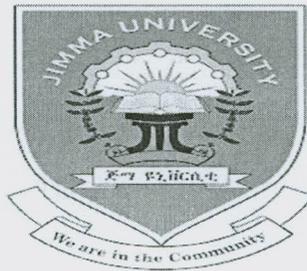


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The Impact of Corporate Governance on Firm Performance: *A study on Selected Insurance Companies in Ethiopia*

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Thesis Submitted to College of Business and Economics in Partial Fulfillment of the Requirements for the Award of Master of Degree in Business Administration (MBA)



By: Hailab Getachew
Main advisor: Arega seyoum (PhD)
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Declaration

I, the under signed, declared that this thesis is my original work and has not been presented for a degree in any other university, and that all sources of materials used for this research are duly acknowledged.

Name: Hailab Getachew

Signature: _____

Date: _____

Jimma University
College Of Business and Economics
Department Of Business and Economics
Master of Business and Economics
Regular Program

The Impact of Corporate Governance on Firm Performance: *A study on
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By Hailab Hetachew

Approved by the examining board:

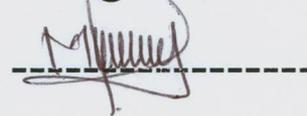
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Abstract

The core aim of this study is to examine the relationship between corporate governance and the firm performance of selected Ethiopian insurance firms. To achieve the objectives of the study, the data were collected from a sample of 10 insurance companies for the financial year covering 2008 to 2012. Variables such as board size, board composition, firm size, board gender diversity and leverage was considered as predictors of the firm performance that was measured employing the return on equity (ROE). Secondary data were collected using documentary information from company annual financial statements and the data were analyzed using a panel data regression analysis by using STATA 11.

The regression result shows that board gender diversity, firm size and leverage positively influence the financial performance of selected insurance firms in Ethiopia and they are significant based on return on equity (ROE); whereas board size and board composition have statistically insignificant impact on financial performance, but board size influence negatively and board composition influence positively the financial performance of selected insurance firms in Ethiopia. The study recommended that the insurance industries encourage women to participate in corporate top position or in the board of directors to enhance financial performance and attention should be given to increase total assets of the insurance firms to improve financial performance.

Key words: *corporate governance, board size, board composition, firm size, board gender diversity, leverage, financial performance.*

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Hailab Getachew Kebede

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Acronyms

- ❖ AACCSA: Addis Ababa Chamber of Commerce and Sectoral Associations
- ❖ BORDCOM: Board Composition
- ❖ BORDSIZ: Board Size
- ❖ CEO: Chief Executive Officer
- ❖ EICG : Ethiopian Institute of Corporate Governance
- ❖ FIRMSIZ: Firm Size
- ❖ MFIs: Micro Finance Institution
- ❖ NBE: National Bank of Ethiopia
- ❖ OECD: Organization for Economic Cooperation Development
- ❖ PSD: Private Sector Development
- ❖ ROA: Return on Asset
- ❖ ROE: Return on Equity
- ❖ SIDA: Swedish International Development Agency
- ❖ USA: United States of America
- ❖ VIF : Variance Inflation Factor
- ❖ WOMDIR: Women Directors in the Board
- ❖ Δ MVE: Change In Market Value of Equity
- ❖ PSD-HUB: Private Sector Development Hub
- ❖ GLS: Generalized Least Square

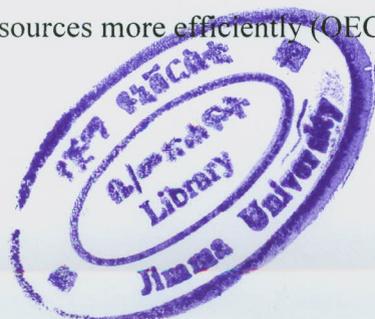
CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Corporate governance is the relationship among shareholders, board of directors and the top management in determining the direction and performance of the corporation. It includes the relationship among the many players involved (the stakeholders) and the goals for which the corporation is governed (Kim & Rasiah, 2010). Companies have long known that good governance generates investor goodwill and confidence. Corporate governance can be considered as an environment of trust, ethics, moral value and confidence- as a systematic effort of all the constituent parts – that is the stakeholders, including government, the general public, professional service providers, and the corporate sectors. The growing demand for capital and other resources from businesses has increased the importance of corporate governance around the world. Raising finance and maintaining profitability and liquidity can be difficult for the companies. It is even harder for those companies that are operating in less developed countries where capital markets and financial institutions are not fully established (McGee, 2009). Corporate governance deals not only with the internal management of the firms, but is also concerned about a firm's relationship with its suppliers, customers, and other stakeholders.

Corporate governance plays a major role in macroeconomic stability; provide the appropriate environment for economic growth as well as society welfare, therefore international institutions give major attention and concerns to this issue at the level of macro and micro aspects. It is a set of relationships between a company's management, its board, its shareholders, and other stakeholders and also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently (OECD, 2004).



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The governance system is a combination of processes, customs, policies, laws and institutions in a country by which public listed companies are directed and controlled, not only to maximize the wealth of shareholders but to achieve other corporate objectives of the company as well. It also deals with the accountability of the individuals through a mechanism which reduces the principal-agent problem in the organization. The agency problem allows manager to extract more private benefits and the firm ultimately performs worse. Therefore, firms needed to improved corporate governance issues in order to survive for long term growth and survival. A system of good corporate governance can occur in the organization by putting the balance between the ownership and control and also among the interests of stakeholders of the firm. This approach might be helpful in developing the positive attitude among the manager and shareholders and reduces the agency problems in the firms. Moreover, this is a principal agent problem where the shareholders are the principal and the chief executive officer (CEO) is the agent. The principal/agent problems which are inherent in the structure of large companies: it arising between management and the shareholders as a class; between majority shareholders and minority shareholders; and between the controllers of the company (whether managers or majority shareholders) and non-shareholder stakeholders. Within a particular company the first two sets of problem are mutually exclusive (at least at any one point in time) and which predominates depends upon the structure of shareholdings. Where shareholdings are dispersed, the principal/agent problem which emerges is that between shareholders as a class and the management of the company (Paul, 2000).

The board of directors is charged with oversight of management on behalf of shareholders. Agency theorists argue that in order to protect the interests of shareholders, the board of directors must assume an effective oversight function. It is assumed that board performance of its monitoring duties is influenced by the effectiveness of the board, which in turn is influenced by factors such as board composition and quality, size of board, duality of chief executive officer, board diversity, information asymmetries and board culture (Brennan, 2006).

Corporate governance is affected by the relationships among participants in the governance system. Controlling shareholders, which may be individuals, family holdings, bloc alliances, or other corporations acting through a holding company or cross shareholdings, can

significantly influence corporate behavior. As owners of equity, institutional investors are increasingly demanding a voice in corporate governance in some markets. Individual shareholders usually do not seek to exercise governance rights but may be highly concerned about obtaining fair treatment from controlling shareholders and management. Creditors play an important role in a number of governance systems and can serve as external monitors over corporate performance. Employees and other stakeholders play an important role in contributing to the long-term success and performance of the corporation, while governments establish the overall institutional and legal framework for corporate governance. The role of each of these participants and their interactions vary widely among OECD countries and among non- OECD countries as well. These relationships are subject, in part, to law and regulation and, in part, to voluntary adaptation and, most importantly, to market forces (OECD, 2004).

A strong and balanced board of directors is necessary as a supervising body for the executive management of a company with dispersed ownership. Hussein (2012), writing on the overview of corporate governance standards states that Ethiopia's company law does not have adequate legislative provisions on governance issues related to the separation of supervision and management responsibilities, and on the composition, independence and remuneration of board of directors in share companies.

The establishments of the Private Sector Development Hub (PSD-HUB) under the Addis Ababa Chamber of Commerce and Sectoral Associations with the financial support from SIDA enables projects in the development of Corporate Governance in Ethiopia. After the establishment of corporate Governance in Ethiopia in 2007, stakeholders draw a road map; a framework that advocate for strong leadership in order for the business community to actively participate and interact for actively executing Corporate Governance in different companies (Addis Abeba Chamber of Commerce, 2014).

1.2 Statements of the problem

Corporate governance mechanism is an important method for companies agency cost and helps improve performance. Given the importance of corporate governance, several studies have been conducted in developed countries on the relationship between corporate

governance mechanisms and firms' financial performance and found mixed results (positive and negative impact) (See for example Bauer, et al., 2008; Ibrahim, et al., 2010; Lupu & Nichitean, 2011). However, most of the prior studies have been undertaken on large firms operating within well organized corporate governance mechanisms in developed economic system. Therefore, it is difficult to generalize the same result from the findings of those studies for relatively small size Ethiopian insurance companies' governance mechanisms.

Furthermore, Ethiopia's corporate governance landscapes are embedded in a setting that differs from a western context in several ways (Dessalegn & Mengistu, 2011). Ethiopian insurance companies' corporate governance is characterized by the absence of an organized share market and the country has different regulations, practices, and economic features which needs to conduct a separate study (cited by Yenesew, 2012).

In Ethiopia so far no study appears to have been made that specifically address the effect of corporate governance and firm performance on insurance industry. Hussein, (2012) on the overview of corporate governance standards states that Ethiopia's "company law does not have adequate legislative provisions on governance issues related to the separation of supervision and management responsibilities, and on the composition, independence and remuneration of board of directors in share companies". This study is a contribution to other studies conducted to examine the impact of corporate governance mechanisms on firm's performance, understand how to effectively minimize the agency costs and design the appropriate organizational structure. This research is conducted to check the impact of corporate governance which is a crucial step in building the market's confidence and attracting positive investment flows to the institution and the economy. Therefore, the study extends and contributes to the body of research using selected insurance companies data to investigate the likely impact of corporate governance on firms' financial performance. Moreover, the study tries to provide sufficient answers to the following basic research questions.

1. To what extent does board size affect corporate financial performance?
2. Is there any relationship between board composition and corporate financial performance?
3. Is there any relationship between leverage and corporate financial performance?

4. To what extent firm size affect corporate financial performance?
5. Is there any relationship between board gender diversity and corporate financial performance?

1.3 Objectives of the Study

1.3.1 General Objective

The main objective of the study is to identify the impact of corporate governance such as board size, board composition, firm size, composition of women in the board of directors and leverage on firm performance of the selected insurance companies in Ethiopia using five years data from the year 2008 up to 2012.

1.3.2 Specific Objectives

This study has the following specific objectives:

- To examine how firm performance is related to board composition of selected insurance firms in Ethiopia.
- To assess the effect of leverage on the performance of selected insurance firms in Ethiopia.
- To determine the effect of board size on the financial performance of selected insurance firms in Ethiopia.
- To examine how firm performance is related to firm size of selected insurance firms in Ethiopia.
- Examine the association between board gender diversity and financial performance of selected insurance firms in Ethiopia.

1.4 Research Hypotheses

The following hypotheses were formulated to guide the researcher in finding answers to the research questions:

Board size refers to the number of directors in the board. It is an important factor to determine the effectiveness of the board. In relation to a relationship between board size and firm performance, there are two distinct thoughts. The first thought considers that the large



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board size will improve a firm's performance (Adams and Mehran, 2005; Rechner and Dalton, 1991). However, the second thought considers that a small board size will improve firms performance (Yokisiwa and Phan, 2004; shakir, 2008)

H1: There is strong negative relationship between board size and corporate financial performance as measured by ROE.

It is widely debated the impact of board composition in the corporate governance literature in the form of representation of outside independent directors may add any economic value to the firm (Kesner et al., 1986; Petra, 2005). Prior research on board composition mainly focused on firms in advanced economies (Guest, 2008). Studies for example by Kaplan and Reishus (1990), Byrd and Hickman (1992), Brickley et al. (1994), and Beasley (1996) found a positive impact from appointing outside independent directors onto the board.

H2: There is strong positive relationship between board composition and corporate financial performance as measured by ROE.

Firms can really maximize value by using more debt in their operations so as to take advantage of the tax shield benefits of leverage Modigliani and Miller (1963). According to Champion (1999), and Leibestein (1966), all contends that companies can use more debt to enhance their financial performance because of debts' capability to cause managers to improve productivity to avoid bankruptcy.

H3: There is strong positive relationship between leverage and corporate performance.

The nature of the relationship between firm size and profitability is an important issue that may shed some light on the factors that maximize profits. Firms achieve economies of scale when their operating costs increase at a rate lower than their output. Firms do not achieve economies of scale simply by increasing their size. Economies of scale are likely to result only if the firms have sufficient idle capacity and organization systems already in place prior to expanding (Katrisher & Scordis, 1998).

H4: There is strong positive relationship between firm size and corporate performance.

Gender diversity in board composition is seen as a part of good corporate governance, and research suggests that board diversity is associated with improved financial value (Carter et al. (2003). Boards are concerned with having right composition to provide diverse perspectives. Welbourne's (1999) study shows that women on the top management team appear to have a positive impact on the firm's short-term performance (measured as Tobin's Q) as well as long-term performance.

H5: There is strong positive relationship between board gender diversity and corporate performance.

1.5 Significance of the Study

The study has great contribution to policy makers and managers of insurance industry in Ethiopia to consider the impact of corporate governance on insurance business. This in turn contributes to the well being of the financial sector of the economy and the society as a whole. Therefore, the major beneficiaries from this study are regulators, policy makers, managers and business people in making policies and decisions. It can serve as a stepping stone for future researchers who want to conduct study on related topic

1.6 Scope of the Study

This project is confined only to the assessment of the impact of corporate governance on firm performance of selected Ethiopian insurance firms from 2008 to 2012 fiscal periods. It would have been much better and exhaustive for this study had there been a chance to incorporate other financial institutions like banks and MFIs.

However, to make the study manageable and to investigate the problem thoroughly the study is limited to incorporate only insurance companies in Ethiopia.

1.7 Limitations of the Study

This study tries to investigate the impact of corporate governance on insurance industries of Ethiopia with a special focus on only selected insurance firms purposively based on age and availability of data. This may introduce bias inherent with non-probability sampling method. The other limitation of the study is the data collection method is only secondary data. These may limit the findings of this study.

1.8 Structure of the Study

This research report is organized into five chapters: Chapter one is the introductory chapter and presents the back ground of the study, statement of the problem, objectives of the study, significance of the study, scope of the study, limitations of the study and the organization of the study. Chapter two contains the review of related theoretical and Empirical literature as well conceptual frameworks. Chapter three presents the methodology that was used to answer the research questions and objectives. The fourth chapter presents the results and discussions of the study, based on data collected from secondary sources. The results of the descriptive statistics, correlation analysis and regression analysis were also presented in the fourth chapter of this study. Chapter five contains conclusion and possible recommendations in a manner that relates to the topic, namely impact of corporate governance mechanisms on firms' financial performance

CHAPTER TWO

LITERATURE REVIEW

2.1 Theoretical Literature

2.1.1 History of Corporate Governance

Corporate governance systems have evolved over centuries, often in response to corporate failures or systemic crises. The first well-documented failure of governance was the South Sea Bubble in the 1700s, which revolutionized business laws and practices in England. Similarly, much of the securities law in the U.S. was put in place following the stock market crash of 1929 (Hanoi, 2010). As democracy flourished in Europe and USA, it created a context for the free-market economic system referred to as capitalism. In the early days of the Industrial Revolution, an unrestrained form of capitalism resulted in a very small number of people becoming very wealthy while most stayed poor. The political system responded to the situation with laws and regulations intended to limit the excesses and abuses of the free and unrestrained markets of the time. In the end, capitalism prevailed under the watchful eye of the federal and state governments (John, et al., 2004).

The success of capitalism created opportunities for businesses to grow larger. One driver of this growth was the opportunity for investors to unite their capital (money) to fund extensive projects and massive enterprises. These investors became owners of portions or shares of the businesses in which they invested, and have come to be known as shareholders. The larger businesses that were created could not be governed effectively by proprietors and partnerships for many reasons. Consequently, in the twentieth century, the publicly owned corporation emerged as the dominant legal form for business enterprises.

According to John, et al. (2004), the corporation has three distinctive features that make it an attractive form for defining the legal entity of a business—its unlimited life, the limited liability of the owners, and the divisibility of ownership that permits transfer of ownership interests without disrupting the structure of the organization.

Today, the public corporation itself operates as a form of representative government. The owners (shareholders) elect directors as their representatives to manage the affairs of the business. The directors, who as a group are referred to as the board of directors, then delegate responsibility for actual operations to the Chief Executive Officer (CEO), whom they hire. The CEO is accountable to the board of directors, which, collectively and individually, is accountable to the shareholders. In addition to its role in selecting the CEO, the board also advises on and consents to the selection of businesses and strategies of the firm as well as oversees results. In sum, this system of authoritative direction, or government, is known as corporate governance (John, et al. 2004).

2.1.2 What Is Corporate Governance?

The OECD (2004) defines corporate governance as, “Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring”. “Corporate Governance as a system by which companies are strategically directed, interactively managed and holistically controlled in an entrepreneurial and ethical way and in a manner appropriate to each particular context” (Martin Hilb, 2011). It’s a set of relationships between company directors, shareholders and other stakeholder’s as it addresses the powers of directors and of controlling shareholders over minority interest, the rights of employees, rights of creditors and other stakeholders (Muriithi, 2009). Corporate governance has also been defined as a system of law and sound approaches by which corporations are directed and controlled focusing on the internal and external corporate structures with the intention of monitoring the actions of management and directors and thereby mitigating agency risks which may stem from the misdeeds of corporate officers (Sifuna, Anazett 2012).

2.1.3 Theories of Corporate Governance

2.1.3.1 The Stewardship Theory

The stewardship theory of corporate governance holds that, because people can be trusted to act in the public good in general and in the interests of their shareholders in particular, it makes sense to create management and authority structures that, because they provide unified command and facilitate autonomous decision making, enable companies to act (and react) quickly and decisively to market opportunities (Alan Calder, 2008). A steward is defined by Davis, Schoorman & Donaldson (1997) as one who protects and maximizes shareholders wealth through firm performance, because by so doing, the steward's utility functions are maximized. This approach leads, for instance, to the combination of the roles of chair and CEO, and for audit committees to be either non-existent or lightweight. It stresses on the position of employees or executives to act more autonomously so that the shareholders' returns are maximized. Indeed, this can minimize the costs aimed at monitoring and controlling behaviors (Daly et al., 2003).

Stewardship theory stresses not on the perspective of individualism, but rather on the role of top management being as stewards, integrating their goals as part of the organization. The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained. It stresses on the position of employees or executives to act more autonomously so that the shareholders' returns are maximized. Indeed, this can minimize the costs aimed at monitoring and controlling behaviors (Daly et al., 2003). The theory believes that there is greater utility in cooperative than individualistic behavior and hence whilst the actions of management would be maximizing shareholder wealth, it would at the same time be meeting their personal needs. The managers protect and maximize shareholders wealth through firm performance, because by so doing, their utility functions are maximized (Davis et al., 1997). Moreover, stewardship theory suggests unifying the role of the CEO and the chairman so as to reduce agency costs and to have greater role as stewards in the organization. It was evident that there would be better safeguarding of the interest of the shareholders.

2.1.3.2 The Agency Theory

The agency theory of corporate governance, on the other hand, sees shareholders as the principals and management as their agents. Agents will, however, act with rational self-interest: as employee directors of a company, they will tend to maximize their monetary compensation, job stability and other perks, and do no more than seek to appease shareholders (Alan Calder, 2008). They cannot, in other words, be expected to act in the interests of the shareholders. They need, instead, to be monitored and controlled to ensure that the principals' best interests are served. The agency theory shareholders expect the agents to act and make decisions in the principal's interest. On the contrary, the agent may not necessarily make decisions in the best interests of the principals (Padilla, 2000). Agency theory is concerned with resolving two problems that can occur in agency relationships. The first is the agency problem that arises when (a) the desires or goals of the principal and agent conflict and (b) it is difficult or expensive for the principal to verify what the agent is actually doing. The problem here is that the principal cannot verify that the agent has behaved appropriately. The second is the problem of risk sharing that arises when the principal and agent have different attitudes toward risk. The problem here is that the principal and the agent may prefer different actions because of the different risk preferences (Kathleen, 2014).

Agency theory can be employed to explore the relationship between the ownership and management structure. However, where there is a separation, the agency model can be applied to align the goals of the management with that of the owners. The model of an employee portrayed in the agency theory is more of a self interested, individualistic and are bounded rationality where rewards and punishments seem to take priority (Jensen & Meckling, 1976). The agency relationship is the principal engaged another person under contract or the agent to perform some services on the behalf of which delegating some decision making authority to agent Jensen and meckling (1976).

Agency theory suggests that the management of an organization is undertaken on behalf of the owners of that organization, in other words the shareholders. Consequently the management of value created by the organization is only pertinent insofar as that value accrues to the shareholders of the firm. The clear implication for corporate governance is

that adequate monitoring mechanisms need to be established to protect shareholders from management's conflict of interest – the so-called “agency costs” of modern capitalism (Fama and Jensen, 1983). The agency model is widely accepted in the business community, as can be seen by the widespread adoption of normative guidelines emphasizing the need for independent directors to monitor the activities of the board (Bosch, 1995). If agency theory holds, therefore, we would expect to find the following patterns:

Pattern (a): *High levels of outsiders on the board are associated with high monitoring of management, which is associated with low agency costs and consequently high corporate performance.*

Alternatively, agency theory suggests that if management interests dominate the board, there will be little opportunity for monitoring of their activities. As a result, we would expect there to be a link between the reduced monitoring and a rise in agency costs. Hence, we would also anticipate finding that:

Pattern (b): *Low levels of outsiders on the board are associated with low monitoring of management, which is associated with high agency costs and low corporate performance.*

Thus Agency Theory argues that managers merely act as custodians of the organization and its operational activities and places upon them the burden of managing in the best interest of the owners of that business. According to agency theory all other stakeholders of the business are largely irrelevant and if they benefit from the business then this is coincidental to the activities of management in running the business to serve shareholders.

2.1.3.3 Resource Dependency Theory

Resource dependence theory is the study of how the external resources of organizations affect the behavior of the organization. Resource dependence theory has implications regarding the optimal divisional structure of organizations, recruitment of board members and employees, production strategies, contract structure, external organizational links, and many other aspects of organizational strategy Pfeffer and Salancik (1978). Resource dependence concerns more than the external organizations that provide, distribute, finance, and compete with a firm. Although executive decisions have more individual weight than non-executive decisions, in aggregate the latter have greater organizational impact. Managers throughout the organization understand their success is tied to customer demand.

Johnson et al, (1996) concurs that resource dependency theorists provide focus on the appointment of representatives of independent organizations as a means for gaining access in resources critical to firm success. For example, outside directors who are partners to a law firm provide legal advice, either in board meetings or in private communication with the firm executives that may otherwise be more costly for the firm to secure. It has been argued that the provision of resources enhances organizational functioning, firm's performance and its survival (Daily et al, 2003). The stakeholder theory focuses on relationships with many groups for individual benefits; resource dependency theory concentrates on the role of board directors in providing access to resources needed by the firm. Hillman, Canella and Paetzold (2000) contend that resource dependency theory focuses on the role that directors play in providing or securing essential resources to an organization through their linkages to the external environment. It has been argued that the provision of resources enhances organizational functioning, firm's performance and its survival (Daily et al, 2003). According to Hillman, Canella and Paetzold (2000) that directors bring resources to the firm, such as information, skills, access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy.

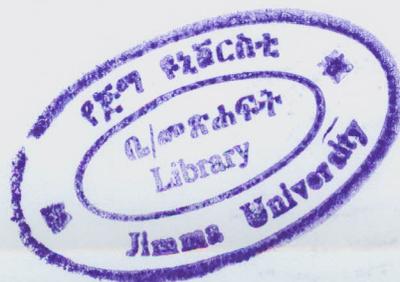
A Resource Dependence Theory Perspective" by Pfeffer and Salancik (1978) marks the starting point of Resource Dependence Theory. The theory's fundamental assumption is that organizations are not self-sufficient, but depend on resources provided by their environments to achieve organizational goals (Hillman, Withers, and Collins (2009); Pfeffer and Salancik (1978)). Because of the division of labor management also depends on the resources such as work effort, expertise, and organizational connections provided by individual employees, work groups, or departments (Bartol and Martin (1988)). The degree to which management depends on any employee is defined as the inverse of the power that same employee has over his or her manager. The more critical and the less substitutable the resources subordinates use to derive their contributions are to management's ability to achieve defined goals, the higher the employee power, and with it the degree of managerial dependence, will be. As a response, managerial dependence will trigger actions such as management control to ensure that goals are achieved (Bartol and Martin (1988); Green and Welsh (1988)).

2.1.3.4 The Stakeholder's Theory

According to David & Shahla, (2011) the arguments for stakeholders theory is based upon the assertion that maximizing wealth for shareholders fails to maximize wealth for society and all its members and that only a concern with managing all stakeholders' interests achieves this. It states that all stakeholders must be considered in the decision making process of the organization. Wheeler, et al., (2002) argued that stakeholder theory was derived from a combination of the sociological and organizational disciplines. Stakeholder theory can be defined as any group or individual who can affect or is affected by the achievement of the organization's objectives. Stakeholder theorists suggest that managers in organizations have a network of relationships to serve – this include the suppliers, employees and business partners.

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Stakeholder theory is managerial, it reflects and directs how managers operate rather than primarily addressing management theorists and economists. The focus of stakeholder theory is articulated in two core questions (Freeman 1994). First, it asks, what is the purpose of the firm? This encourages managers to articulate the shared sense of the value they create, and what brings its core stakeholders together. This propels the firm forward and allows it to generate outstanding performance, determined both in terms of its purpose and marketplace financial metrics. Second, stakeholder theory asks, what responsibility does management have to stakeholders? This pushes managers to articulate how they want to do business. Specifically, what kinds of relationships they want and need to create with their stakeholders to deliver on their purpose.



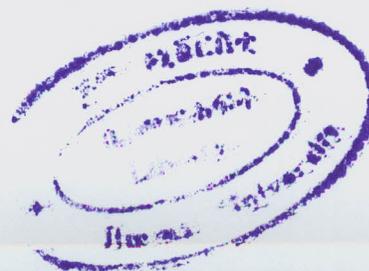
Finally, from the theories discussed from the above the agency theory explains more the corporate governance mechanisms and firms financial performance.

2.1.4 The International Scope of Good Corporate Governance

Numerous codes of best practices and corporate governance principles have been developed over the last 10 years. Worldwide, more than 200 codes have been written in some 72 countries and regions.¹⁹ Most of these codes focus on the role of the Supervisory Board or Board of Directors in a company (OECD 2004). Handfuls are international in scope.

Among these, only the OECD Principles address both policymakers and businesses, and focus on the entire governance framework (shareholder rights, stakeholders, and disclosure and board practices). The OECD Principles have gained worldwide acceptance as a framework and reference point for corporate governance. Published in 1999 and revised in 2004, they were developed to provide principle-based guidance on good governance. The OECD corporate governance framework is built on four core values:

- **Fairness:** The corporate governance framework should protect shareholder rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violations of their rights.
- **Responsibility:** The corporate governance framework should recognize the rights of stakeholders as established by law, and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
- **Transparency:** The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the company, including its financial situation, governance structure, performance and ownership.
- **Accountability:** The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the Board, and the Board's accountability to the company and shareholders.



Corporate governance has been shown to be documented in an effective manner in the literature. For instance, most studies have examined the impact of the board characteristics (CEO duality, CEO tenure, audit committee, leverage, board size and composition of the Board) on firm performance. Hence this study will investigate the relationship between corporate governance mechanisms namely, board size, leverage and board composition with the firm's performance (OECD 2004).

2.1.5 Corporate Governance in Ethiopia

Good corporate governance enhances the confidence of investors in the companies and positively contributes towards the overall business environment. Well-governed companies often draw huge investment premiums, get access to cheaper debt, and outperform their objectives. The issue of corporate governance in Ethiopia is new. The financial sector is still underdeveloped and largely owned and controlled by the government (Asnakech 2012).

The Commercial Code of Ethiopia (hereinafter the Commercial Code) incorporates provisions pertinent to the governance of share companies. However, such provisions are inadequate to address specific issues in corporate governance related to board of directors such as separation of roles of nonexecutive directors and CEOs, composition and independence of the board as well as director's remuneration. Moreover, proclamations and directives governing financial share companies in Ethiopia do not sufficiently address the aforementioned issues (Hussien, 2012)

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

Fekadu (2010) underlines the growing separation between ownership and control in Ethiopia, and he submits some empirical evidence in this regard. Relying on the data and literature on corporate governance, he shows the deficiency of the Commercial Code in protecting the rights of minority shareholders in the context of publicly held companies.

The study conducted by Ethiopian Chambers of Commerce and Sectoral Associations on corporate governance in Ethiopia by Gabo & Zekrie (2009), suggests the introduction of a voluntary code of corporate governance in the country. It recommends that corporate governance law reform should consider key development policy aspects which match with the country's plans for poverty reduction and wealth creation.

This article takes the themes discussed in the aforementioned works further and makes a distinction between corporate governance and corporate management, and examines whether the same should be stipulated in the relevant laws with a clear articulation of the powers of non-executive board members. The article also argues that there is inadequacy in the law on the composition and independence of directors and forwards recommendations.

2.1.6 Insurance Companies in Ethiopia

The history of insurance service is as far back as modern form of banking service in Ethiopia which was introduced in 1905. At the time, an agreement was reached between Emperor Menelik II and a representative of the British owned National Bank of Egypt to open a new bank in Ethiopia. Similarly, modern insurance service, which were introduced in Ethiopia by foreigners, mark out their origin as far back as 1905 when the bank of Abyssinia began to transact fire and marine insurance as an agent of a foreign insurance company. According to a survey made in 1954, there were nine insurance companies that were providing insurance service in the country. With the exception of Imperial Insurance Company that was established in 1951, all the remaining of the insurance companies were either branches or agents of foreign companies. In 1960, the number of insurance companies increased considerably and reached 33. At that time insurance business like any business undertaking was classified as trade and was administered by the provisions of the commercial code.

According to Hailu Zeleke (2007), the first significant event that the Ethiopian insurance market observation was the issuance of proclamation No. 281/1970 and this proclamation was issued to provide for the control & regulation of insurance business in Ethiopia. Consequently, it created an insurance council and an insurance controller's office, its strange impact in the sector. The controller of insurance licensed 15 domestic insurance companies,

36 agents, 7 brokers, 3 actuaries & 11 assessors in accordance with the provisions of the proclamation immediately in the year after the issuance of the law.

Accordingly, as stated by the office mentioned above, the law required an insurer to be a domestic company whose share capital (fully subscribed) not to be less than Ethiopian Birr 400,000 for a general insurance business, Birr 600,000 in the case of long-term insurance business and Birr 1,000,000 to do both long-term & general insurance business. The proclamation defined 'domestic company' as a share company having its head office in Ethiopia and in the case of a company transacting a general insurance business at least 51% and in the case of a company transacting life insurance business, at least 30% of the paid-up capital must be held by Ethiopian nationals or national companies.

After four years that is after the enactment of the proclamation, the military government that came to power in 1974 put an end to all private enterprises. Then all insurance companies operating were nationalized and from January 1, 1975 onwards the government took over the ownership and control of these companies & merged them into a single unit called Ethiopian Insurance Corporation. In the years following nationalization, Ethiopian Insurance Corporation became the sole operator. After the change in the political environment in 1991, the proclamation for the licensing and supervision of insurance business heralded the beginning of a new era. Immediately after the enactment of the proclamation in the 1994, private insurance companies began to increase.

Before October, 2003 in Ethiopia the corporate governance of banks and insurance firms is directed and supervised by the central bank. The National Bank of Ethiopia monitors and controls the insurance business and functions as regulators of the country's money supply. Accordingly, national bank of Ethiopia issued directives on the size, composition and competence of board of directors. According to banking business Proclamation (No. 592/2008) the national bank is responsible to issue directives on the qualification and competency to be fulfilled by directors; the minimum number of directors in the membership of the board of a bank; the duties, responsibilities and good corporate governance of the boards of directors of bank; the maximum number of years a director may serve in any bank.

In October 2013 Addis Ababa Chamber of Commerce and Sectoral Associations (AACCSA) is actively pursuing the establishment of a non-government, private and voluntary membership based organizations and finally they established Institute of Corporate Governance (ICG).

2.1.7 Corporate Governance Mechanisms and Firms Financial Performance

Empirical researches on corporate governance use either market-based measures or accounting-based measures to assess firm performance. Klein (1998) uses return on assets (ROA) and Lo (2003) uses return on equity (ROE) as an operating performance indicator. Brown and Caylor (2005) use ROE and ROA as their two operating performance measures. We can measure the operating performance of a firm through the ROA ratio which shows the amount of earnings have generated from an invested capital assets (Epps & Cereola 2008). Matolcsy & Wright (2011) measured firm performance measured by ROA (Return on Assets = $\text{EBIT} / \text{Average total Assets} - \text{in book value} -$), ROE (Return on Equity = $\text{net profit} / \text{equity} - \text{in book value} -$), ΔMVE (Change in market value of equity), $\Delta\text{MVE risk}$ (Change in market value of equity, adjusted for dividends and risk). Yasser et al. (2011) used return on equity (ROE) and profit margin (PM) for the measurement of firm performance.

Market based measures of companies' performance were done by Shah et al. (2011) by Marris ratio (Market value of equity/ book value of equity) and Tobin's Q (market value of equity + book value of debt/total of assets - in book value -), whereas financial reporting perspective was measured by ROE and Return on investment ($\text{net result} + \text{interest} / (\text{equity} + \text{total debt})$). Bhagat & Black (1999) measured dependent variable firm performance by Tobin's Q, Return on assets ($\text{Operating income}/\text{Assets}$), Turnover ratio ($\text{Sales}/\text{Assets}$), Operating margin ($\text{Operating income}/\text{Sales}$), Sales per employee and also by Growth of Assets, Sales, Operating income, Employees and Cash flows.

Several studies have been done in developed and developing countries (Baysinger & Butler, 1985; Rechner & Dalton, 1991; Coles & Jarrell, 2001; Rhoades et al, 2001; Khatri et al., 2002; Judge et al., 2003) which examined the relationship between corporate governance and firm performance. A thorough review of the relevant literature revealed that there is a

paucity of studies examining the performance implications of corporate governance in the developing countries, in general, and in the Gulf region, in particular. This calls for further research work to be put forth to examine this relationship and that is the direction this study is trying to contribute to through examining the between corporate governance and firm performance of Ethiopian selected insurance companies.

Corporate governance has been shown to be documented in an effective manner in the literature. For instance, most studies have examined the impact of the board characteristics (firm size, leverage, CEO duality, audit committee size, board gender diversity, board size and composition of the board) on firm performance. Hence, this study will investigate the relationship between corporate governance mechanisms namely, firm size, leverage, board gender diversity, board size and composition of the board with the firm's performance.

2.1.7.1 Board Composition and Firm Performance

Board composition has been highly debated in the realms of economics, organizational science literatures, and finance on the empirical and the theoretical levels. It has also been debated that effective ways of monitoring can assist the boards in making executives effectively take care of the shareholder's interests rather than their own (Ramdani & Van, 2009). According to agency theory, a larger proportion of independent directors generally provide better firm performance. In general, it has been concluded by Ramdani and Van (2009) that the proportion of independent directors has an effect on firm performance. Boards mostly compose of executive and non-executive directors. Executive directors refer to dependent directors and non-Executive directors to independent directors (Shah et al., 2011). At least one third of independent directors are preferred in board, for effective working of board and for unbiased monitoring. Dependent directors are also important because they have insider knowledge of the organization which is not available to outside directors, but they can misuse this knowledge by transferring wealth of other stockholders to themselves (Beasley, 1996). Previous studies examining the relationship between board composition and firm performance have been inconsistent. For example, some researchers (such as Forsberg, 1989; Hermalin & Weisbach, 1991; Zahra & Pearce, 1989) found that there is no significant relationship. On the other hand, other studies found that firms with

board of directors dominated by outsiders are able to perform better (Adams & Mehran, 1995; John & Senbet, 1998).

2.1.7.2 Board Size and Firm Performance

Board size refers to the number of directors in the board. It is an important factor to determine the effectiveness of the board. Jensen and Meckling (1976) argued that a bigger size board of directors may improve the companies' board effectiveness and support the management in reducing agency cost that resulted from poor management and consequently leads to better financial results. The Chairman should be allowed to provide commands to all the executive and non-executive directors. Hermalin and Weisbach (2003) argued the possibility that larger boards can be less effective than small boards. When boards consist of too many members agency problems may increase, as some directors may tag along as free-riders. They argued that when a board becomes too big, it often moves into a more symbolic role, rather than fulfilling its intended function as part of the management. On the other hand, very small boards lack the advantage of having the spread of expert advice and opinion around the table that is found in larger boards.

In the relevant literature, even though there have been many studies that examined the relationship between board size and firm performance, the findings turned up to be inconclusive. In examining this relationship in the Japanese listed companies, Yokishawa and Phan (2004) found that there is a negative association between board size and firm performance. Similarly, Shakir (2008) found a negative relationship between board size and firm performance which supported the conclusion of Jensen (1993) that for a firm to be effective in its monitoring, it should have a relatively small board of directors. In relation to that, Haniffa and Hudaib (2006) argued that a large board is seen as less effective in monitoring performance and could also be costly for companies in terms of compensation and increased incentives to shirk.

Vafeas (2000) reported that firms with the smallest boards (minimum of five board members) are better informed about the earnings of the firm and thus can be regarded as having better monitoring abilities. Echoing the above findings, Mak and Yuanto (2003) reported that listed firm valuations of Singaporean and Malaysian firms are highest when the

board consists of five members. Bennedsen, Kongsted and Nielsen (2004), in their analysis of small and medium-sized closely held Danish corporations reported that board size has no effect on performance for a board size of below six members but found a significant negative relation between the two when the board size increases to seven members or more. Bhagat and Black (2002), found no solid evidence on the relationship between board size and performance. In an attempt to compare the effects of board structure on firm performance between Japanese and Australian firms, Bonn, Yokishawa and Phan (2004) found that board size and performance (measured by market-to-book ratio and return on assets) was negatively correlated for Japanese firms but found no relationship between the two variables for its Australian counterpart. However, contrary to the Japanese firms the ratios of outside directors and female directors to total board numbers have a positive impact in the Australian sample (Bonn, 2004).

On the contrary, prior studies regarding the size of the board supported the positive relationship between the size of the board of directors and corporate performance. Large boards are viewed to lead to a better business performance owing to the wide variety of skills present for better decision making and monitor the performance of the CEO. For example, Adams and Mehran (2005) found a positive relationship between board size and performance in the U.S. banking industry. Moreover, Rechner and Dalton (1991) have also reported that large boards are associated with stronger performance. These results supported the conclusion made by Pfeffer (1972) and Zahra and Pearce (1989) regarding the relationship between the board size and firm performance.

2.1.7.3 Leverage and Firm Performance

Leverage has been used in a number of empirical studies (such as Kyereboah-Coleman, Biekpe, 2006; Alsaeed; 2006) that have examined the relationship between corporate governance and financial performance of the company. In their attempt to justify taking the leverage as a control variable, these studies have revealed that the debt has an effect on the financial performance of the company. As suggested by Alsaeed (2006), the firm leverage was measured by dividing total of liabilities by the total of assets.

Significant creditors, such as banks, have large investments in the firm, and want to see the returns on their investments materialize. Their power comes in part because of a variety of control rights they receive when firms default or violate debt covenants (Smith and Warner, 1979) and in part because they typically lend short term, so borrowers have to come back at regular short intervals for more funds. As a result, banks and other large creditors are in many ways similar to the large shareholders. Diamond (1984) presents one of the first models of monitoring by the large creditors. Debt owed to large creditors such as banks is believed to be a useful tool for reducing the agency problem. Large creditors, like large stakeholders, also have interest in seeing that managers take performance-improving measures.

2.1.7.4 Firm Size and Firm Performance

Generally, the firm size of financial institutions has been measured using a combination of financial ratio analysis, benchmarking, measuring performance against budget or a mix of these methodologies (Avkiran, 1995). Dhawan (2001), who examined the relation between firm size and productivity for U.S. firms between 1970 and 1989, actually finds the opposition relationship between firm size and profitability. Nagarajan & Burthwal (1990) revealed the Co-efficient of growth rate of sales was positive and significant, suggesting that factors on the demand side of a firm had a greater impact on profitability than on the supply side. There are predefined methods for measuring the performance of a firm. The difficulty in relying on these measures is that different performance measures can conflict (Lumpkin & Dess, 1996). Dess & Robinson (1984) reported strong and statistically significant relationships between the subjective comparative assessments of the 5-year performance of 18 businesses by their top management against other similar businesses in their industries, and the objective measures of return on assets and sales growth. In a common sense, it is considered that the profitability of a firm depends upon organizational growth. While growth has been considered the most important measure in small firms, it has also been argued that financial performance is multidimensional in nature and that measures such as financial performance and growth are different aspects of performance that need to be considered (Wiklund, 1999). It has also been argued that firms grow in many ways and that a firm's growth pattern is related to age, size and industry (Delmar, Davidsson, & Gartner, 2003).

Hardwick (1997) argues that there is a positive relationship between performance and size due to operating cost efficiencies through increasing output and economizing on unit of cost. Large corporate size also enables insurers to effectively diversify their assumed risks and respond more quickly to changes in market conditions. Industrial organization economists such as Bain (1968) and Scherer (1980) have argued that large firms possess monopoly power which allows them to set prices above the economic costs involved in the production of the products resulting in additional profit for the larger firms. In terms of investment performance, Adams (1996) believes that large companies are able to diversify their investment portfolios and this could reduce their business risks. Grace and Timme (1992) suggest that large companies generally outperform smaller ones because they manage to utilize economies of scale and have the resources to attract and retain managerial talent. Therefore, it is expected that performance is positively related with size of company.

2.1.7.5 Board Gender Diversity and Firm Performance

Gender diversity in the boardroom and in top executive positions has been the focus of public debate, academic research, government considerations and corporate strategy for more than a decade now. Previously considered a social issue and an issue of image, gender diversity is increasingly approached as a value-driver in organizational strategy and corporate governance, and as such has become a challenging issue in recent academic research. Positive performance effects of board gender diversity imply that a higher number of women in corporate top positions or on board of directors will relate to increased firm productivity and profitability.

In order to increase the number of women in top positions, affirmative actions are under discussion or already operational in several countries. In Norway, for example, from 2006 onwards large firms must have at least 40% female representation among the members of the board of directors, as a result of which Norway currently scores 44.2% female board representation (European PWN 2008). In Finland, the new Corporate Governance Code of 2008 requires that from January 1, 2010 Finish listed companies have at least one female board director, or if not, explain the reasons why (www.europeanpwn.net).

A priori, there are several reasons why gender diversity could lead to superior firm performance and improved shareholders' wealth. First, studies of the structure and function of boards of directors provide some insight and perspective on the gender issue. Gender diversity in board composition is seen as a part of good corporate governance, and research suggests that board diversity is associated with improved financial value (Carter et al. (2003)). Board independence can be a necessary condition for a well-functioning board, thus leading to better shareholders' wealth.¹ Carter et al. (2003) argue that diversity can increase board independence because directors with a different gender, ethnicity, or cultural background might ask questions that would not come from directors with more traditional backgrounds. In a recent paper, Adams and Ferreira (2007) provide evidence that gender diversity on boards is related to firm performance that is measured as Tobin's Q and ROA, and that the relation depends on the governance structure. In their findings, gender diversity on the board of directors enhances firm performance when firms have a weak governance structure. Consequently, their results indicate that gender diversity may function as a tough monitor (i.e., a good governance mechanism) upon the strong demand for it.

Second, the studies of the effectiveness of organizational culture suggest that open and flexible organizational environments may contribute to superior firm performance (Rose and Kumar (2006), Samson and Terziovski, and Powell (1995)). The culture of the firm determines the organization's ability to deal with change in the business environment. The "right" culture is critical to improving the effectiveness of management performance. This could be because more open and flexible cultures provide employees with workplaces where they are likely to be self-motivating without the need for controls.

Analyzing U.S. firms where inclusion of women directors is voluntary, Adams and Ferreira (2009) document that boards with women directors have lower director attendance problems and that CEO turnover in such firms is more sensitive to firm performance, consistent with more effective monitoring. They however find that female directors have a negative impact on firm performance, especially for well governed firms. Farrell and Hersch (2005) find that director gender has no impact on firm performance and conclude that the addition of women to the board of directors appears to be driven by tokenism. While Carter, Simkins and Simpson (2003) find a positive relation between gender diversity of the board and firm

performance, Adams and Ferreira (2009) show that this relationship disappears once endogeneity issues are fully addressed.

2.2 Review of Related Empirical Studies

Yenesew (2012) examined the relationship between corporate governance mechanisms and firm financial performance using eight Ethiopian commercial banks with a data set covering five years period from the year 2007 to 2011. The researcher used return on asset, return on equity, net interest margin measure and board size, board gender diversity, board member educational qualification, business management experience of directors, industry specific experience of directors, audit committee size, as explanatory variables and bank size, bank leverage and bank growth as control variables of the study. The study points out that board size has a significant negative effect on return on equity but its negative effect on return on asset and net interest margin was insignificant. No statistically significant relation was found between percentage of female directors and financial performance. However, this is due to very small numbers of female directors as observed in the descriptive statistics which does not permit them to be powerful enough to make a difference to monitoring. Board members educational qualification significantly and positively influences the financial performance of sample commercial banks and industry specific experience of director positively and significantly influence return on asset. Contrary to this negatively and significantly related with net interest margin. But it has not significant relation with return on equity. Audit committee size has a negative relation with all the three financial performance of commercial banks but not statistically significant with return on equity. It implied that audit committee size negatively and significantly influence commercial banks performance as measured by return on asset and net interest margin.

Rashid et al. (2010) examines the influence of corporate board composition in the form of representation of outside independent directors on firm economic performance in Bangladesh. Two hypotheses are developed to examine the relationship among composition of board memberships including independent directors and firm performance. An observation of 274 Bangladeshi firms is used in the study. A linear regression analysis is used to test the hypotheses. Results reveal that the outside (independent) directors cannot add potential value to the firm's economic performance in Bangladesh. The idea of the

introduction of independent directors may have benefits for greater transparency, but the non-consideration of the underlying institutional and cultural differences in an emerging economy such as Bangladesh may not result in economic value addition to the firm.

Abdullah Kaid et al., (2012) examined the relationship between board characteristics and the firm performance of non-financial listed Kuwaiti firms. To achieve the objectives of the study, the data were collected from a sample of 136 companies for the financial year 2009. Variables such as CEO duality, COE tenure, audit committee size, board size and board composition were considered as predictors of the firm performance that was measured employing the return on assets (ROA). By contrast, the effects of CEO tenure and leverage on firm performance were found to be negative and significant at the chosen level of significance. To test the hypotheses of the study, multiple linear regression analysis using SPSS 18.0 was utilized. Using the firm size and leverage as a control variable, the findings of the study support the positive effects of CEO duality and audit committee size on ROA.

Demis (2013) has undertaken a study to evaluate the financial performance of non-life insurance industry in Ethiopia by using CAMEL frame work. The researcher selected 10 insurance companies from the total of 15 based on their year of establishment. Secondary data collected from the individual insurance companies and from the National Bank of Ethiopia from the fiscal year of 2008 to 2012 was used for the completion of the study. ROA has been used as the dependent variable explained by capital adequacy, assets quality, re-insurance, actuarial issues, management efficiency, earning and profitability and liquidity. Multiple linear regressions were applied. From the multiple linear regressions, it was found that assets quality and combined ratio have negative relationship whereas capital adequacy and retention ratio have positive relationship with performance (ROA) of insurance industry in Ethiopia.

Tanna, s. et al., (2013) examine the effect of board size and composition on the efficiency of United Kingdom banks a sample of 17 banking institutions operating in the UK between 2001 and 2006 to provide empirical evidence on the association between the efficiency of UK banks and board structure, namely board size and composition. Their approach is to first use data envelopment analysis to estimate several measures of the efficiency of banks, and then panel data regressions for investigating the impact of board structure on efficiency.

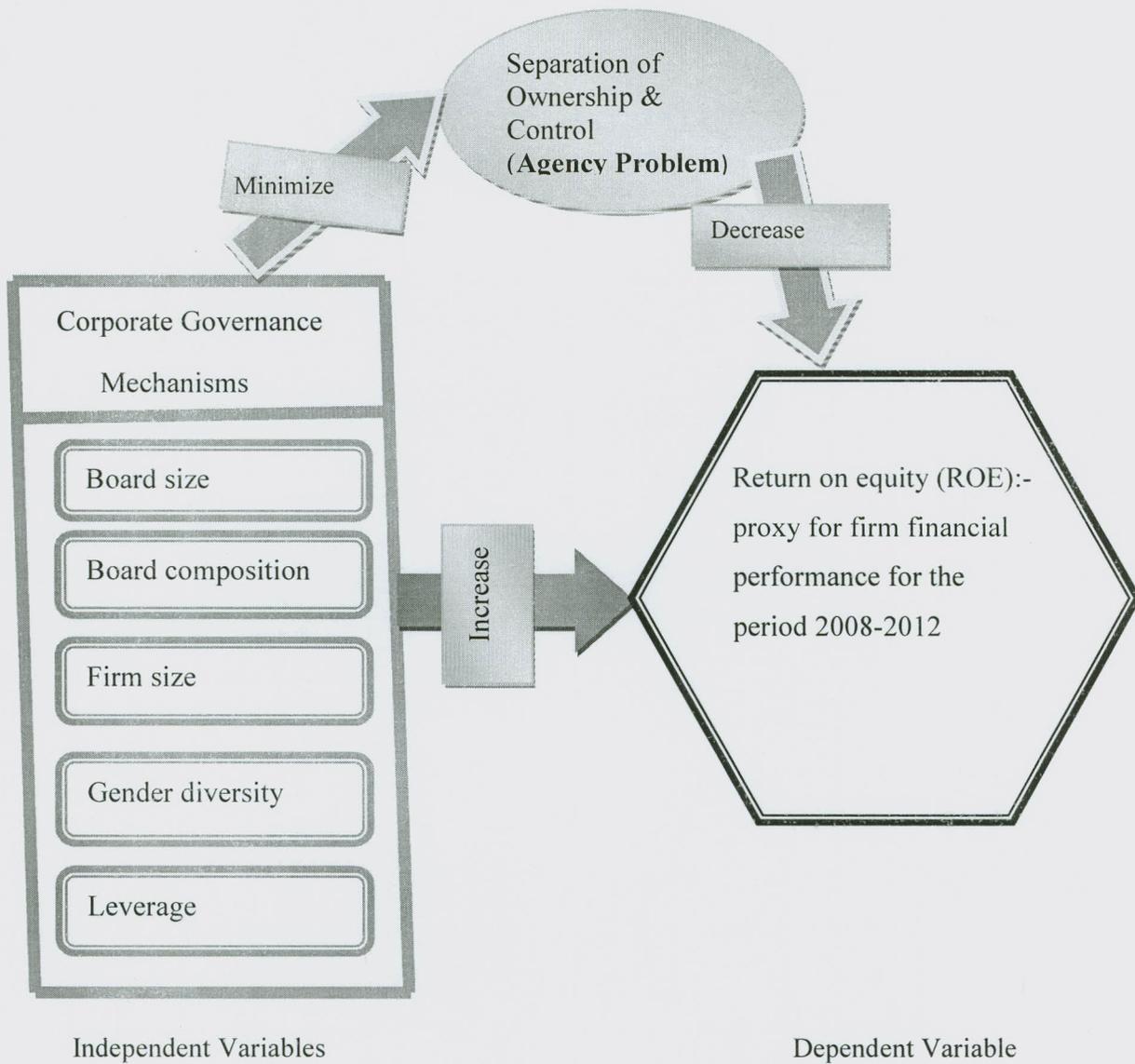
After controlling for bank size and capital strength, they found some evidence of a positive association between board size and efficiency, although this is not robust across all our specifications. Board composition, by contrast, has a robustly significant and positive impact on all measures of efficiency.

Finally, as far as the researcher's knowledge is concerned so far no study appears to have been conducted that provide empirical evidence particularly on the impact of corporate governance mechanisms on financial performance of insurance firms in Ethiopia. Given this lack of empirical evidences, this study fills the gap and provides empirical evidence on the impact of corporate governance mechanisms on financial performance of selected insurance firms in Ethiopia by taking in to consideration the variables related to the realities of the insurance governance mechanism in Ethiopia.

2.3 Conceptual framework of the study

Based on the agency theory the following diagrammatic framework is developed.

Figure 2.1 Conceptual framework of the study



Source: - Adopted from Yenesew (2012)

CHAPTER THREE

RESEARCH DESIGN AND METHODOLOGY

3.1 Introduction

This section provides information on the type of research design that was adopted in the study and gives the population and sample selected for the study. It also shows which sampling techniques were used in the current research. Furthermore, it discusses the data collection, analysis and presentation techniques that were used in the study.

3.2 Research Design

The primary aim of this study is to examine the impact of corporate governance mechanisms on firm's financial performance. To achieve the objectives of this study, the explanatory research design was used to investigate the relationships between board size, board composition, firm size, board gender diversity and leverage as independent variables and firm performance (ROE) as the dependent variable.

3.3 Population and Sample Selection

The sample selected for this research was selected companies listed by National Bank of Ethiopia (NBE). In Ethiopia there are 16 private and one government insurance companies registered. This study sought to investigate the effects of Corporate Governance on the financial performance of selected insurance firms in Ethiopia. In this research Data availability is important, because of this the researcher obliged to apply a purposive sampling technique out of the non probability sample selection techniques. So, insurance companies with financial report from 2008 – 2012 are considered as a representative sample of the study. Thus, ten firms were potentially selected. The data collection technique is mainly document analysis on the annual reports of the companies.

3.4 Data Gathering Techniques

The study has employed secondary data by reviewing of annual reports, financial statements, and other relevant documents of the selected insurance firms, documents of the regulatory bodies and other pertinent offices have been used as the sources of secondary data collection. The secondary data provides a reliable source of the information needed by researchers to investigate the phenomenon and seek efficient ways for problem solving situations (Sekaran, 2003). The data required for this study was collected from the annual reports of the companies as in the end of 2012. Specifically, they were collected from the annual reports particularly from the portion expounding on corporate information and statement of corporate governance as well as from the director's profile. Regarding the data related to the firm performance, they were collected from financial statements like balance sheet, income statement, and cash flow statement provided in the annual reports.

3.5 Data Analysis Techniques

The objective of the analysis is for drawing important conclusions about the impacts of corporate governance on firm performance. Based on the general concepts, the statement of the purpose of the institutions' existence, and their real practices; strengths and gaps can be identified and analyzed using quantitative analysis. This study uses Correlation analysis, which is a statistical tool that can be used to determine the level of association of two variables (Levin & Rubin, 1998). This analysis can be seen as the initial step in statistical modeling to determine the relationship between the dependent and independent variables. This study also used a multiple linear regression analysis using Return on Equity (ROE) as proxy for the firms' financial performance and independent variables comprising of Board Size, Board Composition, firm size, composition of women's in the board of directors and Leverage. The study makes data's statistical description and regression by using STATA 11, which is a common method adopted frequently in descriptive studies.

3.6 Description of Variables and Measurements

This study select the dependent and independent variables based on alternative theories and previous empirical studies related to corporate governance and firm performance to investigate their relation (corporate governance and firm performance) measured by return on equity (ROE).

3.6.1 Dependent Variable

Return on Equity (ROE)

ROE refers to the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. Each insurance firm's ROE has been obtained from its annual reports. ROE is expressed as a percentage and calculated as: $\text{Net Income}/\text{Shareholder's Equity} * 100$.

$$ROE = \frac{\text{Profit After Tax}}{\text{Total Shareholders' Equity}}$$

3.6.2 Independent Variables

In this study, the independent variables are variables that are used as a determinant of corporate governance of the sample Ethiopian insurance firms. The independent variables of the study are board size, board composition, board gender diversity, leverage and firm size. The definition and measurements of the variables are as follows:-

Board Gender Diversity

The ratio of females setting in the board of directors is measured as the percentage of number of female directors divided by the total number of board members. According to Yenesew (2012) in his qualitative analysis revealed that qualified and competent female director's help improve banks operation and monitoring performance.

Board Size

It can be defined as the number of directors sitting on the board. Large board size the greater collective information that the board subsequently possess but in other hand, when the board size is large there is a problem of communication and decision making. Previous studies found negative effect of board size on performance (Jensen, 2003; Sanda et al., 2005; Aduesi, 2011; Al-Manaseer et al., 2012). In this study board size is expected to negatively influence performance.

Board Composition

Board composition is the proportion of independent directors to the total number of directors. Boards mostly compose of executive and non-executive directors. Executive directors refer to dependent directors and non-Executive directors to independent directors (Shah et al., 2011). Independent directors are directors who have no personal affiliations or business dealings with the firm but in Ethiopian context independent directors are directors those have owns the share of the particular company and not the member of the management team.

Firm size:-The natural logarithm of total assets at year-end.

Leverage: - The ratio of total liabilities to total assets.

Table 3.1 Summary for terms of measurement

variables	Acronym	Terms of measurement
Board Size (number)	BORDSIZ	Total number of directors serving on the board of directors
Board Composition	BORDCOM	The ratio of independence directors to the total number of directors
Leverage (%)	LEVERAGE	The ratio of total liabilities to total assets
Firm Size (number)	FIRMSIZ	The natural logarithm of total assets at year-end.
Board gender diversity	WOMDIR	The percentage of number of female directors divided by the total number of board members
Return on Equity	ROE	Amount of net income returned as a percentage of shareholders equity

Source: financial statements of the insurance firms

3.7 Model Specification and Multiple Regressions

The econometrics model from the previous studies undertaken:

$$Y_{it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \dots + \beta_k X_{kit} + \varepsilon$$

adopted from Mamadou (2012)

Based on the hypothesis development procedures, the following regression equation was meant to be estimated:

$$ROE = \beta_0 + \beta_1 BOARDSIZE + \beta_2 *BOADCOM + \beta_3 *LEVERAGE + \beta_4 *FIRMSIZ + \beta_5 *COMWOM + \varepsilon$$

Where, ROE – return on equity

β_0 – Constant

BOARDSIZE –board size

BOADCOM – board composition

LEVERAGE – Leverage

FIRMSIZ – firm size

COMWOM – composition of women’s on the board of directors

ε - Error term

CHAPTER FOUR

RESULTS AND DISCUSSION

This chapter presents two important parts of the paper namely, the descriptive and regression analysis. The descriptive statistics which summarizes the main features of the study variable such as mean, maximum, minimum and standard deviation. The second part is the multiple regression analysis with the help of stata 11.0 that shows the relationship of ROE with the explanatory variables.

4.1 Descriptive Statistics of the Study Variables

In this section a description of the key characteristics and terms of measurement for each variables are discussed. This study focused on Corporate Governance characteristics namely board size, board composition, board gender diversity, firm size and Leverage and how they affect performance. Dependent and independent variables were grouped into components; namely, independent variables which consist of board size, board composition, board gender diversity, firm size and Leverage and dependent variables which indicates performance namely, return on Equity (ROE). Accordingly, the descriptive statistics for all variables are presented below in table 4.1.

Table 4.1: Descriptive Statistics of the study variables

Variables	Mean	Std.div	min	max	Observations
Roe	.1901528	.1183158	-.15	.4997455	50
bordsiz	6.56	1.145711	5	9	50
bordcom	.8968254	.1117364	.6666667	1	50
leverage	.5723616	.1707754	.0667531	.7869095	50
Firmsize	8.392455	.4274998	7.50106	9.414973	50
womdir	.0808921	.0515508	0	.1428571	50

Source: STATA summery statistics result

As presented in table 4.1, the average value of the sample insurance firms return on equity is 19.01 percent (mean=.1901528) and the maximum and minimum value of 49.97 and -15 percent respectively. It deviates by 11.83 percent from the mean value of the sample insurance firms.

It is confirmed in the table above that the average board size for the sample insurance firms is about 7 members (mean = 6.56) with a maximum of 9 and a minimum of 5 directors. This means that the board sizes are appropriate for firm's optimum performance as evidenced by Jensen (1993) and Lipton and Lorsch (1992) who stated that the bigger the board size, the less effective it would mean for the firm performance. The standard deviation indicates that for the sample insurance firms' board size varies by 1.14 from the average value of 6.56. The standard deviation of 1.14 suggests that there is no wide dispersion in the board size of the sample insurance firms.

On average, 8.08 percent (mean=.0808921) of the sample insurance firms directors are female as measured by percentage of female directors divided by total number of directors, which is considerably a disappointing figure. It suggests that the diversity of sample insurance firms boards, as measured by proportion of directorship held by women, is low since its mean value is only 8.08 percent during the last five years. The percentage of female directors in the sample insurance companies is range from 0 (insurances do not have any representation for women on their boards) to 14.28 percent representation with a standard deviation of 5 percent.

In terms of board composition the average, 89.7 percent (mean = .8968254) of the sample insurance firms have independent/outside directors as measured by percentage independent directors by total number of directors, which implies that most of the directors are independent directors in the sample insurance firms. The maximum and minimum value of the board composition is 100 and 66.6 percent respectively. It deviates by 11.17 percent from the mean value of the sample insurance firms.

The mean value of firm size as measured by the natural logarithm of total asset is 8.39 with having a maximum value of 9.4 and a minimum value of 7.5. The standard deviation of firm size among the sample insurance firms is 42.74. On the other hand, the leverage of selected insurance firms in Ethiopia is 57.23 percent on average as measured by debt to total asset with

a range of 6.67 to 78 percent. The deviation is 17.1 percent, from the mean value of financial leverage.

4.2 Correlation Analysis of the Study Variables

Correlation analysis is the statistical tool that can be utilized to determine the level of association between two variables (Levin & Rubin, 1998). This analysis can be seen as the initial step in statistical modelling to determine the relationship between the dependent and independent variables. Prior to carrying out a multiple regression analysis, a correlation matrix was developed to analyze the relationships between the independent variables as this would assist in developing a prediction multiple model which will reveal no relationship in cases where the value of the correlation is 0. On the other hand, a correlation of ± 1.0 means there is a perfect positive or negative relationship (Hair et al., 2010). The values are interpreted between 0 (no relationship) and 1 (perfect relationship). Also, the relationship is considered small when $r = \pm 0.1$ to ± 0.29 , while the relationship is considered medium when $r = \pm 0.30$ to ± 0.49 , and when r is ± 0.50 and above, the relationship can be considered strong. Below in table 4.2, the correlation matrix which shows that the relationship of the return on equity with board size, board composition, insurance firm size, board gender diversity and leverage with firm performance (ROE).

Table 4.2 Correlation analysis of ROE and corporate governance mechanisms

	roe	Bordsiz	womdir	bordcom	Leverage	Firm size
roe	1.00					
bordsiz	-0.1138	1.00				
womdir	0.2806	0.4489	1.00			
bordcom	0.0587	0.2722	0.4480	1.00		
Leverage	0.4697	-0.2467	-0.1077	0.1200	1.00	
Firm size	0.2394	0.1284	-0.0057	-0.1014	-0.0826	1.00

Source: STATA 11 correlation result based on the data obtained from sample insurance firms.

Table 4.2 displays the correlations between the governance variables and control variables with firm performance. These findings show that board size is negatively correlated ($r = -0.11$, $p > 0.05$) with ROE but not significant at the 0.05 level of significance.

In addition to that, the correlation between board gender diversity and ROE was positive but not significant at the 0.05 level of significance ($r = 0.280$, $p > 0.05$). Moreover, board composition, firm size and leverage have positive but insignificant relationships with the ROE at the 0.05 level of significance with coefficients ($r = -0.058$, $p > 0.05$), ($r = -0.2394$, $p > 0.05$) and ($r = -0.469$, $p > 0.05$) respectively. In sum, as evidenced by the above, it can be seen that one variable has a negative correlation with ROE, namely board size. In contrast, four variables have a positive correlation with ROE, board gender diversity, board composition, firm size and leverage.

The outcomes present that there is no significant correlation among independent variables. A maximum of a correlation coefficient of 0.45 is found via a correlation between a womdir and a board's size. This indicates that the association between board size, board composition, insurance firm size, board gender diversity and leverage shows a strong correlation with return on equity and there is no significant correlation among the independent variables.

4.3 Diagnostic Tests of the Data Set

Before running the models, the data sets were tested for the classical linear regression model assumptions (See appendix). Brooks (2008) suggests five critical assumptions that must be met before utilizing GLS estimation in order to validly test the hypothesis and estimate the coefficient. The classical linear regression model assumptions and their diagnostic tests are discussed below.

4.3.1 Test for Multi-collinearity

Gujarati (2004), stated that multi-collinearity is the presence of a "perfect," or exact, linear relationship among some or all explanatory variables of a regression model. The researcher used the VIF and tolerance to check whether there is the problem of multicollinearity or not among the explanatory variables in the model.

Table 4.3 Test for multi-collinearity

variables	VIF	1/VIF
womdir	1.4	0.679149
bordsiz	1.37	0.728332
bordcom	1.34	0.745842
leverage	1.12	0.894953
Firm size	1.04	0.962425
Mean of VIF	1.27	

Source: computed from STATA 11.0

The above table shows the relationship between each independent variable (board size, board composition, insurance firm size, board gender diversity and leverage). A tolerance value (is an indicator of how much of the variability of a specified independent variable is not explained by the other independent variable) less than 0.1 and if the value of Variance Inflation Factor (VIF) is above 10, indicate there is multicollinearity among the independent variables (Morgan et al., 2004). The result in the above table is obtained from the computation by STATA 11.0 and indicates that there are no tolerance values below 0.1 and the values of VIF greater than 10, suggesting the model is free from multicollinearity problem. Therefore, all variables (board size, board composition, insurance firm size, board gender diversity and leverage) can be retained in the model.

4.3.2 Test for Heteroskedasticity

The next important assumption for classical linear regression model is that the disturbances appearing in the population regression are homoskedastic that means the variance of the error term is consistent. If errors do not have a constant variance (not homoscedastic), they are said to be Heteroskedastic Brooks (2008).

To check the problem of heteroskedasticity, the researcher used Breusch Pagan test based on the following null and alternative hypothesis

H0: there is no heteroskedasticity problem in the model

H1: there is heteroskedasticity problem in the model

It is obtained from Breusch Pagan test that the p-value of 0.462 (see the Appendix) which is unable to reject null hypothesis. So, that there is no hetroskedasticity problem.

4.3.3 Test for normality of Data

According to Gujarati (2004), before regression analysis is carried out, it should be noted that there are some classic assumptions in undertaking the regression analysis and one of them is normality of data. Therefore, normality test becomes relevant. Brooks (2008) also pointed out that in order to conduct hypothesis test about the model parameter, the normality assumption must be satisfied. The normality assumption is about the mean of the residuals is zero. Accordingly the researcher used Shapiro- Wilk test for normal data.

Based on this test if the p-value is less than 0.05, then the null hypothesis that the data are normally distributed is rejected. If the p-value is greater than 0.05, then the null hypothesis has not been rejected.

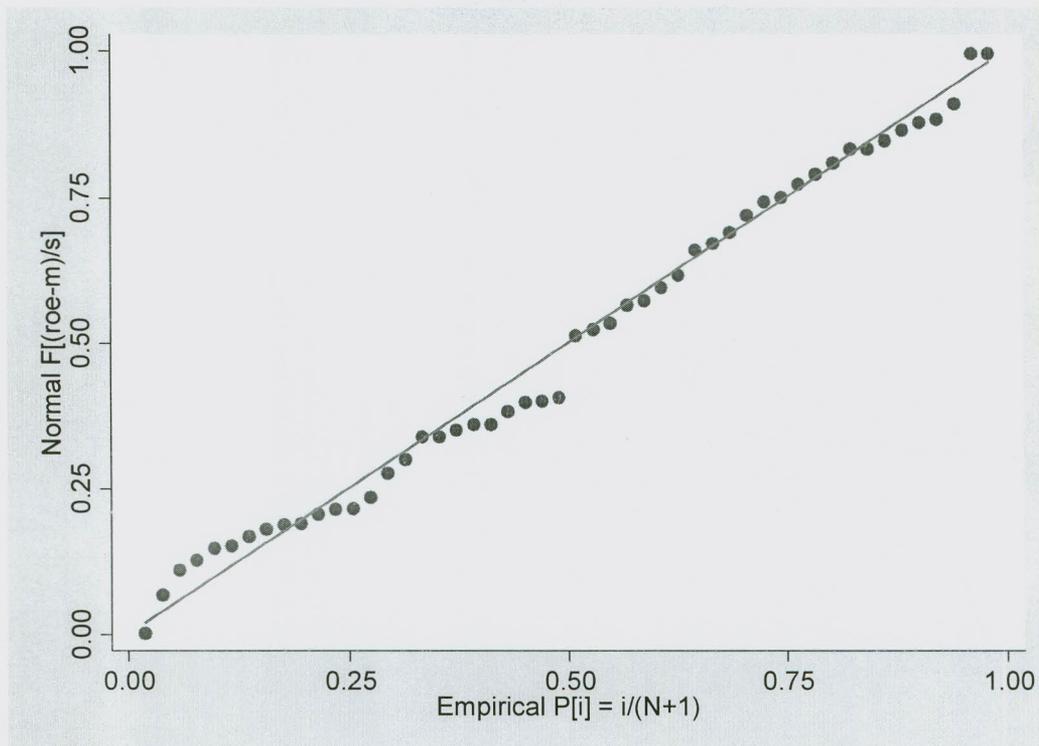
4.3.3.1 Shapiro-Wilk test for normal data

H0: Data are normally distributed

H1: Data are not normally distributed

The Shapiro-Wilk test of the study provided the p-value of 0.18 that is greater than the p-value of 0.05 (See the appendix). Hence, H0 is not rejected that means the data are normally distributed. The above test can be supported by figure as follows

Figure 4.1 Normal Probability Plot



Source: computed from STATA 11.0

The above graph shows the normal distribution of residuals around its mean of zero. Hence the normality assumption is fulfilled as required based on the above figure, it is possible to conclude that the inferences that the researcher made about the population parameter from the sample is valid.

The average value of the errors is zero. If a constant term is included in the regression equation, this assumption will never be violated. So that in the model of this study a constant term is included. As a result this assumption was not violated.

4.3.4 Hausman Test: Fixed Effects versus Random Effects

The Hausman specification test compares the fixed versus random effects under the null hypothesis that the individual effects are uncorrelated with the other regressors in the model (Hausman 1978). If correlated (H0 is rejected), a random effect model produces biased estimators, violating one of the Gauss-Markov assumptions; so a fixed effect model is preferred.

The Hausman specification test provided the p-value of 0.0002 that is less than 0.05 (random effect) (See the appendix). Meaning fixed effect model is not appropriate.

4.4 Model Determination

After considering the extent to which variables suffer from multicollinearity, heteroskedasticity and autocorrelation, a regression was conducted. Table 4.4 presents the regression outcomes using the GLS Random effect method. Gujarati (1950) considers that the GLS random effect method is very useful even if variables have heteroskedasticity and autocorrelation problems.

Table 4.4 Model determination

ROE	Coef.	Std. Err.	T	P> t	[95% Conf. Interval]
BORDSIZ	-.0208674	.0153422	1.36	0.174	-.0092026 .0509375
WOMDIR	.9895228	.36777301	2.69	0.007*	1.710261 .268785
BORDCOM	.0620814	.1502685	0.41	0.680	-.2324394 .3566022
LEVERAGE	.3069861	.0901412	3.41	0.001*	.1303127 .4836596
FIRMSIZ	.10032	.0346557	2.89	0.004*	.0323961 .1682439
-cons	-.9400076	.3444104	-2.73	0.006*	-1.61504 -.2649755

R-sq: within = 0.1273 between = 0.8151 overall = 0.4156

*Significant at 1% level

Source: computed from STATA 11.0

$$ROE = \beta_0 + \beta_1 * BOARDSIZ + \beta_2 * BORDCOM + \beta_3 * LEVERAGE + \beta_4 * FIRMSIZ + \beta_5 * WOMDIR + \epsilon$$

$$ROE = -0.940 - 0.021BOARDSIZ + 0.062BORDCOM + 0.307LEVERAGE + 0.10FIRMSIZ + 0.99WOMDIR$$

The model is regressed using random effects GLS linear regression analysis by STATA version 11 the regression results are presented in Table 4.4. Results indicate that there is no significant relationship between board composition, board size and firm performances in either measure. This implies that the outside independent directors and directors' size cannot influence firms' financial performance. However, womdir, leverage and firm size has positive and significant impact on the financial performance of Ethiopian insurance firms. On the other hand, a unit increase in return on equity of firm's performances is the same to say as 98%, 30.6% and 10% increases in womdir, leverage and firm size respectively.

The adjusted R square indicates how well the model variance has been explained (Morgan et al 2004). It is found that the adjusted R square of this model is 42% (see the Appendix), meaning 42% of the model is explained by the independent variables collectively (the dependent variable, ROE, is explained by board size, board composition, insurance firm size, board gender diversity and leverage) and the remaining is explained by other variables or factors.

4.5 Corporate Governance Mechanisms: Findings and Discussion

The regression result presented in the table 4.4 above shows that the p- value and t- value of board size are 0.174 and 1.36 respectively indicating board size has no effect on ROE of insurance industry in Ethiopia and it has a negative coefficient with return on equity. This negative value indicates that the increase in board size causes the decrease of firm performance measured by ROE. As per the result board size is insignificant, the reason might be the similarity of the board size that the insurance companies have. This outcome is consistent with the findings of Beiner et al. (2004), Bhagat and Black (2002) and Limpaphayom and Connelly (2006) but not consistent with the findings of Yermack (1996) and Shakir (2008). Therefore, the first hypothesis that there is a strong negative relationship between board size and ROE of insurance industry in Ethiopia is rejected.

The relationship between board gender diversity (WOMDIR) and financial performance measures are significant and it has a positive coefficient with return on equity. The p- value and t- value of board gender diversity are 0.007 and 2.69 respectively indicating board gender diversity has effect on ROE on insurance firms in Ethiopia. The positive value indicates that the higher the value of the board gender diversity, the higher the firm performance (ROE). The

percentage of female directors in the sample insurance industries range from 0 (insurances do not have any representation of women on their boards) to 14.28 percent representation, which means the percentage of female in the board of directors are very small and for future they may give attention to increase the percentage of females in the board of director because of it has a positive impact on firm performance of the insurance firms. Smith and Verner (2005), Welbourne's (1999) and Carter, Simkins and Simpson (2003) report that the proportion of women in top management has a positive impact on firm performance.

In relation to board composition, the relationship between firm performance (ROE) and board composition of selected insurance firms of Ethiopia is insignificant, because the p- value and t- value of board composition is 0.680 and 0.41 respectively, and it has a positive coefficient with return on equity and which means board composition has insignificant effect on firm performance of Ethiopian insurance firms based on return on equity. The positive value indicates that the higher the value of the board composition, the higher the firm performance (ROE). This outcome is consistent with the findings of Staikouras et al. (2007), Bhagat and Black (2002) and De Andres et al. (2005) found no significant relationship between the composition of the board and firm performance. Therefore, the second hypothesis that there is a positive relationship between board composition and ROE of insurance industry in Ethiopia is rejected but it has a positive impact on ROE.

The regression results on table 4.4 also shows that leverage (LEVERAGE) has significant positive influence on insurance firms performance measured by return on equity (p-value < 0.05) which has the p-value and t- value of 0.001 and 3.41 respectively and it has positive coefficient with return on equity. It implies that an increase in the debt position is associated with increase in performance. The result indicates that insurance firms with higher levels of debt as a proportion of equity is to perform better than those having lower proportion of debt.

According to the agency theory, the monitoring provided by debt financing reduces management's incentive to misuse free cash flows, and consequently leads to a better firm performance. The finding is consistent with the literature and with some studies conducted earlier (Khatab, et al., 2011; Sanda et al., 2005; Babatunde & Olaniran, 2009. Habbash, 2010) also argues that highly leveraged firms are found to be less involved in fraudulent practices.

Therefore, the third hypothesis that there is a positive relationship between insurance leverage and ROE of insurance industry in Ethiopia is accepted.

Consistent with the hypothesis, the firm size of the insurance firms is observed to be positively related to return on equity and statistically significant at the 1 percent level. The finding is also consistent with the studies by Shiu (2004), Chen and Wong (2004) and Browne, Carson and Hoyt (2001) who find positive relationship between size and financial performance of companies. The result supports the basis for economies of scale, whereby larger companies are more likely to perform better as they can achieve operating cost efficiency through increasing output and economizing on the unit cost of production and process development. When the firm is large, it is more likely to have broader activities, production range, value creation sources and influence on the market (Bohren, 2005).

Table 4.5 summary of the hypothesis result

Hypothesis	Relationship	Result	Decision
H1	Board size and ROE	Negative insignificant	Rejected
H2	Board composition and ROE	Positive insignificant	Rejected
H3	Leverage and ROE	Positive significant	Accepted
H4	Firm size and ROE	Positive significant	Accepted
H5	Board gender diversity and ROE	Positive significant	Accepted

Source: computed from STATA 11

CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

The previous chapter contained the data analysis and the findings of the study. This chapter contains the conclusions drawn and the recommendations given based on the major findings in the previous chapter.

5.1 Conclusion

The study examines the relationship between corporate governance mechanisms and firm performance for the period of five years from the year 2008 to 2012. The researcher drawn the following conclusions based on the result of the data analysis.

Return on equity (ROE) used to determine the financial performance of insurance industry in Ethiopia proxied by net income to average total assets.

The researcher found that board gender diversity, leverage and firm size have a positive effect on ROE and significant where as board size and board composition have negative effect and positive effect respectively on ROE but they have insignificant effect on ROE of selected insurance firms in Ethiopia.

Based on the descriptive statistics the financial performance of sample insurance firms are 19.01 percent as measured by return on equity (ROE). It is therefore the sample insurance firms are performing better in utilizing shareholders capital. The sample insurance firms board composition is characterized by the presence of majority independent directors but, the board is dominated by male and the coverage of women's in the board of directors are only 8.1 percent in selected insurance firms of Ethiopia. In particular, this study finds that female board members represent a diversification of board's membership and this diversified nature will contribute positively to firm's performance.



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The correlation analysis indicates that most of the corporate governance mechanisms significantly correlated with the financial performance of selected Ethiopian insurance firms.

Board gender diversity significantly and positively influence the financial performance of selected insurance firms. The presence of women directors in the board is very small. Only 8.1 percent of the board members are females in the sample insurance firms of Ethiopia. Therefore the role of women's in the board or top position of insurance industry of Ethiopia is very much limited.

Board composition and board size are insignificant to the financial performance of selected insurance firms (ROE). Board composition has a positive impact and board size have a negative impact on financial performance of sample insurance firms. Thus, small board size is effective to improve financial performance of insurance firms. As per the result, board composition and board size are insignificant to the financial performance of Ethiopian insurance industry. The reason of this result might be, in our country context the external directors are not 100% independent, because in all of the insurance companies these external directors owns the share of that particular company. On the other hand the insignificance of board size might come from the similarity of the board size that all the insurance companies have. Because of this identifying the impact of board size and board composition on firm performance will be difficult.

Firm sizes significantly and positively influence the financial performance of sample insurance firms measured by return on equity (ROE). Therefore, high firm size is effective to improve financial performance of sample insurance firms. When the firm is large, it is more likely to have broader activities, production range, value creation sources and influence on the market (Bohren, 2005). Hardwick (1997) argues that there is a positive relationship between performance and size due to operating cost efficiencies through increasing output and economizing on unit of cost. Large corporate size also enables insurers to effectively diversify their assumed risks and respond more quickly to changes in market conditions.

Leverage significantly and positively influence the financial performance of sample insurance firms measured by return on equity (ROE). It implies that an increase in the debt position is

associated with increase in performance. This indicates Ethiopian insurance companies have higher debt potential so, they can use this potential in order to increase their profitability.

Finally, the findings suggest that insurance firms with effective corporate governance mechanisms improve financial performance depending on the financial performance measure being used. Although not all corporate governance variables support the stated hypotheses, the study has achieved its objective by identifying the attributes that help to test the research hypotheses. This study, therefore, finds that agency theory offers a generally good explanation of the associations between corporate governance mechanisms with financial performance.

5.2 Recommendations

Based on the findings and conclusions reached, the following recommendations were forwarded.

- ✓ It is revealed that involving higher number of women in corporate top position or in the board of directors is related to increased performance of firms. Hence, the study recommended that the Ethiopian insurance industry encourage women to participate in corporate top position or in the board of directors.
- ✓ This study revealed that large firm size is related to increase performance of insurance firms. Thus, the study recommended that attention should be given to increase total asset of the insurance firms to improve performance.
- ✓ Finally it is revealed that leverage is related to increase financial performance of insurance firms. Thus, the study recommended that attention should be given to the better utilizing of debt potential.

5.3 Future Research Directions

Due to the earlier discussed limitations, future research could follow various avenues of research to better explain the corporate governance and firm performance relationship. First, future research could attempt to explore the nature of these relationships in other financial companies and unselected companies as well employing different methods and employing the data for longer periods to explore the long-term behavior of such relationships.

Second, further studies on the subject can also be extended to include various aspects of board characteristics and explore board processes such as remuneration and nominating committees, board of director's frequency of meetings and experience on board of directors.

Last but not least, future studies should attempt to investigate the integrated effect of internal and external corporate governance factors on the firms' performance to clarify the potential causes of enhanced performance to attract more capital and generate wealth. Moreover, the effect of the ownership structure with board structure on the firm performance should be considered in the future research.

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APPENDICES

Appendix I: Diagnostic tests results for GLS Assumptions

1. Ramsey Reset test

Ramsey RESET test using powers of the fitted values of roe

Ho: model has no omitted variables

F(3, 41) = 1.44

Prob > F = 0.2459

Source: computed from stata 11.0

2. Durbin Watson test

Durbin-Watson statistic (original) 1.813812

Durbin-Watson statistic (transformed) 2.573248

Source: computed from stata 11.0

3. Brush-Pagan heteroskedasticity test

Breusch-Pagan / Cook-Weisberg test for heteroskedasticity

Ho: Constant variance

Variables: fitted values of roe

chi2(1) = 0.54

Prob > chi2 = 0.4622

Source: computed from stata 11.0

4. Brush and pagan lagrangian test

Breusch and Pagan Lagrangian multiplier test for random effects

$$\text{roe}[\text{company},t] = Xb + u[\text{company}] + e[\text{company},t]$$

Estimated results:

	Var	sd = sqrt(Var)
roe	.0139986	.1183158
e	.0063967	.0799792
u	.0024425	.0494217

Test: $\text{Var}(u) = 0$

$\text{chibar2}(01) = 0.50$

$\text{Prob} > \text{chibar2} = 0.2396$

Source: computed from stata 11.0

5. Shapiro- Wilk W test for normal data

variable	observation	W	V	Z	Prob>z
ROE	50	0.96712	1.546	0.929	0.17636

Source: computed from stata 11.0

6. Fixed effect regression

Roe	Coef.	Std.err.	z	p> z
bordsiz	-.108599	.0754053	-1.44	0.159
womdir	.1214738	.4803124	0.25	0.802
bordcom	-.3720921	.7362953	-0.51	0.616
leverage	.0193468	.2604158	0.07	0.941
firmsize	.3676124	.0782426	4.70	0.000
-cons	-1.869806	.8331451	-2.24	0.031
R ²	6.48%			

Source: computed from stata 11.0

7. Random effect GLS regression

Roe	Coef.	Std.err.	z	p> z
bordsiz	-.0208674	.0153422	1.36	0.174
womdir	.9895228	.3677301	2.69	0.007
bordcom	.0620814	.1502685	0.41	0.680
leverage	.3069861	.0901412	3.41	0.001
firmsize	.10032	.0346557	2.89	0.004
-cons	-.9400076	.3444104	-2.73	0.006
R ²	42%			

Source: computed from stata 11.0

8. Hausman fixed effect versus random effect test

	(b) fixed	(B) random	(b-B) difference	sqrt(diag(V_b- V_B)) S.E.
bordsiz	-.108599	-.0208674	-.1294665	.073828
womdir	.1214738	.9895228	1.110997	.3089896
bordcom	-.3720921	.0620814	-.4341735	.7207983
leverage	.0193468	.3069861	-.2876393	.2443173
firmsize	.3676124	.10032	.2672924	.070149

b = consistent under Ho and Ha; obtained from xtreg

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

Test: Ho: difference in coefficients not systematic

$$\chi^2(5) = (b-B)'[(V_b - V_B)^{-1}](b-B) = 24.24$$

$$\text{Prob} > \chi^2 = 0.0002$$

Source: computed from STATA 11.

Appendix II: List of Sample Insurance Firms

S.No	Insurance companies	Year of establishment
1.	*Abay insurance company	2010
2.	Africa Insurance Company s.c.	1994
3.	Awash Insurance Company S.C	1994
4.	*Berhan insurance S.c	2011
5.	*Ethio-Life and General Insurance S.C.	2008
6.	Ethiopian Insurance Corporation	1975
7.	Global Insurance Company S.C.	1997
8.	Lion Insurance Company S.C	2007
9.	National Insurance Company of Ethiopia S.C.	1994
10.	Nib Insurance Company	2002
11.	Nile Insurance Company S.C	1995
12.	Nyala Insurance Company S.C	1995
13.	*Oromia Insurance Company S.C.	2009
14.	*Tsehay Insurance S.C.	2012
15.	The United Insurance S.C	1997

Note: * insurance companies not selected for the study

Source: <http://www.nbe.gov.et/financial/insurer.htm>



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