

Influence of Corporate Governance on Stock Liquidity for Firms Listed In the Nairobi Securities Exchange

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Abstract:

The main purpose of the paper was to examine the influence of corporate governance on the stock liquidity of firms listed at the Nairobi Securities Exchange. Specifically, the influence of ownership structure on stock liquidity and the influence of audit committee structure on stock liquidity. The study was informed by Agency, Stewardship, and Resource Dependence Theories. This study used a combination of explanatory and longitudinal research design. The target population comprised 67 firms listed in Nairobi stock exchange Nairobi Securities Exchange. The data collection instruments used were structured questionnaire for primary data and content/document analysis guide, which were purposively administered to 67 company secretaries of firms listed at the NSE. Both descriptive and inferential statistics were used to analyze data. Inferential statistics are closely tied to the logic of hypothesis testing discussed. Multiple regressions were used to assess the association between corporate governance and stock liquidity. The results showed that ownership structure has a positive influence on stock liquidity ($\beta_1 = 0.368$, $\rho < 0.05$), audit committee structure had significant positive affect stock liquidity ($\beta_2 = 0.222$, $\rho < 0.05$) It is therefore recommended for regulators to improve the quality and enforcement of legal laws that protect minority shareholders from adverse actions of the controlling shareholders. Additionally, the audit committee needs to be aware of the interests of the investing public and be familiar with basic accounting principles. Finally, it is recommended that listed firms at NSE should disclose more information and have appropriate corporate disclosure policies and procedures.

Keywords: Corporate Governance, Stock Liquidity

Introduction

Stock liquidity is an important phenomenon since stock price, and trading volume influences how the firm is seen by its stakeholders. These recognitions will impact their buying, supply, or speculation choices, which at last influence the company's income (Edmans *et al.*, 2013). Loukil (2015) additionally shows that stock liquidity influences corporate budgetary choices by lessening the expense of capital and urging access to more subsidies on the capital markets. Therefore, management can institute efficiency enhancing actions that can reverse an increasing trend in financial distress, such as having liquid stocks. Stock liquidity is described as the level to which a security or an asset can be purchased or sold in financial markets, without significantly affecting its price (Switzer & Picard, 2016). Stock liquidity is also defined as the extent of trading of a firm's securities. A company's shares/stocks are liquid to the extent that they can be traded quickly (Amihud *et al.*, 2006; Amihud & Mendelson, 2012). A liquid market gives financial specialists the capacity to exchange stocks rapidly and at negligible cost (Brogaard *et al.*, 2017). Amihud & Mendelson (2012) further indicate that a firm's securities are liquid to the degree they can be traded fast. Given that stock liquidity is crucial for both investors and firms, it is vital to investigate the antecedents of stock liquidity. In particular, this study aimed to assess how corporate governance (CG) determines stock liquidity.

According to Gompers *et al.*, (2003) good corporate governance influences a company's strategic decisions. Kajola (2008) observed that corporate governance is making sure the business is well managed, and stakeholder's interest is protected at all times. Organization for Economic Cooperation and Development (OECD) (2004) claimed corporate governance is broad in practice. It defines corporate governance as the system by which business corporations are directed and controlled. It further states that the corporate

governance structure specifies the distribution of rights and responsibilities among different participants in the corporation such as the board, managers, shareholders and other stakeholders; and thus spells out the rules and procedures for making decisions on corporate affairs. According to Akinsulire, (2016), some of the corporate governance variables such as the size of the board, gender diversity, CEO duality may have a direct impact on stock liquidity. Sawicki (2009) showed four dimensions of corporate governance which might be related to stock liquidity are to boards of directors structure, ownership structure. Based on the above this study used board of directors' structure and ownership structure.

In Kenya, among other factors such as the prevailing political environments in the economy, the stock market liquidity has been noted to be one of the major causes of variations in stock returns in the NSE. Despite emphasizes by regulators that listed firms must practice good corporate governance firms still encounter stock liquidity problems, as business success depends heavily on the ability of financial managers and the stakeholders in the execution of business operations (Wamugo *et al.*, 2014). Locally, various studies have been conducted on stock liquidity for example; Sitienei (2005) established a positive relationship between stock ownership patterns and stock liquidity on NSE firms for period 2000-2004. Sakwa (2006) the effect of corporate governance practices on the stock market liquidity of firms listed at the Nairobi securities exchange. In others studies they evaluated the effect of liquidity, for instance, Ayako (2005) found out that liquidity had no effects on return while Koech (2012) found a very weak correlation between liquidity and return of stocks listed at the NSE. On the other hand, Okanga (2014) found that illiquidity was positively significant to Illiquidity and excess stock return. However, little research has been done on the effect of corporate governance on stock liquidity for firms listed at the NSE. The NSE being an emerging market may have different dynamics as compared to more established markets like the NYSE. This research sought to determine whether the result for well established markets where similar research has been done holds for an emerging market like the NSE. Thus, this study hypothesized that;

H₀₁: There is no significant relationship between ownership structure and stock liquidity of firms listed at the Nairobi Securities exchange.

H₀₂: There is no significant relationship between audit committee structure and stock liquidity of firms listed at the Nairobi Securities exchange.

Theoretical Framework

This paper was informed by Agency theory formulated by Jensen & Meckling (1976) in their seminal paper evaluating the agency cost of free cash flow. The agency theory hypothesizes that managers seek to maximize their own interests, but these interests may not be aligned to the interest of shareholders. Agency theory predicts that the misalignment of interests amongst chiefs and investors could prompt office issues. Managers take part in exercises for their own advantages as opposed to the advantages of the company's investors (Jensen and Meckling, 1976). Agency theory relates to the principal-agent relationship that exists between firm managers and shareholders. The theory states that, with low monitoring level to the organization and low discipline in decision making, managers might decide to put resources into ventures with negative net present value (Jensen and Meckling, 1998). A very much reported organization issue is administrative "domain building." This alludes to managers' inclinations to keep up unutilized assets or to develop the firm past its ideal size with the motivation behind expanding individual utility from control, pay, status and glory (Hope & Thomas 2008).

The agency issue can be mitigated by great corporate administration and control administrators' motivators to promote their own advantages to the detriment of the investors (Shleifer & Vishny 1997). Jensen and Meckling (1976) additionally contend that administrative agency costs increment with the partition of proprietorship and control. Directors as the specialists of investors are prone to squander the corporate assets to fulfill their self-interests. In line with the writing, Chrisman *et al.* (2004) noticed that organization issues emerge when important specialist connections are described by disparate interests and enlightening asymmetries. Their

discoveries demonstrate that agency-related expenses emerge from the costs caused for the exercises and frameworks set up by principals to control operators' conduct and from the outcomes of specialists' practices that are not in light of a legitimate concern for principals. Theory suggests that effective governance enhances financial and operational transparency, which in turn, reduces adverse selection. Facing less adverse selection problems, traders provide more liquidity to stocks of well-governed firms. The main argument is that managers with poor corporate governance maintain excessive cash that will lead to agency cost incensement and ultimately will reduce the firm value. A similar argument also means that companies with a strong local ownership structure and a strong board of directors likely have fewer agency problems to take advantage of cash. This makes it important to review the effect of ownership structure and board structure on tax avoidance.

Empirical review

Ownership structure is one of the main dimensions of corporate governance and is widely seen to be determined by other country-level corporate governance characteristics such as the development of the stock market and the nature of state intervention and regulation. Faccio and Lang (2002) reported that of the publicly traded corporations in 13 western European countries that only 36.93 % were widely held firms. Al-Gharaibeh *et al.* (2013), states that ownership structure is an influential factor on a firm's policies. One of these policies is dividend policy. For example, large shareholders could influence decisions for their own benefit and to the disadvantage of other shareholders. However, according to Bradford *et al.*, (2013) the link between ownership structure and firm's dividend policy remain unsolved in the finance literature.

Institutional ownership is deliberated by a total number of shares held by the institutional investors divided by the total number of outstanding shares. This measure is followed by many researchers such as Shah (2009), Hassan and Ahmed (2012), Cao and Petrsek (2014), Boujelbene, Bouri and Prigent (2014) and Ajina *et al.*, (2015). According to Hsu and Koh (2005) organizations are categorized into different types of institutional investor

In this regard, the higher the information asymmetry, the greater the adverse selection cost incurred, which will lead to a larger bid-ask spread. Because of the presence of two types of costs (adverse selection costs and transaction costs), the relationship between ownership structure and liquidity is quite complex in studies. This is compounded by the various types of informed investors, such as managers, majority shareholders and institutional investors (Ajina & Lakhali, 2010). Similarly, Yosra and Sioud (2011) investigated two empirical associations namely, the ownership concentration-stock liquidity association, and the ownership separation-control/market liquidity association. They empirically found that the structure of ownership was still concentrated in most Tunisian companies and that stock liquidity lessens with concentrated ownership. Owners make use of various devices to gain control and therefore, a considerable separation of ownership from control influences liquidity in various ways. These results show that pyramidal structures significantly and negatively affect liquidity for controlled firms – in contrast, for family-owned firms, non-voting shares heighten liquidity for minority shareholders through the reduction of informed trading probability.

The concept of audit committees has been defined according to the goals, functions, and roles assigned to them. Al-Thuneibat (2006) defined it as the committee that is composed of non-executive directors in their formation. AARF (2002) defined an audit committee as a subcommittee of the Board of an organization that creates a forum where directors, auditors, and managers handle issues concerning the management of risk and with other governance obligations. The major goal behind forming the audit committee is to increase auditing quality and questioning of the board of directors. Arens *et al.* (2009) define it as a group of members selected from the board of directors who are responsible for retaining the independence of the auditor. Many governments, local and international vocational bodies have put more effort through the issue of guidelines and standards, which when adopted help restore credibility in the financial data declared. It also strengthens the role of audit

committees, which consolidates the functioning and independence of the external auditor as an impartial party providing its opinion on the declared financial data fairly and objectively. One of these efforts is the recommendation of the Securities and Exchange Commission (SEC), New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASDA), to form a Blue Ribbon Committee (BRC, 1999) to be a natural reaction in case of any alteration in financial statements. These committees aim to develop recommendations which help improve financial reports through consolidating their role. It also put down a series of qualities which should prevail in order to have an active audit committee. Such qualities include the size of the committee, experience, financial knowledge of members, the degree of their independence and frequency of meetings, (Baxter and Cotter, 2009).

Critique of Existing Literature Relevant to the Study

The above studies have established that corporate governance indeed affects stock market liquidity. However, Firms with an unusually low number of restrictive governance provisions compared with other firms in their industries have shown low stock market liquidity. Studies by Chung et al. (2010) argued that corporate governance practices like board size and existence of external directors tend to reduce asymmetric information thereby leading to increased liquidity. Locally studies have not been conclusive on the effect of corporate governance on stock liquidity as they have largely concentrated on its (corporate governance) effect to other variables such as firm performance and capital structure, with one study focusing on the board structure only and ignoring the effect of other corporate governance variables on stock liquidity. Further, the above studies focused on corporate governance practice at the time when awareness was very low, and few companies had not embraced these practices with the existence of little or no corporate governance regulatory framework

Research Gap

Prior research examining the relation between corporate governance and stock liquidity has recently received attention as a potential determinant of stock liquidity and remains largely unexplored in the global context (Elshandidy and Neri 2015 and Karmani et al., 2015). Only a few documents the stock liquidity-leverage relation outside Kenya (Lipson & Mortal, 2009; Udomsirikul et al., 2011). However, the above studies have some significant limitations that this study specifically addressed. Prior research investigating the relationship between CG and stock liquidity is based largely on non-Kenyan data. To date, there is no evidence in Kenya that explores the impact of aggregate CG on stock liquidity. In the Kenyan context, prior research narrowly focuses on the concepts of board size, board tenure, board ownership and board independence using only individual variables of ownership and board structure, with recent research, Sakwa (2016) finding a negative relationship between CG and stock liquidity for firms listed at the NSE. By investigating the effect of CGQ on stock liquidity in Kenya, our study aims to provide empirical evidence on whether results from studies done outside Kenya in the same area using aggregate components of corporate governance held for Kenyan firms.

Material and Methods

This study used a combination of explanatory and longitudinal research design. A sampling frame is a list of all elements from which a sample may be drawn (Kumar, 2011). This study focused on all the firms listed at the Nairobi Securities Exchange. According to the NSE (2017), there were 67 firms listed at the NSE as of December 2017. the study adopted a census approach where data from all the firms listed at the NSE were used in the study. The data collection instruments used in this study was a content/document analysis guide and a structured questionnaire.

Data processing starts with data preparation, coding, editing, and cleaning. Both descriptive and inferential statistics were used to analyze data. Inferential statistics included Pearson Correlation and multiple regression

analysis. Pearson correlation assumes the data is linear and shows the relationship/association between the dependent variable and independent variable whereas multiple regressions show the extent of the effect of the independent variables on the dependent variable. This data was analyzed for correlation using the coefficient of correlation r for association and coefficient of determination R^2 to establish the extent to which corporate governance accounts for changes in stock liquidity.

Model specification

The model testing the direct effects of corporate governance and stock liquidity are as follows:

$$FRQ = \beta_0 + \beta_1 OS + \beta_2 ACS + \rho_{it} \dots \dots \dots (i)$$

Where;

FRQ is the measure of stock liquidity

β_0 is the constant of equation (represents the changes in stock liquidity that cannot be explained by independent variables in the model)

OS is the measure of ownership structure

AS is the measure of Audit Committee structure

ρ is error an term

FINDINGS

The study put into account the age of the firms. Findings are presented in Table 4.1 below. From the results, more than half of the respondents ascertained that majority of the firms have been in operation for periods of over 40 years followed by those that have been operatan ion for 31- 40 years. Few of the firms have been in operation for periods between 1-20 years. In a nutshell, the bulk of the firms have been in operation over for40 years. Firm size was measured by assessing the number of employees in the firms. The results regarding this were summarized and presented in Table 4.2. The findings showed that most of the firms have over 400 employees followed by those with employees ranging from 300-400 with few of the firms having between 201 to 300 employees.

Table 1 Firm Characteristics

	Frequency	Percent
1-10 years	1	0.5
11-20 years	4	7.6
21-30 years	4	11.1
31-40 years	14	28.8
Over 40 years	24	52
Total	47	100
1-100	1	2
101-200	2	4
201-300	4	9
301-400	7	15
Above 400	33	70
Total	47	100

Descriptive statistics and correlation results

The ownership structure is of the essence in that it has an influence on the incentives of the managers and by that also influences the efficiency of the firm. The item realized a mean of 3.21 and a standard deviation of 0.508 meaning it is not clear if the institutional investors under the jurisdiction of the CMA have transparent, honest and fair practices.

Ownership type

This section of the analysis highlights the results on the ownership type. As shown in table 4.4, the lion's share of the firms is under domestic ownership followed by those under managerial ownership while the least being under institutional ownership.

Table 2 Ownership type

	Frequency	Percentage
State ownership	23	48.9
Foreign ownership	17	36.2
Institutional ownership	10	21.3
Domestic ownership	37	78.7
Managerial ownership	28	59.6

Audit committee structure

Findings showed that the firms listed in NSE had an average of four members in the audit committee (mean = 3.76) with 90 percent of the members being independent directors (mean = 0.901). Audit committee gender was at a mean ratio of 0.2097 indicating that on average there is 21 percent female members audit committee. Moreover, audit committee experience was at a mean ratio of 0.46259 revealing that on average 46 percent of audit committee members had financial experience. A summary of findings is presented in table 4.6.

Table 3 Audit committee

	Min	Max	Mean	Std. Deviation	Skewness	Kurtosis
Ac Size	2.00	5.00	3.76087	0.82151	-0.276	-0.304
AC Independence	0.333	1.00	0.90126	0.17254	-1.639	1.783
AC Gender	0.000	0.05	0.20978	0.170821	-0.051	-1.258
AC Experience	0.000	1.00	0.46259	0.234202	0.471	0.184

Stock Liquidity

The findings in table 4.11 show that on average, the stock return in the Nairobi stock market is 0.06% for the ten-year period. The results show that during the period there were negative returns with the minimum return being -0.8268. The average turnover ratio was 4.61% with a standard deviation of 3.6% while the bid-ask spread, on the other hand, was 3.18% with a standard deviation of 49.43% for the ten-year period. The values of both skewness and kurtosis are very high showing that the data may not be asymptotically normally distributed.

Table 4 Stock Liquidity

	Mean	Std. Dev.	Min	Max	Skewness	Kurtosis
Returns	0.0006	0.0417	-0.827	7.2149	89.2729	15271.73
bid-ask	0.0319	0.0365	0	3.252	18.7895	1341.31
turnover rate	0.0005	0.0049	0	1.0131	15.316	3016.49

Hypothesis Testing

The results of the correlation analysis are presented in table 5. The correlation between ownership structure and stock liquidity was significant, $r = 0.706$, $P < 0.01$. The correlation between audit committee structure and stock liquidity was also significant, $r = 0.683$, $P < 0.01$. Table 5 also illustrates the model summary of multiple regression models; the results showed that the two predictors (ownership structure and audit committee structure) explained 73.5 percent variation of stock liquidity. This showed that considering the two study independent variables, there is a probability of predicting stock liquidity by 73.5% ($R^2 = 0.735$). Study findings in ANOVA indicated that the above discussed coefficient of determination was significant as evidence of F ratio of 29.142 with p value $0.000 < 0.05$ (level of significance). Thus, the model was fit to predict stock liquidity using the ownership structure and audit committee structure.

Hypothesis 1 suggested that ownership structure does not significantly affect stock liquidity. Results in Table 4.15 indicated that ownership structure had a beta coefficient of $(\beta) = 0.368$, $\rho = 0.001 > 0.05$, hence hypothesis 1 does not hold. The study, therefore, concluded that for each unit increase in ownership structure, there is up to 0.368 units' increase in stock liquidity. The effect of ownership structure is shown by the t-test value of 3.672 which implies that the effect of ownership structure surpasses that of the error by over 3 times. The results are in tally with findings by Yosra and Sioud (2011) which found that the structure of ownership was concentrated in most Tunisian companies and that stock liquidity lessens with concentrated ownership. In a similar vein, Al-Gharaibeh et al. (2013) were of the opinion that the ownership structure is an influential factor on a firm's policies especially the dividend policy which dictates the number of earnings a firm will pay out to its shareholders.

Hypothesis 2 stated that the audit committee structure does not significantly affect stock liquidity. However, hypothesis 2 does not hold based on findings in table 4.15 that audit committee structure beta coefficient $(\beta) = 0.222$, $\rho = 0.045 > 0.05$. Hence the hypothesis statement is rejected. This suggests for each unit increase in audit committee structure; there is up to 0.222 increases in stock liquidity. Moreover, stock liquidity is shown by the t-test value of 2.062 which is more than the error associated with it. The findings agree with Shi et al. (2015) that corporate governance issues (audit committee structure) had a significant effect on stock market liquidity, also the findings coincide with Elshandidy and Neri (2015) who reported that strongly audit committee structure firms reflected risk information voluntarily as opposed to mandatorily and this enhanced market liquidity in a considerable manner.

Table 5 Hypothesis Testing (Regression Results)

	Unstandardized Coefficients		Standardized Coefficients			correlation zero order	Collinearity Statistics	
	B	Std. Error	Beta	t	Sig.		Tolerance	VIF
(Constant)	-0.104	0.573		-0.181	0.857			
Ownership Structure	0.44	0.12	0.368	3.672	0.001	.706**	0.628	1.592
Audit committee structure	0.251	0.122	0.222	2.062	0.045	.683**	0.545	1.836
Summary Statistics								
R Square	0.735							
Adjusted R Square	0.71							
F	29.142							
Sig.	.000b							

a Dependent Variable: stock liquidity

Conclusion and Recommendations

In conclusion, ownership structure has been found to have a positive influence on stock liquidity. The percentage of ownership held by domestic owners is higher than that of institutions. The challenge, however, is that the minority shareholders are most often not protected from the adverse actions of the controlling shareholder. There is thus a likelihood that they may avoid trading in such stocks since the large shareholders are expected to behave in a self-serving manner. On a positive side, the board ensures that shareholders are treated equitably. The end result is that the ownership structure has a positive impact on stock liquidity.

As well, the audit committee structure positively influences stock liquidity. When there is the independence of the audit committee, there is a marginal increase in stock liquidity. Investors, therefore, react positively to audit committee independence. Besides, the existence of at least three independent and non-executive directors increases the voluntary disclosure of information and in so doing the stock liquidity. The problem is that there is uncertainty if the audit committee members have a professional qualification in either audit or accounting and whether there is awareness of the interests of the investing public and familiarity with basic accounting principles by the audit committee.

Evidently, ownership structure significantly influences stock liquidity. It is therefore essential for regulators to improve the quality and enforcement of legal laws that protect minority shareholders from adverse actions of the controlling shareholder. Besides, the board needs to ensure that shareholders are treated equitably. Furthermore, there should be transparency, honesty and fair practices among institutional investors under the jurisdiction of CMA.

Since the audit committee structure has a positive influence on stock liquidity, the audit committee needs to have at least three independent and non-executive directors. The existence of independent directors will improve its effectiveness in monitoring management thereby positively influencing stock liquidity. Besides, the audit committee should be aware of the interests of the investing public and be familiar with basic accounting principles. In fact, it is important for the audit committee members to possess knowledge that is relevant to the firm.

The study is subject to the following limitations. First, the selection of companies is restricted to firms listed at the NSE. Further research is needed to determine whether the results obtained from this study could be generalized to other firms. Second, the number of firms included in the research is small and represents only 67 firms of the whole market restricted by the availability of data. Further research is needed to extend this examination to include more companies with an extended time period.

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