# Effects of Corporate Governance Practices on Financial Performance of Manufacturing Share Companies in Adama

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## ABSTRACT

*This study focused on the effects of corporate governance on manufacturing share companies' financial performance in Adama, Ethiopia over a period of thirteen years from 2007-2019. There was no sufficient literature on the effects of corporate governance on the financial performance of manufacturing share companies in Ethiopia and therefore, dearth of documented literature. Investigating the effects of corporate governance practices on the financial performance of manufacturing share companies in Adama was the general objective of this study. The type of research design used in the study was explanatory research design in trying to establish the causal effect relationship between corporate governance attributes and manufacturing share company's performance variable (ROE) and the control variable (age of manufacturing share companies) was added. The dependent variable that was used to measure the financial performance of manufacturing share companies is return on equity. All 5 manufacturing share companies were taken in to consideration by the researcher for the study and the total population of manufacturing share companies was obtained from ERCA Adama branch. Board related information was obtained through structured questionnaires filled by the CEOs or board secretaries as they were in a better position to comment on corporate governance issues. Financial statements were collected from each manufacturing share company. The study utilized panel data analysis methodology in drawing conclusions about the study. From the result of this study, it was found that the mean value of board size was 8 members, the mean value of boards' business management experience in terms of persons was 4, the average value for audit committee size was 4 and the average proportion of ownership concentration was 71.21%. Empirical findings stated that the board size; boards' business management experience and ownership concentration has a positive significant effect on the financial performance of manufacturing share companies. Finally, this study advised that shareholders should give priority for board size, boards' business management experience and ownership concentration.*


**Keywords:** *Corporate governance; Financial performance; ROE; ROA; NIM; Adama; Ethiopia.*

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**1.0 Introduction**

Corporate governance refers to the code of conduct through which companies are directed and controlled Gupta (2014). The idea of corporate governance has been in existence for a long period of time but it became official in the United Kingdom in the early 1990's.

The issue of corporate governance has become the most crucial topic in advanced countries after some events such as frauds and company collapses. Currently, it has also attracted a great attention in emerging countries Yılmaza (2018).

The concept of corporate governance has become a burning issue starting from the time when famous organizations of the world such as Enron Corporation & MCI Inc. in U.S, HIH insurance in Australia, Parmalat in Italy and other companies have faced financial scandals. As a result of financial difficulty, corporate governance is getting more attention. Good corporate governance practice is a device of how companies are directed and organized & become a basic topic and obtain wide attention both in practice and in academic research Wondem (2019).

The first objective of any organization is to effectively, efficiently and ethically manage the company for profitable long-term growth and long-lasting existence. Thus, the development of good corporate governance is essential in order to protect corporate stakeholders, and maintain factors for control and prevention of collapse and permanent economic depression Olayiwola (2018).

Good corporate governance ensures that business organizations are fair, transparent, efficient and accountable for their doing. Good corporate governance is associated with productivity of organizations and also the achievement of corporate objectives. Conversely, weak corporate governance leads to waste, mismanagement and corruption WANJIRU (2013). The reasons for weak corporate governance are found across this globe which are mostly tied with fraudulent actions and other major malpractices. Governance is all about inspiring the corporate sector to be accountable, fair, transparent and responsible as indicated by the World Bank president Mbalwa (2014).

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stake holders Nguyen (2017). It specifies the distribution of rights and responsibilities among company's stake holders (including share owners, directors and managers) and articulates the rules and procedures for making decisions on corporate affairs Palaniappan (2017).

Segregation of duties and rights among those parties can strongly overcome the problem of conflicts of interest between the majority and minority shareholders, managers and shareholders and stakeholders and shareholders. To ensure at all times, the interest of key stakeholders adequately without undermining the long term goals of the organization, it is pertinent that organizations evolve and adopt internal structures that will midwife a balanced relationship among the key stake holders NWIKO (2018).

Manufacturing companies' competitiveness enhancement is a crucial motorist for structural transformation and wide based growth. Manufacturing sectors open the door for potential investors to increase their capital rather than the agricultural and service sectors. Pursuant of these potential benefits of manufacturing, the government of Ethiopia has given the manufacturing sector due emphasis in its different development plans, such as the PASDEP I & II and GTP I and II Getahun, (2018).

Since the 2000s, Ethiopia has emerged as one of the fastest growing economies in Africa. Nevertheless, Ethiopia's manufacturing sector is still far from being an engine of growth and structural change Oqubay (2018). The Ethiopian manufacturing sector has had two distinct features: first,' a low level of industrialization in terms of the sector's share in GDP, export earnings, industrial intensity and competitiveness. Second, the industrial structure is dominated by small firms and resource-based industries (in particular the food industry) and (is) concentrated around the capital city' Oqubay (2015).

Wondem (2019) talks about the corporate governance practices of Ethiopian share companies, as they are not going in the way it should be, however, a changing land scape of corporate business environment in the country where the activities of corporate business operations today are like those of industrialized nations but not in governance practice. Firm financial performance is affected by corporate governance attributes of firms, because their achievement or letdown depends on the extent to which they are managed efficiently. Performance measures are the backbone of economic units because no decision can be made without them. Financial performance measure is one of the vital performance measures for economic units.

According to the Ethiopian Commercial Code of 1960, there are six forms of business organizations, namely: Ordinary Partnership, Joint Venture, General Partnership, Limited Partnership, Share Company and Private Limited Company. Among those types, the study was focused on share company types, only specifically manufacturing share companies. This study will add value to the existing literature by giving new evidence about the effect of corporate governance practices on the manufacturing share companies' financial performance measured by accounting-based measures only due to the absence of an organized stock market in Ethiopia.

**1.1 Statement of the problem**

Corporate governance is gradually becoming vital in organizations as an approach of improving organizational performance. Weak corporate governance has led to low performance of organizations throughout this world and also suppressing sound and workable economic decisions. It is highly assumed that the leading agent for the endurance and the progress of the company is mainly its 'Corporate Governance' policies. Companies can follow the stake holder model or shareholder model. Regardless of this fact, the practice of corporate governance is increasingly becoming important. The increase in financial and managerial scams has led the investors to increasingly look for transparency and professional management in handling the company's business Gupta (2014).

For real, there is no system of governance which can totally protect companies from collapses. It is difficult to say that all companies around this visible world are governed by a common set of guidelines because of a complex business environment. However, a review of their corporate governance attributes/ arms / from time to time is the home work for them to reduce the anxiety of being financially underperformance. Companies' corporate governance practices and their financial performance relationships are exposed to many factors that limit these relationships. The legal system and financial structure of a country may have significant impacts on this relationship Yılmaza (2018).

As cited by Yılmaza (2018), Ueng (2016) investigated the relationship between the quality of corporate governance policy and the firm financial performance by using a sample of 3068 firms from a corporate library data base. Thus, the relationship between corporate governance and financial performance has caught the wide attention of researchers in the last epoch. Numerous researches have been conducted in the past to investigate this linkage, but there has been lack of conclusive evidence Aggarwal (2013).

Over the period, due to increase in various corporate frauds, corporate governance mechanisms of companies across the globe brought about the need for good corporate governance practices. Economic crisis and corporate failures have initiated the discussion on corporate governance in both industry and academia Kuntluru (2019).

There is no single model of corporate governance. Governance practices vary not only across countries but also across firms and industry sectors. Each country has through time, developed a wide variety of mechanisms to overcome the agency problems arising from the separation of ownership and control Andersson (1999).

According to Kang *et al.* (2007) there was a call for country-specific corporate governance-performance study to be conducted. In spite of this, there is still a dearth of corporate governance literature in most developing economies Darko *et al.,* (2016). The weakness of corporate governance is possibly the very decisive factor blamed for the corporate failure consequences. Wondem (2019) suggested that the literature on Africa is still very thin or infant although scholars in the advanced economies have established a large body of literature on the subject.

The corporate governance framework in Ethiopia comprises the Commercial Code of the Empire of Ethiopia (1960) and the Ethiopian Code of Corporate Governance (2011, 'the Code'). The Code was developed by the Private Sector Development hub under the Addis Ababa Chamber of Commerce and sectorial associations. For listed companies, the application of the Code is based on the 'apply or explain' approach. The Commercial Code of the Empire of Ethiopia is currently being revised by the Ministry of Justice Low (2017).

Corporate governance practices of Ethiopian share companies are not as expected in line with the varying land scape of the corporate business environment. This is due to a lack of awareness as to corporate governance, lack of up-to-date regulatory framework, absence of policy framework and unstructured governance practices because of national principles and codes Wondem (2019).

Financial performance is used to identify companies' overall financial health over a given period of time and can also be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. Most previous studies have been undertaken in Ethiopia on impacts of corporate governance practices on financial performance of financial institutions like Wolde (2018), Ferede (2012), Harun (2017), Zegeye (2015) and Mitiku (2015)

However, these studies relate to more widely Banking industries, Insurance industries and microfinance institutions and cannot be representing manufacturing industries due to the differences in corporate governance structures and cultures. As per the knowledge of the researcher, there is no published research made on the effects of corporate governance practices on manufacturing share companies' financial performance. The research gap is in case of underdeveloped countries' literature. In addition to the area gap, there is no specific code of conduct for the corporate governance of manufacturing share companies in Ethiopia.

Manufacturing is the production of goods for use or sale using machines, tools and labor. It refers to a series of human activities, from hand craft to high tech, but is most commonly applied to industrial production, in which raw materials are transformed in to new products, finished goods on a large scale. The manufacturing sector comprises establishments engaged in the mechanical, physical, or chemical transformation of materials, substances or components in to new products CSA (2015).

Failure of manufacturing companies would affect the entire economy of a country. Therefore, in order to ensure the improvement of the company's performance, economic efficiency and growth, and to increase investors' confidence; strong, effective and good corporate governance has to be developed and implemented. Keeping this in view and the potential contribution of the manufacturing industry to the economy of underdeveloped countries, this study was conducted to measure and analyze the effect of corporate governance practices on a firm's financial performance using manufacturing companies in Adama, Ethiopia. This study fills the gap and serves as a point of reference for further research in corporate governance. It also provides empirical evidence on the effect of corporate governance mechanisms on the financial performance of manufacturing share companies.

## 1.2 Objective of the study

### 1.2.1 General objective

The overall objective of this study was examining the effect of corporate governance practices on firms' financial performance by taking evidence from manufacturing share companies in Adama, Ethiopia.

### 1.2.2 Specific objectives

By taking in to account the overall objective of examining the effect of corporate governance practices on firms' financial performance, this study was developing several specific objectives. Specifically, the study was taking a look at the following objectives.

- To evaluate the effect of board size on the financial performance of manufacturing share companies in Adama.
- To investigate the effect of the Board of directors' business management experience on the financial performance of manufacturing share companies in Adama.
- To examine the effect of audit committee size on the financial performance of manufacturing share companies in Adama.
- To explore the effect of ownership concentrations on the financial performance of manufacturing share companies in Adama.

### 1.3 Research hypotheses

In this study, the following testable hypotheses were developed.

$H_1$: Size of the board has a positive and statistically significant effect on the financial performance of manufacturing share companies in Adama.

$H_2$: Board of directors' business management experience has a positive and statistically significant effect on the financial performance of manufacturing share companies in Adama.

$H_3$: Size of the audit committee has a negative and statistically significant effect on the financial performance of manufacturing share companies in Adama.

$H_4$: Ownership concentration has a positive and statistically significant effect on the financial performance of manufacturing share companies in Adama.

### 1.5 Scope of the study

The study was confined only to those manufacturing share companies operating in Adama city administration. Even if financial performance can be determined by different factors from different perspectives, the study aims to examine the effect of corporate governance on the financial performance of manufacturing share companies in Adama, Ethiopia. Methodologically, the study used explanatory and descriptive research design with mixed research approach. Besides, the secondary data that was used for the study includes thirteen years' (i.e., 2007-2019) audited financial statement. Dependent variable is delimited to only accounting based measure due to the absence of an organized stock market in Ethiopia.

### 1.6 Significance of the study

This study will add some value to the decision of policy makers by giving clues on how the problem can be tackled. It may also provide basic knowledge concerning corporate governance attributes for the beneficiary. On the other hand, it may help external users of companies' information like suppliers, governmental agencies, creditors, potential investors and customers by identifying both negative and positive effects of corporate governance variables on the financial performance. Additionally, it may be used as a cornerstone for other researchers who intend to conduct a study in the same area. Eventually, it is highly supposed that the outcome of this study will play its lion share for manufacturing companies by identifying relevant corporate governance practices and their effect on their financial performance.

## 2.0 Review of Related Literature

### 2.1 Characteristics of good corporate governance

Different literatures of finance and law have documented that good corporate governance has played its part for firms, markets and countries' success. Good corporate governance is an important pillar of the market economy and it enhances investor confidence Tura (2012). Good corporate governance needs a qualified board of directors as a directing body for the executive management of a company. It also has an association with a profit of organizations and achievements of corporate objectives.

According to Khan (2011), good corporate governance is fundamental to the economies with an extensive business background and also facilitates the success for entrepreneurship. Good Corporate Governance results in higher companies' profit and more efficiently using firms' resource. Investors are always taking a look at good corporate governance and demanding stronger property rights protection. Good corporate governance also helps ensure that corporations take into account the interests of a wide range of constituencies, as well as of the communities within which they operate. Further, it ensures that their boards are accountable to the shareholders. This, in turn, helps assure that corporations operate for the benefit of the society as a whole Mishra & Rani (2011).

As noted by Wondem (2019), good corporate governance practice to gauge how companies are directed and controlled became a key topic and received wide attention both in practice and in academic research. Development of good corporate governance is vital to protect corporate stakeholders. It is also used to maintain factors for the purpose of controlling and preventing company's collapses and perpetual economic depression. In line of this, "The 2009 global economic recession called for an increased need to promote good corporate governance across the globe" Dzingai & Fakoya (2017).

Heenetigala (2011) discussed that good corporate governance practices are regarded as important in reducing risk for investors, attracting investment capital and improving the performance of companies. The exercise of good corporate governance has therefore, become an essential condition for any corporation to be managed effectively in the globalize market. Failure of giant companies of this world increases the need for good corporate governance.

Good corporate governance enables companies to access financing from a much larger pool of investors and if countries are to reap the full benefits of the global capital market, and if they are to attract long-term "patient" capital, corporate governance arrangements must be credible and well understood across borders. Even if corporations do not rely primarily on foreign sources of capital, adherence to good corporate governance practices will help improve the confidence of domestic investors, may reduce the cost of capital, and ultimately induce more stable sources of financing (OECD, 1999).

A good corporate governance framework will decrease the agency problem and invite many investors to invest in to the company. A good system of corporate governance is of great importance for an efficient control of the companies, for the improvement of their performances, as well as for a better approach and accessibility of the external financing. The level of alignment of the interests of the interested parties within the company shows how good the corporate governance is. The basic need of good corporate governance is to maintain: good board practices, control environment, board commitment, transparency in disclosure and well-defined shareholders. For efficiency and profitability of the industry, the reform process should be geared towards developing and implementing policies that will ensure that the principles of good corporate governance are instilled and maintained. A good corporate governance mechanism advances the health of the corporate sector, thus enhancing national competitiveness. It was also believed that good corporate governance helped to generate investor good will and confidence Mbalwa *et al., (*2014).

**2.2 History of corporate governance in Ethiopia**

The definition of corporate governance is not given under the Ethiopian company law. This law doesn't have fully sufficient legislative provisions on governance issues related to the separation of supervision and management responsibilities, and on the composition, independence, and remuneration of the board of directors in share companies. The commercial code of Ethiopia includes provisions essential to the share companies' governance.

Nevertheless, issues in corporate governance related to a board of directors, such as keeping alone the roles of independent directors from CEOs, directors' remuneration and composition and the independence of the board are inadequate due to a lack of clear explanation in the code Hussein (2012).

Most share companies in Ethiopia were formed among founders in the past. Recently, there are a number of companies that are being formed by sale of shares to the broader public. The appearance of publicly held share companies in Ethiopia provides evidence to a number of issues concerning corporate governance. Most principles and codes of corporate governance across the globe such as OECD, SEBI, BIS, etc. clearly provide for the supervisory and controlling role of the board. Unlike these principles of corporate governance, provisions of the commercial code and other related laws of Ethiopia are far from being adequate Hussein (2012).

As per Article 304 of the commercial code, a share company is a company whose capital is fixed in advance and divided in to shares and whose liabilities are met only by the assets of the company. The non-financial share companies including the manufacturing sector operating in Ethiopia, have to comply with the provisions of the commercial code. In general, corporate governance practices of Ethiopian share companies are not as expected, in line with the varying land scape of the corporate business environment Wondem (2019).

### 2.3 Manufacturing share companies in Ethiopia

A share company is a kind of business organization where, in most examples, a large group of people invest their cash or in-kind contributions in a company in return for units of ownership representing a proportion of the company's capital in the form of shares. The share company, including manufacturing sector, is one of the forms of business organization documented under the commercial code of Empire of Ethiopia Batra & Wondem (2016)

Manufacturing industry in Ethiopia started in 1920's with a simple processing technology that produces agriculture-based products; but still the sector is an infant even by African standards, dominantly focusing on semi-processing AACCSA & DAB DRT (2014).

The Ethiopian manufacturing sector contributes to export, employment and national output. Manufacturing is critical and is probably the most important device of long-term growth and development. Manufacturing is the wealth creating sector of an economy, and closely connected with engineering and industrial design and provides important material support for national infrastructure. The sector accounts for 70% of the industrial sector AACCSA & DAB DRT (2014).

There are two basic questions regarding the performance of the manufacturing sector. Firstly, why the private sector tends to invest more in the service sector shying away from the manufacturing sector? Second, why are the much-anticipated public investment projects in the manufacturing sector delayed unbearably with increasing costs? The answers to these questions do not lead to easy answers. However, the explanation could be found in the overall institutional capacity, technological readiness, infrastructure, and weak agriculture- industry linkages UNDP (2011).

Development of the manufacturing sector within an industry is essential to build national technological capacity, industrial capability and create wide based job opportunity and improve income. Although, the manufacturing sector is a way out for sustainable economic development, its growth is not without challenges. These challenges may include Unskilled labor forces with limited experiences, Limited infrastructure, External pressure from the global market, shallow industrial research and development activities, Underdeveloped market information system, problems related to trade logistics and limited promotion made on the resources and other opportunities Eshetie (2018).

### 2.4 Basic theories of corporate governance

Corporate governance is the relationship between shareholders, board of directors and the top management in determining the direction and performance of the corporation. There are a number of theoretical outlooks which are used in explaining the effect of corporate governance mechanisms on firm's financial performance. The normative empirical research paradigm suggests that "good research" must be grounded in and built on extant theory Batra & Wondem (2016). So that, in this research work, different theories of corporate governance were taken in to consideration namely the agency theory, stewardship theory, resource dependency theory and signaling theory have been used in developing the best practices of corporate governance.

### 2.3.1 Agency theory

Berle and Means (1932) suggests that while the ownership of the capital is distributed, control is concentrated in the hands of managers. Jensen and Meckling (1976) formalized the issue by identifying the "agency costs" of such separation of ownership and control. While owners would choose to maximize their profits, executives may invest the free cash flow at a return below the cost of capital, or use it inefficiently, in order to raise their control and power. Agency theory emphasizes the distribution of profits, rather than the generation of profits.

Agency theory suggests that managers (the agents), particularly those of large, publicly owned firms may have different objectives from those of the shareholders (the principals). The shareholders can assure themselves that the managers will make share-holder wealth- maximizing decisions only if the management receives appropriate incentives and only if the management is monitored Horne & Wicz (2008).

According to Dzimiri *et al* (2017) in agency theory, owners are principals and managers are agents. In a company, investors are the shareholders and managers are the agents. The managers are expected to take care of the interest of owners disregarding their own benefit. This may not always happen on account of differences in interest. The agents tend to focus on their interest as against the shareholders' interest of profit maximization. This could be a problem as this may lead to conflict between the principal and agent. Efforts should, therefore, be made to address such conflicts, by changing the rules under which the directors in a company are expected to operate. The shareholders can make use of corporate governance to come up with rules for operations and incentives that motivate the directors to take shareholders' interest on board and reduce agency cost.

Agency theory suggests that as firms increase in size, owners lose effective control andlook for professional managers who have better managing ability than principals. Some times this transfer of the firm's control from owners to agent leads to moral hazards which results in a situation where, to maximize their own wealth, agents may face the dilemma of acting against the interests of their principals. When the interests and utility functions of the self-serving agents coincide with those of the principals, the agency problem will not exist. However, where there is divergence, agency costs are incurred by the principals because the agents will want to maximize their own utility at the expense of the principals Abiahu *et al.*, (2017).

As noted by Wanjiru, (2013) Agency theory is defined as the relationship between the principals, such as shareholders and agents such as the company executives and managers. In this theory, shareholders who are the owners or principals of the company, hire the agents to do work. The agency theory is based on the principal agent relationships. In modern corporations, the shareholders (principals) are widely dispersed and they are not normally involved in the day-to-day operations and management of their companies, rather, they hire managers (agent) to manage the corporation on behalf of them Habbash (2010). The agents are appointed to manage the day-to-day operations of the corporation. The separation of ownership and controlling rights results in conflicts of interest between the agent and principal. To solve this problem or to align the conflicting interests of managers and owners, the company incurs controlling costs including incentives given for managers.

### 2.3.2 Resource dependency theory

The resource dependence model advocates that the board of directors could be used as a mechanism to form relations with the external environment in order to support the management in the attainment of organizational goals Wang (2009). Both agency and resource dependency theories advocate that boards should have a diversity of competent members who are able to effectively monitor top managers and provide organizations with the resources they need.

By performing these roles, board members are able to positively influence the performance of organizations. The resource-dependence view of corporate governance stems from the fundamental logic that various elements of corporate governance can act as critical resources for a firm Udayasankar (2008). Resource-dependence allows for stakeholder interests to be captured, by treating various stakeholder groups as sources of legitimacy, and other resources, including capital.

Resource Dependency Theory asserts that boards enable firms to minimize dependence or gain resources. Thus, although RDT is less commonly used to study boards than agency theory, empirical evidence to date suggests that it is a more successful lens for understanding boards. The resource dependence theory (RDT) started to stand out from the literature as a refreshing viewpoint to study boards of directors. RDT views the concept of board of directors as a supplier of resources to the CEO, high executives and the organization as a whole Pfeffer & Salancik (1978).

According to Werner (2008), a particular resource may only constitute a very small part of the total resource needs or costs, but it is critical if the missing part of that resource endangers the ability of the organization to function. However, RDT does not argue that the environment and dependency on critical resources directly influence organizational behavior behind the backs of the actors involved.

### 2.3.3 Stewardship theory

Stewardship theory is about the employment relationship between two parties, the principal (owner) and the steward (manager) Davis *et al*., (1997), Donaldson & Davis (1991). This theory suggests that stewards will behave in a pro-social manner, behavior which is aimed at the interest of the principal and thus the organization. However, this theory argues that performance variation may rise from structural situations which the executives located or effective actions by the executives.

According to Donaldson & Davis (1991), structures are facilitative of superior performance by providing precise, consistent role of expectations, authorized and empowered senior management. This creates situations which help chief executive officers to achieve the higher performance objectives. This will occur if the CEO is also the chair of the board. Stewardship theory is focused on facilitative empowering structure, and holds that aggregation of the official position period, the role of CEO increases effectiveness, and maximizing the highest return of shareholders, then separation of chair and chief executive officers.

According to the stewardship theory, the stewards or CEO and Management are quenched and motivated when an organization attains its objectives. Stewardship theory recommends CEO duality and the chairman to reduce agency costs and have a better role of safe guarding the firm's assets Donaldson & Davis (1991). It pointed out that there will be an improvement on stewardship of shareholders' interest, and returns will be improved by combining CEO and chairman. Maximum firm performance, such as sales growth or profitability, is the desired outcome of a stewardship perspective Davis *et al*., (1997), Tosi *et al*., (2003).

**2.4 Financial performance**

The term 'performance' comes from the old French word 'parfournir', which means 'to do', 'to carry out' or 'to render.' It refers to the act of performing; execution, accomplishment, fulfillment, etc. With a wider meaning, performance refers to the accomplishment of a given task measured against preset standards of accuracy, completeness, cost and speed. In other words, it refers to the degree to which an achievement is being or has been accomplished (Shodhgan.inflibnet.ac.).

According to Frich Kohlar, performance is general term applied to a part or to all the conducts of activities of an organization over a period of time, often with reference to past or projected cost efficiency, management responsibility or accountability or the like. Therefore, not just the presentation, but the quality of results achieved refers to the performance. Performance is used to indicate a firm's success, conditions and compliance. Financial performance refers to the act of performing a financial activity. In a wider sense, financial performance talks about the degree to which financial objectives are being or have been accomplished. It is the process of measuring the results of a firm's policies and operations in monetary terms. It is used to measure a firm's overall financial health over a given period of time and can also be used to compare similar firms across the same industry or to compare industries or sectors in aggregation (Shodhgan.inflibnet.ac.).

On the other hand, there are three approaches of performance measurement; namely, accounting based approach, goal- centered approach and behavioral approach. In the first approach, performance is assessed with accounting information such as profitability, liquidity and solvency ratios derived from financial statements. In the second approach, it is typically the performance of an organization, or an organizational subunit such as a work group or a project that is assessed relative to goals. The third and last approach is rooted in accounting literature and depends on financial measurements. As per the accounting point of view, financial statements are prepared by a business enterprise at the end of every financial year. Financial Statements are end products of financial accounting. They are capsulated periodical reports of financial and operating data accumulated by a firm in its books of accounts-the General Ledger.

## 2.5 Determinant factors

### 2.5.1 Firms' financial performance and the size of the board

Board size is the number of directors making up the corporate board. Several studies concentrating on the influence of board size on corporate performance have mixed results. The mechanism in which companies can control their internal governance structure is their board of directors Wondem & Batra (2019). There are two schools of thoughts regarding size of board of directors. One recommends a larger board size whilst the other recommends a smaller board size. The first school of thought argues that larger board size improves corporate performance whose members are from different professional backgrounds that bring more ideas that add value to the company.

The larger board of directors, the more experienced and knowledgeable people will be available which will lead to more careful learning, decision making process and ultimately better firm performance Yameen *et al. (*2019). Some studies empirically find that board sizes have a positive significant impact on company performance such as Wondem & Batra (2019), Yameen *et al.*, (2019), Belete (2015). In contrast, other studies found that there is a negative relationship between board size and corporate performance Enilolobo, *et al, (*2019), Olayiwola, (2018), Vu & Nguyen (2017). Still unsettled result is revealed. In this research, the ability of the board of directors to control and promote value-creating activities is more likely to increase with the increase of directors on the board. With more directors, the collective experience and expertise of the board will increase, and therefore, the financial performance of companies would be higher. Therefore, the study hypothesized that: the board of directors' size is positively and significantly related with the manufacturing share companies' financial performance.

### 2.5.2 Firms' financial performance and boards' Business management experience

According to Mitiku (2015), the board's business management experience has a positive effect on corporate financial performance. Nurhussen (2018) in the study of the relationship between corporate governance and company performance with a sample of 8 firms from year 2013 to 2017 and adopting multiple panel linear regression model, discovered a positive and significant association between board's business management experience and the firms' performance. Melkamu, (2016) on the other hand found that board's business management experience on the firms' financial performance was inconclusive.

However, there was another result which reveals an insignificant effect of the board's business management experience on the firm's performance. Ferede (2012) stated that the nature of banking industry is different from other industries and banks are generally more opaque than non-financial firms. As per this study, there is no significant relationship between the boards' business management experience and the firms' financial performance due to the complex and special nature of banks' corporate governance. Standing up on the above discussions, this study hypothesized that: boards' business management experience has a positive and significant effect on manufacturing share companies' financial performance.

### 2.5.3 Firms' financial performance and audit committee size

The Audit Committee is a body of auditors that have been elected by the board of directors and approved by the shareholders and they report back to the board. Audit committee is one of the key factors that play a vital role in improving the firms' performance, it offers a sufficient protection against fraud and makes sure that these protections are in accordance with the best practices Yamen *et al,* (2019). Empirical findings on the impact of audit committee size on corporate performance revealed mixed results. Danoshana & Ravivathani (2013) found that increasing the Audit Committee Size will result in high financial performance, because detailed discussion on the financial statement of the companies will lead to get more ideas regarding the reports and it will guide to increase the firm's performance.

Inversely, Yamen *et al,* (2019) investigated the impact of corporate governance on firms' performance of 39 hotels listed on Bombay Stock Exchange (BSE) for the period from 2013/2014 to 2015/2016 in India and found that there is a negative association between the audit committee size and the firms' performance. The result of this study was consistent with Ferede (2012), Arora (2012) who argue that there is a negative relationship between the audit committee size and the firms' performance. Based on the discussion above, the study anticipates a negative and significant effect of the audit committee size on the manufacturing share companies' financial performance.

### 2.5.4 Firms' financial performance and ownership concentration

Concentrated ownership indicates a few owners hold a large portion of the shares. It is measured as the ratio of share held by the top ten shareholders to the total shares outstanding. The ownership concentration may also call block holdings and has some relationship with corporate performance and a company with higher concentrated ownership structure or block holdings has the tendency to have a better corporate performance Wu (2009). A high concentration of shares tends to create more pressure on managers to behave in ways that are value-maximizing. As per the proponents of agency theory like Jensen & Meckling (1976), the existence of key shareholders is beneficial, because they tend to actively involve themselves in more tighter monitoring activities, which would result in a more efficient governance structure leading to an important value for shareholders. In other words, if the shareholding is diffused (each person's shareholding is so small), it becomes too costly for such a shareholder to monitor the company's activities closely and opens the door for managers to do this for their own setup.

Kibrysfaw (2013) has investigated that ownership concentration had a positive and significant effect on corporate performance. In the opposite of the above result, Fauzi (2012) concluded that a higher proportion of block holders have a significant negative impact on firms' performance, in which the higher the block holder ownership level, the more potential for an agency problem to arise as a consequence of more power to interfere with any decision made by the board. Another result of this mechanism also concludes that there is no significant impact of top ten shareholders' concentration and corporate performance because in case just one or two members hold a very large portion of shares, they have the tendency to act according to their own objectives rather than minority shareholders. In companies with high ownership concentration, the most persistent agency conflict in the firm is between controlling shareholders and minority shareholders, the so-called horizontal agency problem Thi (2011). By taking a look at the arguments above, this study hypothesized that: Ownership concentration has a positive and significant effect on the manufacturing share companies' financial performance.

**2.6 Empirical studies**

The effect of corporate governance attributes on the firm's financial performance in different sectors has been assessed by academicians and researchers at different periods. There were mixed results concluded by previous studies pertaining to the relationship between corporate governance mechanisms and firms' financial performance. Reviews of those studies are presented below.

Dzingai & Fakoya (2017) carried out research on the effect of corporate governance structures on the selected listed mining firms in Johannesburg stock exchange for period 2010-2015 and the results indicated that a weak negative correlation existed between return on equity and board size, a weak but positive relationship between ROE and board independence, a weak but positive correlation between ROE and sales growth and negative and weak relationship between ROE and firm size.

Vu & Nguyen (2017) studied the data of 137 listed Singaporean companies for the period 2013 to 2016 to measure the impact of corporate governance on financial performance and found an inverse relation between the board size and firm performance. The study, however did not find any significant relationship between board independence, CEO duality and company financial performance.

Palaniappan (2017) empirically searched for determinants of corporate financial performance relating to board characteristics of corporate governance in the Indian manufacturing industry. The study draws on data from 275 firms listed in NSE from 2011 to 2015, using a multiple regression model. The findings of the study support an inverse association between the extent of board characteristics and the firm's performance indicators. As per this study, there is a statistically significant negative relationship between board size and Tobin's Q, ROA and ROE.

Yilmaza (2018) examined the relationship of corporate governance and firm performance for a sample of 61 Oman companies traded at Muscat Securities market for the period of 2013- 2016. The study found that there are significant results between financial ratios and corporate governance characteristics, but the overall relationship is weak in case of Oman.

Olayiwola (2018) in the study of the relationship between corporate governance and company performance listed at Nigerian Stock Exchange, with a sample of 10 companies, from the year 2010 to 2016. This study adopted panel data regression to analyze the data and employed exploratory research design. Corporate governance proxies include board size, board composition and audit committee size while performance was measured with net profit margin. Findings disclosed that board size had a significant negative correlation with NPM, board composition had a significant positive correlation with NPM, audit committee size had an insignificant correlation with NPM and jointly, they had a significant joint effect on NPM.

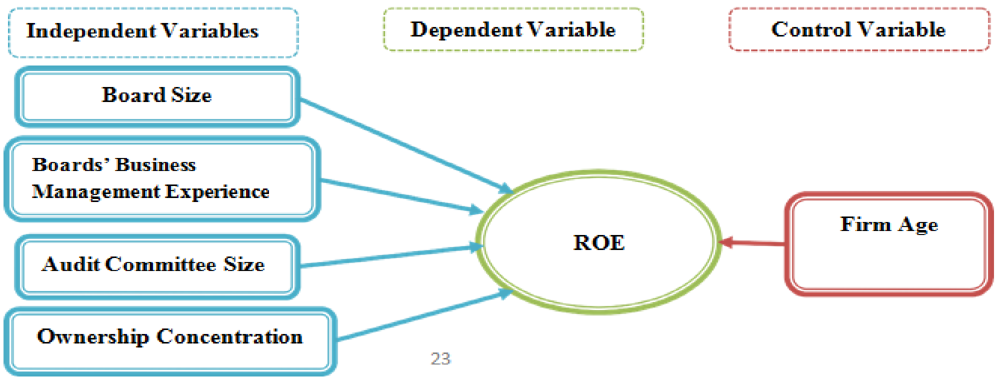
Wondem (2019) evaluated the impact of corporate governance practices on the corporate financial performance in Ethiopia. Panel regression approach was employed to investigate the effect of corporate governance practices on share companies' performance. The study used data of 24 share companies for five years. Findings of the study revealed that corporate governance practices of Ethiopian share companies are not going in the way which should be in line with the changing land scape of the corporate business environment.

Kibrysfaw (2013) provided evidence on the effect of different corporate governance mechanisms on the performance of nine commercial banks of Ethiopia, covering the period of 2005-2012. He has employed panel data regression analysis to test whether the selected corporate governance variables have an impact on firms' financial performance. The results of the study showed that the board ownership and liquidity ratio have a negative but insignificant effect on the firm performance; similarly, board size has a negative but insignificant impact on ROA. In case of composition, there is a negative and significant effect of proportion of the non-executive board on bank performance. The regression result also shows a positive and significant effect of concentrated ownership on the performance of banks. Finally, the result shows a positive and significant impact of deposit to total asset ratio on the performance of banks by using market mechanism. The study also recommends that further research could be possible to come up with a better insight and several extensions to this study are possible.

### 2.7 Conceptual framework of the study

Based on the theoretical and empirical literature review, the following diagrammatic framework was developed.

**Figure 3: Conceptual Framework**




## 3.0 Research Methodology

In this section, the researcher discussed the methods that were used in the research. It includes: description of the study area, research design, data sources, population and sampling, methods of data collection, description of variables and measurements, model specification and methods of data analysis.

### 3.1 Research design and approach

#### 3.1.1 Research design

A research design is the arrangement of conditions for the collection and analysis of data in a manner that aims to combine relevance to the research purpose with the economy in procedure. In fact, the research design is the conceptual structure within which research is conducted; it constitutes the blueprint for the collection, measurement and analysis of data. As such, the design includes an outline of what the researcher will do from writing the hypothesis and its operational implications to the final analysis of data Kothari (2014).

The main objective of this study was examining the effect of corporate governance on the financial performance of manufacturing share companies. In order to attain this purpose, explanatory and descriptive research design was used. Explanatory researches establish or create causal relationships between variables whereas descriptive survey researches describe the state of affairs as it is.

### 3.1.2 Research approach

According to Creswell (2003), in terms of investigative study, there are three common approaches to business and social research namely, quantitative, qualitative and mixed methods approach. Quantitative research is a means for testing objective theories by examining the relationship among variables Creswell (2009). On the other hand, qualitative research approach is a means for exploring and understanding the meaning individuals or groups ascribe to a social or human problem with the intent of developing a theory or pattern inductively Creswell (2009). Finally, mixed methods approach is an approach in which the researchers emphasize the research problem and use all approaches available to understand the problem Creswell (2003). In general, in light of the discussions above on qualitative, quantitative and mixed research methods, in this study, the quantitative method was predominantly used. However, to have a better insight and gain a richer understanding about the research problem, the quantitative method was supplemented by the qualitative method of inquiry. That is, to get the benefits of a mixed methods approach, as presented earlier, and to alleviate the bias in adopting only either quantitative or qualitative approach, this study was combining both quantitative and qualitative research approaches.

## 3.2 Source of data and data collection methods

There are two types of data sources namely: primary and secondary data sources. Primary data can be obtained through observation or through directly communicating with respondents or through personal interviews while secondary data can be extracted from magazines, reports, publications, etc. The researcher used both secondary and primary data sources. The secondary data was collected from the audited financial statement of each manufacturing share company between the years 2007-2019, since this time period can provide the recent financial position of those manufacturing share companies and also it enhances the easiness of data collection. Board related information was collected through questionnaires.

### 3.3 Population of the study and sampling design

The general objective of this study was examining the effect of corporate governance on the financial performance of manufacturing share companies doing their business in adama city administration. The target populations of the study are those manufacturing share companies which operate in Adama city administration. As per the data obtained from ERCA Adama branch, currently in 2020, there are 5 manufacturing share companies providing production activities for their users. For this study, the researcher used census survey. A complete enumeration of all the items in the ‘population’ is known as a census inquiry. It can be presumed that in such an inquiry, when all items are covered, no element of chance is left and the highest accuracy is obtained Kothari (2004).

### 3.4 Variables of the study and their measurement

Variables that were used in this study are classified into three categories. Namely: independent variables, dependent variable and control variable. Independent variable is that variable which is the predecessor to the dependent variables. Dependent variable is the effect variable that is expected to be influenced by cause (independent) variables. Independent variables that are not related to the purpose of the study, but may affect the dependent variable are known as extraneous variables (Kothari, 2004). Thus, the researchers need to lessen the impact of these variables. Accordingly, in this study, the control variable was selected based on previous empirical studies and fundamental corporate governance theories. The brief definition and their measurement were discussed below.

#### 3.4.1 Corporate governance variables (Independent variables)

**Board size:** Board size is the number of board members for the manufacturing share companies during the period under study.

**Boards’ business management experience:** The boards’ business management experience is measured by the number of board of directors having the managerial experience in each study year.

**Audit committee size:** Measured by the total number of audit committee members in each manufacturing share company.

**Ownership concentration:** is the concentration of shares by few shareholders. This can be measured as the percentage of shares held by the top ten shareholders out of the total shares outstanding.

### 3.4.2 Firms' performance variable (Dependent variable)

According to Haniffa & Hudaib (2006), there is no single agreed upon proxy on which financial performance can be measured. They argued that there is no agreement in the literature on which measure is the best indicator of financial performance. Additionally, they state that every measure has its own strengths and weaknesses; thus, there is no specific measure to be the best proxy for financial performance. Financial performance of firms can be observed from two measurement basis. These are market based and accounting based measures. Accounting based measures consider the current company's financial performance while market-based measures deal with long term financial performance.

The two mostly known proxies of firms' financial performance under accounting-based measure are ROA & ROE. From the perspective of shareholders, ROE is considered to be the most crucial ratio to measure corporate performance because it focuses on the returns of the shareholders. Due to the absence of a secondary market in Ethiopia, the researcher has selected the accounting-based measure as proxies for corporate performance and ignores the market based measurement. Market based measures like Tobin's Q needs current market price of stock and other market-based information. Since there is no secondary market in Ethiopia, it is impossible to use Tobin's Q as well as other market-based measures. ROE tends to tell us how effectively an organization is taking advantage of its base of equity, or capital Hannagan (2008). The researcher has preferred ROE for the following reasons.

ROE has gained popularity for several reasons and has become the preferred measure at huge (giant) companies. One larger reason for the growing popularity of ROE is simply, that it is not asset-dependent. ROE can be applied to any line of business or any product. ROE, on the other hand, looks at how effectively any business is using shareholders' equity. Many observers prefer ROE, since equity represents the owners' interest in the business. ROE is also Warren Buffet's favorite measure of performance (www.experian.com). On the other hand, one of the most crucial profitability metrics is Return on Equity. ROE compares one firm against its peers. With ROE, it measures performance and generally the higher the better. For this reason, ROE is best used to compare companies in the same industry. This performance ratio concentrates on past firms' performance to gauge the future expectations. The formula for Return on Equity is: Net profit/Average shareholder equity (Total owners' equity) for period = Return on Equity

### 3.4.3 Control variable

**Firm age:** It is the number of years the firm has been in existence or in operation since its origination as a firm. Performance can also be influenced by the age of the firms. Older firms are likely to achieve greater efficiency by reducing costs than younger firms. The variable of age is defined here as the natural logarithm of years the firm is on the market.

### 3.4.4 Lists of variables and measurement basis

**Table 2: Lists of Variables and Measurement Basis**

| Description of Variables | Measurement basis | Representation |
|---|---|---|
| **Firm Performance Variable** | | |
| Return on Equity (ROE) | Net profit/Total owner's equity | ROE |
| **Independent Variables** | | |
| Board Size | Total number of board members during each period under study. | BS |
| Boards' Business management Experience | Measured by the total number of boards having business management experience in each study year. | BBME |
| Audit Committee size | Measured by the total number of Audit committee members in each period under study. | ACZ |
| Ownership Concentration | Measured as the percentage of shares held by the top ten shareholders out of the total shares outstanding. | OWSHCON |
| **Control Variable** | | |
| Age of manufacturing share companies | Total number of years the firm being in existence. | AMSHC |

***Source:*** *researcher's own calculation*

### 3.5 Model specification

The empirical model for the study to find out the effect of corporate governance practices on the financial performance of manufacturing share companies was as follows:

$$ROE_{it} = \beta 0 + \beta 1a\,(BS_{it}) + \beta 1b\,(BBME_{it}) + \beta 1c\,(ACZ_{it}) + \beta 1d\,(OWSHCON_{it}) + \beta 1e\,(AMSHC_{it}) + \mu_{it}$$

Where: i = cross sectional dimension t = time- series dimension $\beta 0$ = intercept *BS* = Board size
BBME = Boards Business Management Experience ACZ = Audit Committee Size
OWSHCON = Ownership Concentration
AMSHC = Age of Manufacturing Share companies. $\mu$ = Error Term

**3.6 Methods of data analysis**

The data collected through the aforementioned tools were analyzed with correlation and multiple panel linear regression methods. A multiple panel linear regression analysis was used to test the hypothesis and to explain the relationship between corporate governance variables and financial performance measure by controlling the influence of manufacturing share companies' age. Qualitative analysis was used for the qualitative data collected through the questionnaire. The variables were selected based on alternative theories, agency, resource dependency and stewardship and previous empirical studies related to corporate governance and firm performance.

**4.0 Result and Discussion**

The main objective of this study was to investigate the impact of corporate governance practices on firms' financial performance. Therefore, this section presents descriptive statistics, correlation among variables and regression results.

**4.1 Correlation analysis**

This part of the study is concerned with the correlation analysis of the study variables. The purpose of undertaking correlation analysis is to confirm whether there is a multicollinearity problem in the model and to indicate whether the variables move together or not in the same direction and the correlation coefficient indicates the strength of a linear relationship between two variables. The correlation coefficient varies from -1 to +1, -1 shows a perfect negative correlation, and +1 indicates perfect positive correlation. If the correlation is zero, the movements of the variables are said to have no correlation.

Table 3 below has the correlation matrix showing the association of the dependent variable, ROE with independent variables of board size, boards' business management experience, audit committee size, ownership concentration and age of the manufacturing share companies doing their business in Adama, Ethiopia.

**Table 3: Correlation Analysis of ROE and Corporate Governance Attributes**

| | ROE | BS | BBME | ACZ | OWSHCON | AMSHC |
|---|---|---|---|---|---|---|
| ROE | 1.0000 | | | | | |
| BS | 0.3328 | 1.0000 | | | | |
| BBME | 0.4023 | 0.2245 | 1.0000 | | | |
| ACZ | -0.0393 | 0.3009 | 0.1797 | 1.0000 | | |
| OWSHCON | 0.2520 | 0.0602 | -0.0179 | 0.1099 | 1.0000 | |
| AMSHC | 0.0481 | -0.1596 | 0.2339 | 0.1594 | 0.0300 | 1.0000 |

In this study, Return on Equity is the dependent variable. Change in the number of the board of directors has a moderate positive significant association with the dependent variable (ROE). This implies that an increase in the number of directors may result in a high profitability ratio as measured by ROE. ROE also has a moderate positive significant correlation with BBME. This means that the higher the number of boards having business management experience, the higher will be the ROE. On the other hand, audit committee size has a negative, very weak significant correlation with return on equity. This means that although there is weak correlation, it has a significant effect on the dependent variable (ROE).

Ownership concentration also has a reasonable positive significant correlation with return on equity. The other correlation explanation is related with the correlation of explanatory variables. As per the above table 3, boards' business management experience and audit committee size has a moderate positive correlation with the number of board of directors. Ownership concentration has a very weak positive correlation with the number of board of directors. Company age also has a weak negative correlation with the number of board of directors. Audit committee size has a moderate positive association with the boards' business management experience. Ownership concentration has a very weak negative correlation with the boards' business management experience. Age of manufacturing share companies have a moderate positive association with the boards' business management experience. Ownership concentration has a very weak positive association with audit committee size and also the age of manufacturing share companies has a weak positive relationship with the audit committee size. Lastly, the age of manufacturing share companies has a very weak positive relationship with ownership concentration. Eventually, as noted in Gujarati (2004), the association between explanatory variables can be tolerated up to 0.80. If it exceeds this limit, multicollinearity is a potential problem. Generally, the researcher has concluded that the associations among explanatory variables are not sufficiently high to bias the results.

### 4.2 Estimation method

This study employs a longitudinal data that combines observation on a cross-section of units over time. Longitudinal data approach has several benefits over time series and cross- sectional data separately. For instance, panel data permits control for individual heterogeneity. We can also analyze the change over time by using longitudinal data. Panel data gives: more informative data, less collinearity among the variables, more degree of freedom and more efficiency. The general form of the model can be stated as follows:

$$Y\,it = \beta 0 + \beta Xit + \mu_{it}$$

Here $\mu_{it}$ is a random term expressed as μit = *αi* + εit, where *αi* is individual - specific effect or cross –section error component and εit, is the combined cross-section and time series error component. Besides this general model, the selection of estimation methods whether fixed effect or random effect model, is based on the underlying assumption. In a fixed effect model, the company specific effect (*αi)* is a fixed and correlated with *Xit* while εit is uncorrelated with *Xit.* Each cross-sectional unit has its own intercept (*αi).* In contrast, in a random effect model, *αi* and εit are random and uncorrelated with *Xit*. The firms have a common intercept mean value and *αi* stands for the random deviation of individual intercept from its mean value. Moreover, *αi* represents any unobservable firm-specific effect that is not included in the regression model and εit accounts for the remaining disturbance in the regression, which varies within individual firm and time Cameron & Trivedi (2009). Taking this into consideration, in selecting between the fixed and random model, Hausman test under the null hypothesis that individual effects are random at 5% significant level was used.

### 4.3 Diagnostic Test

In classical Linear Regression model, multiple regressions are subject to the following major assumptions, namely mean value disturbance, multicollinearity, heteroscedasticity, normal distribution of residuals, autocorrelation and model misspecification. As a result, the researcher tests these six assumptions whether they are met or not in the model.

#### 4.3.1 Assumption one: The errors have zero mean (E (ε) = 0)

As per Classical Linear Regression Model, the mean value of disturbance term is zero. This means that the assumed value of the random disturbance term is 0. If a constant term is included in the regression equation, the above assumption will never be violated Brooks (2008). Conversely, if the regression model did not include an intercept and the mean value is different from zero so that severe bias in the slope coefficient estimates. In this study, since the regression model included a constant term, there is no problem concerning this assumption.

### 4.3.2 Assumption two: Multicollinearity

HO: multicollinearity is not a serious problem for the model

H1: multicollinearity is a serious problem for the model

Multicollinearity in the regression model suggests substantial correlations among independent variables. This phenomenon introduces a problem because the estimates of the sample parameters become inefficient and entail large standard errors, which make the coefficient values and signs unreliable. The degree of multicollinearity among variables is measured based on variance inflation factors (VIF) suggested in the rule of –thumb. As per this usual threshold, if the variance inflation factor on each variable is less than ten (10) and 1/VIF exceeds 0.1, multicollinearity is not a serious problem. As is shown in the table 4 below, the VIF for all variables is significantly less than 10 and the 1/VIF is significantly exceeds 0.1. Thus, the null hypothesis is not rejected, which is multicollinearity is not a serious problem in the model.

**Table 4: Degree of Multicollinearity for ROE**

| Variable | VIF | 1/VIF |
|---|---|---|
| BS | 1.14 | 0.878289 |
| ACZ | 1.13 | 0.887099 |
| BBME | 1.07 | 0.933916 |
| OWSHCON | 1.02 | 0.985167 |
| **Mean VIF** | **1.09** | |

### 4.3.3 Assumption three: Heteroskedasticity Test-white

HO: heteroskedasticity is not a serious problem for the model

Ha: heteroskedasticity is a serious problem for the model.

The assumption of homoscedasticity states that the variance of error terms should be constant. Homoscedasticity means that the Y populations corresponding to various X values have the same variance Gujarati (2004). There are various testing methods for heteroskedasticity problem. But white's test was used for this study to detect the problem of heteroscedasticity. The method was used to test the developed hypothesis concerning heteroskedasticity test. The null hypothesis is constant variance and the alternative hypothesis is the variance of the error term is not constant. The null hypothesis can be accepted if the p- value is greater than 5% otherwise the alternative hypothesis that describes the occurrence of heteroskedasticity problem.

White's test for HO: homoscedasticity Against Ha: unrestricted heteroskrdasticity

| | | |
|---|---|---|
| Chi2 (14) | = | 19.60 |
| Prob > chi 2 | = | 0.1432 |

***Source:*** *output of STATA version 15, 2020*

Here the p- value of Chi- square of the model is greater than 5% which indicates there is no serious heteroskedasticity problem in the model and therefore the null hypothesis was accepted.

### 4.3.4 Assumption Four: Normality Test

Ho: Disturbance terms are normally distributed

Ha: Disturbance terms are not normally distributed

Normality test is required to conduct hypothesis tests about the model parameters. The study applied tests for normality Shapiro-Wilk W test for normal data that uses the property of a normally distributed random variable. There were two basic hypotheses developed regarding the normality test; null hypothesis and alternative hypothesis tests. Null hypothesis states that disturbance terms are not normally distributed and the alternative hypothesis states that disturbance terms are normally distributed. To test this hypothesis, Shapiro –Wilk W test for normal data was applied. In order to accept the null hypothesis, that disturbance terms are normally distributed, the p-value should be greater than 5% otherwise alternative hypothesis should be accepted.

**Table 5: Shapiro-Wilk W test for Normal Data**

| Variable | Obs | W | V | Z | Prob>z |
|---|---|---|---|---|---|
| Error | 65 | | | | |

### 4.3.5 Assumption five: Autocorrelation test

Ho: autocorrelation is not a serious problem for the model

Ha: autocorrelation is a serious problem for the model

Under the autocorrelation test, the assumption of no autocorrelation between the disturbance terms was tested. The assumption states that the covariance between the error terms over time is zero. Durbin-Watson was used as a test for the model to identify whether the problem exists in the model. According to this test, the value of Durbin-Watson for the model is

### 4.3.6 Assumption six: Model misspecification test

Ho: there is no model misspecification problem Ha: there is a model misspecification problem

An omnibus or information matrix (IM) test is used to diagnose the regression models in response to the specification problem. This method is called a joint test of misspecification. It tests three assumptions of homoscedasticity, skewness and kurtosis jointly. Therefore, if the overall joint IM test is satisfied, the model has no misspecification problem.

White's test for HO: homoscedasticity Against Ha: unrestricted heteroskrdasticity

| | | |
|---|---|---|
| Chi2 (14) | = | 19.60 |
| Prob > chi 2 | = | 0.1432 |

***Source:*** *output of STATA version 15, 2020*

Here the p- value of Chi- square of the model is greater than 5% which indicates there is no serious heteroskedasticity problem in the model and therefore the null hypothesis was accepted.

**Table 6: Cameron and Trivedi's Decomposition of IM-test**

| Source | Ch2 | Df | p-value |
|---|---|---|---|
| Heteroskedasticity | 19.60 | 14 | 0.1432 |
| Skewness | 10.06 | 4 | 0.0395 |
| Kurtosis | 0.08 | 1 | 0.7744 |
| Total | 29.74 | 19 | 0.0552 |

Here, P- values in the all rows above in the model is insignificant, p (-value is 0.55 or 5.5%). As a result, the research accepted the null hypothesis that there is no model misspecification problem. Generally, the assumption is satisfied and the researcher then concluded that models have no specification problem (Cameron & Trivedi's).

### 4.4 Regression results for the manufacturing share companies performance (ROE)

Depending upon the regression result indicated in table 7 below, the study found out that the estimated result of multiple regression analysis is at a fairly satisfactory level. This can be confirmed by the fact that the R- squared is 33.01% for dependent variable (ROE) see appendix "C".

The value of the Adjusted R-squared for the model showed that the occurrence of good associations between dependent and explanatory variables, where all the explanatory variables can explain collectively about 28.4% of the performance of the manufacturing share companies as measured by ROE. Both the R-squared and the Adjusted R-squared values of the model in this study are found to be good suggesting that it has more explanatory power. Furthermore, for longitudinal data, R-Squared greater than 20% (see appendix "C") is still large enough for unfailing conclusions Cameron & Trivedi (2009).

In general, the $R^2$ results indicate the overall Goodness-of-fit of the models used in this study. The overall reliability and validity of the model was also further enhanced by the fact that the probability values begin by 0.0000 for the model, which shows strong statistical significance. Table 4.6 below, reports the Random- Effect Generalized Least Square (GLS) results for the model obtained by regressing return on equity (ROE) on four independent variables and one controlling variable: board size, boards' business management experience, audit committee size, ownership concentration and age of manufacturing share companies. The model is significant at *Wald chi*2 = 29.08, *DF = 4 p- value <0.0.* The interpretation of each explanatory variable is presented below the table.

**Table 7: Random-effects GLS regression**

| | |
|---|---|
| Random-effects GLS regression | Number of obs = 65 |
| Group Variable: id | Number of groups = 5 |
| R-sq: | Obs per group: |
| Within= 0.2428 | min = 13 |
| Between= 0.8044 | avg = 13.0 |
| Overall= 0.3301 | max = 13 |
| Corr (u_i, x) = 0 (assumed) | Wald chi2 (5) = 29.08 |
| | Prob > chi2 = 0.0000 |

| ROE | Coef. | Std. Err | Z | P>\|z\| | [95% conf. Interval] | |
|---|---|---|---|---|---|---|
| BS | .1129505 | .0428916 | 2.63 | 0.008*** | .028844 | .1970166 |
| BBME | .0762498 | .0235618 | 3.24 | 0.001*** | .0300695 | .12243 |
| ACZ | -.0633747 | .0311034 | -2.04 | 0.042** | -.1243362 | -.0024131 |
| OWSHCON | .4522541 | .1836449 | 2.46 | 0.014*** | .0923167 | .8121915 |
| AMSHC | .0009141 | 0025764 | 0.35 | 0.723 | -.0041354 | .0059637 |
| Constant | -1.210353 | .3659495 | -3.31 | 0.001 | -1.927601 | -.4931053 |

***Note:*** **** represents significant at 1% and ** represents significant at 5%*

**a) Board size and performance of manufacturing share companies**

From the regression table above, the coefficient of board size is positive (.1129505) for the dependent variable (ROE) and this study revealed that there is a positive and statistically significant effect between boards size (BS) and the manufacturing share companies' financial performance as measured by ROE, at less than 1% level of significance. Thus, this indicates that the number of board of directors positively affects the manufacturing share companies' financial performance. In other words, the larger the number of board members for these manufacturing share companies, the higher will be their financial performance as measured by ROE.

This result can be expressed in the direction that an increase in the number of board members by one person is anticipated to increase performance by 11.29% which is an astonishing outcome. The result supports the school of thought that large numbers of boards are more effective in monitoring and controlling manufacturing share companies' management and it also helps to reduce agency costs. The result is also consistent with previous studies which argues that a large board size enhances or improves the board independence. Wondem & Batra (2019); Yameen *et al.*, (2019); Belete (2015) pointed out that a large number of board of directors advance the corporate's performance. Hence, the alternative hypothesis was accepted which is that the board size has a positive and statistically significant effect on firms' performance.

**b) Boards' business management experience and performance of manufacturing share companies**

Boards' business management experience has a positive coefficient (0.0762498) and it is statistically significant at (0.001) at 1% level of significance in terms of explaining the variation on performance as measured by return on equity, inferring that having number of boards with a proper level of business management experience would have a positive influence for the manufacturing share company's financial performance as measured by ROE. On the other hand, the results of this study also revealed that an increase in the number of boards having business management experience can lift up the financial performance of manufacturing share companies operating in Adama. This result can also be stated in the way that an increase in the number of boards having business management experience by one person is anticipated to increase performance by 7.62% which is also an interesting output. This result supports the resource dependency theory which argues on the contribution of directors that the board of directors could be used as a mechanism to form relations with the external environment in order to support the management in the attainment of organizational goals. According to this theory, 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.

As a result, the researcher failed to reject the alternative hypothesis. According to Melkamu (2016), Mitiku (2015) and Nurhussen (2018), manufacturing share companies are operating in an industry characterized by severe competition, dealing with the needs and requirements of the customer, requires in-depth knowledge in terms of production cost, market creation for the output, financial feasibility, business proposals and other relevant and necessary business management skills. These researchers have suggested that unless a board of directors of these manufacturing share companies have the appropriate level of business management experience, it might be problematic for them to run a well performing manufacturing share company and discharge their fiduciary, strategic, supervisory and management responsibilities Clarkson, *et al*, *(*1997) as cited by Melkamu (2016). This result was also similar with the above studies.

**c) Audit committee size and performance of manufacturing share companies**

Audit committee size has a negative coefficient (-0.0633747) and it is statistically significant (0.042) at 5% level of significance in terms of explaining the variation on financial performance as measured by ROE. Therefore, this indicates that the size of the audit committee negatively affects the manufacturing share companies' financial performance. In other words, the larger the number of audit committee for these manufacturing share companies, the lower will be their financial performance as measured by ROE. This result also revealed that the increment of audit committee members by one individual will push down the financial performance of manufacturing share companies performing in Adama, Ethiopia by 6.34%.

The result was consistent with studies conducted previously Yamen *et al.*, (2019), Ferede (2012) and Arora (2012). They pointed out that the size of the audit committee negatively influences firms' performance. This study result supports the notion that a certain minimum number of audit committees can enhance the financial performance of firms. As a result, the outcome of this variable is in line with the alternate hypothesis, when financial performance is measured by return on equity.

**d) Ownership concentration and performance of manufacturing share companies**

Ownership concentration has a positive coefficient (0.4522541) and it is statistically significant (0.014) at 1% level of significance, in terms of explaining the variation on performance as measured by ROE, indicating that having ownership concentration would have a positive contribution for the performance of manufacturing share companies as measured by ROE. This result also reveals that the existence of ownership concentration will improve the financial performance of Adama manufacturing share companies by 45.23%. This result supports the agency theory; that occurrence of key shareholders is crucial, because they tend to actively participate themselves in tighter activities, which would result in a more efficient governance structure, leading to an essential value for shareholders. In other words, if the shareholding is diffused, it becomes too costly for such a shareholder to monitor the firm's activities closely and creates the chance for managers to maximize their needs. That means, the more the ownership structure is dispersed, the more the agency costs are higher. This supports the assumption that concentration brings motivation to control the opportunistic behavior of managers and it rejects the assumption of expropriation of minority shareholders by influential shareholders. This result was consistent with Nurhussen (2018); Kibrysfaw (2013) and Wu (2009). Thus, the alternative hypothesis was accepted which is that the ownership concentration has a positive significant effect on the manufacturing share company's financial performance.

**e) Control variable (Manufacturing Share companies Age)**

This control variable was measured by the number of years of being in existence. The age of the firm has a positive coefficient of (0.0009141) and a statistically insignificant relationship with the financial performance of manufacturing share companies operating in Adama city. This means that as the age of the company increases, the return on equity of the company increases by 0.091%.

## 5.0 Conclusions

According to this study, all the corporate governance attributes affect the financial performance of manufacturing share companies. Depending on the results of the descriptive statistics, correlation and regression analysis, the researcher made the following conclusions. The manufacturing share companies' board is characterized by the existence of a mean of 8 board members and has a moderate positive significant correlation with the dependent variable (ROE). As per regression result of this study, size of the board has a significant positive effect on firms' financial performance as measured by ROE. This is because large numbers of boards give greater monitoring, increase boards' independence and effectiveness in monitoring and controlling the manufacturing share companies' management and it helps to reduce agency costs, henceforth, the corporate performance increases. Therefore, manufacturing companies have to raise their board size.

Depending upon descriptive statistics, the number of boards' having business experience was 4 and the effects of boards' business management experience on firms' financial performance as measured by ROE was positive and significant. This is acceptable by the fact that manufacturing share companies are doing their business in an industry characterized by severe competition, dealing with the needs and requirements of the customer, requires in-depth knowledge in terms of production cost, market creation for the output, financial feasibility, business proposals and other relevant and necessary business management skills. Therefore, boards of directors of manufacturing share companies should be enriched with a required level of business management skill in order to run well performing manufacturing share companies. As a result, it is essential for a board of directors to have business management experience.

The study revealed that the audit committee size had a significant and negative effect on the manufacturing share companies' financial performance operating in Adama, Ethiopia. Thus, a small size audit committee is effective in improving the financial performance of manufacturing share companies. Regarding ownership concentration, 71.21% of the companies are owned by the top ten and below shareholders and it has a moderate positive significant correlation with the dependent variable (ROE). Ownership concentration has a positive and statistically significant effect on the financial performance of the manufacturing share companies as measured by ROE. The existence of key shareholders is useful, because they tend to keenly include themselves in more tighter monitoring activities, which would result in a more efficient governance structure leading to an important value for shareholders. Therefore, it is better for these manufacturing share companies to have a higher ownership concentration.

The mean value of manufacturing share companies' age in Adama was 31.6 with a very weak positive insignificant correlation with return on equity. Hence, as the companies' age increases, companies become more experienced in reducing some costs like production costs, improving product's quality, increasing knowhow of reducing risks, etc. So, it is better to say that companies are better in the market to appreciate the benefits created as the age of companies' increases. In general, the outcome recommends that manufacturing share companies operating in Adama city with effective corporate governance arms improve financial performance which is measured by return on equity.

**6.0 Managerial Implications**

The main purpose of this study was examining the effects of corporate governance on firms' financial performance in Adama. Depending upon the findings and conclusions reached, the researcher has the following fruitful recommendations.

- As per the findings of this study, in Adama, the manufacturing share companies' board of directors play a critical role in increasing the firms' financial performance. So if shareholders give due considerations to the director's experience during their nomination for approval, they further allow their company to perform better.
- Manufacturing share companies are better to nominate a board of directors with better managerial skill. A board of directors who have business management experience should be assigned in a committee based on their industry experience that makes them contribute more in encouraging good governance.
- Manufacturing share companies are better to minimize the size of the audit committee to boost up the firms' financial performance as measured by ROE.
- Manufacturing share companies are better to have ownership concentration for the attractive involvement of shareholders on management activities by pre-determining the number and percentage of ownership of shareholders on memorandum of association by the founders of the company.

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