

THE EFFECT OF CORPORATE GOVERNANCE ON
FIRMS FINANCIAL PERFORMANCE: EVIDENCE
FROM SELECTED BANKS IN ETHIOPIA

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CHAPTER ONE

1.1 Background of the Study

According to the report of UNESCAP (2007), the definition of governance is given as the process of decision making by which decisions are implemented or not implemented in corporate business firms. Berghe and Ridder (1999) acknowledged that corporate governance needs to put in place the structures and processes which make it possible for a business firm to pursue its strategy effectively to improve its financial performance.

According to Shleifer and Vishny corporate governance mechanisms defined as follows:

“Corporate governance mechanisms are ways to reduce the agency costs, where they attempts to minimize two types of agency conflicts: first, the conflicts between shareholders (owners) and managers; second, the conflicts between controlling majority shareholders and minority shareholders” (Shleifer & Vishny, 1997, p. 737).

The need for corporate governance arises from the potential conflicts of interest between stakeholders such as chief executive officers, board members and shareholders within the business organizations. Imam and Malik (2007) accredited from their study that, potential conflict of interest between stakeholders within the business firms usually arises from the following two reasons. The first reason is different participants have different objectives and preferences. The second reason is the participants have imperfect information each other's actions, knowledge, and preferences. Therefore, corporate governance used to scale back agency issues in business firm to confirm that shareholders' investment is not expropriated on unprofitable activities.

Scholars have been conducted several studies and developed different theories on corporate governance and agency problem from which this study tried to investigate the effect of corporate governance mechanisms on firms' financial performance; such as agency theory, shareholders' theory and stakeholders' theory (Maria & Thomas, 1999). Study conducted by Hsiang-tsui (2005) confirmed that, best adaptation and application of corporate governance systems in business firms helps effective provision of useful information to investors and its other

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ABSTRACT

Corporate governance is the most recent and youngest discipline and philosophy in global business environment. That is why currently firms in developed and developing countries are jointly incorporated corporate governance in their curriculum. Corporate governance has several development principles which made it to be highly entertained in business environment and to be taken as principal development agenda in business world. In financial industry corporate governance mechanisms have especially attention in contributing towards the protection of agency problems or costs. The ultimate objective in fighting toward agency cost is curbing wastage of resources and avoiding investment of shareholders' funds on unprofitable activities. The works of different scholars mentioned on varieties of literatures revealed that, firms governed and structured according to corporate governance mechanisms have better performance record than firms with no corporate governance mechanisms which are performing poor. Basically, this finding is not to mean that it remain the same for all researchers' findings in their work on the same discipline of study, because works of different scholars oppose this finding as they have found mixed results on the relationships between different variables of corporate governance and financial performance. This study has been tried to examine the effect of corporate governance mechanisms on firms' financial performance on the selected commercial banks in Ethiopia by identifying some selected determinant variables which are believed to consist direct relationship with performance of financial industry in Ethiopia, typically on selected commercial banks through reviewing of financial performance recorded. Dependent variables used to show financial performance are return on asset, return on equity and operating profit margin. Furthermore, two control variables, firm size and financial leverage were used. For the analysis of raw data, both correlation analysis and pooled panel data regression models of cross-sectional and time series data for analysis.

Key words: Corporate Governance Mechanisms, Agency Problem, Firms' Financial Performance and Commercial Banks.

stakeholders to reduce agency problem as well as to help the company to improve its financial performance.

While dealing with agency costs, scholars are using a number of variables in order to investigate and measure how agency cost is affecting financial performance of business firms with the implementation of corporate governance mechanisms. Most widely using variables are board size, board independence, frequency of board meetings, chief executive officer duality, audit committee, board ownership and so on. Klein et al (2005); clearly investigated how Poor practice of corporate governance mechanisms are contributing for the failure and inefficiency of financial performance of business firms'. Contrarily, Jensen & Meckling (1976) suggested from their empirical study that, firm with better corporate governance have better financial performance than those companies with poor corporate governance.

1.2 Statement of the Problem

Shleifer and Vishny (1997) stated that both chief executives and shareholders should have one objective of maximizing firms' financial performance. However, the separation of shareholders from chief executives with the absence of corporate governance mechanisms provides executives with the ability to act in their own self interest which might go against the good interest of organization and shareholders' which paves the ways for agency problem that ultimately results with poor financial performance. There are different mechanisms by which corporate governance can be measured in an organization.

A number of studies have been conducted on the investigation about the effect of corporate governance mechanisms on firms' financial performance by different researchers; such as Hiraki et al. 2001; Zunaidah & Fauzias, (2010); Sanda et al. (2005). They used variables like; board size, board independence, frequency of board meetings, chief executive officer duality, audit committee and board ownership as independent variables predicting financial performance of business firms. Even if their area of study is similar, what they actually investigated is not consistent with ones findings. Example, Sunday (2008), found a mixed results on the relationship between corporate governance mechanisms and firm financial performance i.e., he explored positive and significant relationship between return on equity and board size, return on equity and chief executive status, profitability margin and chief executive status, but there is no

significant relationship between return on equity, board composition and audit committee and profitability margin and board size, board composition and audit committee. Ponnu (2008), from conducted study on Malaysian public listed companies and found no significant relationship between duality and board independence to firms' financial performance.

Though, numerous studies have been conducted in huge firms operating within well organized corporate governance mechanisms in developed economic system, in our country Ethiopia, this area of discipline remained ignorant especially on financial institution sector which is found at infancy stage. Therefore, this study is conducted by taking the commercial banking industry of Ethiopia as the target population of this study with the baseline of investigating the effect of corporate governance mechanisms on firms' financial performance.

1.3 Research Questions

The following basic research questions were answered while undertaking this study;

1. Do corporate governance mechanisms have a significant effect on banks' financial performance?
2. What are the possible determinant factors of corporate governance mechanisms that affect banks' financial performance?
3. How dependent variables are correlated to independent variables?

1.4 Objectives of the Study

1.4.1 General Objective of the Study

The general objective of this study is to examine the effect of corporate governance mechanisms on firms' financial performance by taking evidence from selected commercial banks in Ethiopia, while controlling for a number of banking firms' specific factors that could affect commercial banks financial performance.

1.4.2 Specific objectives of the study

The specific objectives of this study are:

1. To examine whether corporate governance mechanisms have a significant effect on banks' financial performance.
2. To identify the possible determinant factors of corporate governance mechanisms that affect banks' financial performance.
3. To differentiate how dependent variables are associated with independent variables.

1.5 Significance of the Study

The basic findings from this study will be significant for the sampled commercial banks operating with application of corporate governance mechanisms which ultimately results with forwarding alternative recommendations as to maintain the existing working environment if corporate governance mechanisms are properly functioning toward the improvement of financial performance or to recommend them for the improvement of implementation of corporate governance mechanisms through which maximization of their financial performance will be assured. Furthermore, this research will serve other scholars as an empirical works and contributes value to the existing literatures.

1.6 Scope of the Study

This study was delimited to the reach of investigating the effect of corporate governance mechanisms on firms' financial performance on selected commercial banks in Ethiopia by using data available from the year 2003 up to 2009. The used dependent variables to measure financial performance of sampled banks are; return on asset, return of equity and operating profit margin; independent variables are board size, board independence, frequency of board meetings, audit committee and board ownership; and the two control variables used are financial leverage and firm growth rate.

1.7 Limitation of the Study

Most of social science studies are subject to certain limitations due to the nature of the study. The same is true for this study. The critical limiting factor is that, financial institutions in Ethiopia do not have long years documented financial statements or records. Due to this, the research forced to use only available financial statement records from the year 2003- 2009 of six selected commercial banks at National Bank of Ethiopia. The other limitation of this research is that the financial performance of commercial banks in Ethiopia is only measured by using accounting based measurements, which does not shows the exact market value of banks financial performance. Accounting based measurements could not reflect the current market performance rather the past performance by employing accrual based accounting system. Therefore, the accounting based measurements ignore the market based measurement approach, because of the absence of secondary market in Ethiopia, and also the commercial banks in Ethiopia are not listed in stock exchange market.

CHAPTER TWO

REVIEW OF RELETED LITRATURE

2.1 The Concept of Corporate Governance

The definition given by Macedo Jorge (2001) about corporate governance broadly indicates, “corporate governance” refers to the private and public institutions, including laws, regulations and accepted business practices, which together govern the relationship, in a market economy, between corporate managers and entrepreneurs (“corporate insiders”) on one hand, and those who invest resources in corporations, on the other. Investors can include suppliers of equity finance (shareholders), suppliers of debt finance (creditors), suppliers of relatively firm-specific human capital (employees) and suppliers of other tangible and intangible assets that corporations may use to operate and grow.

Oman (2001) defined broadly, "corporate governance" refers to the private and public institutions, including laws, regulations and accepted business practices, which in market economy, govern the relationship between corporate managers and entrepreneurs ("corporate insiders") on one hand, and those who invest resources in corporations, on the other. Other writers like Cochran and Warwick (1988) define corporate governance as: "...an umbrella term that includes specific issues arising from interactions among senior management, shareholders, boards of directors, and other corporate stakeholders."

According to Dr. Charles Asembri, Corporate governance in the context of a modern corporation has become synonymous with the practices and processes used to direct and manage the affairs of a corporate body with the object of balancing the attainment of corporate objectives with the alignment of corporate behaviour to the expectations of society and accountability to shareholders and other stakeholders. Dr. Charles indicated the following points which corporate governance encapsulates: -

- The management of the relationships between a corporate body’s management, its board, its shareholders and other stakeholders.
- The provision of the structure through which the objectives of the company are identified and the monitoring of the means used to attain these objectives including the monitoring of performance in this regard.

- Bringing more transparency to bear on the decision-making processes of the company.
- The provision of proper incentives for the board and management to pursue objectives those are in the interests of the corporate body and shareholders.
- Encouraging the use of resources in a more efficient manner.
- The management of risk and the minimization of the effects of commercial misadventure.

Corporate governance is the basic instrument in which business organizations are operating. It plays a key role in recognizing the improvement and practice of economic efficiency in various business firms. Corporate governance is considered a powerful micro-policy instrument and effective lever for change in transitional economies. If adaptation and implementation of corporate governance is wrongly realized it can however contain the harm arising from such corporate shortcomings and enable the tackling of issues such as defective leadership, persistent poor business performance and a general erosion of trust or confidence in or around businesses. In the circumstances it could be said to contribute to the preservation, sustenance and nurturing of the fruits of entrepreneurial activity. Hence, in any business organization designing and structuring of corporate governance needs big consideration, because principles of corporate governance by themselves couldn't assure any guarantee for their existences and successfulness.

In the real business environment, corporate governance is subject to different internal and external threat which might affect its health functioning. It is affected by the relationships among participants in the governance system, the legal, regulatory, and institutional environment in which, a corporate body operates affects the manner in which it governs. In addition, factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which it operates can also have an impact on the governance of the corporate body. In other words; the factors that determine corporate governance can be internal factors defined by the officers, stockholders or the rules of a company, as well as the external forces such as consumer groups and government regulations. The internal factors affecting corporate governance are, Separation of ownership and control, ownership concentration, board's independence whereas & ROA have been used as measures of performance.

Khurram Khan et al (2011) explained that, corporate governance provides a structure that works for the benefit of the firm and can help in increasing firm's performance. Shleifer and Vishny (1997) states that, "Corporate governance deals with the ways in which suppliers of finance to corporations assure them of getting a return on their investment."

Imam and Malik (2007) state that the need for corporate governance arises from the potential conflicts of interest among participants (stakeholders) in the corporate structure. These conflicts of interest often arise from two main reasons. First, different participants have different goals and preferences. Second, the participants have imperfect information as to each other's actions, knowledge, and preferences.

According to Tricker (1994), corporate governance is an umbrella term that includes specific issues from interactions among senior management, shareholders, board of directors, and other corporate stakeholders. Blair (1995) argues that corporate governance implicates, "the whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated."

Jensen and Meckling (1976) addressed these conflicts by examining the separation of corporate ownership from corporate management. They noted that this separation, with the absence of other corporate governance mechanisms, provides executives with the ability to act in their own self-interest rather than in the interests of shareholders. A large proportion of the regulatory changes have focused on boards of directors. In order to define a board of directors or a system of governance. Caselli, S, & Gatti, S. (2007) say that two elements must be taken into consideration with respect to board of directors: actors and context, by actors they meant not only directors, but the entire range of stakeholders representing interests and power within the firm. Their presence guarantees, on the one hand, the creation of value and the distribution of the value created; on the other, it determines contextual factors, beginning with governance mechanisms. By context, they meant geographical, cultural, sectoral, and firm specific differences and variations. Among these are the degree of dispersion in and the nature of firm ownership, differences in size, lifecycle variations, including crises and the configuration of firm resources, and CEO tenure and its features and background.

Khurram Khan et al (2011) mentioned the pivotal roles which institutional investor plays in the governance of the firm moving from good to great. Institutional investors are organizations which pool large sums of money and invest those sums in companies. Institutional investors can be banks, mutual funds, insurance companies and etc. They can direct the board to protect the rights of the shareholders and improves and can impact the running governance of the company.

If the institutions can more easily select directors, at least for a minority of board seats, they can hire directors to watch companies on their behalf and be accountable to them.

Renato Giovannini (2009) suggests that corporate governance and board ownership as mechanisms to manage and monitor the firm without missing opportunities that stem from shareholder base enlargement, rather than pursuing exploitation of outsider director skills.

According to Tricker (1994), corporate governance is an umbrella term that includes specific issues from interactions among senior management, shareholders, board of directors, and other corporate stakeholders. Blair (1995) argues that corporate governance implicates, “the whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated.”

Corporate governance is concerned with creating a balance between economic and social goals and between individual and communal goals while encouraging efficient use of resources, accountability in the use of power and stewardship and aligning the interests of individuals, corporations and society. It also encompasses the establishment of an appropriate legal, economic and institutional environment that allows companies to thrive as institutions for advancing long-term shareholder value and maximum human-centered development while remaining conscious of their other responsibilities to stakeholders, the environment and the society in general.

Furthermore, corporate governance is also concerned with the processes, systems, practices and procedures as well as the formal and informal rules that govern institutions, the manner in which these rules and regulations are applied and followed, the relationships that these rules and regulations determine or create, and the nature of those relationships. It also addresses the leadership role in the institutional framework. Corporate Governance, therefore, refers to the manner in which the power of a corporation is exercised in the stewardship of the corporation's total portfolio of assets and resources with the objective of maintaining and increasing shareholder value and satisfaction of other stakeholders in the context of its corporate mission. It implies that companies not only maximize shareholders wealth, but balance the interests of shareholders with those of other stakeholders, employees, customers, suppliers, and investors so as to achieve long-term sustainable value.

From a public policy perspective, corporate governance is about managing an enterprise while ensuring accountability in the exercise of power and patronage by firms.

Good corporate governance seeks to promote the following objectives:

- (1) Efficient, effective and sustainable corporations that contribute to the welfare of society by creating wealth, employment and solutions to emerging challenges.
- (2) Responsive and accountable corporations. Legitimate corporations that are managed with integrity, probity and transparency.
- (3) Recognition and protection of stakeholder rights. An inclusive approach based on democratic ideals, legitimate representation and participation.

2.2 Benefits and Principles of Corporate Governance

According to the report released by Center for International Private Enterprise (CIPE, 2002) indicates, when fully implemented, good corporate governance ensures that large corporations are well-run institutions that earn the confidence of investors and lenders. The process ensures safeguards against corruption and mismanagement, while promoting fundamental values of a market economy in a democratic society. These are quite critical for the transitional economies that are struggling to attract foreign direct investment. In a globalized economy, the implementation or otherwise of good corporate governance will increasingly determine the fate of individual companies and entire economies.

The quality of governance is of absolute importance to shareholders as it provides them with a level of assurance that the business of the company is being conducted in a manner that adds shareholder value and safeguards its assets. This means that there is less uncertainty associated with the investment - a situation that encourages bankers and lenders to be favourably disposed to the company. Furthermore, the higher the risk, the higher the expected rate of return. If a company adopts and implements good corporate governance practices, shareholders are retained and new investors attracted.

Institutional investors have indicated a willingness to pay a premium for the shares of a well-governed company. Around the world, price: earnings ratios are higher among companies with good disclosure. Hence good corporate Governance is necessary in order to: (1) Attract investors both local and foreign and assure them that their investments will be secure and efficiently

managed, and in a transparent and accountable process. (2) Create competitive and efficient companies and business enterprises. (3) Enhance the accountability and performance of those entrusted to manage corporations. (4) Promote efficient and effective use of limited resources.

Organization for Economic Co-Operation and Development (2004) depicted the following basic principles of corporate governance are fully captured in the OECD principles of corporate governance:

- (1) The rights of shareholders (and others) to receive relevant information about the company in a timely manner, to have the opportunity to participate in decisions concerning fundamental corporate changes, and to share in the profits of the corporation, among others;
- (2) Equitable treatment of shareholders, especially minority and foreign shareholders;
- (3) The role of stakeholders in corporate governance should be recognized and established by law;
- (4) Timely and accurate disclosure and transparency on all matters material to company performance, ownership;
- (5) The responsibilities of the board.

A number of corporate governance guidelines and regulations have been implemented or adopted globally, examples of such guidelines are: the Combined Code prepared by the Institute of Chartered Accountants in England and Wales following the Turnbull Report and the Code of Corporate Practices and Conduct prepared by the King Commission in South Africa. The Commonwealth Association for Corporate Governance, in its publication "CACG Guidelines Principles for Corporate Governance in the Commonwealth", states: "The globalization of the market place within this context has ushered in an era where the traditional dimensions of corporate governance defined within local laws, regulations and national priorities are becoming increasingly challenged by circumstances and events having an International Impact."

Corporate governance enhances the performance and ensures the conformance of corporations. Its principles stimulate the performance of corporations by creating and maintaining a business environment that motivates managers and entrepreneurs to maximise firms' operational efficiency, returns on investment and long-term productivity growth. They ensure corporate conformance with investors' and society's interests and expectations by limiting the abuse of power, the siphoning-off of assets, the moral hazard, and the wastage of corporate-controlled resources (so-called "agency problems").

Simultaneously, they establish the means to monitor managers' behaviour to ensure corporate accountability and provide for the cost-effective protection of investors' and society's interests vis-a-vis corporate insiders. Elements of good governance considered include transparency, integrity and responsiveness to shareholders; focus on a few core businesses and firm's administration that largely benefit small investors.

New Partnership for Africa's Development (NEPAD) indicated that corporate governance has implications for economic development especially in helping to increase the flow of financial capital to firms in developing countries. This is quite important for policy makers in Africa who are concerned with attaining high long-term growth rates of about 7 percent per annum. Without efficient companies or business enterprises, a country will not create wealth or employment. Without investment, companies will stagnate and collapse. If business enterprises do not prosper, there will be no economic growth; no employment, no taxes paid and invariably the country will not develop. Developing countries, in particular, need well-governed and managed business enterprises that can attract investments, create jobs and wealth and remain viable, sustainable and competitive in the global market place. Good corporate governance, therefore, becomes a prerequisite for national economic development.

A document by the OECD (2004) stated that, the corporate governance structure should promote transparent and efficient markets, be consistent with the rule of law, and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement of authorities. Accordingly there is widespread agreement that corporate governance weaknesses in many less developed countries can be attributed to an important extent to a lack of effective ownership. The revised principles are more specific, taking the perspective that the costs of voting can and should be reduced, and the benefits in terms of what can actually be achieved from ownership participation must also be improved.

The concept of corporate governance in the context of a modern corporation has become identical with the practices and processes used to direct and manage the affairs of a corporate body. Corporate governance is recognized as a key element in improving economic efficiency and is considered a powerful micro policy instrument and effective lever for change in transitional economies. Corporate governance is affected by the relationships among participants in the governance system. The legal, regulatory, and institutional environment in which, a

corporate body operates affects the manner in which it governs. In addition, factors such as business ethics and corporate awareness of the environmental and societal interests of the communities can also have an impact on the governance of the corporate body (Charles, 1993).

The corporate governance theoretical framework is the widest control mechanism of corporate factors, to support the efficient use of corporate resources. The challenge of corporate governance could help to align the interests of individuals, corporations and society through a fundamental ethical basis and it fulfills the long term strategic goal of the owners. It will certainly not be the same for all organizations, but will take into account the expectations of all the key stakeholders.

So maintaining proper compliance with all the applicable legal and regulatory requirements under which the company is carrying out its activities is also achieved by good practice of corporate governance mechanisms (Imam & Malik, 2007).

One of the primary aims of shareholder in recent decades has been the promotion of good corporate governance practices as a means to improve corporate performance and shareholder financial performance. Performance is a complex concept, in terms of both definition and measurement. It has been defined as the result of activity, and the suitable measure selected to assess corporate performance is considered to depend on the type of institution to be evaluated and the objectives to be achieved throughout that evaluation process (Hunger & Wheelan, 1997).

2.3 Corporate Governance Mechanisms and Firms' Financial Performance

Corporate governance mechanisms have been identified as one of the important tools needed in managing any organization including corporation. There are different mechanisms that reduce agency cost by which corporate governance can be measured in an organization. Most of the research studies used board size, board independence, frequency of board meetings, chief executive officer duality, and audit committee and board ownership as a mechanism of corporate governance.

A director of a company is a custodian or trustee of the company's resources and properties and is duly appointed to direct and manage the business of the company. Most regulatory regimes require that a company's board of directors prepare financial statements reflecting a true and fair

view of the operations of the company during the financial year, and to take steps to safeguard the assets of the company to prevent and detect fraud and other irregularities.

2.3.1 Board Size and Firms' Financial Performance

As it is found by Babatunde and Olaniran (2009), bigger board size is likely to show evidence of a good spread of monitoring skills of the board and enhance its effectiveness. On the other hand, the board may be too big and compromise the quality of communication within the board. It does seem then that there is an optimal size of a board beyond which effectiveness is not improved and may indeed begin to decline. Indeed some of the studies point towards smaller boards being more effective than large boards. Accordingly, Yermack (1996) examined the relation between board size and firm performance, concluding that the smaller the boards size the better the performance, and proposing an optimal board size of ten or fewer. This is due to nimbleness, cohesiveness, less communication and coordination costs as well as less 'free-riding' director problems with smaller boards.

Adusei (2011), concluded that a small board size increases the performance of a bank. This is because if the board size is too big it becomes difficult to coordinate and for it to process and tackle strategic problems of the organization. Thus, if the board size is small the financial performance of firms will be strong. The purpose or the responsibility of company's board of directors is explained by different writers. Xiaojun and Zhenhong (2005) stated that the company's board of directors is an executive institution, elected by shareholders and accountable to shareholders. The purpose of the board is to supervise the internal directors, managers and staff to execute business; externally, it is to protect creditors and safety of the transactions with relative third part.

According to Fleming (2005), boards of directors are the supreme governing body of the company, except for those matters which by law or as provided by the Articles of Incorporation must be decided by the general shareholders meeting. The efficient supervision of all corporate activities is vested in the board. A set of board regulations must exist which provide a specific definition of the purpose, functions, obligations and priorities of this body and the way it operates. The board regulations must set out, the internal structure of the company based on

committees, determining their nature, scope and functions and the requirements for a director to belong to each of them. Committees are therefore internal bodies within the board and report to the latter about their activities on a regular basis.

2.3.2 Board Independence and firms' financial performance

Fleming (2005) argued that the board must be made up of internal and external directors. In the case of those companies in which there is no majority shareholder or a controlling group holding a majority interest, there must be a majority of independent directors, who has a share contribution to the firm amongst the external directors. Accordingly in any event, the number of independent directors should not fall below one third of the total board members.

Independent directors are believed to be better monitors of managers as independent directors' value maintaining reputation in the directorship market as important. Likewise, banks with high information asymmetry may benefit from more inside directors as they have more firm-specific knowledge (Fama & Jensen, 1983). This is because independent directors are important for firms as they helps to improve earnings quality and provide compatible compensation incentives to the managers there by increases financial performance of firms.

Pearce and Zahra (1992) suggested that firms with a higher proportion of independent directors on the board of directors are associated with better performance. This can be due to the reason that the higher the proportion of independent directors, the more independent the board is in making decisions which ultimately affect the firms' operating and financial performance. Accordingly the more independent the board is the more effective it becomes and the better the firms' financial performance would be. A balanced board composition is important for the board to function effectively. A balanced board means that the composition is not dominated by board members with executive power, and consists of members who are independent from the management and shareholders (Nahar, 2001). Therefore, board of directors should consist of independent members that are independent directors, who have no any direct connection to the firm. Unlike dependent directors, independent directors are better able to challenge the chief executive officers. However, Forsberg (1989) found insignificant relationship between the proportion of outside directors and various performance measures.

2.3.3 Frequency of Board Meetings and Firms' Financial Performance

Frequency of Board meeting is the board meetings held per year by the board members of a firm. The general meeting by the board members must be a key forum for information and decision making nurturing active participation by the majority of shareholders, which enables the firm to work efficiently. The frequency of board meetings held should be evidence of effective monitoring activity (Cohen et al. 2004). Accordingly if the board does not meet regularly, it is unlikely that effective monitoring of management will occur, even if the board is the appropriate size and has a high percentage of independent directors.

The board must ensure that the overall meeting is properly used as a sufficient channel to communicate with shareholders and foster their participation. As it is stated by the principles of good corporate governance with regard to the general meeting Fleming (2005), the following minimum standards are recommended: Approval of the general meeting charter by chairman of the board, convene the general meeting with sufficient notice, ensure that the complete text of the resolutions to be voted is made public providing the same notice period, vote as a separate item on the agenda the amendments to the articles of incorporation, specifying each Article, acknowledge that a qualified number of shareholders may be entitled, ensure that the agenda provides that the chairman's report is mandatory.

2.3.4 Chief Executive Officer Duality and Firms' Financial Performance

The absence of chief executive officers on the board is perceived as a governance mechanism that could help in monitoring the agency problem. The chief executive officer is responsible in implementing the guidelines and business strategies approved by the board of directors. A firm may adopt the combined leadership structure in which the chief executive officer is also acting as chairman of the board whilst the separated structure clearly divides the positions of chief executive officer from chairmanship. Yermack (1996) showed that firms are more valuable when the chief executive officer and the chairman of the board positions are occupied by different persons.

Callaghan (2005) argued that chief executive officer duality can constrain independence, erode corporate checks and balances, monitoring and oversight. Chief executive officer duality also erodes the board's independence in making decisions because the chief executive officer acquires more control and power.

Rechner and Dalton (1991) argued that companies which have chief executive officers performing dual roles do have lower shareholder returns as the executive managers' ability to distort the financial statements and are also considered as opportunistic shirkers. When the same person is both the chief executive officer and the chairman it results in the conflict of interests it appears that the chief executive officer, being also the chairman, controls himself. This may cause the lack of board independence to fulfill its guiding and controlling functions, and thus, it creates strong possibility for company's mismanagement. Thus, chief executive officer duality is not advisable for business firms to perform its activity very well.

2.1.5 Audit Committee and Firms' Financial Performance

Audit committee acts as the internal auditors for the board for the company's operations, management systems, and general financial control and reporting. Carcello and Neal (2000) argued that audit committee members who are independent of the management are better monitors of the firms' financial accounting process. However, Klein (2002) reports a negative correlation between firms' financial performance and audit committee independence.

As stated by the principles of good corporate governance an audit committee must be created and executive directors may not attend or be appointed members of same. Audit committee, when so required, may request the attendance of executive directors, the chief executive officer or any key employee of the company. The committee shall consist of a majority of independent directors and shall be chaired by one such director. Chairmanship of this committee must be renewed regularly and at least every four years (Fleming, 2005).

Zabihollah (2003) stated that audit committee is empowered to function, on behalf of the board of directors, by assuming an important oversight role in the corporate governance intended to protect investors and ensure corporate accountability. The audit committee has oversight duty over corporate governance, the financial reporting process, internal control structure, internal

audit functions, and external audit activities. Therefore, audit committee has a crucial role in corporate governance of companies so as to improve the performance of companies.

As it stated by Robert (2006), Audit committee as an institution, along with other standing committees, provides for detailed specialization within the board. This smaller group is expected to dedicate its time and attention to a more attentive review of financial statements and the audit results. The board delegates the bulk of the accounting review work to the audit committee members, who are, hopefully, appropriately qualified in analyzing financial statements and adept at interpreting financial jargon. This particular oversight responsibility is too close to the heart of the board's overall purpose to have been delegated.

2.3.6 Board Ownership and Firms' Financial Performance

Jensen and Meckling (1976) argued that managerial (insider) ownership increases, agency costs may be reduced since managers bear a larger share of the costs from activities that reduce firm value. In other words when the relative amount of ownership held by insiders (management) and outsiders (investors with no direct role in the management of the firm) provide managers with the incentives to pursue activities to serve their own benefits.

In addition to the above argument Rose (2005) argued that managers who control a substantial part of the firm's equity may be able to have sufficient influence to secure the most favorable employment conditions, including an attractive salary.

Sulong and Nor (2010) conclude that board ownership role as moderator variable of corporate governance acts to the shareholders' best interests and its effectiveness in controlling the agency conflicts with other governance mechanisms available to firms. Thus, this mechanism of corporate governance has a great contribution on firms' financial performance by reducing agency problem because the board members act as an agent and principal of the firm.



2.4 Agency Theory

Agency Costs

Jensen and Meckling (1976) define the agency relationship as a contract under which one party (the principal) engages another party (the agent) to perform some service on their behalf. As part of this, the principal will delegate some decision-making authority to the agent.

These agency problems arise because of the impossibility of perfectly contracting for every possible action of an agent whose decisions affect both his own welfare and the welfare of the principal, Brennan (1995). Arising from this problem is how to induce the agent to act in the best interests of the principal.

Managers bear the entire cost of failing to pursue their own goals, but capture only a fraction of the benefits. Jensen and Meckling (1976) argue that this inefficiency is reduced as managerial incentives to take value maximizing decisions are increased.

As with any other costs, agency problems will be captured by financial markets and reflected in a company's share price. Agency costs can be seen as the value loss to shareholders, arising from divergences of interests between shareholders and corporate managers. Jensen and Meckling (1976) defined agency costs as the sum of monitoring costs, bonding costs, and residual loss.

Agency theory identifies the role of the monitoring mechanism of corporate governance to decrease agency costs and the conflict between managers and owners. It is clear that the principal agent theory is generally considered as the starting point for any debate on the issue of corporate governance. According to Berle and Means (1967), there are three types of separation of ownership and control. The first is majority control. This is where some of the shareholders own majority of shares, and the remainders are widely diffused and only hold a portion of the shares. Hence, only the rest of the shareholders are separated from control. The second is minority control, where ownership is widely spread. As such, the greater part of ownership is basically without control. The third is management control.

As it is stated by Tandelilin (2007), agency theory suggests that there are a number of mechanisms to reduce the agency problem in the corporate business firm. For example owners' efforts to reduce agency cost of equity, potentially created by moral hazard managers, include the

intention of owners to choose reputable board of directors; direct intervention by shareholders, the threat of firing, and the threat of takeover (Tandelilin, 2007).

Jensen and Meckling (1976) defined agency as the relationship as a contract under which one or more persons or the principal engage another person or the agent to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the irregular activities of the agent.

As it is stated by Lex and James (1991), agency theory is that where chief executive officer duality is retained, shareholder interests could be protected by aligning the interests of the chief executive officer and the shareholders by an appropriate incentive method for the chief executive officer. That is by a system of long term compensation additional to basic salary. Where chief executive officer s hold the dual role of chair, the presence of long-term compensation will align their interests with shareholders and forestall the loss in shareholder benefit otherwise will result from the dual role. Any superiority in shareholder returns observed among dual chief executive officer chairs over independent chairs would be explained away by agency theory as being due to the false effects of financial incentives (Lex & James 1991).

2.5 Shareholders Theory

According to OECD (2004), the objective of the firm is to maximize shareholder wealth through productive and dynamic efficiency. The criteria by which performance is judged in this model can simply be taken as the shareholder value of the firm. Therefore, managers and directors have an implicit obligation to ensure that firms are run in the interests of shareholders. The problem of corporate governance in this model stems from the principal agent relationship that causes the firms' behavior to diverge from the profit maximizing ideal. This happens because the interests and objectives of the principal or the investors and the agent or the managers differ when there is a separation of ownership and control. Since the managers are not the owners of the firm they do not bear the full costs, or reap the full benefits of their actions.

An effective corporate governance framework can minimize the agency costs and hold up problems associated with the separation of ownership and control. There are broadly three types

of mechanisms that can be used to align the interests and objectives of managers with those of shareholders and overcome problems of management entrenchment and monitoring: One method attempts to induce managers to carry out efficient management by directly aligning managers interests with those of shareholders, the second method is giving chance for shareholders and stakeholders in business offers in some extent. Another method involves the strengthening of shareholder's rights so shareholders have both a greater incentive and ability to monitor management (Maher & Andersson, 1999).

According to Shleifer and Vishny (1997), one of the most striking differences between countries corporate governance systems are the contrasts in the ownership and control of firms that exist across countries. Two of the most basic conflicts that can occur in corporate governance are the conflict between controlling managers and shareholders, and the conflict between controlling shareholders and minority shareholders.

2.6 Stakeholders Theory

One of the critiques of the stakeholder model is that managers or directors may use stakeholder reasons to justify poor company performance. The benefit of the shareholder model is that it provides clear guidance in helping managers set priorities and establishes a mechanism for measuring the efficiency of the firms' management team that is firm profitability. On the other hand, the benefit of the stakeholder model emphasis on overcoming problems of under investment associated with opportunistic behavior and in encouraging active co-operation amongst stakeholders to ensure the long-term profitability of the business firm (Maria & Thomas, 1999).

In their report of the Corporate Governance for One-man Company in View of the Theory of Stakeholders, Xiaojun and Zhenhong (2005) argued that corporate governance is essentially the balanced relationship amongst various stakeholders, that is, corporate governance should include all stakeholders, such as employees, creditors, customers and suppliers from the very beginning. Accordingly, 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 be considerate more about the consumers, customers, the community, social organizations and can create a stable environment for long term development.

2.7 Internal Accounting and Financial Audit

This internal system has, as its main objective, the facilitation of early detection of errors or fraud. The internal audit is an integral element of corporate governance and is carried out by an internal auditor who reports to the chief executive officer and is supposed to assist the executive management and the board in the discharge of their obligations relating to safeguarding assets, risk management, operation of adequate controls and reliability of financial statements and stewardship reporting. The Audit Committee plays a vital role in financial and operational controls in the whole system of corporate governance, by making recommendations to the board concerning the appointment and remuneration of external auditors, reviewing auditors' evaluation of the system of internal control and accounting, and considering and making recommendations on the conduct of any aspect of the business of the company which should be brought to the notice of the board, among others.

The establishment of an audit committee is a listing requirement of many stock markets in Africa including the Ghana Stock Exchange, the Nigerian Stock Exchange and the Johannesburg Stock Exchange. Budgetary control is another internal control tool, which involves two levels of activity, namely planning and control. Control is complementary to planning and it involves monitoring actual performance against planned (projected) milestones or targets, extracting variances from trends and exploiting further sources of favorable variances from target.

CHAPTER THREE

RESEARCH METHODOLOGY

This section of the research explains the research design, data collection techniques and sources of data, sampling design, methods used in the analysis of data and constructions of the research models to test the hypotheses and to provide answers to the research questions set out in chapter one of the study.

3.1 Research Design

This study has employed an explanatory survey research design following more of quantitative approach to examine the effect of corporate governance mechanisms on firms' financial performance on selected commercial banks in Ethiopia. Explanatory research design shows the relationship between two variables. The research design in this study used a pooled panel data analysis, which includes both a time series (inter-period) and cross sectional (inter-firm) data analysis. Pooled panel data analysis, also called the constant coefficients model, which has constant coefficients, referring to both intercepts and slopes are constant. It assumes that, there is no significant cross section or temporal effects, where the cross section firm data and time series data are pooled together in a single column and run OLS estimation (Yaffee, 2003).

3.2 Data Source and Collection Methods

Data for this study were collected from both primary and secondary sources. Secondary data i.e. audited financial statements including balance sheet and income statement related to each bank were obtained from National Bank of Ethiopia for 7 year period i.e. 2003 up to 2009. Data required for this study found in National Bank of Ethiopia were limited in number of years, thus this study included only 6 commercial banks audited financial statements for 7 year. Financial statement data for 2002 was not available for this study that would have been used to compute the control variable, firm growth rate for the year 2003. The researcher found it is better to take the following 6 years average firm growth rate for the year 2003 rather than omitting it, by believing that it is better to increase the number of observations by not excluding all variables for the year 2003 because of one control variable. Primary data related to corporate governance

mechanisms were obtained through administering research questionnaires for the respective commercial banks' head offices of the chairman of boards in Addis Ababa.

3.3 Sampling Design

The total population of this study is all commercial banks in Ethiopia. In selecting banks included in this study, a purposive sampling design has been used. The sampling method used is also purposive sampling technique, where each sample elements are selected purposively so as to assure representation of the total population. Currently, 13 commercial banks are operating in Ethiopia. From the total commercial banks in Ethiopia 6 commercial banks are selected on the bases of age of commercial banks since incorporated and audited financial statement availability in National Bank of Ethiopia for the study period. The sampled commercial banks are Commercial Bank of Ethiopia, Dashen Bank, Awash International Bank, Bank of Abyssinia, United Bank and Nib International Bank.

3.4 Data Analysis

In this study descriptive statistics were used as the first stage of the analysis of data to provide detail information about each relevant variables used. At this stage, mean, standard deviation, maximum and minimum values of the required variables have been computed. In addition, to estimate the relationships between the dependant and independent variables and to test the hypothesis, the researcher has been used two quantitative analysis methods. First, pair wise correlation analysis is used to measure the degree of association between the dependent variables and each explanatory variable. Second, multiple regression models of independently pooled panel regression are used to analyze the fundamental relationships of the dependant, independent and control variables. The method of estimation used was pooled OLS method and the pooled OLS estimation makes 60 observations.

Stata10.0 package was used for the purpose of estimation and to test model accuracy and other econometric problems like, normality and heteroskedasticity. The results of analysis were presented by using tables. Furthermore, qualitative data were also analyzed to support the results obtained from quantitative data.

3.5 Description of Variables and Research Hypotheses

3.5.1 Dependent Variables

In this study dependent variables are variables that are used to measure the financial performance of commercial banks. Due to the absence of secondary market in Ethiopia it is impossible to use market indicators such as market value added and Tobin Q. Thus, only accounting measures of financial performance were used, which are explained as follows:

1. Return on Asset (ROA): It measures the overall efficiency of management. It reflects whether the firm uses assets effectively in order to produce its income. So it is an important banking performance indicator.

$$\text{ROA} = \frac{\text{Earnings before Interest and Tax}}{\text{Total Assets}} = \frac{\text{EBIT}}{\text{TA}}$$

2. Return on Equity (ROE): It is a comprehensive indicator of a firms' financial performance. Because it provides information as to how well managers are using the funds invested by the firms' shareholders to generate returns.

$$\text{ROE} = \frac{\text{Earnings before Tax}}{\text{Total Equity}} = \frac{\text{EBT}}{\text{TE}}$$

3. Operating Profit Margin (OPM): This variable is a measure of profit that shows earning arising directly from the commercial operations of the firm without the effect of financing.

$$\text{OPM} = \frac{\text{Earnings before Interest and Tax}}{\text{Net Sales}} = \frac{\text{EBIT}}{\text{NS}}$$

3.5.2 Independent Variables

Scholars and several business organizations can use different variables which have predictive capacity upon dependent variables in the process of measuring financial performance and predicting direction of relationship between independent variables and dependent variables.

Most frequently the typical variables used by researchers are Board size, Board independence, Frequency of board meetings, Chief executive officer Duality, Audit committee and Board ownership as determinants of good corporate governance. The following independent variables are in this study as a predictors of dependent:

1. Board size:

Board size is defined as the number of directors setting on the board of business firms. It is the first variable proposed to deal with agency problem. Limiting board size to a particular level is generally believed to be improving the financial performance of a firm.

H01: There is no significant relationship between board size and financial Performance.

Ha1: There is a significant relationship between board size and financial Performance.

2. Board independence:

Board independence is defined as number of independent directors sitting on the board. It is the other variable proposed to deal with agency problem. Unlike dependent board members, independent directors are believed to be capable in influencing the chief executive officers. Independent directors are members of the board, who have no share contribution for the business firms. Dependent directors are members of the board, who have share contribution for the business firms. The more independent board the more effective it becomes and firms' financial performance also improves.

H02: There is no significant relationship between independent directors sitting on the board and financial performance.

Ha2: There is a significant relationship between independent directors sitting on the board and financial performance.

3. Frequency of board meetings:

Frequency of board meetings is defined as the number of meetings held by the board of the business firms per year. It is the third variable proposed to deal with agency problem. The variable is intended to add value in making process of management effective and successful if frequent and regular meeting is conducted.

H03: There is no significant relationship between the frequency of board meetings and financial performance.

Ha3: There is a significant relationship between the frequency of board meetings and financial performance.

4. Audit committee:

Audit committee is defined as the composition of audit committee, that is, independent audit committee as a proportion of the total number for firms audit committee. It is the other proposed variable to deal with agency cost. When the number of independent audit committees in a given business firm is greater than the number of dependant audit committees the financial performance of a firm is more effective. Independent audit committees are members of audit committee, who have no share contribution for business firms. Dependent audit committees are members of audit committee, who have share contribution for business firms.

H04: There is no significant relationship between the proportion independent audit committee and financial performance.

Ha4: There is a significant relationship between the proportion independent audit committee and financial performance.

5. Board ownership:

Board ownership is defined as the number of board members, who have share contribution for business firms. It is the fifth variable proposed to deal with agency problem. When ownership structure is combined with other governance mechanisms, it maximizes firms' financial performance. It reduces the conflicts between managers and shareholders, when there is stock ownership by board members. To the extent that executive board members own part of the firm, they develop shareholder like interests and are less likely to engage in behavior that is detrimental to shareholders of the firm. Therefore, board ownership is inversely related with agency conflicts between managers and shareholders. In other words, board ownership increases firms' financial performance.

H05: There is no significant relationship between board ownership and financial performance.

Ha5: There is a significant relationship between board ownership and financial performance.

3.5.3 Control Variables

To increase the confidence of the results of estimation most researchers used control variables, which are specific to business firms and general to the economy as a whole (Amir, 2009; Adusei, 2011). Accordingly, in addition to independent variables Financial Leverage (FL) and Firm Growth Rate (FGR) were included in this study as control variables. Logarithms are used to simplify mathematical functions of large numbers. Financial leverage is the total amount owed by the commercial banks divided by its total capital. Firm growth rate is the change in annual revenue of the commercial banks that is $[(\text{revenue}_t - \text{revenue}_{t-1}) / \text{revenue}_{t-1}]$.

3.6 Model Specification

To undertake this study, the following econometric model has been used as an instrument in estimating quantitatively the effect of corporate governance mechanisms on firms' financial performance on selected commercial banks in Ethiopia.

$$Y_i = \beta_0 + \sum \beta_i X_i + \epsilon_i$$

Where:

_ Y_i are the i th observation of dependent variables (ROA, ROE and OPM)

_ β_0 is the constant or intercept term

_ β_i are the coefficients of the X_i variables

_ X_i are the i th observation of the explanatory variables (BSIZE, BINDP, FBM, AUDCM, BOWN, FL and FGR)

_ ϵ_i is the error term of the models

Specifically, when the above general model is changed into the specified variables of this study, the regression equations take the following forms in estimating the effect of corporate governance mechanisms on firms' financial performance;

$$\text{ROA} = \beta_0 + \beta_1 (\text{BSIZE}) + \beta_2 (\text{BINDP}) + \beta_3 (\text{FBM}) + \beta_4 (\text{AUDCM}) + \beta_5 (\text{BOWN}) + \beta_6 (\text{FS}) + \beta_7 (\text{FL}) + \beta_8 (\text{FGR}) + \epsilon \text{ ----- (1)}$$

$$\text{ROE} = \beta_0 + \beta_1 (\text{BSIZE}) + \beta_2 (\text{BINDP}) + \beta_3 (\text{FBM}) + \beta_4 (\text{AUDCM}) + \beta_5 (\text{BOWN}) + \beta_6 (\text{FS}) + \beta_7 (\text{FL}) + \beta_8 (\text{FGR}) + \epsilon \text{ ----- (2)}$$

$$\text{OPM} = \beta_0 + \beta_1 (\text{BSIZE}) + \beta_2 (\text{BINDP}) + \beta_3 (\text{FBM}) + \beta_4 (\text{AUDCM}) + \beta_5 (\text{BOWN}) + \beta_6 (\text{FS}) + \beta_7 (\text{FL}) + \beta_8 (\text{FGR}) + \epsilon \text{ ----- (3)}$$

Where:

- ROA= Return on Asset
- ROE = Return on Equity
- OPM = Operating Profit Margin
- BSIZE = Board Size: Number of directors setting on the board
- BINDP = Board Independence: Number of independent directors sitting on the board (no significant connection with the bank)
- FBM =Frequency of board meetings: The number of board meetings held per year
- AUDCM = Audit Committee: The composition of the audit committee, that is, independent as a proportion/ percentage of the total member for banks audit committee.
- BOWN=Board Ownership: Number of board members, who has share contribution for the bank
- FL=Financial Leverage: The total amount owed by the bank divided by its total capital
- FGR= Firm growth rate: Change in annual revenue of the bank

CHAPTER FOUR

RESULT AND DISCUSSION

This section of the study consists of presentation of descriptive statistics and econometrics tool used by pooled OLS method with detailed presentation of the descriptive statistics analysis, Pearson correlation coefficients matrix among the identified variables and the final hypotheses test is based on multiple regression analysis and pooled OLS estimation.

4.1 Descriptive Statistics for the Study Variables

This sub-section presents descriptive analysis of raw data collected and interpretation of the findings using descriptive statistical tools. Presentations of findings from descriptive statistics could provide detailed description of dependent variables, independent variables and control variables among selected commercial banks in Ethiopia which are included in this study.

Table 4.1 below shows, the descriptive statistics of all variables in the study by measuring the mean distribution, standard deviations, minimum and maximum values for the sampled commercial banks for the study period i.e. 2003 up to 2009. In this study; variables with different categorical differentiations were used in order to clearly identify the effect of independent variables on dependent variables along with control variables. The total of ten variables were used ,i.e. three dependent variables, five independent variables and two control variables for seven consecutive years of five selected commercial banks, which give a total of 60 observations.

Table 4.1 Descriptive Statistics for the Study Variables

VARIABLE	OBS	MEAN	STD. DEV.	MIN	MAX
ROA	60	4.901167	1.427432	2.3	8.1
ROE	60	22.03067	14.28484	2.2	65.1
OPM	60	72.0345	29.87834	-11	177
BS	60	9.133333	1.779989	6	12
BI	60	7.6	1.575232	5	10
FBM	60	2.716667	1.657972	1	7
AC	60	8.783333	3.517952	3	17
BO	60	5.116667	1.88744	1	8
FL	60	5.526	2.889656	1.5	12.6
FGR	60	.73	1.339956	-3.9	5.7

Source: STATA data summary statistics result obtained from data collected from sample of commercial banks in the study.

To measure the impact of selected independent and control variables on financial performance of the sampled commercial banks in Ethiopia, return on asset, return on equity and operating profit margin are used as dependent variables. These variables are summarized as follows: The mean value of return on asset for the sampled commercial banks is about 4.9 percent and the standard deviation is 1.4 percent from the average value among the sampled commercial banks. As depicted on the table, while comparing the average value of return on asset against standard deviation, the difference implies lower value of standard deviation which shows lower dispersion from the mean, i.e. smaller the standard deviation greater the central tendency and data is concentrated around mean. The minimum value of return on asset is 2.3 percent while the maximum value is 8.1 percent.

Measure of return on equity indicates 22 percent of the mean value of financial performance of the sampled commercial banks as measured by return on equity. The measure of central tendency indicates deviation of 14.3 percent from the mean value among the sampled commercial banks. The minimum and maximum values are 2.2 percent and 65.1 percent respectively.

On the other hand, operating profit margin is 72 percent on average for the sample commercial banks with a standard deviation of 30 percent from the mean value among the sampled commercial banks. The minimum value of operating profit margin among the sampled commercial banks is -11 percent and the maximum value is 177 percent.

Generally, as shown in the table 4.1, among the three indicators of financial performance of commercial banks included in this study, operating profit margin stand first, return on equity held the second position and return on asset is the third, when they are ranked from the highest to the lowest value in terms of their mean values and maximum values. Whereas, return on asset, return on equity and operating profit margin stand first, second and third respectively on the bases of standard deviation from the mean which shows the level of variation of financial performance indicators from the mean values. The higher value of standard deviation from the mean is the more it deviate from the central points. Hence, we could have different values of financial performance indicators in all aspects of measurements of descriptive statistical tools.

As shown in the foregoing table, board size, board independence, frequency of board meetings, audit committee and board ownership are independent variables used in this study to measure the effects of corporate governance mechanisms up on selected commercial banks in Ethiopia.

The descriptive statistics of these explanatory variables are summarized as follows:

The average value of board size for the sampled commercial banks in Ethiopia is 9.13 with the standard deviation of 1.78 which is relatively closer to the mean value of board size with the indication of fair representation of the number of directors setting on the board of sampled commercial banks in Ethiopia. The logic behind fairness in board size is that, while delegating boards whom authorized to lead the organization, it is not recommended to enlarge the size of the boards. The variable consists of 6 and 12 minimum and maximum values respectively.

It is depicted on the descriptive statistics result that, the mean value of board independence for the selected commercial banks in Ethiopia is 7.6 percent and the standard deviation from the



mean value is 1.56, which implies nearness of the value dispersion from the mean among commercial banks in Ethiopia which are target population of this study. The variable shows number of independent directors setting on the board with the ultimate objective of challenging other stakeholders in fighting agency problem and doing with the interest of organization. Hence, it is believed that the more independent the board is the more effective it becomes and firms' financial performance position will be affected positively. The minimum and the maximum values of board independence is 5 and 10 respectively.

Another independent variable used in this study for the determination of effect of corporate governance on the selected commercial banks in Ethiopia is annual frequency of board meetings held by the board of the business firms per year. It has an average value of 2.7 and standard deviation of 1.66. From the computed values, i.e. mean value and value of standard deviation, one can understand the presence of wide variation of frequency of board meeting held annual among commercial banks included in the study. Scientifically it is justified that position of firm financial performance could be affected either positively or negatively with the extent of board meetings. That is, the more frequent board meeting is the more effective financial performances of commercial banks in Ethiopia.

The minimum and maximum values of frequency of board meetings among the sampled commercial banks for the study period are 1 and 7 respectively, which strengthen the justification of existence of a wide variation of frequency of board meeting along with commercial banks in Ethiopia.

Audit committee is another explanatory variable used in this study in evaluating the effect of corporate governance on commercial banks financial performance position in Ethiopia. It has an average value of 8.78 and deviates from mean point by 3.5 percent. The minimum and maximum values of audit committee are 3 and 17 respectively. The variation existing between mean value and standard deviation, and between minimum and maximum point indicate the representation of audit committee does not go along with assuring the dominance of independent audit committee, who have no any share contribution for the organization.

The fifth independent variable of corporate governance employed in this study in measuring financial performance position of commercial banks in Ethiopia is board ownership. The fact

behind this variable is that when composition of the board is composed of board members who have share contribution for the business firms. The mean value of board ownership is 5.1 and the value of standard deviation is 1.89 which shows relatively high variation among selected commercial banks in Ethiopia. The minimum and maximum values are 1 and 8 respectively. The estimated results reveal the presence of wide variation among board ownership among commercial banks in Ethiopia.

On the other hand the descriptive statistics of control variables is also summarized as follows:

The first control variable used is financial leverage which shows the proportion of total amount owed by the commercial banks to total capital. The computed mean value of financial leverage as control variable is 5.52 with 2.89 value deviate from the central point. The difference between mean value and standard deviation indicates the existence of high variation among the sampled commercial banks on their level of financial leverage position. The minimum and maximum values of the variable vary between 1.5 and 12.6 respectively which further shows the variation among target commercial banks in this study.

The second control variable used in this study is firm growth rate which shows the change in annual revenue of the commercial banks. The outcome of descriptive statistics estimation provides 0.73 mean value of the variable. The estimated value of standard deviation of the variable is 1.334 which is by far greater than the mean value of firm growth rate. The standard deviation of firm growth rate indicates a high variation among the sampled commercial banks. The deviation between the two values is an indication for the presence of wide variation of annual revenue among sampled commercial banks. In other words, the implication from descriptive statistics result shows the existence of greater variation on annual revenue which sampled commercial banks earn. The minimum and maximum values of the variable ranges between -3.9 and 5.7 respectively; which discloses the presence of bigger variation among target commercial banks in Ethiopian interms of level of annual income they earn.

4.2 Correlation Analysis: Relationship between Corporate Governance Mechanisms and Firms' Financial Performance

The abovementioned descriptive statistics shows the average values which the variables consists at the central point, with their respective variations from the mean, and the minimum and maximum values of the variables used in this study. This part of the study deals with presentation of correlation analysis of the variables along with their computed statistical values. Statistical descriptive analysis of variables in this study through correlation analysis is used to examine the existing linear relationship between corporate governance variables and financial performance indicators on selected commercial banks in Ethiopia. In other words, it enables us to clearly investigate how variables in this study are covariate. The statistical tool employed is in order to look at the relationship among variable is Pearson correlation coefficients. Beyond that, Pearson correlation between explanatory variables, i.e. correlation coefficients between independent variables and control variables is used to test the presence of multicollinearity problem in the model used. According to Gujarati, (2004), the rule of thumb for multicollinearity problem is that, if the pairwise or zero order correlation coefficient between two independent variables is high, in excess of 0.8, then multicollinearity is a serious problem. With the computation and presentation of correlation coefficient values of variables in the study, the P-values are given in parenthesis, to depict that how independent variables affect dependent variables, i.e. their direction of relationships and magnitudes of effects on one another.

2.1 Correlation Analysis of ROA as a Firm Financial Performance Proxy

Under this sub-part of the study, coefficients of correlation analysis matrix which demonstrates the likely relationships exist along with return on assets and explanatory variables are presented. Table 4.2 shows, correlation matrix that predict the likely relationship of the return on asset with board size, board independence, frequency of board meetings, audit committee and board ownership which represent independent variables, and financial leverage and firm growth rate as control variables in the study. Similarly, it is revealed in table 4.2 about the linear relationships between independent variables and control variables used in this study.

Table 4.2 Correlations (Pearson) analysis- ROA as a firm financial performance proxy

	ROA	BS	BI	FBM	AC	BO	FL	FGS
ROA	1.0000							
BS	-0.0227 (0.8631)	1.0000						
BIND	0.0825 (0.0531)	0.8777 (0.0000)	1.0000					
FBM	-0.4052 (0.0013)	0.0302 0.8185	0.0013 0.9921	1.0000				
AUDC	0.1121 (0.0039)	-0.0115 0.9302	0.0942 0.4740	0.0765 0.5614	1.0000			
BO	0.2010 (0.0536)	0.4998 0.0000	0.8198 0.0000	-0.0597 0.6506	0.2183 0.0938	1.0000		
FL	-0.1102 (0.4021)	-0.3428 0.0073	- 0.6210 0.0000	0.0558 0.6719	- 0.2004 0.1247	-0.7326 0.0000	1.0000	
FGS	0.1258 (0.3381)	0.0674 0.6091	0.2360 0.0695	0.1531 0.2428	0.0044 0.9732	0.2627 0.0426	0.2704 0.0367	1.0000

As it is depicted in table 4.2, the computation results gained through Pearson correlation matrix shows explanatory variables which have negative correlation, positive association and those with no relationship with dependent variables of the study. Accordingly, frequency of board meeting is significantly correlated at 1% with negative pattern of relationship. Board size is negatively and insignificantly correlated to return on asset, and the remaining; board independence, audit committee and board ownership are positively and insignificantly connected with return on asset. On the other hand, both control variables, i.e. financial leverage and firm growth rate, have no

significant correlation, and their direction of relationship is that financial leverage is with opposite direction and firm growth rate took the corresponding direction with return on asset.

As shown in table 4.2, the correlation coefficients of board size, board independence, frequency of board meeting, audit committee and board ownership with return on asset are -2.27 percent, 8.25 percent, -40 percent, 11.21 percent and 20.1 percent respectively. The given coefficient values of the variables shows the presence of slightly strong association of frequency of board meeting with return on asset in contrast with board size, board independence, audit committee and board ownership respectively. In case of control variables, both are weakly correlated to return on asset.

4.2.2 Correlation analysis- ROE as a firm financial performance proxy

Table 4.3 shows, the correlation matrix that foresees the likely relationship of the return on equity with board size, board independence, frequency of board meetings, audit committee and board ownership as independent variables, and financial leverage and firm growth rate as control variables of the study. It is also shown in the table about the existing linear relationships between each independent variables and control variables used in the study.

In table 4.3, using the Pearson correlation, independent variable; board independence is positively and significantly correlated at 5 percent level of significance with return on equity. However, frequency of board meeting, audit committee and board ownership are negatively and significantly correlated at 5 percent, 10 percent, 1 percent level of significance respectively. But, board size is insignificantly correlated to return on equity.

Table 4.3 Correlations (Pearson) analysis- ROE as a firm financial performance proxy

	ROE	BS	BI	FBM	AC	BO	FL	FGS
ROE	1.0000							
BS	-0.0659 0.6171	1.0000						
BI	0.3514 0.0141	0.8777 0.0000	1.0000					
FBM	-0.3255 0.0112	0.0302 0.8185	0.0013 0.9921	1.0000				
AC	-0.2527 0.0514	-0.0115 0.9302	0.0942 0.4740	0.0765 0.5614	1.0000			
BO	-0.4635 0.0002	0.4998 0.0000	0.8198 0.0000	-0.0597 0.6506	0.2183 0.0938	1.0000		
FL	0.6960 0.0000	-0.3428 0.0073	-0.6210 0.0000	-0.0558 0.6719	0.2004 0.1247	-0.7326 0.0000	1.0000	
FGS	-0.1370 0.2967	0.0674 0.6091	0.2360 0.0695	0.1531 0.2428	0.0044 0.9732	0.2627 0.0426	0.2704 0.0367	1.0000

It is depicted on table 4.3 that, the correlation coefficients of board size is -6.59 percent, board independence is 35.14 percent, frequency of board meeting is -32.55 percent, audit committee is -25.27percent and board ownership is -46.35 percent with return on equity. Even if the correlation analysis results shows relatively poor association among all the independent variables and return on equity, the association between board independence and board ownership with return on equity is strong in comparison with the others independent variables.

Furthermore, in table 4.3 it is revealed how both control variables are correlated to return on equity. According to the correlation analysis results, financial leverage is perfectly correlated to

return on equity with maximum level of positive association at 69.6 percent. Whereas, firm growth rate has no significant association with return on equity. As it is shown in table 4.3, coefficient of financial leverage shows maximum level of correlation at 69.6 percent with return on equity. This coefficient value is significantly greater than the values of the remaining independent variables.

4.2.3 Correlation analysis- OPM as a firm financial performance proxy

Below given table 4.4 shows, the correlation matrix that predicts the likely relationship of the operating profit margin with board size, board independence, frequency of board meetings, audit committee and board ownership as independent variables, and financial leverage and firm growth rate as control variables of the study. Beside to this, it is exhibited in the table about the existing linear relationships among each independent variables and control variables used in this study.

According to the results of Pearson correlation analysis, independent variables; board independence and board ownership are positively and significantly correlated at 5 percent and 1 percent level of significance with operating profit margin respectively. On the other hand, board size is negatively and significantly correlated at 10 percent level of significance. But, frequency of board meetings and audit committee are insignificantly correlated.

Table 4.4 Correlations (Pearson) analysis- OPM as a firm financial performance proxy								
	OPM	BS	BI	FBM	AC	BO	FL	FGS
OPM	1.0000							
BS	-0.0573 0.06637	1.0000						
BI	0.2899 0.0247	0.8777 0.0000	1.0000					
FBM	-0.1188 0.3658	0.0302 0.8185	0.0013 0.9921	1.0000				
AC	0.0903 0.4926	-0.0115 0.9302	0.0942 0.4740	0.0765 0.5614	1.0000			
BO	0.3420 0.0075	0.4998 0.0000	0.8198 0.0000	-0.0597 0.6506	0.2183 0.0938	1.0000		
FL	0.3537 0.0056	0.3428 0.0073	-0.6210 0.0000	-0.0558 0.6719	-0.2004 0.1247	-0.7326 0.0000	1.0000	
FGS	-0.1384 0.0915	0.0674 0.6091	0.2360 0.0695	0.1531 0.2428	0.0044 0.9732	0.2627 0.0426	-0.2704 0.0367	1.0000

From table 4.4, it can be seen that the correlation coefficients of board size is -5.73 percent, board independence is 28.99 percent and board ownership is 34.2 percent with operating profit margin. According to the coefficient values of significantly correlated independent variables, board independency and board ownership have relatively strong association with operating profit margin in comparison with other variables used in this study.

With regard to control variables, as it can be seen in table 4.4, both control variables; financial leverage and firm growth rate are significantly correlated at 1 percent and 10 percent level of significance with operating profit margin.

The coefficient values of control variables given in the table shows, financial leverage has maximum percentage of association with operating profit margin in comparison with firm growth rate at 35.37 percent and -13.84 percent respectively.

4.3 Econometrics Analysis: The effect of Corporate Governance

Mechanisms on Firms' Financial Performance

Under this part of the study, results and discussions of econometrics analysis is presented. So far, several literatures, i.e. theoretical and empirical literatures, were framed and descriptive statistics tools which helps to examine the correlation analysis among the variables was used in order to investigate the effect of corporate governance mechanisms on firms' financial performance on selected commercial banks in Ethiopia. Furthermore, in order to investigate the detail about existing association between corporate governance mechanisms and sampled commercial banks' financial performance, and moreover in order to further explore the effect of corporate governance mechanisms on firms' financial performance of selected commercial banks in Ethiopia, three pooled linear panel data regression models were computed.

After running the three models independently, the data sets were tested for the classical linear regression model assumptions for pooled OLS estimation in panel data analysis. However, tests for Autocorrelations were not made since the data analysis technique was pooled cross sectional analysis, thus mitigate the autocorrelation problem by ignoring the time effect.

The conclusions for test of the classical linear regression model assumptions of the three models of the study are presented as follows based on the results of tests of classical linear regression model assumptions stated:

First, Kolmogorov-Smirnov test was used to determine whether the distribution of the residuals was significantly different from that of a theoretical normal distribution. Kolmogorov-Smirnov test is one of the commonly used methods of testing the assumption of normality distribution (Park, 2008). The data sets have been tested for normality tests (Residuals are assumed to be normally distributed). Based on the results stated in the appendix, p-values is insignificant for the three models that, the researcher failed to reject null hypothesis, which says the residual value is

normally distributed. Therefore, there no normality problem of the data set on the data used for this study.

Second, test for heteroskedasticity is one of the important assumptions of the classical linear regression model. Breusch-Pagan/Cook-Weisberg test for heteroskedasticity was used to test heteroskedasticity problem of the data sets. If the p-value is greater than the level of significance, the null hypothesis which says the error variance is homogeneous or constant is accepted otherwise it is rejected (Gujarati, 2004). As the results indicated in the appendix, model with return on asset and return on equity as dependent variables have no heteroskedasticity problem. Since the p-value is greater than the level of significance, the researcher accept null hypothesis. Model with operating profit margin as dependent variable were having heteroskedasticity problem because the p-value is less than level of significance, thus the researcher reject null hypothesis. Therefore, robust standard error was used for operating profit margin model to minimize the problem of heteroskedasticity.

Third, in this study `ovtest` command that performs the Ramsey regression specification error test for omitted variables of the model was used. The `ovtest` command of test for omitted variables unlike the `linktest` command performs a model specification error test for single equation models it is a general specification test for the multiple regression models (Ramsey, 1969).

Table 4.5: Summary Of Regression Analysis For The Study Variables

Variables	ROA		ROE		OPM	
	Coef. (Std.Err.)	t-value (p-value)	Coef. (Std.Err.)	t-value (p-value)	Coef. (Std.Err.)	t-value (p-value)
BS	-.0442024 (.2502871)	0.18 (0.0861)	-4.745789 (2.506939)	1.89 (0.064)	-28.07762 (7.448316)	3.77 (0.000)
BI	.2239713 (.3878505)	-0.58 (0.0566)	5.305672 (4.124681)	-1.29 (0.0204)	44.49517 12.19506	-3.65 (0.001)
FBM	-.3639583 (.1225199)	-2.97 (0.004)	-2.692516 (.7525429)	-3.58 (0.001)	-2.940116 2.184658	-1.35 (0.184)
AC	.0431893 (.0490223)	0.88 (0.0582)	-.286558 (.3562212)	-0.80 (0.0025)	1.719386 .8939161	1.92 (0.060)
BO	.2212769 (.1651151)	1.34 (0.186)	1.257369 (1.616217)	0.78 (0.440)	10.79124 4.281973	2.52 (0.015)
FL	.0067681 (.0780295)	0.09 (0.0931)	3.286528 (.536872)	6.12 (0.000)	.4581882 1.277416	0.36 (0.721)
FGR	.1827467 (.1461187)	1.25 (0.217)	1.551432 (1.104935)	2.40 (0.0166)	3.556164 2.545881	2.40 (0.0168)
Number of obs	60		60		60	
R-squared	0.6508		0.6309		0.5823	
Root MSE	11.3251		9.2441		25.013	

Table 4.5 exhibits about the overall results of regressed variables which clearly show the associations between dependent variables and independent variables in terms of their magnitudes and patterns or directions of their association. The regression summary table consists of several indicators; such as, number of observations, R-squared and Root MSE with the inclusion of Coefficients, Standard Errors, t-values and p-values for each of the three models. It is also exhibited in the table that, the explanatory power of variables used in the models represented by R-squared values are 65.08 percent, 63.09 percent and 58.23 percent respectively for return on assets, return on equity and operating profit margin. The values given with R-squared in three models have the implication of 65.08 percent of the changes in return on assets, 63.09 percent of the changes in return on equity and 58.24 percent of the changes in operating profit margin are successfully explained by the variables used in three models of this study. On the other hand, the remaining 34.92 percent of the changes in return on assets, 36.91 percent of the changes in return on equity and 41.76 percent of the changes in operating profit margin are caused by other variables which are not included in this study. 0.0861 0.064 0.000

Table 4.5 indicates that, board size has a coefficient estimate of .0442024, 4.745789 and 28.07762 and it is statistically significant at 10 percent level of significance for both return on asset and return on equity and 1 percent level of significance for operating profit margin. The coefficients of board size imply that commercial banks' financial performance is negatively related with the number of board members. In other words, with the increase in the number of board size in commercial banks, financial performance of the banks' will remain poorly performing and vice versa.

In addition to this, respondents were asked to suggest the association between board size and financial performance of the firms. Accordingly, they reflected that the existing board combination and size is fairly represented. They justified that, when board combination and size is becoming too loose, conflict of interest will be happened among board members which might goes against the interest of organization and results in agency cost.

The proposed null hypothesis says there is no significant association between board size and financial performance. But, the econometric result depicts that there is correlation between board size and financial performance of selected commercial banks included in this study. The p-values show that, board size is significantly correlated to return on asset and return on equity at 10%,

and perfectly correlated to operating profit margin at 1% level of association. Thus, based on the statistical findings, the null hypothesis is rejected and the alternate hypothesis is accepted, which articulates there is a significant relationship between board size and financial performance of commercial banks incorporated in this study. In other words, the findings of this study support what was suggested as alternative hypothesis. The finding could be concluded in that; there is a significant negative relationship between board size and financial performance of commercial banks in Ethiopia. The findings of several empirical studies under taken by Yermack (1996), Adusei (2011) and Sanda et al. (2005) support this result.

Board independence has positive association along with all the three dependent variables used has a proxy of financial performance of commercial banks included in this study. Coefficient values of board independence given from regression result along with the explained variables are 2239713, 5.305672 and 44.49517 respectively with return on asset, return on equity and operating profit margin. The variable has statistically significant association with return on asset at 10 % and equally significant with both return on equity and operating profit margin at 1% level of significance correspondingly.

The regression results for the sampled commercial banks in Ethiopia included in this study shows the presences of positive association between board independence and their financial performances. In other words, the number of board members selected from independent directors has direct reflection up on banks financial performances. This is equally to mean that, the higher the number of independent directors sitting on the board is the higher financial performance of sampled commercial banks in Ethiopia and vice versa.

The null hypothesis designed for this variable is stated as there is no significant relationship between board independence and financial performances of the bank. According to the regression results given as p-values of board independence which shows the presence of significant relationship between board independence and financial performance, the stated null hypothesis is completely rejected and the alternative hypothesis is accepted. Hence, based on the regression results, it can be concluded that board independence has positive and significant relationship with financial performance of sampled commercial banks in Ethiopia. The empirical work of Fleming (2005), Nahar (2001), Pearce and Zahra (1992), Abu- Tapanjeh (2006), Sulong and Nor (2010) and Adusei (2011) support the finding of this study.

Frequency of board meeting has significant association with return on asset and return on equity at 1% level of significance with both dependent variables and it has no any relationship with operating profit margin. The coefficient values of the variable generated from regression result are -.363958, 3-2.692516 and -2.940116 correspondingly for return on asset, return on equity and operating profit margin. Based on the statistical estimation it can be concluded that, annual frequency of board meeting held in sampled commercial banks in Ethiopia could significantly affects financial performance of return on asset and return on equity of the banks and it has no any predictive power on operating profit margin.

The hypothesized null hypothesis will remain valid only for operating profit margin. For return on asset and return on equity alternative hypothesis will be accepted which predict the existence of significant correlation between frequency of board meeting and the two dependent variables, i.e. return on asset and return on equity.

Audit committee as an independent variable influencing financial performance of the sampled commercial banks remains significant variable in determining financial performance of the banks. It significantly affects all the dependent variables used in this study as a proxy of measurement for financial performances of sampled commercial banks. It significantly correlated with return on asset, return on equity and operating profit margin at 10%, 1% and 10% respectively. The estimated coefficient results of the variables are .2212769, 1.257369 and 10.79124 correspondingly for return on asset, return on equity and operating profit margin which shows the existence of positive association between audit committee and the three dependent variables used in this study. The implication of this finding is that, degree and size of independent audit committee incorporated in the system has positive influence on the sampled commercial banks financial performance.

According to the findings from regression results, it is observed that the obtained results do not support the hypothesized null hypothesis due to the existence of significant and positive association between audit committee and the three dependent variables i.e., return on asset, return on equity and operating profit margin. Hence, alternative hypothesis is accepted and the null hypothesis is rejected.

The regression result indicates board ownership has positive and statistically significant correlation only with operating profit margin at 1 percent significance levels among the three financial performance indicators. Even if the coefficient values of dependent variables are represented positively, the variable has no any association with return on asset and return on equity. Based on the findings from the estimation result, one can conclude that board ownership has no greater influence on determining financial performance of sampled commercial banks in Ethiopia. Due to this, the projected null hypothesis will be accepted and the alternative hypothesis will remain valid only for operating profit margin.

The econometric regression also shows direction and existing relationship between control variables dependent variables used in this study. Accordingly, the first control variable shows the presence of positive and significant association between financial leverage and return on asset and return on equity. The variable significantly affects return on asset and return on equity at 10% and 1% level of significance. Whereas, the variable has no any significant association with operating profit margin. The implication of correlation between financial leverage and the first two dependent variables .i.e., return on asset and return on equity, shows that successfulness of firms in using financial leverage as a means of firms' financing system positive affects amount of return firm will gain from assets and equity deployed.

The second control variable has significant relationship with return on equity and operating profit margin. It has a predictive power on return on equity and operating profit margin by equal percent i.e., 10 percent on both variables. According to the outcome of regression, firm growth rate has no any influence on return on asset. The direction of association between firm growth rate and return on asset and operating profit margin is positive linkage.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATION

This portion of the study consists of presentation of conclusions and recommendations which were drawn from the findings of this study.

5.1 Conclusions

Corporate governance mechanism is the youngest work Philosophy in business environment. It attracts attention of many scholars in establishing the discipline as a researchable area, especially for social science. The central theme of this study is to explore the effect of corporate governance mechanisms on firms' financial performance with selection of sampled commercial banks in Ethiopia using three financial performance indicators (return on asset, return on equity and operating profit margin) as dependent variables and five corporate governance mechanisms (board size, board independence, frequency of board meetings, audit committee and board ownership) as independent variables. Along with this, two control variables were also used (financial leverage and firm growth rate). The target population of this study was commercial banks in Ethiopia, from which six of them were selected based on their year of establishment i.e., banks which are very recent were purposely excluded due their failure in satisfying duration of period to be covered in collected data.

The methodology primarily used Panel data in which multiple regression method was used as data analysis and the pooled OLS method of estimation was used. The regression result revealed that; firstly, the association between independent and dependent variables the case with return on asset shows that with the exception of board ownership all independent variables have significant effects upon dependent variables in predicting financial performance of commercial banks.

Concerning the existing correlation between independent variables and return on asset, the only variable which is insignificantly associated to return on asset is board ownership whereas, the remaining independent variables (board size, board independence, frequency of board meeting, and audit committee) maintained significant linkage at different degree of association.

The third dependent variable which used in this study was operating profit margin. The findings from regression result depicts that, with the exclusion of frequency of board meeting, the rest independent variables i.e., board size, board independence, audit committee and board ownership are significantly correlated to operating profit margin.

Regarding to the control variables used, financial leverage is significantly linked to return on asset and return on equity, but it has no relationship with operating profit margin. Whereas, firm growth rate is significantly associated to return on asset and operating profit margin.

5.2 Recommendations

The following points are forwarded as recommendation based on the major findings of this study;

- Financial performance of commercial banks in Ethiopia will be better improved if adoption and implementation of corporate governance mechanisms are systematically performed and clearly framed.
- Financial performance of the banks will be improved if banks are capable of doing towards minimizing the number of dependent directors for which it might be helpful in reducing agency cost i.e., reducing conflict of interest between independent and dependent board directors who have share contribution.
- Balancing proportion of frequency of board meeting and audit committee need to be further adjusted. Escalating number of annual meeting to certain level will further improve financial performance of the banks. Likewise, composition of audit committee needs to be redesigned. In other words, in order to improve financial performance of banks and manage agency costs, it will be appreciable if the composition of audit committee is in a position of clearly determining exactly optimal number of dependent audit committee and independent audit committee. It will be useful for the firms if they might reduce the number of dependent audit committee.

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