TITLE: THE IMPACT OF CORPORATE GOVERNANCE ON FINANCIAL PERFORMANCE OF SMEs: A CASE OF SMEs IN THE RETAIL INDUSTRY IN NAIROBI CBD

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1. Background

Adeyeyeon (2016) asserts that due to the informal nature of the Small and Medium Enterprises (SMEs) sector in Kenya, reliable statistics on the sector are hard to come by. He estimated that there are more than 250,000 formal SMEs in the country. Studies have significantly highlighted the impact of corporate governance on financial performance of firms. However, this study will be targeting SMEs in Nairobi CBD in Kenya. According to the Kenya National Bureau of Statistics (KNBS) report of September 2016, there were 584,600 SMEs in Kenya in 2015 (KNBS, 2016).

It is also estimated that approximately 1 million SMEs are started annually in Kenya, with 40% failing within the first year of operation (KNBS, 2016). The KNBS report further stated that 2.2 million businesses across the Micro and SMEs categories had closed in the 5 years ending September 2016. Closed enterprises were reported to have an average lifespan of only 3.8 years (KNBS, 2016). While SMEs are created in Kenya in large numbers annually, they also have a very high mortality rate.

This section presents key elements of the subject matter i.e. Small and Medium Enterprises (SMEs), and corporate governance and financial performance. The importance of the economic segment to Kenya, factors that hinder its growth and the impact of corporate governance on the financial performance of SMEs are also explored.

1.1. Conceptualising Small and Medium Enterprises (SMEs)

SMEs are defined as those businesses that employ fewer than 300 workers with an annual turnover of US$15 million (World Bank, 2020). According to The Micro and Small Enterprises Act of Kenya (2012), SMEs employ between 10 and 50 people and have an annual turnover of US$5,000 to US$50,000. Wairimu (2015), in her report published for the United Nations Development Program (UNDP), defines medium size enterprises as those that employ 51 to 100 people with a capital investment of no more than US$300,000 (converted at a dollar exchange rate of 100 Kenya Shillings for every 1 US$). Other than having a common theme around the number of employees, the definition of SMEs varies. The World Bank (2020) determined that the annual turnover of SMEs is at US$15 million. The Nation Media Group(2020)determines the cap turnover for SMEs to be US$10 million

1.2. The Role and Economic Contribution of SMEs

In developing any nation's economy, particularly the less developed countries (LDCs) such as Kenya, SMEs are critical. They complement the larger firms owing to their flexibility and adaptability (KNBS, 2016). As a result, they are catalytical to entrepreneurial activities across sectors and geographies, resulting in an enormous contribution to socio-economic development and transformation(Kenya National Bureau of Statistics, 2016).

The World Bank (2020) reported that 90% of global businesses are SMEswhichcontribute more than 50% to global employment, and formal SMEs alone contribute 40% to GDP. Adeyeyeon (2016) estimated that Kenya's 7.5 million MSMEs contributed 44% to GDP in 2008. SMEs contributed an estimated 34% to Kenya's GDP in 2016 (International Trade Centre, 2019). 3% out of the 6.4% of Kenya's economic growth in 2017 was from SMEs(Viffa Consult, 2018).

1.3. Factors Hindering Growth of SMEs in Kenya

Gallardo et al. (2005) established that access to finance for SMEs from banks and micro-finance institutions is limited. This is attributable to a lack of formal business structures(which included corporate governance structures). They asserted that SMEs are usually family owned and run with few structures to support formalization and further growth. As a result, SMEs often face numerous succession challenges that, if not quickly addressed, lead to business failure. These challenges range from governance to accounting to human resources, which significantly impact the ability of SMEs to grow and become sustainable businesses.

ShleferandVishny (2017) agree that SMEs in developing countries suffer from many challenges, such as access to finance from local and international sources. The lack of corporate governance enhances this challenge which is a great deal in providing assurance to the undertakings to perform on investment or finance obligations. Briefly, these aspects may caste negative impact of corporate governance on financial performance of the targeted firm. Mahmood (2014) suggests that even where there is care for corporate governance and good business management practices, there is an apprehension towards implementing such practices due to the associated cost of implementation.

KNBS(2016) cites the main reasons for the closure of Kenyan SMEs: a shortage of operating funds, reduced income, diversion of returns, losses incurred from the businesses, and operating capital. Other reasons were personal in nature ranging from social matters to health reasons. Delloitte (2016) asserted that the growth of the SME sector in Kenya had been

hampered by several factors, such as poor infrastructure, limited capital, knowledge and skills gaps, poor market access, and rapid technological change. It thus makes governance for businesses and SMEs a very important field of study.

1.4. Interventions in Kenya Aimed at Improving the Performance of SMEs

Over the last 20 years, the government of Kenya has developed and implemented several initiatives to support and regulate the SME sector. Perhaps the most important intervention to date is the historic enactment of the Micro and Small Enterprises Bill of 2012. The act was set up to provide for MSMEs' development, promotion and regulation. The MSE Act of 2012 does not address the regulation of "medium enterprises". However, various private and non-governmental organisations have been set up to support SMEs under the auspices of the MSE Act of 2012. Indirectly, the East African Common Market protocol has opened up the East African Community for trade. This presents an opportunity for Kenyan SMEs to be regional players.

2. Literature Review

This section of the report delves into some of the studies that have explored the impact of corporate governance on financial performance of firms while also evaluating its relationship with business performance. The literature review will also specify the gap in the studies that have been undertaken and what is left to learn or to be researched.

2.1. Defining corporate governance

Shefler and Vishny (2012) defined corporate governance as a mechanism of control over the management of a business to ensure that management does not compromise the ability of a business to attain a return on investment for its shareholders. As described by OECD (1999), Principles suggest that corporate governance is the internal means upon which businesses are operated. Good corporate governance ensures organisations use their capital effectively and consider the internal and external interests of an organisation. Ultimately, the board is accountable to both the company and its shareholders.

The Capital Markets Authority of Kenya (2015) defines corporate governance as the process and structure used for managing and directing a company to enhance its business prospects and accountability to realise shareholder value while accounting for the interests of its long-term stakeholders. The definitions above present a common thread about the

overarching structure of a company that oversees management's activities to ensure the security and effective use of a company's resources and ensure that all stakeholder's interests in relation to a business are safeguarded.

2.2. Defining financial performance

Webster (2020) defines finance as*"Money or other liquid resources of a government, business, group or individual or the system that includes the circulation of money, the granting of credit, the making of investments, and the provision of banking or the science or study of the management of funds".*

Webster (2020) also defines the word "performance" as the manner in which "the ability to perform**:** efficiency" or how a mechanism performs". It can be concluded from the above statements that financial performance is the extent of achievement of an entity's financial targets. Various measures of financial performance such as profitability, revenues, returns and several others, could be used depending on the interest of the business. Bhagat and Black (1997) assert that there is no agreement on the most suitable measure for financial performance.

2.3. Corporate governance and financial performance

Several studies have examined various aspects linking corporate governance to financial performance. This literature reviews a few global and local studies undertaken and their conclusions. Aksoy &Bozkus, studied 47,063 Turkish SMEs. They established a positive link between credit usage, trade openness, financial performance, and corporate governance implementations.

Mang'unyi (2011) found that corporate governance has supported progress in countries like Kenya, given that it is the inward structure which serves the necessities of investors and others by organising business processes with objectivity, obligation and accountability. McGee (2009) suggests that business leaders, proprietors and corporate administrators are starting to appreciate the benefits of implementing decent corporate governance practices. Murithii (2014) evaluated 44 companies on the Nairobi Stock Exchange (NSE) between 1999 and 2003 and found a strong and direct link between company performance and corporate governance. These aspects clearly highlight the Impact of corporate governance on financial performance of SME's in Nairobi CBD.

In an investigation of 11,736 firms studied on the United States stock exchange between 1990 and 2004, Bhagat & Bolton (2008) established that

splitting roles between the CEO and the chairman significantly and positively affects operating performance. Similarly, Sanda et al. (2005) examined 93 companies on the Nigerian Stock Exchange from 1996 to 1999 and established that separating the Chairman and CEO roles directly impacts a company's performance positively. These studies indicate the importance of separating oversight and day-to-day operational roles.

Paniagu et al. (2018) analysed 1,207 companies across 59 countries from 2013 to 2015. They established that increasing the board by one member would decrease the return on equity by between 3.55% and 5%, keeping all other factors constant. Sanda et al. (2005) established that company’s financial performance, and the size of the board are inversely proportional. Yermack (2011), in an investigation of Forbes’s largest 500 companies over the period 1984 to 1991, established that limiting board size improved the effectiveness of that board. Eisenberg et al. (1998), in an investigation of Finnish SMEs (785 healthy and 94 bankrupt firms), established a negative correlation between the profitability of SMEs and board size. These studies indicate the impact of board size on business performance.

Drobetz et al. (2003) surveyed 91 German firms and highlighted the connection between firm performance and corporate governance. They learned that great corporate governance has a direct and positive effect on firm valuation, while poor corporate governance showed the reverse. Boubaker and Nguyen (2014) undertook a study of 374 firms in 14 nations, finding a strong positive correlation between the value of the firm and corporate governance practices. These show that financial performance is positively linked to corporate governance.

Boubaker et al. (2015) studied 597 French-listed companies from 2001-2007. It was established that firms with more effective boards accumulated fewer cash reserves in comparison with less effective boards. This is evidence that corporate governance creates efficient and effective use of financial resources, thereby claiming positive Impact of corporate governance on financial performance of a firm. Klapper and Love (2017) analysed 374 firms in 14 nations and determined a positive relationship between fairly estimated worth, return on asset and corporate governance. Similarly, Maranga (2014) revealed that the relationship between corporate governance and Return on Assets in SMEs is positive.

Ujunwa (2012) examined 160 small firms in Nigeria from 1991 to 2008. The study found that firm performance was positively linked to firm

performance and that higher PhD qualifications at the board level negatively affected the firm's performance. While skills at the board level are critical, this finding raises doubts as to whether PhDs at the board level for SMEs negatively affect financial performance. Afande (2015) studied 30 SMEs in the assembling segment in Kariobangi Light Industries, Nairobi, Kenya, implementing some corporate governance practices. The disclosures indicated a positive association between corporate governance practices and the efficiency of SMEs. Afande concluded that corporate governance can extraordinarily help SMEs in Kenya by instilling better administration routines that ensure more grounded interior scrutiny of entities.
Ongore&K'Obonyo (2011) investigated 54 firms listed on the Nairobi Stock Exchange. They established that management performs better if they have more latitude to make decisions than if the principals of the business closely monitor them. This indicates that having an independent corporate governance structure could help ease the friction between owners and managers and improve performance.

Ndagu&Obuobi (2010), in their survey of 111 companies in three East African countries (Uganda, Kenya, and Tanzania), established that while SMEs did not generally have robust corporate governance structures, they appreciated their effect on business performance and showed a willingness to learn more about business governance. They further established that some of the reasons why enterprises have not developed corporate governance practices included; a lack of awareness of corporate governance, its importance, and time and financial constraints, a lack of understanding of the value addition from non-executive directors to the business and the impact of directors' fees on the cash flows and profitability of their businesses.

As noted in the literature above, most studies proved that there is a substantial impact of corporate governance on financial performance of companies by reviewing the various aspects of corporate governance and comparing them to financial performance. These were board composition, the board size, board skills and the existence of a board to financial performance aspects such as profitability, firm value, return on assets, sales and several other measures.

However, there have not been many studies done in Nairobi, particularly in the retail sector. Nairobi, the capital city of Kenya, is exposed to various skills that could be valuable at the board level. It seems to be a natural place to get a more detailed study of corporate governance's impact on SMEs' financial performance.

3. Purpose of the Study

As noted earlier, SMEs in Kenya have a high mortality rate. It has also been shown that some of this mortality is attributable to poor performance emanating from poor governance. This research will highlight some elements associated with the Impact of corporate governance on financial performance corporate of enterprises. These should provide some input for SMEs to effectively apply good corporate governance practices that improve business performance and reduce mortality in the sector.

4. Decision Problems

Owners and managers of SMEs need to address their enterprises' governance practices to ensure SMEs' sustainable financial performance. SMEs do not often have deep pockets for directors' costs, and it is, therefore, imperative to ensure that the board is fairly compensated but that its size and cost do not negatively impact the profitability of SMEs.

It is in the interest of the Government, at both the national and county levels, to establish some measures that will ensure SMEs are well governed and that loopholes that may lead to poor governance are removed. This will ensure more sustainable gains for the government with respect to government revenue and sustainable employment in Kenya.

5. Research Aims and Objectives

5.1. Aim

The study aims to establish the impact of corporate governance on the financial performance of SMEs in the retail industry in Nairobi Central Business District (NCBD).

5.2. Objectives

The main objective is to search the literature to determine what has been learned from previous research on how corporate governance relates to the financial performance of SMEs in Nairobi CBD. The literature review will also identify unanswered questions and establish gaps that this research could address. More specifically, the research will seek the following:

i. To establish the impact of board meeting frequency on the financial performance of SMEs in Nairobi CBD
ii. To determine board compensation's impact on SMEs' financial performance in Nairobi CBD.

iii. To assess CEO duality's impact on SMEs' financial performance in Nairobi CBD.
iv. To determine the impact of the number of board members on the financial performance of SMEs in Nairobi CBD
v. To offer a set of recommendations as to how SMEs can implement effective corporate governance strategies

6. Research Question

- What is corporate governance practices' impact on SMEs' financial performance in the retail industry in Nairobi CBD?

7. Research Methodology

A descriptive research design will determine the association of study variables and summarize the revelations to a greater population. This study will summarize the findings of all the retail business SMEs in Nairobi CBD. The choice of tools and techniques will depend on the aim of the research. The research will be carried out through mixed research in which qualitative data will be collected from the previous studies' foreseen data and existing findings. In contrast, primary data collection will be done through questionnaires from the owners and managers of randomly selected SMEs.

Primary data will be significant to the research since it will be directly collected from the SMEs and is expected to be precise. Qualitative data will be collected to support the quantitative data. Questionnaires will be administered through a drop-and-pick procedure giving the respondents one week to respond. Data collected from the study will be analysed using the SPSS tool, applying various statistical measures such as averages, means, frequencies and percentages. The results will be presented in the form of charts and tables.

8. Significance of the Research

The output, lessons and advantages from this study will be critical to the various stakeholders related to SMEs in Nairobi CBD, such as owners, directors, managers, lenders and investors. These stakeholders will be faced with information on how corporate governance can be used to arrest declining financial performance in SMEs in Nairobi CBD.

The research will positively impact the appreciation of policymakers makers by proving that corporate governance has a directly proportional relationship to the financial performance of SMEs. This will enable policymakers to plan and execute educated strategies that will ensure the

effective implementation of corporate governance to accomplish the best possible financial performance of the retail business of SMEs.

Researchers will also benefit from the study as they will obtain meaningful data on the relationship between SMEs’ performance and corporate governance.

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