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Effect of Corporate governance on Financial Distress among the Firms Listed at Nairobi Securities Exchange

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Abstract

This study delves into the intricate effect of corporate governance on financial distress in Kenya among the firms listed at the Nairobi Securities Exchange. The recent economic growth and development in Kenya have attracted increased attention to the effectiveness of corporate governance practices adopted by businesses. The study examines the effect of various corporate governance factors, such as Board Size, Board Independence, Audit Committee Independence, and Firm Size, on financial distress in listed companies on the Nairobi Securities Exchange. To evaluate the significance of each factor in influencing financial distress, the analysis employs a Type I Sum of Squares approach using XLSTAT software. The findings reveal that Board Size and Firm Size exhibit highly significant relationships with financial distress, indicating their crucial roles in influencing a company's financial stability. Furthermore, Board Independence demonstrates a statistically significant relationship with financial distress, underscoring the importance of independent directors in mitigating financial risks. Although Audit Committee Independence exhibits borderline significance, it provides indications of a potential relationship with financial distress. Overall, the study offers valuable insights into the factors affecting financial distress in Kenyan companies and emphasizes the significance of robust corporate governance practices in ensuring financial stability and resilience.

Key Words: Corporate governance, Financial Distress, Board Independence, Board size, Audit committee, Firm Size

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1. Introduction

In the recent years, Kenya has undergone a substantial upswing in its economic growth and development, thereby making it an attractive destination for both domestic and foreign investments. However, as this growth continues to burgeon, it is accompanied by a heightened level of scrutiny on the efficacy and efficiency of the corporate governance paradigms that are being adopted by Kenyan businesses. It is imperative to note that corporate governance is a critical determinant that can significantly influence a company's

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overall performance and resilience, particularly in phases of financial distress. The present study delves into the intricate correlation between corporate governance and financial distress in Kenya, and its far-reaching implications for businesses and stakeholders alike.

There is a growing body of empirical evidence that supports the link between corporate governance and financial distress. For example, a study by La Porta et al. (2000) found that countries with weak corporate governance have higher rates of corporate bankruptcies. Another study by Bravo-Urquiza and Moreno-Ureba (2021) found that companies with strong corporate governance are less likely to experience financial distress. The study found that the likelihood of financial distress is considerably decreased whenever corporate governance practices are strengthened.

Kenya, similar to numerous other developing countries, has acknowledged the significance of robust corporate governance practices in order to entice investments, cultivate economic advancement, and ensure sustainable commercial practices. In this regard, the Capital Markets Authority (CMA) and the Nairobi Securities Exchange (NSE) have instated regulations and directives aimed at encouraging sound corporate governance principles among listed firms. These legal provisions accentuate the ideals of openness, answerability, and safeguarding of the stakeholders' privileges.

2. Empirical Review

Younas et al. (2021) conducted an observation on the Pakistani listed firms to determine the presence of significant positive effects of organizational control on financial distress. The study further reveals that there exists a substantial adverse correlation between the size of the board, dual CEO roles, and financial distress metrics. Dianova & Nahumury (2019) conducted research and found that liquidity, leverage, sales growth, and good corporate governance have no effect on financial distress. Accordingly, the conclusion of the study is that there are still other factors that can affect endogenous variables. In a similar vein, Handriani et al. (2021) conducted a study and discovered that organizations ownership, firm size, earnings, and independence of boards have a favorable correlation in an effort to avert financial distress. Conversely, the board size factor had a negligible favorable interaction. Research by Manan & Hasnawati (2022) shows that the factors associated with organization ownership, executive ownership, and the size of a firm's board of directors have a substantial adverse effect on financial distress; however, the size of the oversight board, audit committee members, and company size do not influence financial distress.

Destriwanti (2022) conducted research on a variety of variables that have had a significant effect on projected levels of financial distress. The study revealed that Executive Ownership, Institutional Control, Credit Ratio, Return on Equity (ROE), retained profits to Total Assets (RETA), earnings Before Interest Tax to Total Assets (EBITTA), and return on assets (ROA) are the major factors impacting financial distress. Tron et al. (2023) carried out some research on the use of corporate governance variables. The study found that the application of corporate governance elements, particularly with respect to CEO renewal and stability in the makeup of the governing board of directors, enhances the level of precision of the Random Forest technique and contributes to the efficacy of the turnaround process.

Abang'a et al. (2022) conducted a panel analysis of the data and found that board meetings and conferences, board expertise, and gender disparity, among other aspects of corporate governance, have a significant and favorable relationship with the capital budget realization ratio (CBRR). Furthermore, the research observes that the corporate governance disclosure index, board sub-committees, size of boards, and non-executives who are independent are favorable but slightly associated with financial performance. Kamau et al. (2022) conducted a study to determine the possibility that any relationship exists between earnings management and financial distress. The analysis further emphasizes the degree of significance of the influence of earnings management on financial distress. The study by Ogachi et al. (2020) established that stock turnover, asset turnover, debt-equity ratio, receivable turnover, total assets, ratio of debt, current ratio, and working capital ratio were among the most significant metrics to forecast bankruptcy.

3. Methodology

Secondary data was obtained from the financial statements of 39 listed companies that are publicly available since they have all been listed on the Nairobi Securities Exchange. This data was meticulously collected to ensure accuracy and reliability in order to estimate financial distress through the application of Altman's Z-Score analysis. Consequently, the Z score (FD) was subjected to regression analysis against various parameters, namely the Board size (Brd Sz), Board Independence (Brd Ind), Audit committee independence (AC Ind), and firm size (Frm.Sz) using xlstat software. This analytical approach was used to provide a comprehensive and in-depth assessment of the financial health and stability of these companies, thereby enabling informed decision-making and strategic planning.

Given that the data subjected to analysis was in the form of a panel, the analytical approach employed was Type I sums of squares analysis. The Type I Sum of Squares analysis technique is predicated on the sequential consideration of every source or factor listed in the model. It is important to note that this analytical approach is primarily geared towards examining the effects of each factor in isolation, thereby facilitating the determination of the unique contribution of each factor to the overall model.

4. Findings and Discussion

4.1 Regression Analysis

The results of a Type I Sum of Squares analysis (FD) are shown in Table 1, together with numerous sources of variation and their corresponding mean squares, sum of squares, F-values, and p-values. Four elements make up the analysis: Frm Sz (Firm Size), Brd Sz (Board Size), Brd Ind (Board Industry), and AC Ind (Activity Industry). The p-values

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represent how significant each component is in relation to the response variable under investigation. The levels of significance are indicated by the significance codes.

Table 1: Type I Sum of Squares analysis (FD):

Source	Sum of squares	Mean squares	F	Pr > F	p-values signification codes
Brd.Sz	579.249	579.249	32.630	<0.0001	***
Brd.Ind	86.258	86.258	4.859	0.029	*
AC.Ind	59.556	59.556	3.355	0.069	.
Frm.Sz	155.932	155.932	8.784	0.004	**

*Signification codes: 0 < *** < 0.001 < ** < 0.01 < * < 0.05 < . < 0.1 < ° < 1*

The examination of the data reveals that the Board Size factor displays a remarkably noteworthy relationship with the response variable. The calculated p-value, which is less than 0.0001, indicates that there is substantial evidence to reject the null hypothesis that Board Size has no impact on financial distress. Moreover, the Board Independence factor demonstrates a statistically significant relationship with the Financial Distress, as the obtained p-value of 0.029 is less than the predetermined threshold of 0.05, hence providing evidence to reject the null hypothesis. The significance code that indicates significance at the 0.05 level further corroborates this finding.

Additionally, the Audit Committee Independence factor exhibits borderline significance with the response variable. Despite the p-value of 0.069 being greater than 0.05 but less than 0.1, it is not statistically significant at the conventional 0.05 level. However, there is some indication of a potential relationship. The signification code that indicates significance at the 0.1 level supports this claim.

Finally, the Firm Size factor demonstrates a statistically significant relationship with the response variable. The p-value of 0.004 is less than 0.05, which provides evidence to reject the null hypothesis. The signification code that indicates significance at the 0.01 level strengthens this finding.

Based on the Type I sum of squares, it has been determined that the variables AC Ind and Frm Sz are of significant importance in providing valuable information to elucidate the variability of the dependent variable FD. This is to say that these aforementioned variables contribute substantially to the overall understanding of the variation present within the dependent variable, FD.

4.1 Discussion

The analysis conducted has revealed that both Board Size and Firm Size exhibit a highly significant relationship with financial distress. This implies that any fluctuations in Board Size and Firm Size are strongly linked to changes in financial distress. Such findings are consistent with the outcomes presented by Handriani et al. (2021), yet they counter the

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contentions made by Manan & Hasnawati (2022). The term "highly significant" signifies that the association is robust and is less likely to be attributed to chance. These factors are expected to play crucial roles in influencing the outcome of the study.

The outcomes observed indicate that Board Independence also exhibits a statistically significant relationship with financial distress. These findings align with the discoveries reported by Abang'a et al. (2022). A statistically significant relationship implies that there is evidence to indicate that any variations in Board Independence are associated with changes in financial distress. Such findings are significant at the conventional significance level ($p < 0.05$), indicating a relatively strong relationship.

With regard to Audit Committee Independence, the results depict a borderline significance with the Financial Distress. This suggests that there is some indication of a potential relationship between Audit Committee Independence and financial distress, but the evidence is not strong enough to reach the conventional significance level ($p < 0.05$). Such outcomes are consistent with those presented by Manan and Hasnawati (2022). The term "borderline significance" indicates that further inquiry or a larger sample size might be required to validate the relationship definitively.

5. Conclusion

In conclusion, the present analysis effectively highlights the utmost significance of Board Size and Firm size while taking into account the noteworthy relationship of board independence and the potential relationship of audit committee independence with the response variable. The study makes a clear allusion to the fact that smaller boards tend to make decisions with much higher efficiency as compared to larger ones. The presence of a smaller board can indeed facilitate quicker decision-making and better coordination, thereby enabling the company to respond swiftly to financial challenges and avoid or mitigate distress situations. On the other hand, it is important to note that larger firms often have more diversified revenue streams and business operations, which in turn reduces their reliance on a single product or market. This diversification can act as a buffer against economic downturns, thereby decreasing the likelihood of financial distress.

It is worth noting that the significant effect of Board Size and Firm Size on financial distress can be attributed to a combination of factors related to decision-making efficiency, information processing, risk management, access to resources, corporate governance, and market perception. A thorough understanding of these causes can help companies and stakeholders take proactive measures in order to enhance financial resilience and mitigate the risk of financial distress. Furthermore, it is important to highlight that the presence of independent directors on a company's board effectively correlates with a statistically significant relationship with financial distress. Board independence can indeed lead to more objective decision-making, stronger risk management, improved corporate governance, and enhanced stakeholder trust, all of which contribute to a company's ability to prevent or manage financial distress. The valuable insights derived from this comprehensive analysis effectively contribute to a much deeper understanding of the various factors that significantly impact the response variable within the scope of the study. It is suggested that further research can indeed build upon these findings in order to draw more comprehensive conclusions and implications for relevant stakeholders.

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