EFFECT OF CORPORATE GOVERNANCE PRACTICES ON FINANCIAL PERFORMANCE AMONG PARASTATALS IN KENYA: CASE OF KENYA PIPELINE COMPANY (KPC), ELDORET

Kipruto J.
Kenyatta University, School of Humanities and Social Sciences, Kenyatta University, Kenya
Minja D.
Kenyatta University, School of Humanities and Social Sciences, Kenyatta University, Kenya

International Academic Journal of Economics and Finance (IAJEF) | ISSN 2518-2366

Received: 17th October 2020

Published: 24th November 2020

Full Length Research

Available Online at: http://iajournals.org/articles/iajef_v3_i6_223_232.pdf

Citation: Kipruto, J., Minja, D. (2020). Effect of corporate governance practices on financial performance among parastatals in Kenya: Case of Kenya Pipeline Company (KPC), Eldoret. *International Academic Journal of Economics and Finance, 3*(6), 223-232

ABSTRACT

Poor financial management and lack of good governance structures make it difficult for the parastatals to constantly underperform thus lagging the private sectors. Due to this, the services of these parastatals have been substandard and unreliable leading to lack of confidence by the public in them. The study aimed at evaluating the impact of practices in corporate governance on financial performance of parastatals in Kenya with specific regard to the Kenya Pipeline Company, KPC, Eldoret. Specifically, the study set to evaluate the impact of board independence and board members knowledge on financial performance of the board of Kenya Pipeline Company. The study employed descriptive survey design and targeted a participant population of 178 employees who comprised of employees from all levels of management within the company. Using the statistical formula described by Yamane (1967), a sample size of 123 respondents was reached and selected from the population. The study applied a simple random probability sampling. Both primary and secondary data collection methodologies were used for data collection. Research instruments was validated by the university supervisors piloting 2 state corporate states are used to test the reliability of the questionnaires. A correction coefficient of <0.7 was within acceptable limit. In data analysis, a descriptive statistic was used.

INTRODUCTION

Corporate Governance refers to a collection of collaborative efforts amongst company directors, stakeholders including customers for their products and services as well as shareholders. It enables the development of a power structures trickling down from the top to low management and personnel as well as other external stakeholders in a given business (Mang'unyi, 2011).

According to Braga-Alves and Shastri (2011) organizations that take up corporate governance voluntarily are practice it are often ranked higher in value than organizations without cooperate governance practices. This was more interesting finding as Brazilian laws and regulations do not provide proper environment for the flourishing of the corporate sector and governance. Balasubramanian et al., 2011 and Price et al., (2011) confirms these findings through a series of studies focused in developing countries with emerging economies such as Mexico and India that specifically highlighted the impact that corporate governance practices have had on ultimate company values.

A wide range of other studies have also been conducted especially in Kenya, with a focus on Nairobi Securities Exchange (NSE) listed companies as well as financial institutions highlighting and focusing on corporate governance. Some of these include: corporate communication, as well as technology and leadership application by Wanjiku et al (2011), interrelations among board members and organization ownership as well as manager characteristics impact to organization performance (Ongore and K'Obonyo, 2011).

According to Yasser (2011) two measures including the ROA and the ROE are among the commonly used when it comes to determination of an organization's financial performance, in his study, Yasser (2011) measure financial performance using two parameters: The Profit Margin (PM) and the ROE. Shah et al. (2011), however, indicates that financial performance is determined by market measures of companies' financial position.

STATEMENT OF THE PROBLEM

The fundamental problem with Kenyan parastatals, KPC included, is the inadequate structures of governance in a corporate environment which is quite evident given the continued collapse of companies within the state management. Most state corporations experience substandard board representation due to problems such as inadequate monitoring and review of the performance, less than effective board meetings, declining financial performance, embezzlement and misappropriation of parastatal assets as well as limited or no statutory audits. In addition, the elevated levels of corruption enable the lack of prosecution of fraud and misappropriating agents of the state corporations.

Poor financial management and lack of good governance structures make it inevitable for the parastatals to constantly underperform thus lagging the private sectors. Due to this, the services of these parastatals have been substandard and unreliable leading to lack of confidence by the citizens in them. An evaluation of governance in corporate state organizations as well as the impact they have in the eventual performance as such, especially with bias to the different aspects of the governance including leadership, transparency, knowledge and board independence is critical in the solution of the outlined problem. These prompt the study that aims to evaluate the impact of governance and governance structures in corporate environment on the eventual financial outcome of parastatals in Kenya, with a specific focus to the Kenya, Pipeline Company, Eldoret.

OBJECTIVES OF THE RESEARCH

i. To establish the impact of board independence on the financial performance of Kenya Pipeline Company.
ii. To establish the effect of board members knowledge on financial performance of Kenya Pipeline Company.

LITERATURE REVIEW

Independence of the Board and Financial Performance

As highlighted in the Agency theory, an organization's board of governance should be independent from the management. This is crucial given that the board oversees monitoring and regulating the organizations management. O 'Regan and Oster (2005) points out that the board are much more objective when it is independent from the management of the same organization, this is important to ensure the maintenance of efficiency of their performance. This subsequently underscores the need of an adequate amount of board members to ensure effective monitoring and management of the respective organization.

Common board committees specified by Nor Hashimah, Norman, Jaffar and Mohamat, (2007) should therefore mainly comprise independent non-executive directors with a designated chairman and split Chief Executive Officer (CEO) roles to avoid any potential conflicts. Further the Agency theory advocates for the alienation of roles and duties of the CEO and the chair of the board. This is to also enable the monitoring and coordination of the CEOs activities and interests. Overall this is crucial to ensure the CEO does not put ahead their own priorities rather than the shareholders priorities.

The organizations should also have an audit committee that is also independent to ensure an objective audit of the company's overall performance and everyone's direct contribution. Klein (2002) points out that whether the audit committee is independent increase progressively with the increase in board independence and size and decreases for firms that exhibit opportunities of growth but experience consecutive losses. According to Cohen and Hanno (2000) the independence of the Audit committee is significant to improve management duties especially with specific concern to risk assessment. In addition, given their status as independent directors a lack of personal investment or interests emphasizes their objectivity when it comes to their monitoring and control functions over the executive management (Munro & Buckby, 2008).

Board composition represents another corporate governance variable that significantly impact corporate governance. According to Shahadat (2011) a majority of boards are made up of dependent and independent directors. For a more unbiased and objective board however a third of the composition should comprise independent directors as a requirement and preference. This however does not negate the importance of the dependent board members given their insider knowledge on the products on services offered as opposed to the independent members who do not possess any insider information. (Beasly, 2014) highlights that a lack of independent board members would enable the dependent members to misuse the insider knowledge and exploit other stakeholders.

Boards can also be made of purely independent board members. This minimizes any chance of occurrence of conflict of interests due to the lack of personal interests within the company for any board member. Independent directors also enable a wide magnitude of external information which the dependent directors may not have thereby positively impacting the growth of the company Mak and Yuanto (2013). According to Staikouras et al (2013) the composition of the board is not significant in impacting a firm's financial performance in any negative manner, however a beneficial connection was established between performance and board composition.

Despite studies on the connection between the composition of the board and an organization financial outcome being inconclusive, a wide range of scholars including (Rhoades et al. (2010): Omar (2013): Dehaena et al (2011); Krivogorsky (2011) and Limpaphayom and Connelly (2011) believe NED positively relates to an organization eventual financial performance. they highlight that the eventual composition of an organization considering the various dependent and independent board members has an eventual positive performance on enhancing company performance.

Despite the positive impacts brought in by independent directors however Coles et al. (2011) demonstrates a possible negative impact of outside influence by independent directors to the performance of an organization. Hutchinson and Gul (2013) and Kee et al. (2013) agree, further highlighting that higher numbers of independent directors counter the any negative connection between the company's investment and its eventual performance.

Board Members Knowledge and Financial Performance

Within the current century, knowledge is the most important element of business and enhances performance of organizations improving their competitive advantage and thus impacting their success. Based on a study by Fairchild & Li (2005) and Ferreira (2007) knowledge is a critical component when it comes to decision making. Good policies reflect in progressive policies and decisions made by the board while a lack of effective knowledge is exhibited in bad policies that eventually impact performance. Carpenter & Westphal (2001) emphasize that highly qualified board members are valuable to an organization given the wide mix of competencies, innovations ideas and capabilities that they can offer in the process of policy development.

Empirical evidence on qualification of directors is quite limited however; numerous studies from developed countries highlight a positive relationship for examples (Ljungquist, 2007) whose results indicate that educational heterogeneity of board members positively affects the market share growth as well as profits of a firm. The demographic diversity of the board members including their age, gender as well as the education qualification of the members has received very limited attention in literature, yet they provide important measures of evaluating the performance of the board and their decision-making ability. An individual's educational qualification enriches the decision-making process, quality of policies made and a platform for compromise that influences organization performance.

While finding board members is not quite difficult in the current UK business market, a survey by Hartvigsen (2007) and Raber (2005) emphasize that there is no shortage of qualified individuals rather an existence of highly stringent laws as concerns to directorship and litigation by shareholders. The concentration on directors who are knowledgeable and with effective expertise to positively contribute to an organization's management is among the major priority of companies (Berube, 2005). An individual's educational qualification enriches the decision-making process, quality of policies made and a platform for compromise that influences organization performance.

THEORETICAL REVIEW

Agency Theory (Financial performance Theory)

Although largely attributed to Jensen and Meckling (1976) due their role in furthering its development, the Agency theory was first explored by Alchian and Demsetz in 1972. It theorizes that in any organization management do not act in the best interest of the stakeholders particularly optimizing investment returns unless appropriate structures are put in place. Jensen and Meckling held that the investors and management relate in a shared co-habitable engagement to foster a shared goals. In the purview of corporate governance, the investors employ individuals to ensure running of day-to-day activities and general sustainability of the firm acting as agents.

Essentially, the theory capture the instance where an organization' decision-making process lies largely on the hired agents (principal). The relationships is not limited to the management-stakeholder but rather goes further to debtholders-stockholders. Nevertheless, it inputs a prospect that the agents might be self-interested and opportunistic fostering personal interest instead of the mandated and general firm's. As such, this principal-agent conflict forces an organization to incur 'agency costs' where it incentivizes the executives to align their interest to those of the shareholders (company) while working to prevent abuse of respective powers.

Over the past decades, agency theorist have explored by testing the effectiveness of adopting different approaches aimed at executive focusing move on the organization interest over theirs. The studies have shown increased influence of the Agency in shaping the reforms in corporate governance. For instance, it has played a large part in enhancing openness and integrity towards financial disclosure particularly within stock market operation under market governance. The studies pointed to the importance of market mechanisms 'market for corporate control' and managerial labour market'. The former outlines taking a drastic approach of replacing management team with more effective individuals in order to instill discipline whereas the latter purport uphold performance of an individual as a prospect of future growth through positive and high reputation and career-enhancing effects.

Stewardship Theory

Donaldson and Kay (1976) argued that executives can aligns personal goals to the organizational rather than being taken over by greed and identification. It holds that managing individuals are driven by personal conviction and objectives to performance satisfactorily rather than greed and personal interest. Steward theory upholds different that, to some extent, executive aims are aligned to those of stakeholders while roles held by main decision-makers should be protected. While Agency theory is considerably pessimistic towards human nature arguing one's, action is largely driven by the self-centered motives that in return have a negative consequence on the company's performance, steward theory refutes this views.

METHODOLOGY

The researcher chose descriptive survey as the research design to undertake the study because it forms and establishes the relationship between the variables in a given situation. The research study design was also effective due to its capacity of being able to involve a wide number of individuals as well as describe the characteristics of a population by a selection of unbiased samples Gupta (2010). The study specifically targeted the senior management of KPC given the aim of the study, which is to evaluate the effects of corporate governance practices in the performance of parastatals in Kenya. A representative sample of 42 respondents was selected.

The st5udy used a questionnaire to collect primary data which was analyzed through descriptive and inferential statistics.

RESEARCH FINDINGS AND DISCUSSION

Majority of the respondents were male and all of them had effective experience with regards to the operation of the board and its eventual impact to the financial performance of the company. senior management generally consists of individuals with majors and degrees in business management as well as information Technology and a few experts in oil and petroleum products. In addition to the lengthy experience possessed by these individuals with regards to the management and operation of the KPC, none of them have vested personal interest in the company and as such present unbiased and credible sources of information with regards to the company's operations and management.

Board Independence and Financial performance

Among the various aspects of board performance investigated with regards to their impact to the eventual financial performance of the company include board independence. All 35 of the respondents affirmed that the prospect of board independence does indeed influence the outcome of the board and subsequently its financial performance. One of the board member respondents confirmed that independence of operation is paramount and guaranteed by the law given that dependence on any other factor that compromise the decision making processes and abilities of the board. He points out that

> *"Any external or external interference will mean lack of integrity and transparency in its activities. These will therefore have a negative impact on how the company is ran and its performance will be compromised"*

The findings also highlight that board independence helps in monitoring the performance of the company, ensures the development and installation of policies and procedures that are well structured in accordance with the strategies and objectives of the company and as such ensure effective decision making with regards to financial matters. This highlights the importance of the board independence as highlighted by O 'Regan and Oster (2005) who points out that, the board tend to be much more objective when it is independent from the management of the same organization, this is important to ensure the maintenance of efficiency of their performance.

One senior management respondent further highlights that board independence is extremely necessary to ensure that the directors do not put their interest above the interests of the company. Kenton (2019) points out that as a result of board independence the directors and fellow board members owe the stakeholders of the company a duty of good faith and maintenance of a prescribed standard of Care, loyalty and prudence when making decisions with relation to the company. This affirms that directors should not have any vested personal interests in the company to act unequivocally solely to the benefit of the company and subsequent stakeholders. Board independence as such represents a significant component of parastatal financial performance and has been significant in the management of KPC, Eldoret.

Knowledge and Financial Performance

A key difference exists between actual knowledge and education. Having an education refers to the possession of necessary educational qualifications as granted by schools and educational institutions at the end of a course completion. Knowledge, on the other hand, includes information with regards to a particular activity, task or skill that is required in the implementation of an action at hand. According to the collected data, while 23 respondents highlight bachelors' degree as the necessary education qualifications associated with having a membership in the board, another 8 respondents highlight masters' degrees and 4 respondent highlights a PhD. Only one respondent points out a certificate degree and another one a diploma degree.

This highlights that while education is significant for consideration into the management position and proving one's worth as a manager, knowledge with regards to the respective areas of study is much more important given its potential of use in decision making.

While the empirical evidence on qualification of directors is quite limited, numerous studies from developed countries highlight a positive relationship between educational qualifications and board members success. Ljungquist (2007) highlights that educational heterogeneity of board members positively affects the market share growth as well as profits of a firm alluding the importance of the eventual totality of knowledge presented by the board members rather than their various educational qualifications as the essential factor for success. However, despite the impact of demographic diversity of the board members on aspects such as their age, gender as well as the education qualification, these aspects have received very limited attention in literature, and do not have a significant impact to the eventual financial performance of the company.

All the 35 respondents were, however, in agreement that knowledge is critical for effective financial performance of a company highlighting that the different knowledge areas brought in by different members of the board have had effective and immense impact in the way KPC is managed and its eventual performance. While all the 35 respondents point out business management as the most relevant knowledge area related to board membership, another 12 respondents, all 5 of the board members among them, also identify social management as critical in business management and therefore crucial for directors. Another 10 respondents cited scientific and research skills while 22 respondents additionally add that technical skill and legal based knowledge also provide effective additional knowledge that would be effective within the board meeting in making financial related decisions.

Concurrent to the established literature review, the findings point out a wide range of ways as highlighted by the respondents for which knowledge of the board members have impacted the management of KPC. 23 respondents point out that knowledge with regards to areas of financial accounting significantly impact decision making in board meetings. One of the respondents points out that

> *'Effective financial decisions making as a result of board members advice due to their knowledge with regards to the accounting and finance fields go a long way into ensuring effective financial decision making that significantly impacts increased financial outcome.'*

Knowledge of the board members also enables increased diversity and innovation in the development of policies and procedures, strategic objectives and goals as well as strategic decision-making processes all of which significantly impact eventual financial performance. One respondent clarifies that

> *'The board undertakes to state the mission and vision of the strategic plan of the company by development and implementations of strategies using their knowledge in business management and other management factors. Any wrong/right decision in the implementation could most likely have financial impact'*

This is emphasized by Carpenter & Westphal (2001) who clarify that highly qualified board members are valuable to an organization given the wide mix of competencies, innovations ideas and capabilities that they can offer in the process of policy development. Fairchild & Li (2005) and Ferreira (2007) confirm that knowledge is indeed a critical component when it comes to decision making, stressing that good policies reflect in progressive policies and decisions made by the board while a lack of effective knowledge is exhibited in bad policies that eventually impact performance.

CONCLUSION AND RECOMMENDATION

Conclusion

The study drew the following conclusions:

Board Independence

Both the literature review and first hand collected information confirm that board independence is a significant factor for eventual financial management. Board independence enables KPCs board to be able to make effective decisions absent of any external factors or internal conflicts and misunderstanding. Given the no stake policy in the board membership position at KPC, individuals serving within the board do not have any stakes in the company and as such are entirely dedicated to making decisions in the interests of the company at all circumstance. Effective board independence inspires more objectivity when it comes to the process of decision making and this is significant in the eventual financial performance of the organization.

Knowledge of the Board Members

The level of education of an individual has been proven by the findings to have no significant impact on the eventual board decision making and financial outcome rather is only used as a standard requirement for consideration into the board. Instead the knowledge and skills possessed by different board members in their various fields combined impacts innovative, creative and effective decision making. This enhances the process of policy and regulations development to guide and protect the company through its growth. An efficiently knowledgeable board further inspires development of brilliant strategies which not only enhances realization of the organization's goals, objectives and set visions but also impact optimization of the company resource use. This significantly impacts the eventual financial outcome and performance of the company.

Recommendations

Following the findings presented and the conclusions highlighted a wide range of recommendations can be taken up by companies both private and public towards ascertaining the best fit board for its corporate governance, through consideration of the various advised factors, the following recommendations can be adopted in the process of board appointments to ensure effective corporate governance and organization performance;

First, alienating the various knowledge areas required for the task to be achieved within the company including: business management, law. Technical skills, technological requirements and others, then develop a board membership containing all these in a defined variety mix to ensure effective performance

REFERENCES

Byran, D. M. Lui et. S.L (2004). The influence of independent and effective audit committees on earnings quality. *document de travail*.

Carpenter, M. A.& Westphal,J.D. (2001). The Strategic context of external network ties: Examining Impact of director appointments on board involvementin strategic decision making. *Academy of Management Journal, 44*, 639-660.

Central Bank of Kenya, (2013). *Profiling developments in financial access and usage in Kenya, Financial access survey*, 2013, 18.

Coleman, A. (2006). The link between corporate governance and performance of the non-traditional export sector: evidence from Ghana, *Journal of corporate governance,* Volume 6, Number 5, pp. 609-623.

Coles, J.W., McWilliams, V.B. &Sen, N. (2011). An examination of the relationship of governance mechanism to performance. *Journal of Management*, 27: 23—50.

De Andres, P., Azofra V. and Lopez F. (2011). Corporate Boards in OECD Countries: size, composition, functioning and effectiveness. *Corporate Governance:* An International Review, 13(2), 197-210.

Fairchild, L. and Li, J. (2005). Director Quality and firm Performance. *The financial Review 40(2),257-279,*

Gallo, G. A., Tapies, J., &Cappuyns, K. (2011), *Comparison of family and non-family business: Financial logic and personal preferences,* “Chair of Family Business” IESE Research Paper No. 406 BIS, University of Navarra.

Government of Kenya (2013). *National Tourism Strategy 2013-2018*.

Hambrick, D., & Jackson, E. (2000). Outside directors with a stake: the linchpin in improving governance, *California Management Review, Vol. 42*, No. 4, pp108-127.

Islam D.F., Richardson, A.A. and Tuna, (2010), Corporate Governance, *Accounting Outcomes, and Organizational Performance*, The Accounting Review, Vol. 82, NO.4, pp. 963-1008.

Kajola. O.S. (2008). Corporate Governance and Firm Performance: the last of Nigeria listed firms *European; Journal of Economic , Finance and Administrative sciences.*

Krivogorsky (2011) and Limpaphayom and Connelly (2011

Krivogorsky, V (2011), ‘Ownership, board structure, and performance in continental Europe’, *The International Journal of Accounting*, vol.41, no.2, pp.176-197.

Ljungquist, U. (2007). Core competency beyond identification: presentation of a model. *Management Decisions 45(3)*, 393-402.

Mak, C., & Yuanto, C. (2011). *Corporate social reporting in China*: Symbol or substance. Organization Science, 25, 127–148.

Munro, L. & Buckby, S. (2008). *Audit committee regulation in Australia: How far have we come. Australian Accounting Review*, 18(4), 310-323.

Nicholson, G. & Kiel,G. C. (2007). Can directors impact performance? A case-based test of three theories of corporate governance. *Corporate governance an international review, 15(4)*, 585-608.

O'Regan, K., and Oster, S. M. (2005). Does the structure and composition of the board matter? The case of nonprofit organizations. *Journal of Law, Economics, and Organization.* 21(1), 205-227.

Rhoades J. & Friedman, V.J. (2010) *Identity, conflict, and organizational learning, in M. Dierkes, A.B. Antal, J.Child& I. Nonaka (Eds.), Handbook of Organizational Learning and Knowledge,* (pp. 582-97), New York: Oxford University Press

Wanyama, F. O. (2009). *Surviving liberalization; the co-operative movement in Kenya*, ILO, job creation and enterprise development department

Wood, F., & Sangster, A. (2005). Business accounting 1, 10th edition, Pearson education Ltd, London.