

# **EFFECTS OF CHIEF EXECUTIVE OFFICERS' CHARACTERISTICS ON THE FINANCIAL PERFORMANCE OF FIRMS LISTED AT THE NAIROBI SECURITIES EXCHANGE**

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## **Abstract**

*The purpose of this study was to determine the effects of CEO characteristics on the performance of firms listed at the Nairobi Securities Exchange. This study adopted an explanatory research design with the target population being all firms listed at the Nairobi Securities Exchange (NSE). The data for all the variables in the study was extracted from published annual reports and financial statements of the listed companies at the NSE covering the years 2008 to 2014. The data was obtained from the NSE hand books for the period of reference. Multiple regression analysis technique was used to determine the effect of independent variables on the dependent variable. The study findings indicated CEO age and CEO education had positive and significant effect on firm performance. The study concludes that with better knowledge of company will get thus increased firm performance. CEO age diversity has the potential to improve firm performance. CEOs with a broad functional and educational background are at a better chance of improving performance. There is need to diversify the management so as to benefit from the skills of the young. Further, those in management level should at least be holders of a degree at worst and a Masters' degree at best.*

*Keywords: CEO's characteristics, Demographics, Firm Performance, Diversity, Kenya*

## INTRODUCTION

Competition within the global business environment has continued to get intense and complex thereby increasing the scramble for more resources. The numerous and growing challenges which businesses face, particularly in the area of operations ,cost-cutting and production efficiency makes the need to examine how CEO characteristics could be beneficial for firm performance very relevant. Interest in CEO characteristics and firm performance has gained impetus in recent times from the assumption that CEOs have a strategic role to play in the performance of a firm given the symbolic power that they exercise on decision making and key operations of a firm (Ofa Hosea Ayaba, 2012). While top management team members may contribute through their individual task and teamwork to the strategic direction and achievement of the overall goal of a firm, the CEO is however looked upon as the final individual to give a go ahead and make decisions which are crucial to the vision and the strategic direction of the firm (Alice et al., 2000). In the daily planning, innovation, cost reduction and strategic direction of an organization, CEOs act as a filtering mechanism or mirror image through which their own cognitive behavior and values influence the way they perceive and interpret data (Daellenbach et al., 2009).

In line with this literature, recent empirical evidence suggests that CEO-specific characteristics indeed influence firms' performance (Berger et al, 1997, Graham and Harvey, 2001, Bertrand and Schoar, 2003). Most dynamic capital structure models that attempt to (as argued by Hennessy and Whited, 2005) provide tighter connections between theory and empirics, however, either assume the CEO behaves in the interests of value-maximizing shareholders or that all agents, including the CEO, are risk-neutral. Therefore, the effects on firms of CEO-specific characteristics such as ability and risk aversion, and agency conflicts between undiversified CEOs and well-diversified outside investors, have yet to be fully explored in dynamic settings. According to Bulent and Cuneyt and Arif (2013) most studies have given much attention on the developed countries, such as United States, leaving a gap in the existing literature on the CEO characteristics on firm performance in emerging economies such as Kenya.

### Statement of the Problem

With the increasing trend of sudden corporate failure in both global and local context, shareholders and other stakeholders are increasingly becoming more concerned of the financial performance of their firms (Omondi and Muturi, 2013). However, despite impressive performance at the Nairobi Securities Exchange, a number of problems relating to the way companies are controlled and directed have been identified. These problems range from errors,

mistakes to outright fraud. The origins of these problems range from concentrated ownership, weak incentives, and poor protection of minority shareholders to weak information standards (Ongore and K'Obonyo, 2011). With such an environment in the background, together with weak judicial system, the interest of both the minority shareholders could be compromised and managed to be skewed towards the interest of such block shareholders. Consequently, performance of such firms might be compromised. This situation is worsened by the fact that limited research has been done on the effect of CEO characteristics on performance of listed companies especially in the developing countries

Selecting a new CEO is among the most delicate decisions a board of directors will ever face. The selection process is exposed to so many unknowns: personality, integrity, technical skills, and experience. In spite of a general agreement that CEOs influence firm's performance in some specific way due to their heterogeneous talents and skills for example (Gabaix *et al.*, 2008; Bennedsen *et al.*, 2008), theorist and scholars remain divided and have provided little evidence to support which CEO behavioral characteristics, educational background or CEO attributes are essential for firm performance. This leaves us with the question of which characteristics of the CEO really matters to enhance firm performance given today's challenges in the business world. Thus this study hypothesized that;

*H<sub>01</sub>: There is no significant effect of CEO age on Financial Performance (Return on assets) of Companies listed at Nairobi Securities Exchange.*

*H<sub>02</sub>: There is no significant effect of CEO education on Financial Performance (Return on assets) of Companies listed at Nairobi Securities Exchange.*

## **EMPIRICAL REVIEW**

### **Effect of CEO Age on the Financial Performance**

Recent research suggests that CEO personal characteristics impact corporate policies. For instance, personal life experiences, CEO age shape a CEO's financing decisions and attitudes towards risk hence improved firm performance (Malmendier and Nagel (2011); Malmendier, Tate, and Yan (2011); Cronqvist, Makhija, and Yonker (2012)). Yet, although CEO age is readily observable, there is surprisingly little evidence on how a CEO's age affects the CEO's corporate risk-taking behavior.

Prior theoretical work predicts that a CEO's age impacts his/her risk preferences and risk-taking behavior, but predictions are mixed. Specifically, models incorporating career concerns predict that younger CEOs are more risk-averse because they do not yet have reputations as high quality managers hence improved firm performance (Holmstrom, 1999). As such, younger CEOs can be punished more harshly for poor performance through markedly

reduced future career opportunities, which can induce them to adopt more conservative investment policies.

A field study was conducted by Wegge *et al.*, (2008) and find that age heterogeneity improved the ability of CEO to solve tasks with high complexity such as issues of debt and equity financing. For groups working on simple tasks, however, age heterogeneity increased the number of self-reported health problems - which in turn indicates that board of diverse ages should be utilized particularly for innovation or solving complex problems.

Age diversity has the potential to enhance board performance, because directors of different ages will, to some extent, have different backgrounds, skills, experiences and social networks. Several examples of the benefits of a more age diverse board of directors come to the authors' minds. For example, different age groups have varied access to information and expertise about capital structure of a firm (Dagsson *et al.*, 2010).

Today's younger generations have grown up with computers and Internet at home, and may be better informed and more experienced on the subject of online business and better ideas on debt and equity financing. The older generation may, however, be more experienced dealing with the business offline, as they have greater experience in this field through their career. Today more and more businesses have both online and offline services, so experience of both types of business is of importance to many firms. Carter *et al.*, (2010) state this clearly when they argue that "diversity holds the potential to improve the information provided by the board to managers due to the unique information held by diverse directors."

The only empirical study of the relationship between age diversity on the board of directors and firm capital structure is McIntyre *et al.*, (2007). Their review of relevant literature on the role and function of the board particularly notes the increasing use of organizational behavior theory to predict board function and improve board processes. From this they argue that governance research should concentrate on creating and testing a theoretically sound model of Board effectiveness, rather than trying to relate team attribute variables to firm performance and capital structure. McIntyre *et al.*, (2007) hypothesizes that a firm's capital structure management will be lower in the case of low or high variation in the ages of directors than in the case of moderate variation, and that better management will also increase with the average age of directors.

### **Effects of CEO Education on Financial Performance**

Frydman, Carola, 2006 in their study found that CEOs who had a technical educational background operations, Research & development devoted more time and spending in

innovation hence improved firm performance. However, they also pointed out that firms were more likely to cut spending in R&D when profitability levels were low.

Daniel, (2002) argues that firms managed by CEOs with educational background in operations related subjects and those with technical education, experienced better technological initiatives than firms headed by CEOs with a support function like finance and accounting hence improved firm performance . His study also found evidence to support that, there existed a positive relationship between firm profitability (ROA) and educational background in scientific fields that enhance innovation. Notably amongst their findings was that firms with low performance (ROA) invested considerably low in R&D compared to their competitors. They however failed to say if this poor performance was caused by a low R&D in previous years, or the low research and development was caused by poor performance in previous years (Daellenbach *et al.*, 1999).

Daellenbach *et al.* (1999) therefore argued that a better understanding of a firm's vision and strategic direction could be easily assessed using a thorough analysis of the educational background of the CEO and the top management teams. Daellenbach *et al.* (1999) concluded that firms should concentrate on the selection of top management in operations and technical experience if their core strategy for competition was innovation in product development.

Koyuncu *et al.* (2010), examine the role CEO educational background has on firm performance based on a sample of 437 CEOs of firms selected from S&P 500, from 1992-2005. The results of their study showed evidence in support of the hypothesis that firms managed by a CEO with an educational background in operation related subjects such as engineering had better firm performance than firms headed by CEOs with other functional background. In addition, the results of the study also showed evidence to support that firms which were experiencing low performance were more likely to recruit a CEO with a background in operations than those with a background in marketing, finance, law or accounting. Also firms managed by CEOs with a functional background in operations were more likely to experience higher post succession performance firm performance after three years of holding the position of CEO) than other firms with CEOs with a non-operations background.

Buyl *et al.* (2011) compares the performance of firms who were headed by CEO generalist CEO with multifunctional background to a CEO who had a specialized knowledge in marketing. They based their study on 54 firms in the IT industry in Belgium and Germany. Results of the study showed evidence to support the claim that firms with a CEO who has a marketing background out performed firms headed by a CEO who had a generalist background.

Buyl *et al.* (2011) argued that this success recorded by firms managed by CEOs with a marketing background, was because a marketing specialist was able to coordinate,

communicate, and exchange ideas with other members of the top management teams and lower line manager effectively than a CEO generalists.

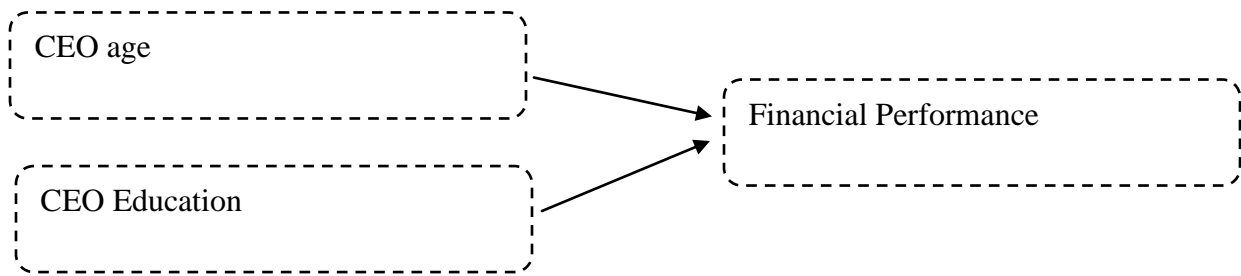
Aaron *et al.* (2010) investigate if the educational background of the CEO had any influence on firm performance. They found no evidence in support that firms managed by a CEO who has an MBA had better performance than firms headed by CEOs who hold a liberal arts degree, or a law degree. The study also failed to show any evidence for the hypothesis that firm headed by CEOs with a postgraduate degree had better performance than firms managed by CEOs with a bachelor or undergraduate degree. Barker & Muller (2002) study the impact of CEO educational background and firm spending on research and development. Findings from

Barker & Muller (2002) provided evidence that, there was no relationship between CEO educational backgrounds and spending on research and development. However, there was a positive relationship between CEOs who had a postgraduate degree in technical and scientific background to research and development spending.

Warren *et al.* (2005) are of the suggestion that it would be very important for firms to link the CEO educational background to the strategy of the firm. Warren *et al.* (2005) suggests that the educational background and experience of the CEO is often reflected on firm strategy through the way the CEO cognitive attitude and interpretation of events in the business environment. Berkeley *et al.* (1991) argue that firms managed by a CEO with a broad functional and educational background had better chances of improving their performance than those that were headed by CEO who had a specialist's knowledge. They based their arguments on the grounds that a CEO with a broad functional background could bring broad and new ideas, thereby opening a new page for the company.

Warren *et al.* (2005) studies based on a sample of 282 firms indicate that firms managed by CEOs with extensive functional and executive background had higher level of firm performance (ROA). The results of their study also indicated that it would be important to take into consideration the quality of the functional and educational experience, when this experience was gained, at what level this experience was gained and the intensity associated in the process the experience was gained.

Based on view of different scholars from the above empirical review, the conceptual framework was therefore be based on two independent variables. Namely CEO Age, the significance of age as a contingency is as follows. As a CEO's age increases, the intellectual capabilities of the executive are enhanced due to the knowledge and experience gained from the position as well as the attainment of education and one dependent variable as shown diagrammatically illustrating the conceptualized relationship between the independent, and dependent variables.



## METHODOLOGY

This study adopted an explanatory research design to analyze the effect of CEO characteristics on performance of firms listed at the Nairobi Securities Exchange in Kenya. Explanatory research sought to establish causal relationship between variables (Saunders et al., 2009). This study therefore used explanatory design seeking to establish the relationship between CEO characteristics and firm financial performance.

In this study the target population comprised of all firms listed at the Nairobi Securities Exchange (NSE). The NSE had 61 firms as at August 10, 2014. In this study the population of interest was the firms quoted at the Nairobi securities exchange, and a census of all firms listed at the Nairobi Securities Exchange from year 2008-2013 was the sample. The data for all the variables in the study was extracted from published annual reports and financial statements of the listed companies at the NSE covering the years 2008 to 2014. The data was obtained from the NSE hand books for the period of reference. Data extracted included the income statement, statement of financial position, and notes to the accounts using a document review guide. Secondary data was obtained from the published annual reports and financial statements of the listed companies at the NSE covering the years 2008 to 2014.

Multiple regression analysis technique was used to determine the effect of independent variables on the dependent variable, The following reduced multiple linear regressions model was used to model the data:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \varepsilon$$

Where;

Y = Firm performance

$\alpha$  = the y-intercept (constant) whose influence on the model is insignificant

$\beta_1 \dots \beta_3$  = the slope which represents the degree with which firm performance changes as the independent variable changes by one unit variable.

$X_1$  = CEO age

$X_2$  = CEO education

$\varepsilon$  = error component

## ANALYSIS AND RESULTS

### Descriptive and Correlation Statistics

Study findings in table 1 illustrated the results in all the sectors. Results in table 4.10 revealed that the average CEO age in all the sectors was 51 years (mean = 51.997). CEO gender mean ratio was 1.2007. In all sectors the CEOs had a Master's degree (mean = 5.2587). Additionally, CEO tenure was 2 years (mean = 2.7108).

Table 1. Descriptive and Correlation Statistics

	Mean	Std. Deviation	Firm performance	CEO age	CEO education
Firm performance	0.111	0.10295	1		
CEO age	11.997	6.27248	.310**	1	
CEO education	5.2587	2.8598	.304**	-0.098	1

\*\* Correlation is significant at the 0.01 level (2-tailed).

\* Correlation is significant at the 0.05 level (2-tailed).

From the results, CEO age was shown to contribute 31% of the change in firm performance as indicated by the correlation coefficient value of 0.310 which is significant at  $\alpha = 0.01$ . CEO education had a positive and significant correlation with firm performance as evidenced by correlation coefficient value of 0.304 (significant at  $\alpha = 0.01$ ).

### Regression Analysis (Hypothesis testing)

The regression analysis revealed that CEO age and CEO education explained 45.3% variation of firm performance. This showed that considering the independent variables, there is a probability of firm performance (R squared = 0.453). The Durbin Watson value of 1.743 was within the thumb rule of 2 thus no autocorrelation. Study results in table 2 revealed that F value 57.86, with p value = 0.000 significant at 0.05, this implies that the joint prediction of CEO age, CEO gender, CEO tenure and CEO education is significant. This shows that the model can be used in future to predict firm performance.

The regression results presented in Table 2 highlights the direct effect. From the table, CEO age showed a positive and significant effect on firm performance ( $\beta = 0.331$ ,  $p < 0.05$ ). Specifically an increase in CEO age by 0.331 units, leads to an increase in firm performance by the same unit. Further support to the study findings is by Wegge et al., (2008) who finds that age heterogeneity improved the ability of CEO to solve tasks with high complexity such as issues of debt and equity financing. Despite the experience that comes with age, it is



important to have age diversity. As such, Carter et al., (2010) argues that diversity holds the potential to improve the information provided by the board to managers due to the unique information held by diverse directors.

CEO education showed a positive and significant effect on firm performance ( $\beta = -0.172$ ,  $p < 0.05$ ). Consequently, an increase in CEO education by 0.172 units leads to a decrease in firm performance by the same unit. In line with the results, Leland, (2001) infers that CEO tenure is positively associated with firm financial performance since CEOs that have managed to enjoy long periods of tenure have been able to do so because of their tremendous performance (Leland, 2001). In a similar vein, Farrel, (2003) posits that long CEO tenure makes them overconfident and complacent subordinates become reluctant to challenge anything which could influence their CEO characteristics decision making skills thus increased firm performance. However, Graham, (2008) found that there is a negative relation between CEO tenure and firm performance. Also, Myers, (2001) showed a negative relationship between executive firm tenure and CEO characteristics.

Table 2. Regression Analysis (hypothesis testing)

	Unstandardized		Standardized Coefficients	Collinearity Statistics			
	Coefficients	Std. Error		Beta	T	Sig.	Tolerance
(Constant)	-9.894	2.048		-4.831	0.000		
CEO Age	0.259	0.035	0.331	7.351	0.000	0.968	1.033
CEO Education	0.287	0.098	0.172	2.928	0.004	0.825	1.212
R Square	0.453						
Adjusted R Square	0.446						
Durbin-Watson	1.743						
F	57.86						
Sig.	0.000						

a Dependent Variable: Firm Performance

## CONCLUSION AND RECOMMENDATIONS

The study has established that there is a significant relationship between the age of the managers and the capital structure. The results also indicate that majority of the managers are of a mature age as they are tasked with making important decisions. In this context, younger CEOs are more risk-averse since they lack the experience. However, a board with age diversity

has the potential to improve firm performance since individuals of different ages bring a variety of skills, experiences and social networks.

Further, the education level of CEOs has a significant effect on firm performance. The study has established that the CEOs are majorly Masters Holders hence they are well educated and open to new experiences. Also, the CEOs have the capability to choose the best financial instruments and thereby maximize firm value. Therefore, CEOs with a broad functional and educational background are at a better chance of improving performance.

The study has established that the CEOs age has a positive and significant effect on firm performance. Since majority of the CEOs were old, there is need to diversify the management so as to benefit from the skills of the young. There is due to the fact that age diversity enables the firm to benefit from individuals from different backgrounds who have a wide array of skills, experiences and social networks.

Also, the level of education of the CEO has an influence on firm performance. It is therefore important for firms to be managed by CEOs with a broad functional and educational background than those with a specialist's knowledge. It is also important for CEO to have experience in operations related subjects and those with technical education. Further, those in management level should at least be holders of a degree at worst and a Masters' degree at best.

This study sought to investigate effect of chief executive characteristic and firm performance among firms listed in Nairobi Security Exchange. The study however concentrated on only the firms listed at the Nairobi Securities Exchange. This study therefore recommends that in the future a similar study be conducted across all firms in the country so as to generalize the findings. The study also recommends that in the future a study be conducted on the effects of the organization culture on firm financial performance. This will enable the organizations establish how their culture contributes to the performance of the firm and thus make changes accordingly.

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