Corporate Governance Mechanism and Financial Performance: A study on Selected Commercial Banks in Ethiopia.

A Thesis Submitted to the School of Graduate Studies of Jimma University in Partial Fulfillment of The Requirements for The Award of the Degree of Master of Science in Accounting And Finance (M.Sc.)

By:

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JIMMA UNIVERSITY

COLLEGE OF BUSINESS & ECONOMICS

DEPARTMENT OF ACCOUNTING AND FINANCE

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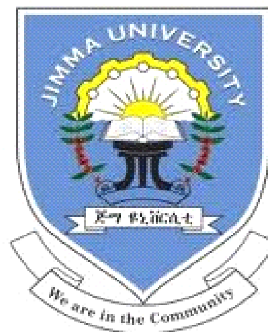

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DECLARATION

I hereby declare that this thesis entitled "Corporate Governance Mechanism and Financial Performance: A Study on Selected Commercial Banks in Ethiopia", has been carried out by me under the guidance and supervision of Mr. Yonas Mekonnen and Mr. Weldemichael Shibru. The thesis is original and has not been submitted for the award of any degree or diploma to any university or institutions.

Researcher's Name Date Signature

_________________________ ________________ __________

CERTIFICATE

This is to certify that the thesis entitled “Corporate Governance Mechanism and Financial Performance: A study on Selected Commercial Banks in Ethiopia”, submitted to Jimma University for the award of the Degree of Master of Science in Accounting and Finance (MSc) and is a record of bona fide research work carried out by Mr. Alelign Eliyas Zemenaw under our guidance and supervision.

Therefore, we hereby declare that no part of this thesis has been submitted to any other university or institutions for the award of any degree or diploma.

Main Advisor's Name *Date* *Signature*

_____________________________ __________________ _____________________

Co-Advisor's Name *Date* *Signature*

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Abstract

Corporate governance provides the structure through which the objectives of the company are set, and the means of achieving those objectives and monitoring performance are determined. The purpose of this study was to investigate the relationship between corporate governance mechanisms and financial performance of Ethiopian commercial banks. From the total of 17 commercial banks which are operating in the country, eight commercial banks have been selected for the study by way of a purposive sampling. The study use ROA as dependent variable and Whereas, independent variables like (board size, board meeting frequency, audit committee size, board experience in finance sector and liquidity) and control variable like bank size and leverage have been used . To achieve this objective descriptive and explanatory type of research design with a mixed approach, more of quantitative, was employed .Primary data was collected using structured questionnaires completed by the CEOs as they were in a better position to comment on corporate governance affairs. Secondary data was collected from the NBE. The finding revealed that, board size and liquidity have negative and significant impact on the performance of Ethiopian commercial banks. On the other hand, board meeting frequency, audit committee size, board experience in finance sector and bank size had a positive and significant impact on banks performance. Finally, it is recommended that, all commercial banks should have reasonable small board size in order to increase profitability. The banks should have optimum board member with experience in finance sector. The board of directors should meet at least once monthly by having a good agenda to generate superior financial performance. The bank governor(NBE) needs to revisit its policy or it should take some corrective actions like paying at least equal interest with that of the deposit in order to enhance the performance of the sector in general. In addition having adequate audit committee in the board member advisable to assists the banks internal control systems. It is advisable to increase the bank size and capability in order to have more market share which helps in generating more profit.

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List of Abbreviation or Acronyms

ACS	=	*Audit committee size*
BES	=	*Board experience in the finance sector*
BMF	=	*Board Meeting frequency*
BS	=	*Bank size*
BSIZE	=	*Board Size*
ICGN	=	International Corporate Governance Network
LE	=	*Banks leverage*
LIQ	=	*Liquidity ratio*
NBE	=	*National Bank of Ethiopia*
OECD	=	Organization for Economic Cooperation and Development
OLS	=	Ordinary Least square
ROA	=	*Return on Asset*
ROE	=	*Return on Equity*
VIF	=	Variance of Inflation Factor

CHAPTER ONE

1. INTRODUCTION

1.1. Background of the study

According to the UK Corporate Governance Code, 2012, corporate governance (CG) has been defined as the system by which organizations are directed and controlled. Good corporate governance maximizes the profitability and long term value of the firm for shareholders. It is also defined by Organization for Economic Cooperation and Development (OECD, 2004) as a set of relationships between a company's directors, its shareholders and other stakeholders. As per OECD, corporate governance also provides the structure through which the objectives of the company are set, and the means of achieving those objectives and monitoring performance are determined. Jensen (1993) also defines Corporate Governance as the top-level control structure, consisting of the decision rights possessed by the board of directors and the Chief Executive Officer (CEO), the procedures for changing them, the size and membership of the board, and the compensation and equity holdings of managers and the board. However, this definition is prone to criticism due to the fact that it doesn't recognize other most important players of CG such as finance providers, suppliers and most importantly the public at large (ACCA, Paper P1).

The issue of corporate governance on firm performance has received enormous attention in economic and finance literature in recent years. This attention has been motivated by financial scandals that shocked the U.S. economy in early and late 2000 and the Asian financial crisis of late 90s. Despite a number of studies having been undertaken on the subject matter, there is still much debate on the relationship between corporate governance and firm performance and more soon the relationship between corporate governance and performance of commercial bank

In recognition of the vital role the banking sector plays in economic development, there has been a rise of initiatives by Central Banks and Reserve Banks alongside other institutions worldwide such as the Basel Committee on Banking and Supervision and OECD to provide governance principles with a view of enhancing management and performance of this important sector. Most of these initiatives have prominently featured in developed nations such as: U.S.A., United

Kingdom, Germany, Canada, and France among others with South Africa taking a lead in addressing corporate governance issues among developing nations (Elewechi, 2007)

In corporate organization the conflict of interest arises among stakeholder. According to Imam and Malik (2007) these conflicts of interest often arise from two main reasons. First, different participants have different objectives and preferences. Second, the participants have imperfect information as to each other's actions, knowledge, and preferences. Corporate governance is the methods employed, at the firm level, to solve corporate governance problems (Basuony et al., 2014). Since it is viewed as a necessary element of market discipline, strong corporate governance is highly demanded by investors and other financial market participants (Ramsay, 2001). Regulators have enacted corporate governance reforms into law in many countries, such as the USA through (Sarbanes-Oxley Act, 2002) which states that in order to safeguard their long-term successes, organizations implement corporate governance to ensure that they are directed and controlled in a professional, responsible, and transparent manner. In other countries, such as the UK, the corporate governance codes, known as the Combined Code of Corporate Governance of 2003, are principles of best practice with some indirect element of legislature operating through the respective stock exchange listing rules. For the banking sector, Basel I, II, and recently Basel III are widely adopted by developing and emerging market economies to enhance their corporate governance codes. Bank governance was altered tremendously during the 1990s and early 2000s, principally due to bank ownership changes, such as mergers and acquisitions (Berger et al., 2005; Arouri et al., 2011). The worldwide financial crisis of 2008, which started in the United States, was attributed to U.S. banks‟ excessive risk-taking. Consequently, in order to control such risk and draw people‟s attention to the agency problem within banks, there are statements made by bankers, central bank officials, and other related authorities, emphasizing the importance of effective corporate governance in the banking industry since 2008 and until now (Beltratti and Stulz, 2009; Peni and Vahamaa, 2012).so robust system of corporate governance is considered an important tool for mitigating the conflict of interests between stakeholders and management (Pandya, 2011).The relationship between corporate governance and organizational performance lies in the multi-dimensional nature of good governance.

The definition of „corporate governance‟ is not provided under the Ethiopian company law. For the purpose of this study, it is thus important to adopt a working definition for corporate governance as a system of rules and institutions that determine the control and direction of a company and that define relations among the company's primary participants including board of directors, managers, shareholders and other stakeholders (Hussein Ahmed Tura, 2012). This combines the narrow and broad definitions and it considers corporate governance as a system of rules and institutions which determine the control and direction of a company. It recognizes not only shareholders but also stakeholders that should be involved in the governance of share companies.

Tewodros Meheret (2011) discusses the legal regime applicable to governance of share companies in Ethiopia. He explores the theoretical background and legal framework of corporate governance and examines the rules of governance in light of available standards. The agency problems that could occur between dispersed shareholders and managers and/or block holders of share companies in Ethiopia, therefore, necessitate good corporate governance laws and institutions. Good corporate governance makes the company more profitable. The management or decisions made by the corporate highly affect the performance since the company operates accordingly.

The corporate governance is highly increasing and becoming more complexes in today's banking industry with complexes business situation. Generally, banks occupy an important position in the economic equation of any country such that its (good or poor) performance invariably affects the economy of the country. Poor corporate governance may contribute to bank failures, which can increase public costs significantly and consequences due to their potential impact on any applicable system. Poor corporate governance can also lead markets to lose confidence in the ability of a bank to properly manage its assets and liabilities, including deposits, which could in turn trigger liquidity crisis *(*Uwuigbe olubukunolaranti 2011*)*

Studies on corporate governance in banking firms have revealed the critical role banks play in economic progress of any nation. Therefore it is on the responsibility of the government to assume a central role in managing banks through a regulator who is charged with the responsibility of „keeping banks safe" given that banking crises in any part of the world

dramatically manifests the enormous negative effects of failure in corporate governance practices generally. Banks are more disposed to corporate governance risks than other firms due to the following reasons: heterogeneity of exposures, complexity of their business, high level dependence on technology and the judgment driven nature of their business that increases the scope of managerial entrenchment. On the same token, the magnitude of shift of risks, private benefits and absolute misuse of power is more pronounced in banking firms than any other kinds of firms. Just as it is for any other forms of firms, the value of the banks‟ shareholders can ensue from increased risk-taking behavior by the management at the expense of debt claimholders and the government. Hence there is need to put in place a good corporate governance mechanism that will protect the interest of all the stakeholders in this important sector (Joshua 2015) also An expose by Prowse (1997) shows that research on corporate governance applied to financial intermediaries especially banks, is indeed scarce. This shortage is confirmed in Oman (2001); Goswami (2001); Lin (2001); Malherbe and Segal (2001) and Arun and Turner (2002). They held a consensus that although the subject of corporate governance in developing economies has recently received a lot of attention in the literature, however, the corporate governance of banks in developing economies has been almost ignored by researchers. The idea was also shared by Caprio and Levine (2001). Macey and O‟ara (2002) shared the same opinion and noted that even in developed economies; the corporate governance of banks has only recently been discussed in the literature. To the best of the researcher's knowledge based on the literatures reviewed, only few studies were found in the context of Ethiopian banks. Due to neglect of banking sector by other studies and with radical changes in Ethiopian banking sector in the last few years, initiate prime study on bank governance. Based up on above facts, this study sought to investigate the relationship between corporate governance mechanisms and bank financial performance to give information to the users.

1.2. Statement of the problem

Development of financial sector is necessary for the progress of the economy. It is difficult to attain economic development without efficiently working of financial sector. Banks are the integral part of the financial sector, and have a dominant position in developing economic financial systems, and are important engines of economic growth (Levine, 1997). The concept of corporate governance of banks and very large firms have been a priority on the policy agenda in

developed countries for over a decade and is warming itself as a priority in African continent (Uwuigbe, 2012). Agency theory and many other corporate governance mechanisms suggest that good corporate governance improves firm performance (Garcia-Marco & Fernandez, 2008). However, global events concerning poor performance and eventual collapse of high profile companies such as Enron, World.com, Bank of Commerce and Credit International, among others have awakened need to strengthen corporate governance in both developed and developing countries (Sanda, et al. 2005).Bank failures are known to generate negative externalities in a country for two reasons: they destroy specific capital leading to further contagion losses in the system. On the same token, bank closures reduce economic welfare in a country because they create loss of relationship between banks with their clients and specific knowledge of management and risk preferences required to improve performance (Myron et al. 1999). The costs of bank closures are also quite enormous because they may spread throughout the entire banking system hence amplifying negative effects on unrelated intermediaries. Based on these findings, Linyiru, (2006), argues that even though there is awareness and existence of corporate governance mechanisms in the banking sector, there is need to strengthen these practices owing to the special nature of banks.

Recent findings in studies on the relationship between corporate governance and performance in banking firms in different parts of the world are inconclusive or even contradictory. Love and Rachinsky, (2007) find a negative relationship between corporate governance and bank performance. However, Mangu"nyi, (2011) finds that there is no significant difference between banks ownership structure, financial performance and corporate governance practices commercial banks in Kenya .Among the Ethiopians studies Desta (2016) find that disclosure practice, board size, board gender diversity and ownership type have no significant impact on the financial performance of Ethiopian commercial banks, Kelifa (2012)finds that board size and existence of audit committee in the board had statistically significant negative effect on bank performance in terms of both ROE and ROA; whereas bank size had statistically significant positive effect on bank performance in terms of both ROE and ROA, Ferede (2012) concluded that large size board and audit committee negatively influences financial performance; board members educational qualification positively associated with financial performance; industry specific experience of director positively related with return on asset but it has a negative effect

on net interest margin; and the percentage of female directors and board members business management experience does not have a significant effect. These contradictions in findings could create aspersions as to whether corporate governance impacts on performance of commercial banks in Ethiopia. In addition to above facts the reason why the researcher exert his time and other resources on this study even if it was studied by some researchers is that; our country currently struggling for economic growth and here by rapid Economic structural transformation across both public and private sectors particularly, commercial banks to bring such change, banking industry play a great pivotal role in transformation of economic transaction intermediation and in accelerating effective payment method in satisfying investments pipeline avenues in the country. To achieve this, maintaining the soundness and safety our banking environment is crucial. Moreover ,Malherbe and Segal (2001) and Arun and Turner (2002) who find that although the subject matter has received a lot of attention in developing countries of late, corporate governance studies on banks has almost been ignored by researchers. Similar sentiments are come back by Macey and O‟Hara (2002) that even in developed economies, corporate governance of banks has only been discussed in recent literature. In view of the above findings, Al-Manseer *et al.* (2012) conclude that more research needs to be conducted on corporate governance in the banking sector. However, the researcher sought to investigate the relationship between of corporate governance mechanisms and financial performance on commercial banks in Ethiopia by including other corporate governance mechanism variables not studied by prior researcher with recent data to provide more reliable information for the users. Finally the researcher hope, to fill knowledge gap by adding new empirical insights to accountancy and finance discipline.

1.3 Objective of the Study

1.3.1 General Objective

The general objective of this study is to analyze effect between corporate governance and financial performance of commercial banks in Ethiopia.

1.3.2 Specific Objectives

The specific objectives are;

- To Investigate the relationship between board size and bank financial performance
- To identify the negative or positive impacts of Board Meeting frequency on firm performance
- To examine the association between audit committee size and bank financial performance.
- To find out the influence board experience in finance sector on financial performance of commercial banks
- To ascertain the extent to which liquidity affect bank financial performance

1.4. Hypotheses of the Study

In line with the broad purpose statement and research objective, the following hypothesis has been developed for the study.

Board size

The size of the board is measured by the number of board members as has been done by many authors such as Hermalin and Weisbach (1999, 2002), (Ferede, 2012), (Akpan, 2015) and (Jensen & Meckling, 1976). In their various studies, the size of the board has been seen to have an inverse relationship with firm performance. Jensen M. (1993) argues that a larger board leads to less effective monitoring due to coordination and process problems inherent in large board size. Larger boards can be less participative, less cohesive, and less able to reach consensus. Small board size was favored to promote critical, genuine and intellectual deliberation and

In contrast, a number of scholars have contended that larger boards have their benefits and when board size increases firm performance also goes up as more board members provide greater monitoring, advice and make available better linkages to the external environment (Chenuos, Mohamed, & Bitok, 2014). Moreover, Klein (2002) suggested that larger boards able to promote effective monitoring due to their ability to distribute the work load over a greater number of observers. Moreover, Results from (Akpan & Amran, 2014) study showed that board size has positive significant influence on company performance Therefore, depending on the above theory and related literature the first null hypothesis is stated as:

*H*a1: There is a statistically significant relationship between board size and commercial banks financial performance**.**

Board meetings frequency

Vefeas (1999) reported a statistical significance and negative relationship between frequency board meetings and corporate performance. He also finds that operating performance significantly improves following a year of abnormal board activity. Meeting Frequency has a significant negative impact on ROA and an increasing in meeting frequency will reduce the ROA. (Ms.S.Danoshana & Ms.T.Ravivathani, 2013). Moreover, Akpan (2015) found that board meetings negatively and significantly relate with company performance. Another study conducted on public listed companies in Malaysia using five years data 2003 to 2007 of 328 companies, shows that the higher the number of meetings the worse the firm performance (Amran, 2011).

Whereas, Karamanou et al (2005) found a positive association between frequency board meeting and management earnings forecasts, using a sample of 157 firms in Zimbabwe from 2001-2003; Mangena & Tauringana (2008) report a positive relationship .

Moreover, Ntim & Osei (2011) found a statistically significant and positive association between the frequency of corporate board meetings and corporate performance, implying that South Africa boards that meet more frequently tend to generate higher financial performance. Therefore, the hypothesis is stated as:

- *H*a2: Frequency of board meeting is significantly and positively associated with commercial banks performance

Size of Board Audit committee

Empirical findings on the effect of size of audit committee and corporate performance show mixed results. Ms.S.Danoshana et al (2013) found that increasing Audit Committee Size will result high financial performance, because detailed discussion on the financial statement of the companies will lead to get more ideas regarding the reports and it will guide to increase the firm's performance.

However, in Ethiopia banking industry, Ferede (2012) found that large number of audit committee has a negative and significant effect on financial performance. He added that Limiting audit committee size to reasonable number improves audit committee effectiveness. Therefore, the hypothesis is stated as:
*H*a3: Size of audit committee in a board has a significant positive relationship with the financial performance of commercial banks

Board Experience in the Finance Sector

Their paper claimed that experience of directors enables them to guide, steer and monitor the firm more effectively. In other words, their knowledge of the industry, its opportunities and threats and their connections to the industry participants based on their experience enables them to contribute substantively in the firm performance. Moreover, Ferede (2012) found that a positive association is found between industry specific experience and return on asset and return on equity in Ethiopian Banking Industry. Therefore, the hypothesis is stated as:
*H*a4: There is a significant positive association between board members experience in the Finance sector and commercial banks financial performance

Liquidity and bank performance

Regulation used by NBE to protect bank stakeholders is liquidity ratio. Through the financial inter-mediation role, the commercial banks reactivate the idle funds borrowed from the lenders by investing such funds in different classes of portfolios. Referring to previous empirical findings, the results concerning liquidity are mixed. Molyneux & Thorton (1992) and Guru et al.

(2002) find a negative relationship between liquidity and bank profitability. In contrast, Pasiouras & 32 Kosmidou (2007) found a significant positive relationship between liquidity and bank Profit. And further more Olokoyo (20011) founds no significant relationship between bank liquidity and bank performance. The hypothesis for the study regarding liquidity is stated as follows:

Ho5 There is significant and negative relationship between liquidity and bank performance

1.5 Significance of the Study

- The result of this study would contribute to commercial banking firms by identifying relevant corporate governance mechanisms and look into how such can be integrated in their business practices to enhance performance
- For the researchers who want to conduct further research on similar subjects it shows knowledge gap and pave the way for their new finding
- The result of this study would also contribute to the existing literature by providing evidence on the relation between corporate governance mechanisms and banks' financial performance.

1.6 Scope and limitation of study

There are a number of corporate governance variable that probably influence the performance of banks. But the current study focused on some corporate governance variable to see their relationship with bank performance. This includes: board size, board meeting frequency, liquidity, board experience in finance sector and board audit size. In addition, the study covered only the commercial banking industry which consists of government and private banks .The study period is for 10 years, ranging from 2007 to 2016. One of the limitations was that this study relied on accounting based return, return on asset (ROA), to measure bank financial performance because of lack of secondary market to use market based returns. Adusie (2011) highlighted some of the problems associated with financial accounting reports. These reports suffered from the following defects such as subjection to manipulation, systematically undervaluation of assets, and create distortions due to the nature of depreciation policies adopted, inventory valuation,

treatment of certain revenue and expenditure items. In addition to that, the samples are not selected by employing random sampling technique. Simply they are selected based on availability of data from 2007-2016.

1.7. Organization of the study

The researcher was conduct the final research paper inclusive of statement of the problem, general and specific objective of the study, significance and scope and limitation of study under chapter one part of the study. Chapter two presents theoretical and empirical review of the literature related to the issue of corporate governance and financial performance of commercial banks in Ethiopia; Chapter three provides research design and methodology that would be employed in the analysis; Chapter four contains results and discussion; and Chapter five gives summary, conclusion and recommendations. A "Reference" of related literature was referred while writing the proposal and final paper and appendices are included after chapter five.

CHAPTER TWO

RELATED LITERATURE REVIEW

This chapter reviews related literature on the subject under study as presented by various researchers, scholars, analysts and authors. The review has presented literature on the definition of corporate governance, theories, empirical evidence, the conceptual framework measurements of performance, relevant previous and current studies addressing the importance of corporate governance and its relationship financial performance and measurements of performance that will be relevant to the study.

2.1 Theoretical Review

2.1.1. Defining corporate Governance.

Corporate governance has been defined in different ways by different researcher and authors. According Brigham and Daves ,2004 Corporate governance can be defined as the set of laws, rules and procedures that influence a company's operations and the decisions made by it managers They further state that most corporate governance provisions come in two forms, sticks and carrots. The primary stick is the threat of removal if managers do not maximize the value of the resources entrusted to them while the carrot is compensation that acts as an incentive for managers to maximize intrinsic stock value. Shleifer and Vishny define corporate governance as the ways in which suppliers of finance to corporations make sure of getting a return on their investment. Gillan and Starks take a broad perspective on corporate governance and define it as the system of laws, rules, and factors that control operations in a company. The Organization for Economic Cooperation and Development (OECD) offer a more comprehensive definition of corporate governance as a set of relationships between management of a corporation, its board, its shareholders and other stakeholders, while also providing the structure through which corporate objectives are set, and the means of attaining those objectives and monitoring performance are determined. According to Kim & Rasiah, Corporate governance is the relationship among shareholders, board of directors and the top management in determining the direction and performance of the corporation. It includes the relationship among the many players involved (the stakeholders) and the goals for which the corporation is governed (Kim & Rasiah, 2010). From these definitions, it may be stated that corporate governance frameworks establish systems of accountability and responsibility between the company and its major constituencies by defining the nature of relationship.

2.1.2. Corporate Governance in Ethiopia

There are a lot of companies that are being formed by sale of shares to the wider public unlike most share companies in the past which were formed among founders. The emergence of publicly held share companies in Ethiopia gives rise to a multitude of issues on corporate governance. Typically, ownership separates from the control of dispersed shareholders and goes into the hands of few managers, which in turn creates the principal-agent relationship. In such situations, agents (managers) may misappropriate the principals‟ (shareholders‟) investments as they have more information and knowledge than the shareholders. Where there exist few block holders in share companies, minority shareholders could be exploited in the hands of such block holders. The agency problems that could occur between dispersed shareholders and managers and/or block holders of share companies in Ethiopia, therefore, necessitate good corporate governance laws and institutions. Some scholarly works have been published recently on company law in general and corporate governance in particular by Ethiopian academics.

Minga Negash (2008) observes that the status of corporate governance in Ethiopia is disappointing and notes that "the Commercial Code of 1960 does not provide adequate legislative response to complex governance issues of the day, and the new draft corporate law has not yet been finalized;" and he further states that "key international conventions, codes and standards are not ratified or adequately incorporated in the Proclamations" and that "the Decrees and Directives lack coherence and foresights, and at times suffer from poor drafting."

Fekadu Petros (2010) underlines the growing separation between ownership and control in Ethiopia, and he submits some empirical evidence in this regard. Relying on the data and literature on corporate governance, he shows the deficiency of the Commercial Code in protecting the rights of minority shareholders in the context of publicly held companies. He raises crucial issues such as: "what powers does the board have? Who is it accountable to? How is it organized? What are its standards of liability?" among others. In his book titled „Ethiopian Company Law‟ (2011), Fekadu further addresses most of the issues in corporate governance related to board of directors.

Tewodros Meheret (2011) discusses the legal regime applicable to governance of share companies in Ethiopia. He explores the theoretical background and legal framework of corporate governance and examines the rules of governance in light of available standards. In particular, he discusses the structural choice, appointment and removal, powers, duties and responsibilities,

remuneration, and the working methods and mechanism for controlling the boards of directors. Tewodros states that "a share *company is managed* by its board which is composed of directors appointed by the general meeting of shareholders."

The study conducted by the Addis Ababa and Ethiopia Chambers of Commerce and Sectoral Associations on corporate governance in Ethiopia suggests the introduction of a voluntary code of corporate governance in the country. It recommends that "corporate governance law reform should consider key development policy aspects which match with the country's plans for poverty reduction and wealth creation." This article takes the themes discussed in the aforementioned works further and makes a distinction between corporate governance and corporate management, and examines whether the same should be stipulated in the relevant laws with a clear articulation of the powers of non-executive board members. I contend that corporate governance is different from corporate management; and share companies are governed by a non-executive board while management is the task of the executive of a company. The article also argues that there is inadequacy in the law on the composition and independence of directors and forwards recommendations. Prior works have dealt with the importance of the remuneration of directors. This author takes this theme further and argues that companies should pay directors‟ remuneration even where articles of associations are silent. A procedure helpful for the determination of directors‟ remuneration will be indicated to resolve the controversies surrounding the quantum of directors‟ remuneration. This article tries to deal with issues that have not been addressed by making specific reference to the roles, composition and remuneration of board of directors in the governance of share companies in Ethiopia.

2.1.3. Theories of Corporate Governance

In this section, some of the corporate governance theories are reviewed for understanding how they relate to corporate governance. In this study, the discussion of corporate governance theories included agency theory, stakeholder theory, stewardship theory, and resource dependency theory.

2.1.3.1 Agency theory.

According to Habbash (2010) agency theory is the most popular and has received greater attention from academics and practitioners. The agency theory is based on the principal agent

relationships. The separation of ownership from management in modern corporations provides the context for the functioning of the agency theory. In modern corporations the shareholders (principals) are widely dispersed and they are not normally involved in the day to day operations and management of their companies rather they hire mangers (agent) to manage the corporation on behalf of them (Habbash, 2010). The agents are appointed to manage the day to day operations of the corporation. The separation of ownership and controlling rights results conflicts of interest between agent and principal. To solve this problem or to align the conflicting interests of managers and owners the company incurs controlling costs including incentives given for managers.

According to Jensen and Meckling (2006) stated that an agency relationship is a contract under which one or more persons (the principal (s)) engage another person (the agent) to perform some services on their behalf which involves delegating some decision – making authority to the agent. The problem is that the interest of managers and shareholders is not always the same. Managers will use the excess free cash flow available to fulfill their personal interests instead of increasing returns to the shareholders (Jensen and Reeback, 2003).

In agency theory, shareholders of a company are the only owners and the duty of top management should be solely to ensure that shareholders' interests are met. This means in other words, the duty of top managers is to manage the company in such a way that returns to shareholders are maximized thereby increasing the profit figures and cash flows (Ellist, 2002). However, Jensen and Meckling (2006) described that managers do not always run the firm to maximize returns to the shareholders. Their agency theory was developed from this explanation and the principal-agent problem was taken into consideration as a main element to determine the performance of the firm.

Agency problems arise within a firm whenever managers have incentives to pursue their own interests at the expense of the shareholders' interests. Several mechanisms can reduce these agency problems. An obvious one is managerial shareholdings. In addition, concentrated shareholdings by institutions or by block holders can increase managerial monitoring and so improve firm performance, as can an outsider representation on corporate boards. The use of debt financing can improve performance by inducing monitoring by lenders. The idea of agency theory therefore is precisely to address problems arising from the separation between ownership

and management caused by differences in motivation and objectives between owners and managers, asymmetry of information and risk references. (Agrawal and Knoeber 1996)

From agency theory view point, corporate governance improves corporate performance by resolving agency problems through monitoring management activities, controlling self-centered behaviors of management and inspecting the financial reporting process (Habbash, 2010). Moreover, corporate governance is able to alleviate agency costs by aligning the conflicting interests of management and shareholders through monitoring management and using different corporate governance mechanisms. Therefore, corporate governance mechanism such as boards of directors and audit committees enables shareholders to closely monitor the activities of managers. Ineffective board and audit committee may give confidence for managers to pursue their own interests but effective board and audit committee can reduce deceptive behavior of managers by detecting fraudulent financial report and actively monitoring.

According to the assumptions of agency theory corporate governance affect financial performance. As a consequence, enhancing corporate governance should result improved financial performance.

2.1.3.2 Stakeholders Theory

Stakeholder's theory is considered as the most leading challenge to the agency theory because it emphasizes that the purpose of firm should be defined broader than the mere maximization of shareholder welfare.(ochola,2013) Other parties who have interest in firm's long term success should also be taken into account when a firm's objective function is defined. Different scholars have given different definitions of stakeholder theory.

According to Clarkson (1994) stakeholder's theory defined as firm is a system of stakeholders operating within the larger system of the host society that provides the necessary legal and market infrastructure for the firm's activities. The purpose of the firm is to create wealth or value for its stakeholders by converting their stakes into goods and services. This view was supported by Blair (1995) who proposed that the goal of directors and management should be maximizing total wealth creation by the firm. The key to achieving this is to enhance the voice of and provide ownership-like incentives to those participants in the firm who contribute or control critical,

specialized inputs (firm specific human capital) and to align the interests of these critical stakeholders with the interests of outside, passive shareholders.

According to Mangunyi, (2011) stakeholders can include shareholders, suppliers, customers, Governments, lenders employees, local charities, and various interest groups Stakeholder theory balances between the interests of firm stakeholders and their satisfaction. The advocates of stakeholder theory require firm managers to design and implement proper methodologies to identify the nature of the relationship between the managers and interested parties to achieve their goals. The economic value for any firm is created by parties who voluntarily come together, coordinate, cooperate, and then improve and enhance everyone's c According to Freeman et al. (2004), stakeholder theory begins with the assumption that values are necessarily and explicitly a part of doing business. It asks managers to articulate the shared sense of the value they create, and what brings its core stakeholders together. It also pushes managers to be clear about how they want to do business, specifically what kinds of relationships they want and need to create with their stakeholders to deliver on their purpose. According to stakeholder theory the purpose of the firm is to serve and coordinate the interests of its various stakeholders such as shareholders, employees, creditors, customers, suppliers, government, and the community.

According to Habbash (2010), stakeholder refers to any one whose goals have direct or indirect connections with the firm and influenced by a firm or who exert influence on the firms goal achievement. These include management, employees, clients, suppliers, government, political parties and local community. According to this theory, the stakeholders in corporate governance can create a favorable external environment which is conducive to the realization of corporate social responsibility. Moreover, the stakeholders in corporate governance will enable the company to consider more about the customers, the community and social organizations and can create a stable environment for long term development.

The advantage of the stakeholder model emphasis on overcoming problems of underinvestment related with opportunistic behavior and in encouraging active co-operation amongst stakeholders to ensure the long-term profitability of the business firm (Maher & Andersson, 1999). According to Kyereboah-Coleman (2007) management receive capital from shareholders, they depend upon employees to accomplish the objective of the company. External stakeholders such as customers, suppliers, and the community are equally important, and also constrained by formal and informal

rules that business must respect. According to stakeholders theory the best firms are ones with committed suppliers, customers, and employees and management. Recently, stakeholder theory has received attention than earlier because researchers have recognized that the activities of a corporate entity impact on the external environment requiring accountability of the organization to a wider audience than simply its shareholders (Kyereboah-Coleman, 2007). Companies are no longer the instrument of shareholders alone but exist within society. It has responsibilities to the stakeholders. However, most researchers argue that it is unrealistic task for managers (Sundaram & Inkpen, 2004b; Sanda et al., 2005). The stakeholder theory has not been subjected to much empirical study.

The common criticisms for stakeholder theory is that how to align the stakeholders conflicting interests since the difficulties result from how to administer different stakeholders with various needs and demands. It is not possible to treat all stakeholders equally (Habbash, 2010). Moreover, it is not practical for all stakeholders to be effectively represented in corporate governance recommendations as this may undermine the welfare of company (Habbash). The other critique of the stakeholder model is that managers or directors may use "stakeholder" reasons to justify poor company performance (Maher & Andersson, 1999).

2.1.3.3 Stewardship theory

In contrast to agency theory, stewardship presents a different model of management, where managers are considered good stewards who will act in the best interest of the owners (Donaldson & Davis, 1991) the exponents of stewardship theory assume that management aspires to high objectives by high levels of responsibility and achievement, and self-motivation, and also protecting the firm through collective actions. In stewardship theory, management acts selflessly for the benefits of the firm and owners (Pelayo-Maciel et al., 2012)

According to Smallman (2004) where shareholder wealth is maximized, the steward's utilities are maximized too, because organizational success will serve most requirements and the stewards will have a clear mission. He also states that, stewards balance tensions between different beneficiaries and other interest groups. Therefore stewardship theory is an argument

Put forward in firm performance that satisfies the requirements of the interested parties resulting in dynamic performance equilibrium for balanced governance

Stewardship theory sees a strong relationship between managers and the success of the firm, and therefore the stewards protect and maximize shareholder wealth through firm performance. A steward, who improves performance successfully, satisfies most stakeholder groups in an organization, when these groups have interests that are well served by increasing organizational wealth (Davis, Schoorman & Donaldson 1997). When the position of the CEO and Chairman is held by a single person, the fate of the organization and the power to determine strategy is the responsibility of a single person. Thus the focus of stewardship theory is on structures that facilitate and empower rather than monitor and control (Davis, Schoorman & Donaldson 1997). Therefore stewardship theory takes a more relaxed view of the separation of the role of chairman and CEO, and supports appointment of a single person for the position of chairman and CEO and a majority of specialist executive directors rather than non-executive directors (Clarke 2004).

2.1.3.4 Resource dependency theory

Resource dependency theory was developed by Pfeffer (1972), which posited that companies depend on one another for getting the required resources; there by links are created (Ovidiu-Niculae, Lucian, & Cristiana, 2012). According to this theory, there are motivations and incentives for a company to create linkages with outside parties, as this help to reduce the environmental uncertainties the company faces. The companies will consider the advantages of linking and engaging in open dialogue by taking into account the costs and direct benefits associated with their decisions due to their commitment to dialogue. Also, companies that have a good relationship with the key stakeholders can create value for the companies and reduce their risks. Accordingly, companies with strong relationship with stakeholders face less uncertainty (Rehbein, Logsdon, & Buren, 2013).

The agency theory concentrated on the monitoring and controlling role of board of directors whereas the resource dependency theory focus on the advisory and counseling role of directors to a firm management. Recently, both economists and management scholars tend to assign to boards the dual role of monitors and advisers of management. However, whether boards perform such functions effectively is still a controversial issue (Ferreira, 2010). Within a corporate governance framework, the composition of corporate boards is crucial to aligning the interest of management and shareholders, to providing information for monitoring and counseling, and to ensuring effective decision-making (Marinova et al., 2010). The dual role of boards is

recognized. However, board structure has relied heavily on agency theory concepts, focusing on the control function of the board (Habbash, 2010).

Each of the three theories is useful in considering the efficiency and effectiveness of the monitoring and control functions of corporate governance. But, many of these theoretical perspectives are intended as complements to, not substitutes for, agency theory (Habbash, 2010). Among the various theories discussed, agency theory is the most popular and has received the most attention from academics and practitioners. According to Habbash (2010), the influence of agency theory has been instrumental in the development of corporate governance standards, principles and codes. Mallin (2007) provides a comprehensive discussion of corporate governance theories and argues that the agency approach is the most appropriate because it provides a better explanation for corporate governance roles (as cited by Habash, 2010).

2.1.4. Corporate Governance and Banks

Corporate governance is an essential issue for the management of banks, which can be viewed from two dimensions. One is the transparency in the corporate function, thus protecting the investors‟ interest (reference to agency problem), while the other is concerned with having a sound risk management system in place (special reference to banks) (Jensen and Meckling, 1976).

The Basel Committee on Banking Supervision (2014) states that from a banking industry perspective, corporate governance involves the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management. This thus affect how banks:

- Set the bank’s strategy and objectives.
- Determine the bank’s risk tolerance
- Operate the bank’s business on a day-to-day basis
- Protect the interests of depositors, meet shareholder obligations, and take into account the interests of other recognized stakeholders; and
- Align corporate activities and behavior with the expectation that the bank will operate in a safe and sound manner, with integrity and in compliance with applicable laws and regulations.

King and Levine (1993) and Levine (1997) emphasized the importance of corporate governance of banks in developing economies and observed that: first, banks have an overwhelmingly dominant position in the financial system of a developing economy and are extremely important engines of economic growth. Second, as financial markets are usually underdeveloped, banks in developing economies are typically the most important source of finance for majority of firms. Third, as well as providing a generally accepted means of payment, banks in developing countries are usually the main depository for the economy‟s savings. Banking supervision cannot function if there does not exist what Hettes (2002) calls "correct corporate governance" since experience emphasizes the need for an appropriate level of responsibility, control and balance of competences in each bank. Hettes explained further on this by observing that correct corporate governance simplifies the work of banking supervision and contributes towards corporation between the management of a bank and the banking supervision authority.

Crespi, Cestona and Salas (2002) contend that corporate governance of banks refers to the various methods by which bank owners attempt to induce managers to implement value maximizing policies. They observed that these methods may be external to the firm, as the market for corporate control or the level of competition in the product and labor markets and that there are also internal mechanisms such as a disciplinary intervention by shareholders (what they refer to as proxy fights) or intervention from the board of directors. Donald Brash the Governor of the Reserve Bank of New Zealand when addressing the conference for Commonwealth Central Banks on Corporate Governance for the Banking Sector in London, June 2001 observed that: …improving corporate governance is an important way to promote financial stability. The effectiveness of banks internal governance arrangements has a very substantial effect on the ability of a bank to identify, monitor and control its risks. Although banking crises are caused by many factors, some of which are beyond the control of bank management, almost every bank failure is at least partially the result of mismanagement within the bank itself. And mismanagement is ultimately a failure of internal governance. Although banking supervision and the regulation of banks‟ risk positions can go some way towards countering the effects of poor governance, supervision by some external official agency is not a substitute for sound corporate governance practices. Ultimately, banking risks are most likely to be reduced to acceptable levels

by fostering sound risk management practices within individual banks. An instilling sound corporate governance practice within banks is a crucial element of achieving this.

2.1.5. The nature of commercial banks

A commercial bank is a type of bank that provides services such as accepting deposits, making business loans, and offering basic investment products. Commercial bank can also refer to a bank or a division of a bank that mostly deals with deposits and loans from corporations or large businesses, as opposed to individual members of the public (retail banking). In the United States the term "commercial bank" was often used to distinguish it from an investment bank due to differences in bank regulation. After the great depression, through the Glass–Steagall Act, the U.S. Congress required that commercial banks only engage in banking activities, whereas investment banks were limited to capital market activities. This separation was mostly repealed in the 1990s.

The activities of commercial banks: Commercial banks engage in the following activities, processing payments via telegraphic transfer, electronic fund transfer, point of sales, internet banking, or other, issuing bank drafts and bank cheques, accepting money on term deposit, lending money by overdraft, installment loan, or other, providing documentary and study guarantees, performance bonds, securities underwriting commitments and other forms of off balance sheet exposure, cash management and treasury, merchant banking and private equity financing. Traditionally, large commercial banks also underwrite bonds, and make markets in currency, interest rates, and credit-related securities, but today large commercial banks usually have an investment bank arm that is involved in the aforementioned activities.

Functions: Commercial banks perform many functions. They satisfy the financial needs of the sectors such as agriculture, industry, trade, communication, so they play very significant role in a process of economic social needs. The functions performed by banks, since recently, are becoming customer-centered and are widening their functions. Generally, the functions of commercial banks are divided into two categories: primary functions and the secondary functions.

Primary functions include: Commercial banks accept various types of deposits from public especially from its clients, including saving account deposits, recurring account deposits, and fixed deposits. These deposits are payable after a certain time period Commercial banks provide

loans and advances of various forms, including an overdraft facility, cash credit, bill discounting, money at call etc. They also give demand and demand and term loans to all types of clients against proper security. Credit creation is most significant function of commercial banks. While sanctioning a loan to a customer, they do not provide cash to the borrower. Instead, they open a deposit account from which the borrower can withdraw. In other words, while sanctioning a loan, they automatically create deposits, known as a credit creation from commercial banks. Along with primary functions, commercial banks perform several secondary functions, including many agency functions or general utility functions. The secondary functions of commercial banks can be divided into agency functions and utility functions.

Agency functions include:

- To collect and clear checks, dividends and interest warrant.
- To make payments of rent, insurance premium, etc.
- To make deal in foreign exchange transactions.
- To purchase and sell securities.
- To act as trustee, attorney, correspondent and executor.
- To accept tax proceeds and tax returns.

Utility functions include:

- To provide safety locker facility to customers.
- To provide money transfer facility.
- To issue travelers cheques.
- To act as referees.
- To accept various bills for payment: phone bills, gas bills, water bills, etc.
- To provide merchant banking facility.
- To provide various cards: credit cards, debit cards, smart cards, etc.

2.1.6. The role of banks

To start very basic, this paragraph discusses the role of banks in the economy and examines the question why banks exist. At first sight, the answer to this question is very intuitive and simple; banks act as an intermediary between those who are in need for money and those who have excess of money. Looking more closely to this question there could be a more detailed explanation. Namely, in a perfect capital market of Modigliani-Miller (1958),

financial institutions are superfluous Santos (2001); namely, entities can borrow and save directly through the capital market. In reality, such perfect market does not exist; transaction costs and monitoring costs distort capital markets. Furthermore, capital markets suffer from the information asymmetry and the agency problem. The agency problem refers to the dissimilar incentives of borrowers and savers, in a broader context it refers to the dissimilar incentives of principles and agents Jensen & Meckling (1976). In a case of financial distress, borrowers are limited liable; implying that they have incentives to alter their behavior by taking on more risk than savers are willing to accept. Monitoring the borrower"s behavior is time consuming, complex and expensive for individuals. In general, in inefficient markets, financial intermediation is beneficial since banks have lower monitoring and transaction costs than individuals, due to economies of scale and scope. Another important aspect of banking is the function of maturity transformation. Banks receive short-term savings from depositors and transform those savings into long-term loans to borrowers.

By holding a part of the short-term savings in liquid assets and cash, banks could withstand daily withdrawals from depositors. Banks offer a unique service; lending long term while guaranteeing the liquidity of their liabilities to depositors, which can withdraw their money at any time without a decline in nominal value Schooner & Talyor (2010) cited in van Ommeren (2011). Capital markets cannot achieve maturity transformation with the same benefits as banks can. Individual investors face liquidity, price and credit risk, which they cannot diversify to the extent banks can. As savers do not withdraw their deposits at the same time, banks hold only a minor part of the savings in liquid cash. Thus, banks diversify liquidity risks over a large pool of savers. Individual savers can also diversify their investments in terms of credit and price risks but it remains unlikely that they could withdraw the investments at any time without facing liquidity issues.

Nowadays, bank activities are more diverse than ever. In the past decades, competition has increased and new activities have emerged. The traditional form of banking, receiving deposits and extending credits, has become less important. Ever since the complexity of balance sheet has increased, as did balance sheet and risk management van Greuning & Bratanovic (2009) cited in van Ommeren (2011). Besides the incorporations of liquidity, price and credit risks in banking activities, banks increasingly faces market risks (e.g. interest rate risk and currency risk). One

may assume that bank‟s risk managers properly diversify these risks and closely monitor borrower‟s behavior to avoid bank failure or financial distress. Nevertheless, monitoring bank behavior is required to safeguard the continuity and stability of the banking sector due to moral hazard issues.

2.2 Empirical Literature

2.2.1 Corporate governance mechanisms and firms financial performance

Agency theory and many other corporate governance mechanisms suggest that good corporate governance improves firm performance (Garcia-Marco & Fernandez, 2008). However, global events concerning poor performance and eventual collapse of high profile companies such as Enron, World.com, Bank of Commerce and Credit International, among others have awakened need to strengthen corporate governance in both developed and developing countries (Sanda, et al. 2005). Due to the importance of corporate governance, the Basel II committee on banking underscored the need for commercial banks to embrace uniform corporate governance practices for the sake of fostering stability and performance in this important sector. Bank failures are known to generate negative externalities in a country for two reasons: they destroy specific capital leading to further contagion losses in the system. On the same token, bank closures reduce economic welfare in a country because they create loss of relationship between banks with their clients and specific knowledge of management and risk preferences required to improve performance (Myron et al. 1999). The costs of bank closures are also quite enormous because they may spread throughout the entire banking system hence amplifying negative effects on unrelated intermediaries. Based on these findings, Linyiru, (2006), argues that even though there is awareness and existence of corporate governance mechanisms in the banking sector, there is need to strengthen these practices owing to the special nature of banks.

Recent findings in studies on the relationship between corporate governance and performance in banking firms in different parts of the world are inconclusive or even contradictory. Love and Rachinsky, (2007) find a negative relationship between corporate governance and bank performance. However, Mangu‟nyi, (2011) finds that there is no significant difference between banks ownership structure, financial performance and corporate governance practices commercial banks in Kenya .Among the Ethiopians studies Desta (2016) find that disclosure practice, board size, board gender diversity and ownership type have no significant impact on the

financial performance of Ethiopian commercial banks, Kelifa (2012)finds that board size and existence of audit committee in the board had statistically significant negative effect on bank performance in terms of both ROE and ROA; whereas bank size had statistically significant positive effect on bank performance in terms of both ROE and ROA, Ferede (2012) concluded that large size board and audit committee negatively influences financial performance; board members educational qualification positively associated with financial performance; industry specific experience of director positively related with return on asset but it has a negative effect on net interest margin; and the percentage of female directors and board members business management experience does not have a significant effect . The corporate governance elements considered in this research include Board size, Board meetings frequency, Liquidity ratio, Size of Board Audit committee and Board Experience in the Finance Sector

2.2.1.1 Board size

Board size affects the extent of supervision, controlling, monitoring, and decision making in a firm. The scholars have not concurred on one optimal size for the board of directors. Vintila & Gherghina, 2012 concluded that there is an inverse relationship between a company value and board size. However, determining an ideal size of the board has being an ongoing and controversial debate in corporate governance literature (Lawal, 2012). Whether large or small board help improve firm performance it is debatable issue and researchers found mixed result about the relation between board size and firm performance.

The size of the board is measured by the number of board members as has been done by many authors such as Hermalin and Weisbach (1999, 2002), (Ferede, 2012), (Akpan, 2015) and (Jensen & Meckling, 1976). In their various studies, the size of the board has been seen to have an inverse relationship with firm performance. Jensen M. (1993) argues that a larger board leads to less effective monitoring due to coordination and process problems inherent in large board size. Larger boards can be less participative, less cohesive, and less able to reach consensus. Small board size was favored to promote critical, genuine and intellectual deliberation and involvement among members which presumably might led to effective corporate decision making, monitoring and improved performance (Lawal, 2012). Moreover, Akpan (2015) found that board size and equity are also found to be negative and significant with company performance. Ferede (2012) also found that the numbers of board of directors' are negatively

related with Ethiopian commercial banks' financial performance. His result indicates that small boards are more effective in monitoring and controlling banks management and it help to reduce agency costs. Thus, it is expected that the size of the board would have a direct correlation with performance.

In contrast, a number of scholars have contended that larger boards have their benefits and when board size increases firm performance also goes up as more board members provide greater monitoring, advice and make available better linkages to the external environment (Chenuos, Mohamed, & Bitok, 2014). Moreover, Klein (2002) suggested that larger boards able to promote effective monitoring due to their ability to distribute the work load over a greater number of observers. Moreover, Results from (Akpan & Amran, 2014) study showed that board size has positive significant influence on company performance.

They also found that Educational qualification affects the oversight and monitoring role of boards of directors. Akpan (2015) found board education is positively significant impact on the firm performance. Moreover, Ferede (2012) found that the presence of qualified directors on the board plays an important role in carrying out the boards monitoring responsibility and in improving financial performance. Thus, board members educational qualification has a significant positive effect on Ethiopian banks financial performance.

2.2.1.2 Board meetings frequency

Meeting frequency refers to how much time Board meet on a year. For board to effectively perform its oversight function and monitor management performance, the board must hold a regular meeting. Measuring the intensity and effectiveness of corporate monitoring and discharging is the frequency of board meetings (Jensen M. 1993).

Empirical findings on the effect of frequent board meetings and corporate performance show mixed results.

Some studies concluded more meeting frequency has a negative impact on the performance. Vefeas (1999) reported a statistical significance and negative relationship between frequency board meetings and corporate performance. He also finds that operating performance significantly improves following a year of abnormal board activity. Meeting Frequency has a significant negative impact on ROA and an increasing in meeting frequency will reduce the

ROA. (Ms.S.Danoshana & Ms.T.Ravivathani, 2013). Moreover, Akpan (2015) found that board meetings negatively and significantly relate with company performance. Another study conducted on public listed companies in Malaysia using five years data 2003 to 2007 of 328 companies, shows that the higher the number of meetings the worse the firm performance (Amran, 2011).

Whereas, Karamanou et al (2005) found a positive association between frequency board meeting and management earnings forecasts, using a sample of 157 firms in Zimbabwe from 2001-2003; Mangena & Tauringana (2008) report a positive relationship between board meeting frequency and corporate performance. Similarly in a study of the sample of 169 listed corporations from 2002-2007 in South African, a statistical significant and positive association between the frequency of board meeting and corporate performance exist (Ntim & Osei, June 2011). This implies that the board of directors in South Africa that meet more frequently tend to generate higher financial performance. Moreover, Ntim & Osei (2011) found a statistically significant and positive association between the frequency of corporate board meetings and corporate performance, implying that South Africa boards that meet more frequently tend to generate higher financial performance.

2.2.1.3 Liquidity and bank performance

Regulation used by NBE to protect bank stakeholders is liquidity ratio. Through the financial inter-mediation role, the commercial banks reactivate the idle funds borrowed from the lenders by investing such funds in different classes of portfolios. Such business activity of the bank is not without problems since the deposits from these fund savers which have been invested by the banks for profit maximization, can be recalled or demanded when the latter is not in position to meet their financial obligations. There are two conflicting views as to the impact of liquidity on bank performance. The first view is that liquidity has a positive impact on bank performance. According to this view, when a bank has adequate liquidity, it can obtain sufficient funds, either by increasing liabilities or by converting assets promptly, at a reasonable cost, thereby affecting profitability positively. The second view is that since investment in liquid asset has relatively lower income than investment in illiquid assets, keeping more liquid asset affects the profitability negatively. Referring to previous empirical findings, the results concerning liquidity are mixed. Molyneux & Thorton (1992) and Guru et al. (2002) find a negative relationship between

liquidity and bank profitability. In contrast, Pasiouras & 32 Kosmidou (2007) found a significant positive relationship between liquidity and bank Profit. And further more Olokoyo (20011) founds no significant relationship between bank liquidity and bank performance.

2.2.1.4 Size of Board Audit committee

An audit committee is an operating committee of the board of directors charged with oversight of financial reporting and disclosure. Committee members are drawn from members of the company's board of directors, with a Chairperson selected from among the committee members. Its role includes choice and monitoring of accounting principles and policies, overseeing appointment, dismissal of external auditors, monitoring internal control process, discussing risk management policies and practice with management and overseeing the performance of internal audit function

Internationally, the audit committee is a committee of the board of directors responsible for oversight of the financial reporting process, selection of the independent auditor, and receipt of audit results both internal and external. The committee assists the board of directors fulfill its corporate governance and overseeing responsibilities in relation to an entity’s financial reporting, internal control system, risk management system and internal and external audit functions. Its role is to provide advice and recommendations to the board within the scope of its terms of reference / charter.

Empirical findings on the effect of size of audit committee and corporate performance show mixed results. Ms.S.Danoshana et al (2013) found that increasing Audit Committee Size will result high financial performance, because detailed discussion on the financial statement of the companies will lead to get more ideas regarding the reports and it will guide to increase the firm’s performance.

However, in Ethiopia banking industry, Ferede (2012) found that large number of audit committee has a negative and significant effect on financial performance. He added that Limiting audit committee size to reasonable number improves audit committee effectiveness.

2.2.1.5 Board Experience in the Finance Sector

Board experience in the sector refers to board member who had any finance related work experience.

Appointing directors with related and relevant skills and knowledge to perform task specific duties such as the firm's internal control and procedures will enhance the quality of information gathered and the solution to problems and of the views held and judgments made during the decision-making process (DeZoort, 1998 as cited by Saat et al 2011). Their paper claimed that experience of directors enables them to guide, steer and monitor the firm more effectively. In other words, their knowledge of the industry, its opportunities and threats and their connections to the industry participants based on their experience enables them to contribute substantively in the firm performance. Moreover, Ferede (2012) found that a positive association is found between industry specific experience and return on asset and return on equity in Ethiopian Banking Industry.

2.2.2 Summary of empirical study and research gap

Adnan et al (2011) investigated the impact of corporate governance on efficiency of twelve listed banks in Malaysia between 1996 and 2005. The corporate governance variables were represented by board leadership structure, board composition, board size, director ownership, institutional ownership and block ownership, while bank efficiency was used to measure the performance. The findings revealed that smaller board size and higher percentage of block ownership led to better efficiency. However, the rest of the corporate governance variables did not have significant and consistent impact on efficiency.

Miring'u and Muoria (2011) examined how corporate governance affects performance in commercial state corporations in Kenya. The results were based on a sample of 30 respondents out of 41 commercial state corporations. The findings were that the board size mean for the sample was found to be ten while a minimum of three outside directors is required on the board. The study disclosed that there was a positive relations between Return on Equity and board size and board compositions of all state corporations.

Ferede (2012) studied the impact of corporate governance Mechanism on Bank performance in Ethiopia and concluded that large size board and audit committee negatively influences financial performance; board members educational qualification positively associated with financial performance; industry specific experience of director positively related with return on asset but it

has a negative effect on net interest margin; and the percentage of female directors and board members business management experience does not have a significant effect.

Ashenafi *et al.* (2013) examined corporate governance mechanisms and their impact on performance of commercial banks. The study assessed the relationship between selected internal corporate governance mechanisms (board of directors‟ structure, board size, audit existence, bank size, and ownership type) and external corporate governance mechanism (government regulation and supervision, capital adequacy ratio, loan loss provision allowance) that were adopted as independent variables. ROA and ROE (dependent variables) were adopted as performance measures. The findings of the study indicated that: board size and existence of audit committee in the board had statistically significant positive effect on bank performance (ROA and ROE). Similarly, capital adequacy ratio as a proxy of external corporate governance had statistically significant positive effect on bank

However, Desta (2016) studied the effect of corporate governance on financial performance of Ethiopian commercial banks. He used annual reports of sample commercial were the sources of data. The proxies used for financial performance are return on equity and return on asset. Content analysis was applied to determine the level of disclosure using un-weighted checklist. In addition, correlation and regression analyses were made to determine the relation between corporate governance and financial performance. The results indicate that disclosure practice, board size, board gender diversity and ownership type have no significant impact on the financial performance of Ethiopian commercial banks. However, asset size and capital structure have significant effect on both on the return on equity and return on asset

Based on the empirical studies gathered there have been mixed findings on the relationship between corporate governance and bank performance. Furthermore, the contradictory conclusions that results from the above researches call for a detailed investigation to be conducted in the area. In general, the lack of sufficient research on the relationship between governance mechanism and bank performance in the context of Ethiopia and the existence of knowledge gap in the area are the root causes for undertaking this study. Therefore, the objective of this study will be to investigate the relationship between corporate governance mechanism and

financial performance of commercial banks in Ethiopia and to fill the knowledge gap that exists in the area.

CHAPTER THREE

3. RESEARCH DESIGN AND METHODOLOGY

This chapter discusses the methods and procedures that were employed in carrying out the research. It discusses the research design, study population, data collection procedure, data analysis and presentation.

3.1 Research design

The primary aim of this study is to examine the relationship between corporate governance mechanisms and financial performance. To achieve this objective explanatory type of research design with a mixed approach, more of quantitative, was employed. The explanatory type of research design helps to identify and evaluate the causal relationships between the different variables under consideration (Marczyk et al., 2005). So that, in this study the explanatory research design was employed to examine the relationship of the stated variables. Mixed

methods research provides better (stronger) inferences. Therefore, by using a mixed approach it is able to capitalize the strength of quantitative and qualitative approach and remove any biases that exist in any single research method (Creswell, 2003). A panel data study design which combines the attributes of cross sectional (inter-firm) and time series data (inter-period) was used. The advantage of panel data analysis is that more reliable estimates of the parameters in the model can be obtained (Gujarati, 2004).

3.2 Source of data and type of data

In order to achieve the objective of the study the researcher used both primary and secondary data source. The secondary data collected from the audited financial statements of sample banks from NBE and the primary data was collected through the use of questionnaires.

3.3 Population and Sample for the Study

According to official website of the NBE, Currently there are 17 commercial banks operating in Ethiopia, however the researcher selected only banks under operation at least two years before starting point of sample period (2007). Commercial banks did not have information for the required period and their year of service was below ten years were excluded in the sampling frame to make the balanced data structured, i.e. every cross section follows the same regular frequency with the same start and end dates. Therefore, purposive sampling was employed so as to include all commercial banks established and serving with in the specified period of time from 2007 to 2016. Sample size was determined by the availability of information on the variables under the study. The size for sample was eight commercial banks operating over the period of ten years and the rest of commercial banks were not having a chance to be included.

Table 3.1 list of sample selected bank

S.N	Name of bank	Year of establishment
1	Commercial banks of Ethiopia (CBE)	1963 E.C
2	Awash Banks S.C (AB)	1994 E.C
3	Dashen Bank S.C (DB)	1995 E.C
4	Bank of Abyssinia S.C (BoA)	1996 E.C
5	Wegagen Bank S.C (WB)	1997 E.C
6	United Bank S.C (UB)	1998 E.C
7	Nib International Bank S.C (NIB)	1999 E.C
8	Cooperative Bank of Oromia S.C(CBO)	2004.E.C

3.4 Data Analysis and presentation

The method of analysis used in the study is descriptive statistics, correlation and linear regression methods. The descriptive statistics used to quantitatively describe the important features of the variables using mean, maximum, minimum and standard deviations. The correlation analysis would be used to identify the relationship between the independent, dependent and control variables. The correlation analysis shows only the degree of association between variables and does not permit the researcher to make causal inferences regarding the relationship between variables. Therefore, multiple panel linear regression analysis also used to test the hypothesis and to explain the relationship between corporate governance variables and financial performance measures by controlling the influence of some selected variables. Stat version 12 also used for analysis and the results were presented through tables, percentage and diagram.

Due to the combination of cross-sectional data and time-series data, the OLS regression technique is unsuitable for the analysis (Learner 1978). The appropriate method of analysis involves panel data regression techniques. The big advantage of working with panel data is that we will be able to control for individual- specific, time- invariant, unobserved heterogeneity, the presence of which could lead to bias in standard estimator. In addition to the points mentioned earlier, there are some advantages of using panel data. Some of them are highlighted as follows (Pesaran, Shin and Smith, 2000; Wooldridge, 2003; Baum, 2006 cited in Westham, 2009):

i) It gives more informative data, more variability, less co-linearity among variables, more degrees of freedom, and more efficiency. This is because it combines time series of cross-section observations.

ii) It can detect and measure effects that simply cannot be observed when using only cross-section or time series data.

iii) It minimizes the bias that might result from aggregation of individual units into broad aggregates. This is due to the fact that data are made available for several units in a panel data setting. Therefore, panel multiple regression model used employed in this study to investigate the relationship between corporate governance variables and financial performance.

3.5 Description of Variables and Measurements

In this study, the variables selected based on alternative theories and previous empirical studies related to corporate governance and firm performance. In accordance with the theory and empirical studies, the independent, dependent and control variables of the study have been identified in order to investigate the relationship of corporate governance mechanisms and financial performance of commercial banks in Ethiopia.

3.5.1. Dependent Variable

Bank performance variables mostly financial performance measures either with accounting-based return, market based return or both. Even though market-based returns are widely acceptable for performance measure by most researchers, they are excluded from this study. This is because of the unavailability of data. For example, to use Tobin's Q we need current market price of stock. Such data is not available in Ethiopia as the country has no stock market. In absence of market based data most researches used ROA and ROE as a proxy to performance. In

this study the researcher chooses ROA over ROE as a proxy to bank performance because of the following reasons. Because ROE weighs net income only against owners' equity, it doesn't say much about how well a company uses its financing from borrowing and bonds. Such company may deliver an impressive ROE without actually being more effective at using the shareholders' equity to grow the company. ROA, because its denominator includes both debt and equity, can help us to see how well a company uses both these forms of financing. Since banking industry financial structure is more of debt than equity using ROA (return on both equity and debt) is judicious base to measure performance. In this study accounting-based measure, ROA is used. ROA is measured by the ratio of after tax net income to total assets of the sample banks.

$$ROA = \frac{\text{Profit before tax}}{\text{Total Asset}}$$

3.5.2. Independent Variables

The independent variables which are going to be used for this study are variables that are used as a determinant of corporate governance of commercial bank. Board size, Board meetings frequency, Liquidity Size of Board Audit committee and Board Experience in the Finance Sector.

3.5.2.1 Board Size

Board size can be defined as the number of directors sitting on the board. According to the agency theory limiting board size to a particular level is generally believed to be improving financial performance.

3.5.2.2 Meeting frequency of Board

Meeting frequency refers to how much time Board meet on a year. For board to effectively perform its oversight function and monitor management performance, the board must hold a regular meeting.

3.5.2.3 Liquidity ratio

Liquidity ratio other tool used as governance mechanism by NBE is liquidity ratio.

And for this research purpose liquidity is calculated as follows:

$$\text{Liquidity ratio} = \frac{\text{liquid asset}}{\text{Total asset}}$$

3.5.2.4. Board experience in the sector

Board experience in the sector refers to board member who had any finance related work experience.

3.5.2.5. Size of Board Audit committee

An audit committee is an operating committee of the board of directors charged with oversight of financial reporting and disclosure mixed results. Ms.S.Danoshana et al (2013) found that increasing Audit Committee Size will result high financial performance, because detailed discussion on the financial statement of the companies will lead to get more ideas regarding the reports and it will guide to increase the firm's performance.

3.6 Specifications of empirical research model

To investigate the relationship of corporate governance mechanisms and financial performance of sample commercial banks in Ethiopia the following general empirical research model is developed.

$Yit = \beta o + \beta 1Git + \beta 2Cit + eit$

Where,

Yit: represents financial performance of banks at time t.

Git: is a vector of corporate governance variables.

C it: Control variables.

eit: the error term which account for other possible factors that could influence Yit that are not captured in the model.

Based on the above linear simple definitional regression equation is developed to do the desire analysis: This model is: board size, board meetings frequency, Liquidity, Board experience in finance sector, and board audit committee size,

$ROA\ it = \alpha 0 + \beta 1BSIZEit + \beta 2BMFit + \beta 3LIQit + \beta 4BESit + \beta 5ACSit + \beta 6BSit + \beta 7LEit + \varepsilon\ it$

Where,

ROA it: ROA of individual bank i at time t.

β: coefficients to be estimated, β1----β7.

i: individual banks

t: time periods

Independent variables

BSIZEit: - Board Size for ith bank and time period t

BMFit- Board meeting frequency of ith bank *and time period t*

β3LIQi*t:* Liquidity ratio *ith bank and time period t*

BESit: - Board experience in the sector *for ith bank and time period t*

ACSit: Audite committee size for ith bank and time period t

Control variables

BS*it*- Bank size for *i*th bank and time period *t*

LE*it* -Banks leverage for *i*th bank and time period *t*

4. CHAPTER FOUR

This chapter presents the descriptive statistics, correlation analysis and multiple panel linear regression analysis of the study variables. It has three sections. The first section is the descriptive statistics which summarizes the main features of the study variable such as mean, maximum, minimum and standard deviation. The second section is the correlation analysis which shows the degree of association between the study variables. The third sections of the chapter, regression results report the random effect OLS estimation output of the regression model.

4.1 Descriptive statistics of the study variables

This section discussed the summery statistics of each variables of the study. The variables include the dependent, independent and control variables. The dependent variables used in this study in order to measure the sample commercial banks financial performance is return on asset, whereas the explanatory variables are: Board size, Board meetings frequency, liquidity, Size of Board Audit committee, Board Experience in the Finance Sector, In addition to the explanatory variables control variables were included are bank size and banks leverage . Accordingly, the descriptive statistics for all variables are presented below in table.4.1

Table 4.1 Descriptive statics

Variable	Observation	Mean	Std.dev	Min	Max
ROA	80	.0280495	.0085616	.0023033	.0510056
BSIZE	80	9.9625	1.538072	8	12
BMF	80	8.175	1.854007	5	10
LIQ	80	.3331188	.1277678	.129632	.5904824
BES	80	2.0625	1.047526	1	4
ACS	80	1.1125	.6749355	0	2
LE	80	6.644877	.9538749	.0710573	8.254096
BS	80	9.269625	1.219938	6.05	12.53

Source: STATA 12 output from Ethiopian Commercial banks financial statements from 2007-2016

The table 4.1 above shows the mean, standard deviation, minimum and maximum values for the dependent and independent variables. The total observation for the each dependent and

explanatory variable was 80.As above table shows, the maximum value of return on asset is 0.051 and the minimum return is 0.0023033, the maximum profit commercial banks earned was 5 cents of net income from a single birr of investment and the minimum profit earned is 2 cents. That means, the most profitable bank of the sample banks earned 5.1 cents of net income from a single birr of asset investment. The mean of ROA equals 2.80 with a minimum of 0.023 cents on each birr of asset investment and also most the remaining banks from the sample earned an average of 2.80 cents from each birr investment by the bank.

It is confirmed in the table 4.1 above that the average board size for the sample commercial banks is about 10 (99 percent of the maximum number 12 person which settled by NBE) and a minimum of 8 directors. The standard deviation indicates that for the sample commercial banks board size varies by 1.538072 from the average value of 10 .The standard deviation of 1.538072 suggests that there is high dispersion in the board size of the sample commercial banks.
The number of meeting held by board of director's commercial banks for the last ten years has a mean of 8 minutes per year with a minimum of 5 minutes and maximum of 10 minutes held per annum.

Regarding liquidity, on average, Ethiopian commercial banks invest 33.3 % of their money on liquid assets which is by far higher than the statutory requirement of 20%.the maximum and minimum values were 59 % and 13% respectively. This shows two things. First, in all Sample years on average Ethiopian commercial banks maintain liquid asset more than statutory requirement of 20%, which is a good signal to corporate governance strength. But on other hand the average reserve ratio maintained by sample banks was by far more than reserve ratio required by the regulation. In the latter case given liquid assets' low returns relative to other assets maintain higher amount of liquid may reduce the profitability of commercial banks

The other explanatory variable is board of directors' experience in the finance sector. The board experience in finance sector of sample commercial banks has a mean of 2.0625 with a minimum of 1 and maximum of 4 as measured by the proportion of directors who had experience in the sector. This shows that Ethiopian commercial banks board of directors' experience in the

finance sector is low for the last 10 years. The standard deviation is 1.047526 from the mean value.

The audit committee of the sample commercial banks has a mean value of 1.1125 with a minimum of null audit committee and a maximum of 2 audit committee members. The standard deviation is 0.6749355from the mean. This shows that in Ethiopia there are commercial banks which do not have an audit committee.

Leverage of the sample commercial banks, as measured by debt to equity ratio, has a mean value of 6.64 and minimum and maximum values of .0710 and 8.25, respectively, indicating that the highly leveraged commercial banks has 825 percent debt to equity and it has financed most of its assets with debt while the less leveraged has 71 percent of debt to equity and most of its assets are financed by shareholders' funds

Bank size which is measured by natural log of total asset had mean score of 9.26 with the standard deviation 1.219. The maximum and minimum values were 12.53 and 6.05respectively. The standard deviation of this variable is high, which means it is the most deviated variable from its mean compared to other variables. This variation is due to the total assets differences in sizes of the sample bank.

4.2 Correlation Analysis

This part presents the results and discussions of the correlation analysis. To identify the relationship among the variables of corporate governance and financial performance correlation coefficients were used. Below in table 4.2.1 the correlation matrix which shows the relationship of the return on asset with Board size, Board meetings frequency, liquidity ratio, Size of Board Audit committee, Board Experience in the Finance Sector ,leverage and bank size. Based on the correlation matrix independent variables Board meeting frequency, financial expertise of directors, audit committee size, leverage and bank size are positively correlated with ROA. This indicates that as those variables increase profitability also moves to same direction.However, Board size and Liquidity are negatively correlated with return on asset. This indicates that as board size and liquidity increase, profitability also moves to opposite direction .The correlation analysis shows only the direction and degree of association between variables and it does not

permit the researcher to make causal inferences regarding the relationship between the identified variables. Therefore, it is not possible to explain the relationship between corporate governance variables and performance measure by controlling the influence of some selected variables using correlation analysis. As a result the main analysis is left for regression analysis that overcomes the shortcomings of correlation analysis

Table 4.2.1 Correlation of ROA with independent variables

	ROA	BSIZE	BMF	LIQ	BES	ACS	LE	BS
ROA	1.0000							
BSIZE	-0.1690	1.0000						
BMF	0.3207	0.1990	1.0000					
LIQ	-0.1009	-0.2466	-0.0617	1.0000				
BES	0.2430	-0.0316	0.0379	-0.0946	1.0000			
ACS	0.3414	0.1201	-0.0057	-0.1873	0.0974	1.0000		
LE	0.0677	-0.1236	-0.0988	0.0082	-0.1075	0.1781	1.0000	
BS	0.4469	0.0982	0.0298	-0.5307	-0.0711	0.3058	0.2866	1.0000.

4.3 Results of Regression Analysis

This section covers the empirical regression model used in this study and the result of the regression analysis. The panel data is used to run the regression to investigate relationship between corporate governance and financial performance in Ethiopian commercial banks measured by return on asset. In doing this, the empirical model was developed in chapter three to guide the analyses are provided as follow

$$ROA\ it = \alpha 0 + \beta 1BSIZEit + \beta 2BMFit + \beta 3LIQit + \beta 4BESit + \beta 5ACSit + \beta 6BSit + \beta 7LEit + \varepsilon\ it$$

4.3.1 Testing assumptions of classical linear regression model (CLRM)

In this part of the research paper, the linearity of the parameter is assumed since the model applies multiple panel linear regression. The objective of the model is to predict the strength and direction of association among the dependent and independent variables. Thus, in order to maintain the validity and robustness of the regression result of the research in CLRM, it is better to satisfy basic assumption CLRM. When these assumptions are satisfied, it is considered as all

available information is used in the model. However, if these assumptions are violated, there will be data that left out of the model (Brooks, 2008).

Accordingly, before applying the model for testing the significance of the slopes and analyzing the regressed result, normality, multicolinearity, autocorrelation and heteroscedasticity tests are made for identifying misspecification of data if any so as to fulfill research quality.

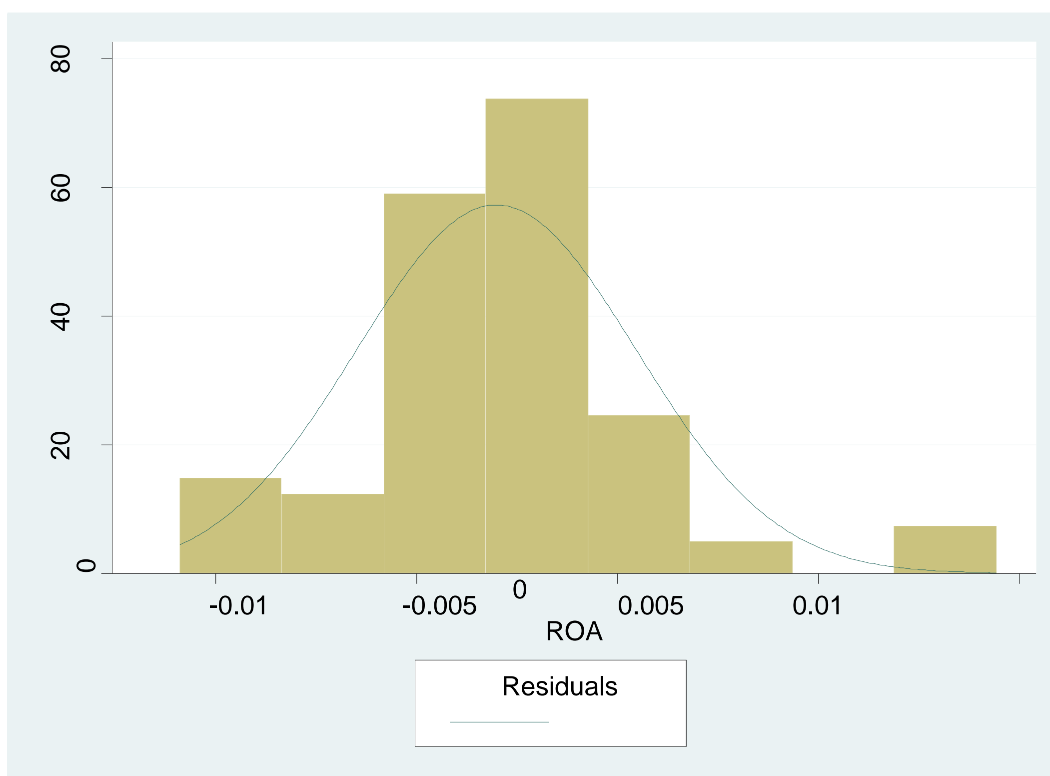
- **Test for average value of the error term is zero (E (ut) = 0) assumption**

  The first assumption required is that the average value of the errors is zero. In fact, if a constant term is included in the regression equation, this assumption will never be violated. Therefore, since the constant term (i.e. α) was included in the regression equation, the average value of the error term in this study is expected to be zero.

- **Normality Test**

  Based on the Kernel Plot, if the two plots (the non - smooth normal distribution curve and smooth and bell shaped curve) are insignificantly different, it is concluded that the error term is normally distributed. According to Brooks (2008), if the residuals are normally distributed, the histogram should be bell-shaped and the Jarque Bera statistic would not be significant. This means that the p-value given at the bottom of the normality test screen should be greater than 0.05 to support the null hypothesis of presence of normal distribution at the 5 percent level. 0 20 40 60 80 Density -0.01,-0.005, 0.005 and 0.01 residuals.

  The below 4.1.diagram witnesses that normality assumption holds Also, it implies that the inferences made about the population parameters from the sample parameters tend to be valid.



Graph 4.1 Kernel Density Estimate Test of normality

- **Heteroscedasticity**

Test among the OLS assumptions, one of the diagnostic tests which conducted in this study is heteroscedastic test. This theoretically expressed as by Brooks (2008, p.133) var (ut) = σ2 < ∞; it has been assumed that the variance of the errors is constant σ2. In the classical linear regression model, one of the basic assumptions is Homoskedasticity assumption that states as the probability distribution of the disturbance term remains same for all observations. That is the variance of each u i is the same for all values of the explanatory variable. If the errors do not have a constant variance, they are said to be heteroscedastic. Accordingly, in order to detect the heteroscedasticity problems, Breusch-Pagan test was utilized in this study. This test states that if the p-value is significant at 95 confidence interval, the data has heteroscedasticity problem, whereas if the value is insignificant (greater than 0.05), the data has no heteroscedasticity problem.

Breusch-Pagan / Cook-Weisberg test for heteroskedasticity
Ho: Constant variance
Variables: ROA

chi2 (1) = 0.20
Prop > chi2 = 0.6563

The BP/CW test value 0.6563 (ROA) is greater than the p-value of 0.05(5%). Since, the probability value fail to reject the null hypothesis of homoskedasticity presence at 5% significant level and the regression model has no hetroskedasity problem. Therefore, it is possible to conclude that the variance of error term is constant or there is no evidence of hetroskedasticity in the regression model of ROA of the study.

- **Autocorrelation**

Test The other important diagnostic test which is performed in this research is autocorrelation test. This assumption of OLS is theoretically expressed by the numbers of scholar like Brooks (2008). According to Reyna, O. (2007), serial correlation tests apply to macro panels with long time series (over 20-30 years). Not a problem in micro panels (with very few years). Therefore, since panel data for this study used few years, as a result there is no autocorrelation.

- **Multicolinearity**

Multicollinearity in the regression model suggests substantial correlations among independent variables. This phenomenon introduces a problem because the estimates of the sample parameters become inefficient and entail large standard errors, which makes the coefficient values and signs unreliable. In addition, multiple independent variables with high correlation add no additional information to the model. It also conceals the real impact of each variable on the dependent variable (Anderson et al.2008) The other most widely used and best technique to test the presence of multicollinearity problem is the Variance Inflation Factor, (VIF). The null hypothesis (serious multicollinearity problem does not exist) is accepted if each VIF and Mean VIF values of the independent variables are less than 10 (Lawrence, 2006). In relation to this type of problem, the Mean VIF tells by how much is the true variance inflated because of multicollinearity. As

shown above table there is no multicollinearity effect since all values of the variable and mean is less than 10.

The VIF Technique

Table 4.3 VIF test of multicollinearity

Variable	*VIF*	*1/VIF*
BS	*3.32*	*0.301591*
LIQ	*3.15*	*0.317720*
LE	*1.55*	*0.645338*
ACS	*1.49*	*0.670870*
BES	*1.43*	*0.700233*
BSIZE	*1.25*	*0.800616*
BMF	*1.13*	*0.886609*
Mean VIF 1.90		

Source: STATA 12 result

4.3.2 Random versus fixed effect model

One issue that may arise from the use of panel data is whether the individual effect is considered to be fixed or random. It is necessary to determine whether the fixed effect (FE) or random effect (RE) model is appropriate. A common practice in finance is to make the choice between both approaches by running a Hausman test. To conduct a Hausman test the number of cross-section should be greater than the number of coefficients to be estimated. So, in this study the numbers of coefficients are lower than the number of cross-sections as a result it is possible to conduct a Hausman test. This test performed through STATA 12.0 version running hausman specification test at five (5%) percent levels enables to choose the researcher between fixed effects and random effects. Basically; the RE estimator assumes that the intercept of an individual unit is a random component that is drawn from a larger population with a constant mean value. The individual intercept is then expressed as a deviation from this constant mean value. One major

merit of the RE over the FE is that it is economical (parsimonious) in degrees of freedom. This is because one does not have to estimate N cross sectional intercepts but just only the mean value of the intercept and its variance. The RE technique is suitable in cases where the (random) intercept of each cross-sectional unit is uncorrelated with the repressors. So the random effect is selected in order to run the regression analysis

b = consistent under Ho and Ha; obtained from xtreg

B = inconsistent under Ha, efficient under Ho; obtained from xtreg

Test: Ho: difference in coefficients not systematic

chi2 (7) = (b-B)'[(V_b-V_B) ^ (-1)](b-B)

= 5.77

Prob>chi2 = 0.5669

(V_b-V_B is not positive definite)

All the above tests of basic classical linear regression model assumptions for OLS estimation prove that, the results obtained from the regression model in this study is consistent, free from bias and efficient since the assumption holds and the next step is analyzing and discussing the outputs of the regression.

The R-squared statistic measures the success of the regression in predicting the values of the dependent variable within the sample. In standard settings may be interpreted as the fraction of the variance of the dependent variable explained by the independent variable. The statistic will equal one if the regression fits perfectly, and zero if it fits no better than the simple mean of the dependent variable. Specifically, the adjusted R-squared is a modification of R- squared that adjusts for the number of explanatory variables in the model, in other words it takes into account the number of control variables. As it is shown in the table 4.5 below, the adjusted R –squared of the ROA model is equal to .0.520, which indicates that 52 % of the variation in ROA is explained by the regression variables. Hence, the explanatory variables included in this regression are good predictors of ROA.

Table 4.4 Random effect Regression result of ROA

Variable	Measure					
ROA	Coef.	Std. Err.	Z	P>|Z|	[95% Conf.	Interval]
BSIZE	-.0310335	.0098293	-3.16	0.002	.0141296	-.0117684
BMF	.0263504	.0062352	4.23	0.000	.0011006	.0385711
LIQ	- .0144452	.0068086	-2.12	0.034	-.0006563	.0277897
ACS	.0020039	.0006875	2.91	0.004	.0009109	0033515
BES	.0030898	.0011118	2.78	0.005	-.0025333	.0052688
LE	-.0009718	.0007967	-1.22	0.223	.0024165	.0005897
BS	.0038723	.0007427	5.21	0.000	-.0328411	.005328
_cons |	.2034413	.0468898	4.34	0.000	.1115389	.2953437

R-sq: within = 0.3832

R 2 between = 0.7910

Adjusted R 2 *overall = 0.5202*

Wald chi2 (8) = 78.06

corr(u_i, X) = 0 (assumed) *Prob > chi2 = 0.0000*

Source: STATA 12 version output from Ethiopian Commercial banks financial statements from 2007-2016

4.3.3. Corporate governance: Results and Discussion

Board size

As shown above, table 4.5 this study found a negative and statistically significant association between boards size (BSIZE) and return on asset at 5 percent level of significance. It implies that the numbers of board of directors' are negatively related with commercial banks‟ financial performance. In other words, the higher the number of board members of commercial banks, the lower their financial performance achievement is and vice versa. The result indicates that reasonable boards are more effective in monitoring and controlling banks management and it

help to reduce agency costs. The finding supports the argument of Jensen (1993) that an increase in board size leads to less effective monitoring due to coordination and process problems inherent in large board size. The result is also consistent with prior studies which argue that coordination, communication and decision-making problems increasingly impede company performance when the number of directors increases (Sanda et al., 2005; Adusei, 2011; Yermack, 1996; Al-Manaseer et al., 2012). In addition Cheng Wu, Chiang Lin;I-Cheng & Feng Lai (2005) also found that board size is negatively and significantly related to firm performance and governance. In conjunction with Beyene, Srmolo & Kasaa found that, the size of board of directors negatively affects the profitability of the bank, implying that the less the number of directors in the board, the better profitable a bank becomes. Uwuigbe olubukunolanti (2011) also supported by its finding that board size negatively affect the profitability of the bank.

Recalling the first hypothesis stating that board size has a significant relationship with the financial performance of commercial banks, the finding supports this and the hypothesis is failed rejected.

Meeting Frequency

Return on Asset with Meeting Frequency (M.F), coefficient is 0263504, test of p-value is 0.0000< 0.05. This result depicts that, Meeting Frequency has a significant positive impact on ROA. For this reason, boards that meet frequently are more likely to perform their duties non-negligently and in accordance with shareholders interest. That is why the amount of time and effort directors devote to board meetings is taken as an indicator of board effectiveness. So meeting frequency has significant positive impact on the firm performance of commercial banks. The result is consistent with previous studies such as (Karamanou & Vefeas, 2005); (Mangena & Tauringana, April 2008); and (Ntim & Osei, June 2011). In Ethiopia, since shareholders are only allowed to be a board member, high board meeting frequency may indicate significant involvement of shareholders on the management decision. High owner involvement on management decision in turn can promote firm performance as it may be difficult for the management to pass a decision that benefits him at the expense of the owners closely watching him. Frequent board meetings can result in higher qualities of management monitoring that in turn impact positively on corporate financial performance. Therefore, failed to reject alternative

hypothesis H2, and means that, increasing Meeting Frequency will result high financial performance that Board who meet frequently generate new idea and follow up the banks

Liquidity

Bank liquidity which is measured in terms of liquid asset to total asset has significantly and negatively influences Ethiopian sampled bank performance. Because holding liquid assets imposes an opportunity cost on the bank given their low return relative to other assets; it has a negative impact on profitability. In the Ethiopian banking industry, as per the result of descriptive statistics there was excess liquidity ratio. Almost all the banks had excess liquidity ratio which is above the liquidity requirement set by the NBE. This shows as the Ethiopian banks are still underutilized their capacity as far as they prefer to maintain higher liquidity position rather than putting it on different investments or providing it to customers in the form of loan which in turn results in an increase in their profitability. Therefore hypothesis that states there is a significant negative relationship between liquidity and commercial banks performance is failed to rejected .This result is supported by the finding of Amdemikael (2012).

Audit committee size

Size of audit committee on the board had positive impact on banks performance (ROA) and it is statistically significant at 5% significant level because, the audit committee assists the board in fulfilling its oversight responsibilities by reviewing the financial information and internal control systems. More ever, according to Klein (2002) the availability of audit committee in the board decreases earning manipulation in the company there by increase performance. The hypothesis that states the size of audit committee has a positive impact on bank performance is failed to reject. This study is supported by Waweru, MN, &Kamau, RG, Uliana, E, (2008) Keyerebahcolenan (2007) and Chin and Li (2008). Accordingly, hypothesis four is failed to reject

Board Experience in the Finance Sector

Hypothesis Ha4 expected that Board Experience in the Finance Sector (BES) is positively and significantly associated with commercial banks financial performance. As expected, a positive (Coefficient = 0020039) and significant (p-value of 0.004) It means the higher the proportions of directors who had earlier working experience in the financial sector the higher the financial

performance (as measured by return on asset) of sample commercial banks in Ethiopia and vice versa. Respondents were asked a subjective question (Q. No. 7 appendix I) about directors' prior experience in the financial sector. The respondents in which the board consists directors who had prior experience in financial sector said "yes" and justified that board of directors who had an experience in the financial sector is highly important because they share the experience they had, challenges they faced and actions they took in their previous job. The qualitative result and regression result based on return on asset performance measures support the alternative hypothesis of Board Experience in the Finance Sector (BES) is positively and significantly associated with commercial banks financial performance.

Bank size

Bank size has positive and significant effect on the banks profitability as seen from ROA measure of profitability. In most literatures, the effect of size on banks profitability is positive. Indranarain R. (2009) indicated that larger banks are better placed than smaller banks in harnessing economies of scale in transactions and enjoy a higher level of profits. In developing economies the impact of bank size on profitability is positive because it makes large banks capable of providing extended banking service for large number of customers. The data of this study shows the size of sample Ethiopian commercial banks which is measured by log of total asset is increased for the last 10 years. Consequently, this improvement leads to the performance of commercial banks in Ethiopia. The result implies that larger banks enjoy the higher profit than smaller banks in Ethiopia banking sector because they are exploiting the benefit of economies of scale

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

The main objective of this chapter is to provide a summary, draw a conclusion and make necessary recommendations based on the qualitative and quantitative analysis presented in chapter four.

5.1 Summary of Findings

The study sought to investigate the relationship between corporate governance mechanism and performance of commercial banks in Ethiopia with a data set covering ten years period from 2007 to 2016. This study made used both primary and secondary data in analyzing and interpreting the relationship between corporate governance mechanisms and financial performance of the eight sample commercial banks. The secondary data was obtained basically from audited financial statements of selected banks and NBE. Correlation and regression analysis was also used to find out whether there is a relationship between the variables to be measured (i.e. corporate governance and commercial banks financial performance) and also to find out whether the relationship is significant or not. The variables that were used as corporate governance mechanisms were size of the board, board meeting frequency, liquidity ratio, board experience in finance sector and board audit committee as independent variables and commercial banks leverage and bank size were used as control variables. Board size has negative and significant effect on the performance of Ethiopian commercial banks. It implies that the numbers of board of directors' are negatively related with commercial banks‟ financial performance in other words, the higher the number of board members of commercial banks, the lower their financial performance achievement is and vice versa

Meeting Frequency has a significant positive impact on ROA and an increasing in meeting frequency will improve the financial performance of commercial banks. The result is consistent with previous studies such as (Karamanou & Vefeas, 2005);(Mangena & Tauringana, April 2008); and (Ntim & Osei, June 2011) in a way that the frequency of board meetings is a measure of board activities and effectiveness of its monitoring ability .Liquidity has significantly and negatively influences Ethiopian sampled bank performance. Because holding liquid assets

imposes an opportunity cost on the bank given their low return relative to other assets; it has a negative impact on profitability.

From the regression result, Board Experience in the Finance sector positively and significantly influence return on asset. Moreover, from the qualitative analysis, respondent justified that board of directors who had an experience in the financial sector is highly important because they share the experience they had, challenges they faced and actions they took in their previous job.

Size of audit Committee has a positive and statistically significant relation with the financial performance of commercial banks of Ethiopia because; the audit committee assists the board in fulfilling its oversight responsibilities by reviewing the financial information and internal control systems. Bank size has positive and significant effect in a sense, the higher the bank size the higher the market share and the higher the revenue banks generate. Bank leverage has negative and insignificant relationship with commercial banks financial performance.

5.2 Conclusions

Financial sector is playing main role towards the development of economic system of the country. Banking sector progress is essential if we want economy on the path of success. This study is focused on financial performance of banking sector; Governance is the main problem for many corporations, so this study investigates the relationship between corporate governance and financial performance on commercial banks in Ethiopia using eight commercial banks with a data set covering ten years period from the year 2007 to 2017. In order to achieve this objective, five hypotheses have been developed. To address research hypotheses and achieve the broad research objective, the study used mixed research approach. Random effect model was used to estimate the regression equation. In the study considering ROA measure of performance and size of the board, board meeting frequency, liquidity ratio, board experience in finance sector and board audit committee as independent variables and commercial banks leverage and bank size were used as control variables

5.3 Recommendations

- In view of the findings that commercial banks in Ethiopia have got relatively the high board size that impact on their performance negatively, the study recommends that the board size of individual banks should have reasonable small number because smaller board size can enhance banks' performance as the smaller size, can take quick and adequate decision for the performance of the banks as large boardrooms tend to be slow in making decisions, and hence can be an obstacle.
- This research found that there are limited numbers of experienced board of directors in commercial banks. But the experience of board of directors in the finance sector is positively and significantly affects the performance of banks. Therefore, the researcher recommends that Ethiopian commercial banks should have optimum number of experienced board in finance related area to improve their financial performance.
- Government regulation which forced commercial banks especially private banks to make investment on bonds that amounts about 27% of the total loans provided by the bank to customers is currently affecting the Ethiopian private banks liquidity in general. As per the result of regression analysis liquidity affect financial performance of commercial banks of Ethiopia. Therefore the researcher should recommend the bank governor(NBE) needs to revisit its policy or it should take some corrective actions like paying at least equal interest with that of the deposit in order to enhance the performance of the sector in general.
- This research found that Meeting Frequency has a significant positive impact on ROA of banks. Therefore, board of directors should meet at least one monthly by having a good agenda to generate superior financial performance
- The bank size has significant role in grasping high profit so Commercial banks should increase their branches as well as their size in order to improve profitability due to economies of scale

5.4 Recommendation for future Research

The relationship between corporate governance mechanisms and bank financial performance can also be further explained and the result will be more robust by increasing the sample size and number of year of observation. Moreover, the researcher recommend for future researchers to conduct study by including more corporate governance variables focusing on Board of directors and CEO characteristics

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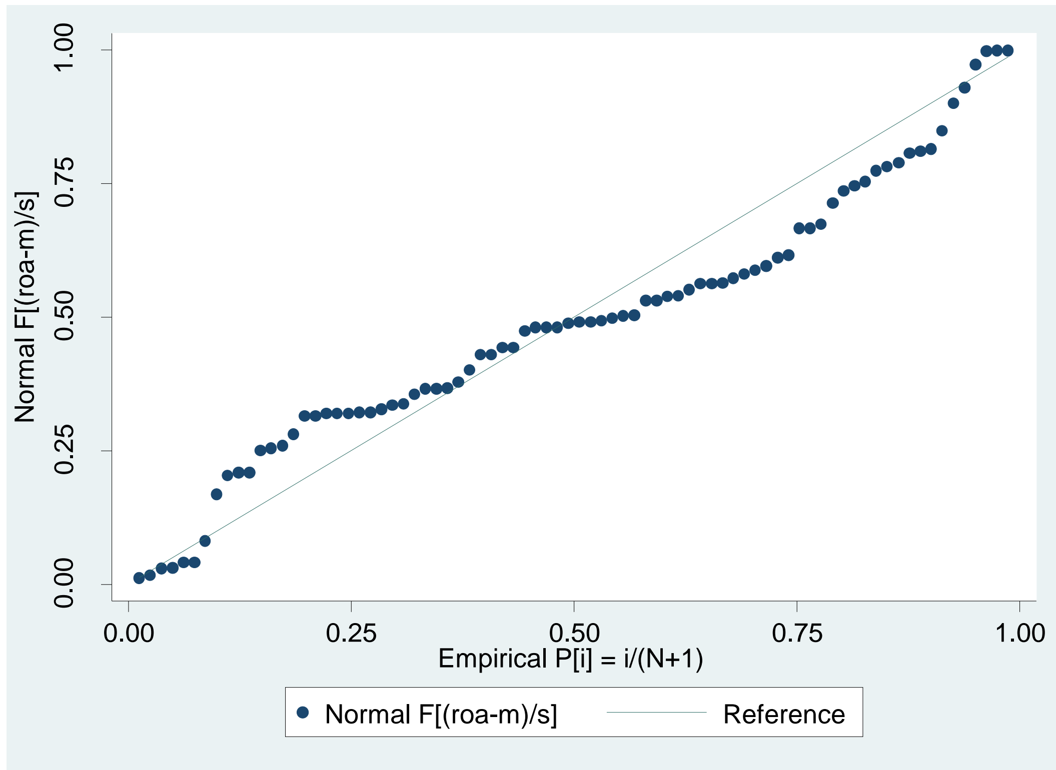
Appendix 1

Test of normality



Appendix 2

The study Questionnaires

Note for the respondents: Dear respondents, the purpose of this questionnaire is to conduct a study on the relationship between corporate governance variables and financial performance of commercial banks in Ethiopia for partial fulfillment of the requirement for MSC in accounting and finance. Your response supposed to have a paramount contribution for the success of the study and I would like to request your genuine responses for each questionnaire. I would like also to assure you that the information provided here will be used only for academic purposes and thus will be treated with maximum confidentiality.

Thank you in advance for your cooperation!!!

Part 1. General Information

1. Years you have served in the organization (Please Tick)

a) Below 10 years _____________

b) 11-20 _____________

c) 21-30 _____________

d) 31-40 _____________

e) Above 40years _____________

2. Your position in the organization (Please Tick)

a) CEO ____________

b) Middle level manager ____________

c) Supervisor ____________

d) Any other (Specify) ____

Part 2 Composition of the board

1. Size of the board

a) Less than 5 member's ___________

b) 5 to 10 member's ___________

c) 11 to 15 members ____________

d) More than 15 members______________

Comment (s) (if any) ____

3. Have the Board established supervisory committees other than the main Board?

Name of the Committee	**Yes**	**No**
Audit committee		
Remuneration committee		
Legal Committee		

3. If your bank has an audit committee, what is the number of the audit committee members?

a) One _________

b) Two _________

c) Three_________

d) Four_________
f) Any other _________

f) Any other _________

6. How many of the board of directors have experience in finance sector experience?

a) One ______________

b) Two ______________

c) Three _____________

d) Four ______________

e) All ________________

f) Any other __________

How many times in a year does the Board meet?

a) Once a year -----------------------------

b) Semiannually --------------------------

C) Quarterly ----------------------------

d) Monthly ----------------------------

e) Other Specify_____

7. Are there any board members who had earlier working experience on banking area or Financial Institutions like insurance, microfinance now in your company?

YES ☐ NO ☐

In what ways do these members contribute better than other directors?

…………………………………………………………………………
……………………………………………………………………………………………
……………………………………………………………………………………………

8. Do you think boards that meet more frequently tend to generate higher financial performance?

Yes ☐ No ☐

Please justify it?
....
....
....

Part II: Please fill the number for each period for questions listed below.
Fiscal Year in Gregorian calendar

S. N	Item	2006/ 7	2007/ 08	2008/ 9	2009/ 10	2010/ 11	2011/ 12	2012/ 13	2013/ 14	2014/ 15	2015/ 16
1	Total number of directors sitting on the board										
2	Total Number of meeting held by Board Per Annum										
3	Number of board members who served in the same capacity in other banks or other financial institution earlier										
4	Total number of audit committee members										