROE range	Frequency	Percent	Mean	Min	Max	Std. dev
0.10-0.15	2	8.0	0.2476	0.12	0.37	0.0705
0.16-0.20	6	24.0				
0.21-0.25	8	32.0				
0.26-0.30	2	8.0				
0.31-0.35	4	16.0				
0.36-0.40	3	12.0				
Total	**25**	**100.0**				

Hypothesis Testing

Table 5 revealed an R-square of 0.14, therefore board composition explained about 14.1% of the change in the financial performance of MFIs in Nairobi County.

Model Summary for board composition

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
dimension0 1	.375[a]	.141	.126	.688

a. Predictors: (Constant), Board composition

Results in table 6 revealed an F-ratio of 9.489 and a p-value of 0.003. The results of the study, therefore, revealed that the model with board composition as a predictor was significant in predicting the financial performance of MFIs in Nairobi County *p-value* of 0.003 was less than 0.05. The study, therefore, rejected the null hypothesis which stated that: *Board composition has no significant influence on the financial performance of MFIs in Nairobi County*. The findings are also in agreement with those of Manyaga et al. (2020) when they studied how the financial performance of commercial banks in Kenya was influenced by the composition of its board. The study revealed a positive relationship between a diverse board of composition and financial performance. The study concluded that a board comprised of members with unique qualities and experience background, as well as disciplines including leadership, financial management, and law and compliance skills, had a lot to advise the CEO in ensuring that the company improves performance.

Table 6: ANOVA for Board composition

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	4.490	1	4.490	9.489	.003[a]
	Residual	27.443	58	.473		
	Total	**31.933**	**59**			

a.Predictors: (Constant), Board composition
b. Dependent Variable: Financial performance
Table 7 revealed a β=0.552, t=3.080, and a p-value associated with it as 0.003. The study, therefore, noted that Board composition significantly influences the financial performance of MFIs in Nairobi County. The findings are also in agreement with those of Ali (2020) when studying whether the relationship between corporate governance and firms' performance at the shanghai stock exchange in China can be mediated by the use of corporate social responsibility. The study found including female directors in the board influences positively the financial performance of the firms with corporate social responsibility moderating the relationship. Therefore, the inclusion of female directors in strategic direction and also in policies formulation had a positive influence on financial performance. Besides the study revealed that foreign investment in the firms had a positive relationship on financial performance, with corporate social responsibility effectively moderating the relationship.

Coefficients for Board composition

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.242	.272		4.570	.000
	Board composition	.552	.179	.375	3.080	.003

a. Dependent Variable: Performance

CONCLUSIONS AND DISCUSSIONS

The study also concluded that board composition significantly influences the financial performance of MFIs in Nairobi County. The study, therefore, rejected the null hypothesis that: Board composition does not significantly influence the financial performance of MFIs in Nairobi County. This study proposed that a good mix of directors in terms of gender proportion, both executive and non-executive, a good blend of professionals, and experienced members to ensure higher financial performance. The study recommended that the MFIs in Kenya should ensure appropriate decisions are made in appointing their board members to ensure that factors such as gender diversity, independence, and size of the board are taken into consideration.

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