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RELATIONSHIP BETWEEN BOARD OF GOVERNANCE AND FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN KENYA (A Survey of SMEs Registered under the GEM Segment at NSE)

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ABSTRACT

Board of governance has become a crucial subject in corporate governance, encountering a substantial change in firms and companies of late. The lack of proper governance mechanisms has been attributed for the failure of at least 70% of firms listed at Nairobi Security Exchange (NSE). Some of the Small and Medium Enterprises under the Growth Enterprise Market Segments segment have started showing poor performance indicators. The aim of the research was to analyze the relation between board of governance and financial performance of Small and Medium Enterprises in Kenya. The research was carried on Small and Medium Enterprises registered under the Growth Enterprise Market Segments segment at Nairobi Security Exchange. This study adopted a descriptive survey research design. The population for this study was 485 chief executive officers and the managing directors, departmental manager and subordinate staff of the 11 Small and Medium Enterprises registered under Growth Enterprise Market Segments segment. Yamane (1967) formula was used to determine the sample size. Stratified random sampling was employed proportionately in selecting 218 respondents. The structured and semi-structured questionnaires were used to collect primary data. The descriptive statistics aided in data analysis. The data was analyzed using Microsoft Excel and a social science statistical software to provide quantitative results using measures of central tendency, percentages, and tabulations. A simple regression model was used to analyze quantitative data. The study concluded that the board of governance has a statistical significance on the financial performance of SMEs registered under the GEMS segment in Kenya. The further concludes that boards are usually more independent when the proportion of outside director's increases and the number of annual board meetings impacts significantly on the entity's financial performance. The study recommends that the firms should carefully constitute their boards. There is a need for the shareholders to provide an environment for the board of directors and management to have a strong value of ownership of the firms to realize the stakeholder objectives.

Key words: *Board of Governance, Financial Performance*

INTRODUCTION

Corporate governance has become a crucial subject, encountering a substantial change in firms and companies of late. Employees, managers, supervisors of the corporations, directors and owners have started to comprehend that there exist many benefits that maybe gotten from holding a good structure of corporate governance. In Singapore listed firms are needed to comply voluntarily with the code, Nonetheless, they as well needed disclosure of their practices on corporate governance and reporting any deviations from the corporate governance code, whose explanation must be given in the annual reports (Nguyen & Nguyen, 2016).

Kenya, like other countries has not been left behind in highlighting the issue of Corporate Governance (Ekadah & Mboya, 2011). This is due to the increased failure of entities which were found or recognized as not practicing good corporate governance. In particular, The Private Sector Corporate Governance Trust (PSCGT) has taken up the role of advocating for good corporate governance in the country. The genesis of CG framework in Kenya was introduced around the year 1999 whereby the Center for Corporate Governance Kenya came up with a structure which organizations would adopt voluntarily. SMEs are very essential in development of a nation's economy, particularly developing nations and Kenya is part of them. The Kenyan sector of SMEs has faced tremendous transformation and growth over previous years and has stood as the most aggressive sector in the economy of Kenya. Based on the Economic Survey (2013), the Kenyan sector of SMEs contributed beyond 50% of every job created in year 2012.

Growth Enterprise Market Segments (GEMS) is a market segment that was established NSE for SME's to grow through raising significant starting capital and for continuity of their businesses (Manyuru, 2015). GEMS will enable SMEs obtain long term financing through equity issuance and this will contribute immensely to economic progress as SMEs relates to poverty reduction and job creation. GEMS give small and medium sized enterprises the perfect opportunity to raise funds through listing. Even though GEMS operate on a buyer beware policy, it ensures that investors' funds are not put on risk by requiring companies seeking listing subscribe to strict corporate governance in order to be allowed on the securities exchange (Bauer & Guenster, 2014).

There has been an advancement of a big number of descriptions of corporate governance over the many years. The typical description relates to protection of interests of the shareholders (Tirole, 2014) and is rooted in the matter of distinction of control and management. Monks *etal* (2015) hold, corporate governance explains the link among different participants in determination of corporations' performance and direction. To Kawakami (2014), corporate governance happens to be a generic term describing the means where responsibilities and rights are divided amongst different corporate members, particularly the shareholders and the management.

Though at the moment, EU has begun standardizing the idea. Its present definition categorizes firms with less than fifty workers to be small, and the ones that have less than 250 to be medium. Through comparison, in US, where small business is described through number of workers, it mostly alludes to the ones with below 100 workers, whereas medium-sized enterprises mostly allude to the ones that have below 500 workers. Nonetheless, the most broadly employed

American description of micro-enterprise by the sum of workers is similar to the one of the EU: below 10 workers (Solomon & Solomon, 2014)

SMEs tend to be the strength of nearly all the world's economies. They pursue a major role towards developing and transitioning nations. Typically, companies amount to above than 90 per cent of all companies' exterior to the sector of agriculture, institute a main employment source and produce significant export and domestic earnings. Like so, development of SME appears as a significant tool in efforts of reducing poverty and promoting competitiveness and growth of SME in an economy may be anticipated not just to be yielding increased economic and social returns locally but as swell empowering the private industry in its constant integration in the international economy (Audu, 2014). Nonetheless, the process has faced constrains by restricted accessibility and availability of financial resources towards meeting various investment and operational needs in the sector of SMEs. Aspects of the side of supply and demand have had a contribution in the problem of financing in developing nations (Matlay, 2015).

Performance alludes to fulfillment, accomplishment, execution, performing and so on. Performance alludes to achievement of a task given measured in contrast to preset speed, cost, completeness and accuracy standard. Conversely, it alludes to the level by which an accomplishment is accomplished or was accomplished. Conversely, Frich (2009) states that performance happens to be a common word used to all or some of the organization's conduct of operations over a certain span mostly referring to the projected or past accountability or responsibility, management responsibility and cost efficiency or so. Therefore, not only the presentation, but also outcomes quality attained alludes to the performance. Performance is employed in indicating compliance, conditions and success of a company.

Financial performance entails an organization's actual outcomes or output measured in contrast to the outputs intendeds. Richard (2015) states that the performance of an organization entails 3 specific regions of the outcomes of an enterprise: (a) financial performance (ROA, profits, ROI, etc.); (b) market performance of the product (market-share, sales etc.) and (c) return to shareholder (total return to shareholder, etc.). There exist different ways of measuring Financial Performance, though all of the measures are supposed to be pursued in combination. Line items for instance operational revenue, cash flow or income from operations may be employed, and also total sales units. Furthermore, the investor or analyst might be willing to look comprehensively on the financial statements and search for margin rates of growth or a deteriorating debt.

Statement of the Problem

SME in the context of European Union and other international organizations is used to select companies that have a specified and limited number of employees. In Kenya, a micro enterprise refers to an organization with less than 10 employees, a small enterprise with less than 50 workers and a large and medium enterprise with more than 50 employees. In the nation of Kenya, SMEs contribute a lot to economic development, because they tend to be the major generators of employment and growth of output. Corporate governance is one vital factor that enables development of the SME in Kenya. Practice of proper governance would aid the SMEs in establishing strong processes of business and replacing them for further expansion in future.

Absence of professional governance and management malpractices has seen some GEMs listed experience significant financial challenges. According to the Daily Nation 14th November 2014 Flame Tree Group's shares rose to Sh14 on the first day of trading, but they have been dropping ever since that time. Home Afrika's a real estate developer saw its half-year profits of June 2018 drop by 72 per cent to Sh42.9 million from Sh115.5 million. Flame Tree has also been closing its financial year with a deficit in cash from 2016 to date. The lack of proper governance mechanisms has been attributed for the failure of at least 70% of companies listed at NSE. As indicated in this document, some of the SMEs under the GEM segment have started showing poor performance indicators. If this phenomenon continues it might cripple the effective development and growth of SMEs under the GEM segment in Kenya. It's therefore significant for the sector's ideal management ensuring improved performance.

In the vicinity, Manyuru (2015) did a study on corporate governance and performance of organization of firms listed in NSE and determined, distinction of control and ownership maximizes the wealth of the shareholders whereas Ngugi (2017) study on the relation between structures of governance and how Kenyan Insurance firms perform and discovered inside directors tend to be quite familiar with activities of the firm and may serve as top management monitors particularly where they see the opportunity to progress into positions that inept executives hold.

Regardless of the many researches done on corporate governance, a gap still existed which made this research a necessity. This study was seeking to cover the gap in research through giving solutions to the questions; what is the relationship between board of governance and performance of Kenyan SMEs?

General Objective

To assess the influence of board of governance on financial performance of SMEs registered under GEMS segment in Kenya.

Research Hypothesis

H_{01}: Board of governance has no Statistical significance on financial performance of SMEs registered under GEMS segment in Kenya.

Theoretical Review

The Agency Theory

It was established by Demsetz and Alchian (1972) with roots from the economic theory and then Meckling and Jensen (1976) developed it. The theory maintains, managers are not going to ensure maximization of shareholders' returns unless ideal structures of governance are executed in the big corporation towards safeguarding the shareholders' interests. Based on Meckling and Jensen (1976), the relation between management and owners is described as principals involve agents towards performing services on behalf of them. As used in Corporate governance, this theory imposes a serious challenge for distant or absent stockholders or owners who recruit professional executives for purposes on acting on the stockholder's behalf.

One of the major assumption of this theory is, there is a high possibility of an agent becoming opportunistic and self-interested. This brings about the view that an executive, acting as the agent, is going to be serving self-interests instead of the principal's interests. To mitigate those kind of challenges, the principal is going to cater for costs of agency which come from the urge of bringing in incentives which put in line the executive's interests with the shareholder's and expenses bore by the need of inspecting the conduct of the executive towards preventing the abuse of the interests of the owner. It's key noting that this theory tends to be deductive in its approach. Assumptions of the theory have become subject of wide empirical studies though this has normally relied on assessing different propositions relating to large sets of data.

In this theory's criticism, theorists have heavily explored the success of the different mechanisms structured to make the concerns of the policymaking to serve the interests of the bondholders. Currently, a number of empirical studies have ambiguously based on the association between proper governance and performance of the firm. The assumption of this theory have nonetheless become influential towards shaping modifications in systems of corporate governance. In this case, its fundamental to have a clear illustration on the difference between market-oriented and external mechanisms that are board-based. According to governance of a market, it is critical to have integrity and openness of monetary disclosures to the stock market operation in determination of the share prices of a firm and its principal market valuation.

The theory of Agency is important because it identifies the SMEs ownership from agents. Through this theory, a board pursues a conformance role to safeguard the interest of the principal through overseeing SMEs management and monitoring compliance. This theory recognizes the board's role in giving service to members through ratification of decisions that the managers have made and inspecting execution of the decisions. Agents are going to behave opportunistically, getting the most out of their benefit at the principal's expense. As a result, a control pattern must be imposed on the agents to ensure that they perform as much as possible for the shareholders. The costs of monitoring force a principle to appoint an external auditor who forms part of controls measures put in place.

Empirical Review

Board diversity, composition and size impacts positively on the organization's performance. By use of one of the biggest sets of data that has 120 provisions from 2010 UK Combined Code, Yan, Ntim and Elmagrhi (2016) researched on the practices of disclosure and compliance of 100 listed companies from 2008-2012. The firms involved in the study all had data on market and financial performance, annual reports, and constant listing for the 6 years of research. The research's dependent variable, the UK Corporate Governance Index, consisted 5 parts, namely: board accountability; board effectiveness and leadership, executive remuneration; and associations with the shareholders. The research's independent variables entailed the board size, the percentage representation of independent directors, diversity of the board on gender, board diversity on ethnicity and presence of a distinct committee on compliance. By use of 2-stage least squares and multiples regression analyses, the research discovered that companies with larger size of the board, more directors who are independent and greater diversity of the board practiced greater disclosure and transparency.

In an exploratory study of French co-operatives, Raimbault, Brullebaut and Allemand (2013) determined that the board's role may be improved by enhancing decision-making, selecting good bodies of governance and maintaining effective relation between the management and the board. Based on their research, the boards' role in a firm begins with identifying and making sure of commitment to the co-operative's values and roles, and as well it's capacity of predicting the

future. The board's role in joint decision-making was seen as improved by coming up with committees towards debating specific concerns and coming up with commendations to the board to pay attention to the significant.
In India, Mitra and Sharma (2015) discovered companies where members of the board stood corruption involved in misconducts for instance payment of bribes for purposes of evading taxes or getting favors from officials of the government. Payment of bribes affected the performance of the company negatively by reduction of profitability. This implies, banks have a high likeliness to report poor performance in case the directors choose engagement in corruption towards achieving some ends like avoiding regulations. Matama (2012) pursued a research on examining corporate governance role in facilitating performance of commercial banks selected in Uganda and determined, corporate governance created a difference in the overall financial performance of Uganda's banks. Based on their findings, he demonstrated that it was apparent that managerial trust levels impacted greatly to the performance of the organisation. Trust was developed though disclosures and high levels of transparency by the studied commercial banks.
Wambua (2014) during his research focused at determining the impact of corporate governance on Kenyan SMEs' financial performance carried out a study on the 180 SMEs in Nairobi and sampled 100 SMEs. A questionnaire was used for collection of data whose analysis was done by use of SPSS and determined, the sum of non-executive directors impacted on how the SMEs performed because directors got engaged in coming up with mechanisms of internal corporate governance for institutions. He determined, financial monitoring through sub-committee impacted on SMEs performance. Sum of meetings which the sub-committee held impacted on how SMEs performed. Leadership served a key role to select, monitor and replace a CEO.
Similarly, Ongeri (2013) carried out a research on financial performance and how much incorporation of practices of corporate governance by Kenya's SMEs. She focused on 30 SMEs that were registered in Kariobangi and a questionnaire was employed in data collection. She employed descriptive technique and SPSS to do data analysis. The outcomes demonstrated a positive strong correlation of corporate governance and SMEs profitability: presence of directors' sub-committee; presence of a method of sub-committee evaluation as well as sole directors; presence of Bylaws towards governing meetings of the sub-committee; and employment of cumulative voting for director's elections.

Conceptual Framework

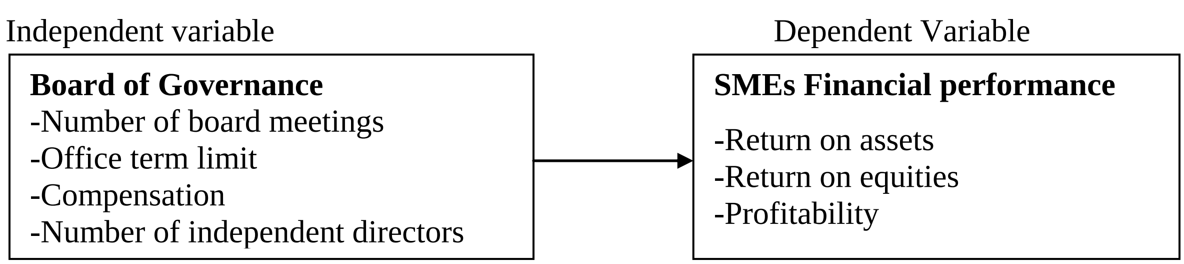

Figure 1: Conceptual framework

METHODOLOGY

This research incorporated a descriptive design. Questions such as how, where, when, what, and who are addressed in descriptive surveys. The purpose of the design is to assist the researcher in obtaining information about the phenomenon by drawing conclusions from the data that was obtained. The populations for this study was CEOs/MDs, departmental manager and subordinate staff of the 11 SMEs registered under GEMs segment. Thus the research targeted 485 respondents. This study included a scientific sampling methodology that was used to determine the optimal sample size. Yamane (1967) proposed the following formulae which was used in computing the sample size.

$$n = \frac{N}{1+N(e)2}$$

n = 485/[1+ (485 x 0.0025)]

= 485/2.22

n = 218

Stratified random sampling was used proportionately to pick 218 respondents from a total of 485 respondents who made up the target population. Primary data sources were used in the research. Primary data was collected using structured and semi-structured questionnaires, which included closed and open ended items. A pilot questionnaire was done by testing the questionnaire's reliability and validity. A small figure of fifteen respondents from SMEs was employed to make small adjustments to the questionnaire to make sure the data collected is ideal to answering certain questions towards solving the problem under research.

Data was collected in both qualitative and quantitative forms, and was analyzed using content and descriptive analysis. The descriptive tools of statistics are used to aid in data description and degree determination. The data was analyzed using Microsoft Excel and SPSS to provide quantitative results using central tendency, percentages, and tabulations. Tables were used to present responses as well as to make comparisons easier. A simple linear predictor model was used in this study $Y= \beta_0+ \beta_1X_1 + e$

RESULTS AND DISCUSSION

Response rate

The study sampled a sample size of 218 respondents from SMEs registered under GEMs segment. Out of this, 186 respondents returned the questionnaires accounting for an 85.3% response rate. This response rate was appropriate based on Bailey (2017) who postulated that an adequate response rate is greater than 50% but a good response rate is greater than 70%.

Influence of Board of Governance on Financial Performance of SMEs

The influence of the board of governance on the financial performance of SMEs registered under the GEMS segment in Kenya was assessed as the first objective in this study. The respondents indicated their levels of agreement with statements on board of Governance and financial performance as shown in Table 1.

Table 1: Statements on board of Governance and financial performance

Statement	N	Min	Max	Mean	Std. Deviation
The number of meetings by the board significantly influence the firms performance.	186	1.00	5.00	4.07	0.52
The Board office term limit is adequate so that they can participate and add value to their organisation	186	2.00	5.00	3.96	0.74
The Board is adequately compensated in terms of board allowances.	186	2.00	5.00	3.99	0.74
When the number of outside directors on the board rises, the board becomes more independent.	186	1.00	5.00	4.08	0.80
The Board does have ready procedures for ensuring that the entity is satisfying its legal duties.	186	2.00	5.00	3.95	0.79
Adequately resourced and gender balanced board are expected to oversee corporate governance	186	1.00	5.00	3.91	0.84
Valid N (listwise)	**186**				

The findings show that the respondents agreed with the statements that the when the number of outside directors on the board rises, the board becomes more independent as shown by a mean of 4.08 and a standard deviation of 0.80 and that the number of annual board meetings impacts significantly on the entity's financial performance as illustrated by a mean of 4.07 and a standard deviation 0.52. The respondents agreed that the board is adequately compensated in terms of board allowances as demonstrated by a mean of 3.99 and a standard deviation of 0.74 as well as that the board office term limit is adequate so that they can participate and add value to their organization as shown by a mean of 3.96 and a standard deviation 0.74. In addition, the respondents were in agreement with the statements that the board does have ready procedures for ensuring that the entity is satisfying its legal duties as described by a mean of 3.95 and a standard deviation of 0.79 and adequately resourced and gender-balanced board are expected to oversee corporate governance as demonstrated by a mean of 3.91 and a standard deviation 0.84. Consistent with the study findings, Wambua (2014) established that the sum of meetings that the sub-committee held impacted how SMEs performed. Similarly, Ongeri (2013) demonstrated a positive correlation between the practices of corporate governance and SME's profitability.

Financial Performance

The study evaluated the financial performance of SMEs registered under the GEMS segment through return on assets, return on equity and profits. The respondents indicated their firm's rank on the measures compared to the competitors in the industry.

Table 2: Firms' financial performance

	N	Minimum	Maximum	Mean	Std. Deviation
Return on Assets	186	1.00	5.00	3.16	0.96
Return on Equity	186	2.00	5.00	3.57	0.92
Profits	186	1.00	5.00	3.25	0.87
Valid N (listwise)	**186**				

The findings on the financial performance of the SMEs registered under the GEMS segment in Kenya show that the respondents ranked their firm's return on assets at middle (41-60)% compared to the competitors in the industry as shown by a mean of 3.16 and a standard deviation of 0.96. The respondents ranked their firms' Return on Equity at next (61-80) % compared to the competitors in the industry as illustrated by a mean of 3.57 and a standard deviation of 0.92. In addition, the firm's profits were ranked at middle (41-60) % compared to the competitors in the industry as demonstrated by a mean of 3.25 and a standard deviation of 0.87.

Regression Analysis

Table 3: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.774[a]	.599	.524	.44532

a. Predictors: (Constant), Board Of Governance

The adjusted R^2, which is the coefficient of determination, showed that 59.9% of the variations in the financial performance of the SMEs registered under the GEMS segment in Kenya was explained by Board of Governance. Other predictors not included in the model account for 40.1% of the variations in the financial performance of SMEs.

Table 4: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	36.747	1	16.747	90.782	.000[b]
	Residual	74.075	183	.405		
	Total	110.823	185			

a. Dependent Variable: Financial performance

b. Predictors: (Constant), Board of Governance

The population parameters significance threshold was 0.000 in Table 4, indicating that the data could be utilized to form conclusions because the p-value was less than 0.05. At a 5% level of significance, the total model association was declared significant since F computed (90.782) was higher than F crucial (value = 3.893).

Table 51: Coefficients

	Unstandardized Coefficients		Standardized Coefficients		
Model	B	Std. Error	Beta	t	Sig.
(Constant)	1.713	0.33		5.191	.000
Board of governance	0.388	0.082	0.33	4.732	.000

On the regression model, it was noted that when the independent variable were held to constant zero financial performance of the SMEs registered under the GEMS segment in Kenya would be at 1.713. A unit increase in the board of governance would increase the financial performance of SMEs with 0.388 units. The null hypothesis was that the board of governance has no statistical significance on the financial performance of SMEs registered under the GEMS segment in Kenya. Since the p-value (0.000) was less than 0.05 we reject the null hypothesis and accept the alternate hypothesis. Thus, board of governance has a statistical significance on the financial performance of SMEs registered under the GEMS segment in Kenya.

Conclusions

The study concludes that the board of governance has a statistical significance on the financial performance of SMEs registered under the GEMS segment in Kenya. The boards are more independent when the proportion of outside director's increases and the number of annual board meetings impacts significantly on the entity's financial performance. The boards are adequately compensated in terms of board allowances and their term limits are adequate so that they can participate and add value to their organizations.

Recommendations

Because board composition is so important for financial performance, companies should carefully select their board members. They should carefully assess the size of their boards to ensure that they are able to achieve their goals while also fulfilling the interests of numerous stakeholders.

The study focused on SMEs registered under the GEM segment at NSE and thus recommends that further studies should be conducted in other sectors of the economy for comparison of the findings. The study was limited to the board of governance, however other studies could be conducted including other variables as the current model only explains 59.9% of the financial performance of the SMEs.

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