

BOARD CHARACTERISTICS, FIRM SIZE AND FINANCIAL LEVERAGE OF MANUFACTURING FIRMS LISTED AT NAIROBI SECURITY EXCHANGE, KENYA: THEORETICAL REVIEW

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ABSTRACT

Kenyan manufacturing firms' structural inefficiencies with huge uncontrollable debts levels coupled with poor performance poses a great threat to Kenyan economy. The sector is financed through debts and equity to avoid dire negative impact such as collapse arising from firm's illiquidity. Kenyan manufacturing firms are crippled by poor corporate governance and huge unsustainable debts leading to stakeholders losing their investment and unsettled suppliers claims associated with poor financial management decisions. Kenyan manufacturing sector growth depicts a worrying declining trend. The government efforts in setting up sector's improvement policies, have not yielded fruits. The financial leverage and the board of director's characteristics have been identified as a root cause. The problem is catalyzed by numerous court cases against manufacturing

firms' former directors on mismanagement and embezzlement of funds. This independent study paper offers a background and theorizes on financial leverage and board of directors characteristics. It provides literature and theoretical overview on the relationship that exists between financial leverage decisions and Board of director's characteristics in manufacturing sector. This paper concludes that Board of directors characteristics affect financial leverage decisions and that firm size influences how much external borrowing a firm may secure. This paper indicate a need to an empirical research to ascertain the exert relationship between the board of directors characteristics, firm size and financial leverage of manufacturing firms.

Key Words: *financial leverage, firm size, manufacturing, board characteristics, domestic product*

INTRODUCTION

Financial leverage is the ability of a firm to use the available resources both debts and equity to make maximum profits for its shareholders (Ojo 2012). Firms finance their projects through a mix of debts and equity to avoid illiquidity challenges which has a dire negative impact on firms operations (Koech, 2013). The financing options determine collapse or the going concern of any profit making entity (Ahmed 2017). Firms operate optimally with a good mix of equity and debts and therefore it is critical for all the stakeholders to be concerned with firms considered financing options (Raza 2013 & Al-Otaibi, 2015). Pandey (2003) contends that an unlevered firm is an all-equity firm, whereas a levered firm is made up of ownership equity and debt. Financial leverage takes the form of a loan or other borrowing (debt), the proceeds of which are (re)invested with the intent to earn a greater rate of return than the cost of interest.

The firm attributes such as the firm size which is determined by the firm turn over and its asset structure among other factors (Chandrapala and Knapkova 2013) is a key consideration of how much a firm can be externally financed. In extension, firm size influences the firm

decisions regarding debts and equity (Bhutto, Memmon, and Abbas, 2012). Further, firm size decreases the long term debt of firms (Gul, Sajid, Mumrtaza 2012) and asset size maturity leads to an increase in debts (Gul, Sajid, Mumrtaza, 2012). Debt ratio is negatively correlated with firm size Sheikh and Wang (2011). Ramlall 2019. Firms with small asset structure size would find difficulties in sourcing external funds visa-viz a firm which has a large asset base (Abdu, 2016). This is basically because the asset structure is explained as the assets which are directly involved in production process and hence directly related to loan serviceability (Zhenge 2016). Generally, the specific firm attributes determines the firm financial leverage speed of adjustment (Buvanendra and Sridharan, 2017).

Further, besides the fundamental analysis on capital structure decisions, Myers theory (1978) introduces the human aspect as pivotal in determining firm` debt. The fiduciary role by directors to systemize the organization, direct and control (Cadbury Report (1992) as the agent of shareholders (Salomon Vs Salomon, 1897) is critical to financing decision in a firm. In extension, resource based theory asserts that firm`s intangibility and tangibility resources are immobile and heterogeneously existing.

Critically, the firms` Board of directors` decisions on funding operations whether short or long term is an indicator of firm`s survival and a mirror of the Bod characteristics. Financial leverage decisions can therefore be argued to be a reflection of Bod`s characteristics diversity such as education background, expertise/experience, percentage shareholding in the firm, tenure of service and age of director among other factors.

Kenyan manufacturing firms have continued to sink into un-proportional debt levels compared to their asset base. Many manufacturing firms have been liquidated or operation crippled such as sugar industry in Kenya (Miwani, Muhoroni, Nzoia, Sony, and Chemilil factories). Generally, firms in Kenya have a slower speed of adjustment of targeted capital structure pointing to higher costs hence reduced profits margins but they also adjust faster to shorter term debts targets than in long term debts, (Mohammed and Tendai, 2013).

Further, the economic survey according to KNBS 2018 and 2016 reports on financial growth of the manufacturing sector depicts a worrying declining trend from a higher of 7.2 % in 2011 to the lowest of 0.4% in year 2017. In addition, manufacturing sector`s growth rate is slow than in its comparator countries and is facing risk of being hollowed out as firms move to more attractive location, (Kenya economic update, vol 94697 and NSE, 2013 survey report). The government efforts in setting up sector`s improvement policies, have not yielded fruits (World Bank, 2014).

The manufacturing firms` structural inefficiencies with huge uncontrollable debts levels coupled with poor performance poses a great threat to Kenyan economy. Various studies points possibilities of poor governance as a cause to poor decisions on financial leverage though with

no precision on direction and To avert this Kenyan bleak manufacturing sector's future, its therefore critical to check the exact magnitude and effect of the role played by the board of directors characteristics toward decisions on financial leverage.

STATEMENT OF THE PROBLEM

Manufacturing firms are financed through debts and equity (Akoto. et al, 2013) to avoid dire negative impact arising from firm's illiquidity (Koech, 2013). The financing options determine collapse or the going concern of any profit making entity (Ahmed, 2017). Kenyan manufacturing sector has been crippled by poor corporate governance and huge unsustainable debts. According to Deloitte & touche audit report (2016), it opined a qualified report due to the huge debts at Athi-river mining cement plc suggesting to the firm's shareholders to auction the firm. Further according to KPMG report (2015), Mumias Sugar Company was crippled by huge unmanageable debts poor corporate governance coupled with funds embezzlement. These factors led to stakeholders losing their investment and accumulation of unsettled suppliers claims. According to Mohammed and Tendai (2013) research findings, besides the many challenges in manufacturing firms, the sector has slower speed of adjustment to targeted capital structure; and adjust faster to shorter term debts targets than in long term debts leading to higher costs of operation and subsequently reduced profits margins. Indeed, the sectors' vicious negative effect has a major impact on the attainment of Kenya's vision 2030 of converting the country into an industrialized middle level country (Mohammed and Tendai, 2013). The current study aims to find a solution to the bleak future of manufacturing sector owing to huge and unmanageable debt levels coupled with poor corporate governance by investigating the effect of manufacturing firms' board of director's characteristics on firm's financial leverage.

THEORETICAL REVIEW

Capital Structure Theories

Myers & Mailuf on pecking order (1984) theorized on the firm hierarchical financing options. The theory posits that the management of any firm prefers to fund projects and their operations by giving preference to raising funds from retained earnings which are less costly, followed by debts with last option of financing through a hybrid convertible loans and eventual issuing of shares respectively.

The theory proponents emphasizes that when firms are floating shares, they should target to maximize reducing costs arising from information asymmetry, bankruptcy costs and agency costs which affect the capital structure policies. Issuing of equities will lead to diluting ownership while debts will increase financial costs / bankruptcy cost (Pandey, 2012). However, the relevance of debt in firm capital structure re-dates from Modigliallian and Miller theory (1978) on levered and un-levered firms on firm value. The MM theory posit that debt affect the

value of the firm by taking advantage of tax shields. However, for any firm to realize the value addition, there is a desirable level of debt that take advantage of the interest tax deductibility beyond which additional debt is not economical. Its therefore critical for any business entity to take cautionary measures in determining level of debt in its financial decisions. The trade-off theory by Kraus and Litzenberger, (1973) emphasizes that the firm should always balance on the distress cost *vis-a-vis* the benefit accruing on debt financing to prevent firms from being declared bankrupt. Critically, the firm's forms of financing whether debt or equity signals the firm's going concern.

The capital structure theories informs the dependent variable (financial leverage) which will be calculated as ratio between the debts and equities

Board Characteristics Theories

The need to separate ownership and control of firms was theorized in 1976. This theory was modeled on assumption that firm managers are opportunistic and may maximize their own utility instead of enhancing shareholder value (Jensen and Meckling, 1976); information asymmetrical distribution between the manager and shareholders and that writing and enforcing contract is costly (Fama and Jensen, 1983) since the principals cannot correctly measure the managers effort who know the details of the operations of the firm. The theory assumes that there exists a conflict of interest between the owners of the firm and its manager/ agents due to divergence of interests between the firm manager and the principle. It also assumes an obvious conflict between the lessor and lessee.

The opportunistic behavior of the manager at the expense of the shareholders is effectively controlled by addressing the agency problem. The board of directors systemizes the organization in view of controlling and subduing the managers' opportunistic behavior. The agency problems arises where the managers fails to cooperate but act defensively by being reluctant to implement the policies as directed by the board of directors. The concept of agency theory has dominated in the corporate governance discussion / studies with the issue of board composition and its characteristics viewed as pivotal in solving the agency problems (Meme, 2017).

The board of directors oversight ability roles becomes clear and easy to implement by separating the Ceo and chairman role independency. The independency dilutes the Ceo's power and increases the board of directors effectiveness to perform their oversight role. To enhance independency, some of internal mechanisms employed is the concern of increasing representation of outside independent non-executive directors and having a large board. Large boards are hard to be controlled by the Ceo contrary to small boards but interferes with group dynamics (Jensen, 1983).

The theory advocates for inclusion of non-executive boards by aiming an enlarged board size to ensure that the CEO is skewed toward best interests of the shareholders of the firm. Agency theory assumes that the independent directors largely represent the shareholders (stewardship theory, Sundaram and Inkpen in 2004) interests hence dilutes either the CEO or board of directors' dominance conflicts in decision making or in either party making unilateral decision. Agency Theory assumes that the firm's performance will improve when the roles of board chairman and CEO are separated; with higher proportion of outside directors are appointed to the board; increasing the board size; higher proportion of independent or non-executive directors on board; board with higher average age; and board members with lower average tenure. The agency theory anchors the board characteristics parameters.

EMPIRICAL LITERATURE

Financial Leverage

Koech (2011) study on the effect of capital structure on profitability of financial firms listed at Nairobi stock exchange posits that listed firms fund their activities through debts and equity and that they support pecking order theory while Ahmed, 2017 findings concluded that debt levels determine the firm's going concern. However, according to Mohammed and Tendai (2013) study findings, firms in Kenya have a slower speed of adjustment of targeted capital structure pointing to higher costs and reduced profits margins contrary to Ting et al 2017 findings that financial leverage play an important role in maximizing its shareholder's wealth.

Specifically, the study by Anshu and Narendra Dhansoia, (2009) on financial leverage and firm value concluded that the Manufacturing sector firms Capital Structure is too rigid to offer any scope for adjustment. To cushion the shareholders and the government from poor governance, Kenyan budget speech 2009 raised capitalization of investment banks and stock brokerage to enable firms compensate its investors instead of government covering the costs. (Wahome, 2009) identified excessive compensation, improper loans, self-dealing, under performance or shirking as crucial pointers of sinister motives that the public should note.

Firm Size as Moderating Variable

Wong study (2018) concludes that firm size determine the suitable board size and no particular board size is applicable to all industries. In extension, Bhutto, Memnon, and Abbas (2012) study on Capital Structure and Firm Performance of Pakistan textile industry concluded that firm size influences the firm decisions in regards to debts and equity while Rashid (2013) study findings on the manufacturing firms external financing decisions in Pakistan concluded that the firms' specific factors are more important to influences their external funding than the macro factors.

The findings were in support of Ramlall (2019) that firms with small asset structure size would find difficulties in sourcing external funds visa-viz firms which have a large asset base (Abdu,2016). In another study by Ting et al (2017), findings concluded that firm size have a significant negative relationship with dividend payout while financial leverage play an important role in maximizing its shareholder's wealth. Based on the empirically proven interlinkages between the firm size effect and on financial leverage and element of board of directors characteristics on various researches, firm size may be argued to play a role as a moderator between the two variables.

Independent Variables

Kenga (2018) study on board characteristics role of corporate governance practices on firm performance of sme found that small board was more effective in decision making, while large board have superior monitoring ability to push the managers to pursue lower costs of debt hence improves firm value. This proposition is supported by Meme (2017) study findings on board diversity and firm financial performance of manufacturing firms which concluded that board characteristics in regard to board size has a significant effect on the financial performance. In enjoining the proposition, Abidin et al. (2009) findings concluded that board composition such as size have a positive impact on firm performance of listed firms in Malaysia Stock Exchange. However, Carmen et al. (2011) study findings on board effectiveness and cost of debt found that large boards are outweighed by the cost of poorer communication and increased decision-making. However, While in agreement with effect of board size on financial performance, Wambua (2011) study on corporate governance qualified on magnitude of board size by concluding that board size has a positive but little effect on financial performance while Wong study (2018) concluded that no particular board size is applicable to all industries but rather it boils down to the firm size to determine the suitable board size.

Findings by Nali and Aida (2018) on director tenure diversity and board monitoring effectiveness concluded that boards with higher tenure diversity are more performance sensitive. However, Wambui (2011) study on Cadbury report (1992) implementation on Kenyan investment banks found that tenure of service beyond 3 years has to be approved by shareholders. This was contrary to Stefano et al 2017 seminal paper cited that the presence of a long tenured director is truly beneficial to his/her company, the average tenure of independent board members does not increase firm value and in some specifications, appears to have a negative impact on firm performance and firm stability. Further the extended tenure of service, for a director is positively related with performance for up to more than 20 years; Good firm performance likely leads to longer tenures for the board as a whole; similarly, poorly performing firms will lead to board-wide director turnover.

According to OECD (2012), concentrated ownership brings more effective monitoring of management and helps overcome the agency problems arising from the separation of ownership

and control while on the other hand, Wong (2018) study findings on Malaysian listed firms on corporate structure and firm financial performance indicates that a higher ownership concentration result in better performance in ROE. Further, Ting et al (2017) study on Malaysian firms concluded that ownership concentration appears to be an effective internal corporate governance strategy that helps to enhance performance.

Stefano et al (2017) indicates that when considering directors personal characteristics and career, long tenured directors are characterized by superior professional which can be traced from earlier days on in their careers. In addition, their findings concluded that directors who have accumulated information about past events in the firm and about responses to exogenous market shocks helps the firm weather crises and discontinuities.

Further, Wong (2018) study findings concluded that education diversity in board would diminish firm performance especially in government linked companies and not in non-government linked. This was basically due to the fact that government linked firms had culture in appointing successful directors emphasizes on network with governance characteristics rather than education characteristic. This position on poor performance due to lack of skilled professionals was supported by research carried out by Kenga and Nzulwa whose research findings concluded that high skills levels of company directors enhances the accuracy and honesty in executing firm's business transactions (Kenga & Nzulwa, 2018).

RESEARCH FINDINGS

Generally, the reviewed literature unearth the importance of debts in manufacturing firms. This is however not so with Kenyan manufacturing firms where the debts levels are seen to be leading into firms' closure and stakeholders losing their valued investments while supplies end up not being paid their dues. Literature reviews that the role played by the board of governance of these firms is critical to salvage the bleak future of Kenyan manufacturing sector. Further, The firm's financial leverage decisions by the board of directors are seen to be moderated by the country's gross domestic product.

CONCLUSION

The reviewed literature indicate a strong evidence of the interactions of the board characteristics and financial leverage of manufacturing firms. However, there is both contextual and methodological gaps evidenced in the reviewed journals. To enable the precision and validity of the reviewed journals, there is a need for an empirical research on these variables to gauge the nature, extent and the magnitude of impact and effect of the board characteristics on the manufacturing firms level of financial leverage in a single study.

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