BOARD STRUCTURE AND THE FINANCIAL DISTRESS: INSIGHTS FROM NON-FINANCIAL FIRMS LISTED AT NAIROBI SECURITIES EXCHANGE

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ABSTRACT

Financial distress has been a major concern for managers, practitioners and scholars globally. For a long time, companies have faced financial distress worldwide. In the recent past companies such as Wirecard in Germany, Silicon Valley Bank and Signature Bank in United States as well as Signa Holding in Austria have collapsed. The phenomenon is the same in Kenya with companies such as Eveready East Africa, Karuturi Ltd, Mumias Sugar Company, Nakumatt Holdings and Uchumi Supermarkets having collapsed. Others such as Kenya airways have experienced financial distress. This situation creates Panic among the existing investors and may finally erode investor's confidence and may result in loss of huge sums invested in the capital markets. As a result, there is need to tame the situation before investors lose confidence in the market. The focus of this study was to determine the effect of board structure on financial distress of non-financial firms listed on the NSE. This study applied the Z-score for emerging economies to test financial distress. The study was anchored on institutional theory. The study applied positivistic philosophical foundation. The research design applied was cross-sectional research design. The population comprised of 46 non-financial listed firms as at December 2023. A census of all the firms was conducted. The study utilised secondary data that was extracted from published financial statements and other annual reports of the respective individual firms for a period of ten years from 2014 to 2023. Both descriptive and inferential statistics were used to analyse the data. Univariate logistic regression analysis and Pearson's correlation analysis were used. Tables and graphs were used to present the findings. Results showed that a significant negative correlation exist between financial distress and board structure ($r = -0.771$; $p=0.000$). Regression analysis results showed that there is a strong negative relationship between board structure and financial distress. The descriptive statistical analysis revealed that, on average, 90.97% of board members are non-executive directors. However, the unilabiate analysis revealed that board structure accounts for 31.2% to 41.2% of the variance in financial distress among listed firms. Consequently, this study revealed that for every one-unit improvement in board structure, the odds of financial distress decreases by approximately 36.4%, as shown by the odds ratio (Exp(B)= 0.636). The study thus recommends that non-financial listed firms must endeavour to have well-structured and diverse boards in terms of independence, gender and board size.

Keywords: Board Structure; Financial Distress; Non-financial Listed Firms.

INTRODUCTION

Financial distress, also referred to bankruptcy has been a major concern to management of listed companies, investors, government agencies and practitioners mainly because distressed firms cannot be able to meet their short-term maturing financial obligations as and when they fall due (Amoa-Gyarteng, 2019). Investors are concerned about losing their investment while the management and employees are worried about their jobs is the company collapses and is liquidated. Financial distress may adversely affect investors which may lead to loss of their investment (Miglani et al., 2015). According to Silva and Saito (2020) concluded that bankruptcy may lead to either liquidation or reorganization. Among the key concerns in relation to bankruptcy is leverage level. Gao et al. (2017) postulates that bankruptcy is closely linked to a firm's leverage position, and if no interventions are done, then this can lead to the firm's bankruptcy or liquidation. Besides leverage, financial distress is also associated with investment decisions and corporate governance (Silva & Saito, 2020).

As postulated by Bhaskar et al. (2017), corporate governance is one of the critical factors that may cause financial distress. In this regard, corporate governance practices have been poised as critical determinants of financial distress of firms across the world. Failures and weaknesses in corporate governance of certain financial institutions are largely regarded as a major cause of the financial crisis. According to Van Essen et al. (2013), lack of investor confidence in financial markets around the globe may be attributable to the poor corporate governance practices among the non-financial firms just like their financial counterparts. In this regard, conflicts of interest have arisen due to these failures between shareholders and managers of these firms as well as between firm shareholders and the board. Some of the corporate governance indicators that have been empirically shown to affect financial distress include board composition, ownership concentration, board diversity, board independence, board competence, board transparency, and occupational expertise (Miglani et al., 2015). However, while the other attributes of corporate governance have received considerable attention among non-financial firms, board structure has received relatively little attention. As a result, the focus of this study was limited to board structure.

Bhagat and Black (2002) provided that board structure reflects various degrees of heterogeneity. It is a mix of director skills, independence, diversity, and tenure, each of which has its own complexities. Other critical components of board composition include individual personalities and how the directors interact and relate with each other and the management but these are difficult to measure or to objectively assess. According to Rashid (2020), common measures of board composition include the ratio of independent non-executive directors, board size, director's experience and regional representation and balance. In this case, the former three measures shall be used in this study. Gender and age diversity are two other board composition criteria that have been studied. However, no significant evidence of a correlation between board composition and financial troubles has been found so far (Bhaskar et al., 2017). The board structure encompasses board composition which is made up of both executive and non-executive directors, gender and ethnicity (Endraswati, 2018); the skills and experience of members of the board, are occupational expertise of board members (Chijoke-Mgbame, et al.

(2020). The average age of the board members and board size (Rashid, 2020). The board performs various activities via committees set up by board for specific duties. The board structure also entails board tenure which is basically the duration the directors take in a firm (Aluoch et al., 2019); board ownership which is the holdings in a firm's stock by board members; board tools which are necessary tools and aids in place to enable discharging of responsibilities of the board; board meetings including statutory and non-statutory meetings and board committees for deliberations of board activities. Board compensation is the remuneration to board members (Aluoch et al., 2019).

Board occupational expertise entails the background, education and experience of board members. Occupational expertise enables the board members in understanding complicated business transactions and gives better decision making. Differences among firms' directors are viewed in terms of their education, background, experience and expertise (Corvino, 2018). Board size is the number of directors instituting the board (Al-Saidi, 2020). Board size may reflect the complexity of a firm's environment which is inherently challenging; influences board's cohesiveness and ability to oversee corporate governance (Reuer & Klijn, 2020). Board tenure, board ownership, board tools, board meetings, board committees, and board salary are all examples of corporate governance board activities.

The financial distress phenomenon has been a major challenge globally with companies such as Wirecard collapsing in Germany in 2020, Silicon Valley Bank (2023) United States, Signature Bank (2023) United States and Signa Holding (2023) in Austria. In Kenya, companies such as Eveready East Africa, Karuturi Ltd, Mumias Sugar Company, Nakumatt Holdings and Uchumi Supermarkets, Kenya airways among others have experienced financial distress (Dirman, 2020). Literature suggests that approximately 20% of listed non-financial firms in Kenya are in financial distress (Ooko et al., 2018). If this phenomenon continue, investors are likely to lose their investment, job opportunities are lost, their contribution to economic growth will diminish hence decreasing overall economic growth.

Additionally, 21 listed firms were placed under statutory management and recovery board, undertaken financial restructuring or delisted from NSE (CMA, 2021). Further, according to Capital Markets Authority report 2020, at least twelve companies risked being delisted from the NSE due to poor performance and corporate governance challenges. Corporate governance is one of the critical factors that may cause financial distress (Bhaskar et al., 2017). Mumias sugar and Kenya airways are among companies listed in NSE that their poor performance has been attributed to poor governance (Mwangi, 2014).

Most firms that fall into financial distress, often have corporate governance issues (Edirisinghe, 2019). In the recent past, managers and directors of listed firms have been on the spot due to varying corporate governance practices which has resulted in financial distress and collapse of listed firms. Corporate governance is critical to listed firms because it provides ground rules, direction and control. It also outlines the processes and practices on which an organization is governed (Ludwig et al., 2022). Despite the growing importance of corporate governance, there are still gaps in the understanding of how corporate governance affects the likelihood and severity of financial distress of listed non-financial companies in Kenya. Questions persist regarding the role of board structure in exacerbating financial distress.

Although there exists extensive literature on board structure and financial distress have produced in conclusive results. For instance, in their study on the effect of corporate governance on firm financial distress, Nugrahanti et al., (2020) established that board structure had weak relationship with financial distress. On the contrary, Handriani et al. (2021); Waititu and Memba (2018); Din et al., (2020) found that board structure had a significant impact on firm financial distress. The study also determined that other studies have focused on the general concept of corporate governance and have given a blind eye to its components such as board structure. For instance, Younas et al., (2021) also while assessing the role played by corporate governance revealed that corporate governance had insignificant impact on financial distress. Hence, despite there being studies on the study constructs, the studies have given conflicting results. Besides, the studies have used different approaches and methodologies, and focused on different contexts which may not be generalized in a Kenyan Perspective. This therefore motivated this study to assess the effect of board structure on financial distress among non-financial firms listed at Nairobi Securities Exchange.

LITERATURE REVIEW

This section outlines the theoretical anchorage of the study as well as the empirical literature relevant in the study. The study was anchored on institutional theory proposed by John Meyer and Brian Rowan in the late 1970s. According to the theory, structures including schemes, rules, norms and routines, become established as authoritative guidelines for social behaviour (Scott, 2004). Central to institutional theory is its emphasis on the manner in which organizations adopt structures, procedures, or ideas based, not on "efficiency," but rather on external definitions of legitimacy (Meyer & Rowan, 2006). The potential for organizational actors to manage institutional structures depends both on the nature of the institutional context and on the resources held by the interested actors. This theory has however been criticized on its assumption of organizational positivity to address strategic behaviour and the exercise of influence in its conceptions of institutionalization. Despite the criticism, the theory was relevant to the current study since board structure is the key structure that must be streamlined within the firms for optimal performance. According to this theory a properly constituted board structure in terms of board size, diversity, competence and independence will enhance the effectiveness of corporate governance in facilitating the attainment of organizational goals and objectives in high performing firms.

Empirical literature on the relationship between board structure and financial distress was also reviewed aimed at identifying research gaps. For instance,

Handriani et al (2021) conducted a study on influence of corporate governance on financial distress of listed manufacturing firms in Indonesia. The study applied Lisrel software and the Multiple regression models to analyse the most significant profitability determinants of manufacturing firms in Indonesia. The study revealed that board size had an insignificant positive relationship with financial distress. Celiktas et al. (2024) examined the relationship

between board structures on financial distress of 23 developed and 27 developing countries in different markets during periods of financial distress. The study established that CEO duality increases financial distress in developed markets which can be alleviated by the existence of independent boards and majority stockholders. Cardoso et al. (2019) conducted a study on board structure and financial distress among non-financial listed firms at the Brazilian securities exchange. The study aimed to investigate what board characteristics will affect firms during periods of financial distress. This study employed secondary data for periods of 2010 to 2016.The data analysis was done using conditional logistic regression. The findings revealed the existence of a U – Shaped relationship between the board structure and financial distress.
Salloum et al. (2016) conducted a study on the effect of board structure on financial distress of Lebanon's non-listed family-owned firms. The impact of outside directors, insider equity ownership, and CEO-board chair duality on the financial distress of non-listed family-owned enterprises was studied from 2007 to 2010. This study focused on 276 non-publicly traded family firms. The investigation used a multivariate logistic regression analysis. According to empirical findings, the presence of external directors on the board has no effect on financial distress; insider equity ownership reduces the likelihood of financial distress; and the CEO-board chair duality increases the likelihood of financial distress of Lebanese family businesses. Akhmetova et al. (2014) conducted study on board composition and financial trouble in Sweden and Denmark. This study used both Multiple and Binary Regression analysis to see if there was a link between board composition and financial distress. According to the study, board independence, managerial ownership, employee representation, and market capitalization (control variable) all have a significant relationship with the chance of a financial distress.

A study on board structure and the possibility of financial difficulty was conducted by Ud-Din et al. (2020). The researchers employed panel logistic regression to evaluate the relationship between board structure attributes and the likelihood of financial trouble. The Altman Z-Score was used as a substitute for corporate financial distress in the study. The research uncovered a correlation between the size of the board of directors and the possibility of financial difficulty. According to the research, increasing the board size reduces the risk of financial distress. Jodjana et al. (2021) investigated the effect of board and ownership structure on the likelihood of financial distress of firms listed at the Indonesia securities exchange. This study applied conditional logistic regression analysis. The study revealed that increased board ownership and reduced board independence can increase the probability of financial distress. However, institutional ownership and concentrated ownership have no effect on financial distress.

Maorwe (2019) conducted a study on the effect of corporate board structure on financial distress of non-financial firms listed at the Nairobi securities exchange. The study focused on evaluating the effect of board composition, ownership concentration and board diversity on financial distress of non-financial listed firms. Both descriptive and inferential statistics were used in this study. This study revealed that board composition is negatively correlated with financial distress whereas ownership concentration is positively correlated with financial distress. In a study on corporate governance and financial distress on Chinese listed companies, Wang and Deng (2006) employed a sample of 96 financially challenged organizations and 96 healthy corporations. The size of the board, according to the data, has a significant impact on distress. Altaf and Shah (2016) looked into the impact of corporate governance on the financial issues of non-listed companies in Pakistan. The data show that board size has a detrimental effect on financial distress. Board independence and board meeting frequency, on the other hand, have a significant positive impact on financial distress.

RESEARCH METHODOLOGY

The study adopted a positivistic philosophical approach in which a cross-sectional research design was adopted. This design was deemed appropriate in this study as it entails use of quantitative data from corporate annual reports, which fits within the positivism research philosophy adopted in this study. In addition, the design emphasizes the measurement and analysis of causal relationships between variables through defined quantitative approaches such as multivariate statistical analysis (Bangdiwala, 2019). The study's target population covered all non-financial firms listed on the Nairobi Securities Exchange (NSE) as of December 2023. The study determined that there were 45 non-financial companies classified as agricultural, automobile, communication and accessories, energy and petroleum, construction and allied, manufacturing and allied, investment and commercial and services. The study adopted a census of all listed non-financial companies. Thus, a panel of 45 publicly traded non-financial companies from 2014 to 2023 was conducted. The study utilised secondary data for the period between years 2014 to year 2023 that was collected from the websites of the listed firms and from NSE archives via a secondary data collection sheet. Collected data was analysed using descriptive and inferential analysis techniques. Descriptive statistic included mean, standard deviation, frequencies and percentages. Inferential statistics on the other hand included logistic regression under the panel data framework and Pearson's product moment correlation analysis and presented using tables and figures.

RESESARCH FINDINGS AND DISCUSSION

This section is divided in to three parts for descriptive. Correlation analysis and regression analysis.

Descriptive Statistics

The descriptive statistics provide insights on the board structure which was measured through board independence ratio which is the ratio of Non-Executive Directors (NED) to board size. Table 1 presents summary statistics.

Table 1: Descriptive Statistics for Board Structure

Sub-Variables	Count	Mean	Std	min	Max
Proportion of NEDs in board	495	0.9097	0.2844	0.0000	1.0000

Non-Executive Directors (NEDs) on the board were used to determine board independence. The proportion of NEDs in the board, with a mean of 0.9097 and a standard deviation of 0.2844, shows that, on average, 90.97% of board members are non-executive directors. This high proportion indicates that most firms emphasize a structure where the majority of the board is independent from the company's day-to-day management, which can enhance oversight and reduce conflicts of interest. The variability which is measured by the standard deviation of 0.2844 suggests that some firms have boards composed of majority NEDs. A board predominantly consisting of NEDs is generally considered beneficial for corporate governance, as it can improve the monitoring of management and contribute to more objective decision-making.

This trend is particularly significant for firms in non-financial sectors like Energy and Petroleum and manufacturing and Allied, where the complexity and scale of operations necessitate rigorous oversight. Empirical evidence supports this observation. Handriani et al. (2021) found that institutional ownership and board independence had a positive significant relationship with efforts to avoid financial distress. Conversely, Salloum et al. (2016) indicated that the presence of external directors on the board had no effect on financial distress in non-listed family-owned firms in Lebanon, highlighting the contextual differences in board composition effectiveness.

A higher score on this measure implies better adherence to recommended governance practices, potentially translating to better oversight and strategic guidance for the firm. In sectors such as Construction & Allied and Communication and Accessories, a strong board structure can be particularly advantageous, providing strategic direction and enhancing the firm's ability to navigate sector-specific challenges and opportunities. This aligns with findings from Akhmetova and Batomunkueva (2014), who noted significant relationships between board independence, managerial ownership, and reduced likelihood of financial distress. Furthermore, Handriani et al. (2021) highlighted that board independence positively impacts efforts to avoid financial distress in Indonesian manufacturing firms, emphasizing the importance of a strong and independent board structure.

Correlation Analysis

Correlation analysis in this study was conducted via Pearson's product-moment correlation coefficient to assess the relationships between board structure and financial distress. Results were presented in table 2.

Table 2: Correlation Analysis

Variable		**Board Structure**	**Financial Distress**
Board Structure	Pearson Correlation	1	
	Sig. (2-tailed)		
	N	495	
Financial Distress (Z-Score)	**Pearson Correlation**	**-.771***	**1**
	Sig. (2-tailed)	**0.000**	
	N	495	

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

The Pearson correlation coefficient between board structure and financial distress is -0.771, with a p-value of 0.000. This indicates a strong negative relationship, meaning that as the quality or robustness of the board structure increases, the level of financial distress significantly decreases. This finding is consistent with the literature which suggests that an effective board structure, including aspects such as board composition, board expertise, and board independence, can enhance oversight and strategic decision-making, thereby reducing financial distress. Handriani, et al. (2021) found that board independence had a positive significant relationship in efforts to avoid financial distress. Similarly, Cardoso et al. (2019) revealed that board size has a U-shaped relationship with financial distress, suggesting an optimal number of six board members during periods of financial distress. These findings support the idea that a well-structured board is crucial for effective corporate governance and financial stability.

Logistic Regression Analysis

Univariate logistic regression analysis was employed in this section to examine the effects of board structure on financial distress among non-financial firms listed on the Nairobi Securities Exchange. Results were summarised in table 3.

Table 3: Summary of Regression Analysis Results

Step	-2 Log Likelihood	Cox & Snell R Square	Nagelkerke R Square
1	320.456	0.312	0.412

Source	Sum of Squares	Df	Mean Square	Chi-square	Sig.
Regression	82.651	1	82.651	48.123	0.000
Residual	451.349	460	0.981		
Total	534.000	461			

Variable	Coefficient (B)	Standard Error	Wald Statistic	p-value	Odds Ratio (Exp (B))
Constant	-1.230	0.345	12.724	0.000	0.292
Board Structure	-0.453	0.087	27.087	0.000	0.636

The model summary in Table 3 provides an overview of the logistic regression's overall fit to the data. The -2 Log likelihood value of 320.456 indicates the degree to which the model predicts financial distress outcomes. Lower values suggest better model fit, and the reported value highlights a reasonable fit between the model and the observed data. Additionally, the

Cox & Snell R Square value of 0.312 and the Nagelkerke R Square value of 0.412 demonstrate that board structure accounts for 31.2% to 41.2% of the variance in financial distress among listed firms. This suggests that while board structure plays a significant role, other factors also contribute to financial distress.

The ANOVA results demonstrate the statistical significance of the model in predicting financial distress. The regression's Chi-square value of 48.123 and corresponding p-value of 0.000 confirm that board structure significantly contributes to explaining the variance in financial distress. The coefficient for board structure ($B=-0.453$) indicates a strong negative relationship between board structure and financial distress. This suggests that as board structure improves, the likelihood of financial distress decreases. Specifically, for every one-unit improvement in board structure, the odds of financial distress decrease by approximately 36.4%, as shown by the odds ratio (Exp(B)= 0.636). The Wald Statistic of 27.087 and p-value of 0.000 confirm the statistical significance of board structure as a predictor of financial distress.

These results align with studies by Ud-Din, Khan, Javeed, and Pham et al (2020), who found that increasing board size and independence significantly reduces the risk of financial difficulties. Similarly, Maorwe (2019) observed that board composition and diversity are negatively correlated with financial distress, underscoring the importance of well-structured boards in mitigating risks. The findings of this study align with Akhmetova and Batomunkueva et al (2014), who emphasized that board independence and managerial ownership significantly influence financial outcomes. Similarly, the work of Ali and Nasir (2018) on corporate governance in Malaysia supports the view that board independence and board size are critical determinants of financial health. These studies collectively suggest that robust board governance enhances strategic oversight and accountability, reducing financial instability risks.

These finding highlights the critical role of governance mechanisms, particularly board structure, in mitigating financial distress. By prioritizing diverse, independent, and well-composed boards, firms can enhance their ability to navigate financial challenges and improve overall resilience. These results reinforce the importance of board governance as a core component of corporate strategy, aligning with both empirical research and theoretical perspectives on financial stability and governance.

Conclusions

The board structure of the non-financial listed firms at NSE has a significant negative effect on financial distress. Whereas board structure has a significant influence on these firm's financial distress other factors may come into play to influence financial distress of the non-financial listed firms. This underscores the critical role of a well-structured board in enhancing corporate governance and financial stability of the non-financial listed firms. The optimal board size that comprises of mixed gender will significantly reduce financial distress of the non-financial listed. Further, boards of firms that have more female members are more effective and less likely to make decisions that will expose firms to financial distress. This is because female board members are risk averse and are extremely cautious in terms of decisions they make.

This study revealed that 90.97% of the board members on average of the non-financial listed firms are non- executive directors and that 31.2% to 41.2% of the variations in financial distress among listed firms are attributable to board structure.

Recommendations

- The study recommends that the management of non-financial listed firms must endeavour to have well-structured boards. Specifically, the recommends that the board should be diverse in terms of independence, with a higher proportion of non-executive directors, the board should also be diverse in terms of gender.
- Similarly, optimal board size should be pursued with optimal number of members. This enables firms to benefit from the expertise of the board members. The robustness of the board may enable firms navigate through turbulent tides in a competitive and dynamic contemporary business environment.
- Finally, the CEOs of the non-financial listed firms should not be the chair of the board. This is because this creates conflict of interest and weakens the oversight role of the board. The separation strengthens the oversight role and could reduce possibility of firms heading into financial distress

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