

**CORPORATE GOVERNANCE, FINANCIAL RISK MANAGEMENT AND SUSTAINABILITY
OF MFIs IN UGANDA: A CASE OF JINJA MUNICIPAL COUNCIL**

**1 Alex Irumba, 2 Peter Bakaaki, 3 Dr Arinaitwe Julius, 4 Dr Ariyo Gracious
Kazaara**

1, 2, 3, 4 Metropolitan International University

ABSTRACT

This study was entitled, “Corporate governance, financial risk management and sustainability of MFIs”. Over the last decade, sustainability of enterprises has proved a difficult task especially with the downfall of worldwide corporate giants such as Enron, Xerox, WorldCom and Parmalat, many suggesting that corporate governance and financial risk management could be the perfect solution. This study was established with objectives of examining the relationship between corporate governance and sustainability, financial risk management and sustainability as well as relationship between corporate governance and financial risk management within Jinja Municipal Council. Literature for different authors was reviewed and contrasted. The study was a cross sectional research design and adopted a quantitative research approach in a population of 125 MFIs in Jinja Municipal Council.

*The major findings were; corporate governance and sustainability had a significant positive relationship ($r=0.958^{**}$, $p<0.01$) and that corporate governance was a significant predictor with regression results of ($\text{Beta} = .017$ sig $=0.002$). Components of corporate governance were also significant in sustainability including; CEO Duality ($r=.401^{**}$, $p<0.01$), board independence ($r=.901^{**}$, $p<0.01$), board composition ($r=.413^{**}$, $p<0.01$) and audit committee ($r=.885^{**}$, $p<0.01$). Much emphasis on board independence, internal controls regular updating and experienced board members were also highlighted. In relation to financial risk management and sustainability of*

*MFIs, a significant association ($r = 0.291^{**}$, $p < 0.01$) and regression results of (Beta = 0.986, sig. = 0.000).*

The study recommended board independence, sensitization of employees within MFIs about financial risk management, strengthening internal controls, board members emphasis on implementing recommendations from the audit team as well as appointment of experienced boards as ones that would improve sustainability of MFIs. The study also suggested that effect of employee turnover on sustainability of MFIs in Uganda and analysis of the different financial risks faced by MFIs in Uganda be conducted to give a more foundation for improving sustainability among MFIs.

Key words: corporate governance, financial risk management and sustainability

Background to the study

By developing a "green" strategy geared toward the natural environment, environmental sustainability is a business strategy that generates long-term customer and employee value (Schnackenberg and Tomlinson, 2014). According to RAO (2001), durability in microfinance can be taken into account at various organizational, group, and individual levels and can relate to organizational, managerial, and financial factors. Robinson (2002) asserts that microfinance durability establishes a company's financial viability by enhancing its repayment rates, operational cost ratio, market rates of interest, portfolio quality, and demand-driven rural credit system that reduces hunger.

The method through which businesses are managed and controlled is known as corporate governance (Cadbury Report, 1992). It creates a climate of confidence for the business among society, experts and service providers, and the business

community in general. According to OECD (1999), corporate governance is crucial because it offers a framework through which financial organizations can set goals, determine how to achieve those goals, and establish a system for institutional monitoring. According to Kang and Kim (2011), the breakdown of the board, the board's independence, the CEO's dual role, and the makeup of the audit committee are all examples of excellent corporate governance.

On the other hand, financial risk management is the practice of economic value in a firm to use financial instruments to manage exposure to risk, particularly credit risk and market risk.

According to Frey (2010), regardless of the nature of the business, managing financial hazards is one of the most crucial tasks in every organization and cannot be disregarded. A economic institution's stability and continuous earnings depend on good management of financial risks, while MFIs perform poorly financially and are in poor condition due to decreasing control of financial risks (Harper and Chan, 2003).

Problem statement

According to sources in the Jinja Municipal Council, more than 15 MFIs in the area shut down over a period of four years (Kezaala, 2014). Victoria Basin Savings, Microfinance Cooperative Trust Ltd., and Pearl Microfinance all stopped operating in the region in 2013 (Kaketo, 2013). The number of loans that are not performing is also rising, putting most MFIs at risk of having to write off not performing loans and report poor earnings, both of which are essential to an enterprise's survival. Therefore, the purpose of this study was to ascertain how much corporate governance and managing financial risks might influence the viability of MFIs in Jinja Municipal Council.

Research objectives

1. *To examine the relationship between corporate governance and sustainability of MFIs within Jinja Municipal Council*
2. *To establish the relationship between financial risk management and sustainability of MFIs within Jinja Municipal Council*
3. *To establish the relationship between corporate governance and financial risk management within Jinja Municipal Council*

Research questions

1. *What is the relationship between corporate governance and sustainability of MFIs within Jinja Municipal Council?*
2. *What is the relationship between financial risk management and sustainability of MFIs within Jinja Municipal Council?*
3. *What is the relationship between corporate governance and financial risk management within Jinja Municipal Council?*

Methodology

Research Design

A cross sectional research design was used for this investigation. This study's method was chosen because, in order to draw generalizations about phenomena over an extensive population, something this design can easily achieve, it necessitates gathering data at a particular point in time from participants of various MFIs and serving in various jobs. A quantitative research strategy was also applied. This strategy was chosen because gathering numerical data is simpler, and it allowed the study to collect data from the many MFIs used for this study in the minimum amount of time. The organization and manipulation of numerical information into reports for analysis is similarly simple.

Study Population

The study population for this constituted 125 MFIs in Jinja Municipal Council. This number was selected based on the Jinja Municipal council Statistical Abstract (2010) report that indicated there were 125 MFIs in Jinja Municipal Council by close of 2010. According to Krejcie and Morgan (1970), a population of 125 MFIs can be represented by a sample size of 92.

Table 1: Unit of analysis

<i>Category</i>	<i>Population</i>	<i>Sample size</i>
<i>MFIs</i>	<i>125</i>	<i>92</i>
<i>Totals</i>	<i>125</i>	<i>92</i>

Source: Jinja Municipal council Statistical Abstract (2010)

<i>Category</i>	<i>Sample size</i>
<i>Managers</i>	<i>92</i>
<i>Internal auditors</i>	<i>92</i>
<i>Financial managers</i>	<i>92</i>
<i>Totals</i>	<i>276</i>

Source: Jinja Municipal Council Statistical Abstract, (2010)

Data Collection Instruments

Utilizing the questionnaire method, data was gathered. A questionnaire should be used since it protects anonymity and allows participants to fill it out at their discretion. The closed-ended survey was created with the study's aims and variables in mind. The replies to these questions were scored on a Likert scale of 1 to 5, where 1 meant "strongly disapprove," 2 meant "completely disapprove," 3 meant "not sure," 4 meant "agree," and 5 meant "strongly agree." To improve the accuracy of the data, the investigator individually administered the surveys.

Data processing and analysis

To enable speedy analysis of the data, data were gathered from the field, organized, edited, coded, and calculated using the Statistical Package for Social Sciences (SPSS). To ascertain whether the concepts included in the theoretical framework were precise indicators of the research variable, factor analysis was utilized. To ascertain

how the variables related to one another, inferential statistics of correlation and regression were also collected.

RESULTS

Factor analysis

Under this area, the study was interested in determining whether the constructs that were presented in the conceptual framework were good measures of the independent variables (corporate governance and financial risk management). The extraction method used was the Rotated Component Factor Analysis and the rotation method was Varimax with Kaiser Normalization. The cut-off for variables of corporate governance and financial risk management with a correlation of less than 0.4 was excluded from the rotation table.

Factor analysis for corporate governance

Factor analysis was used to extract factors that measure corporate governance using the principal Component Analysis and Varimax Rotation Methods. A summary of these findings is indicated in the table 1 on the following page.

Table 1: Rotated Component Matrix for corporate governance

	Component			
	1	2	3	4
<i>Within our MFI, the board sets policies implemented by the management</i>	.834			
<i>The board members can make decisions without encountering interference from management</i>	.830			
<i>The board members freely ask management for explanations on pertinent issues of the institution</i>	.577			
<i>Our board is financially dependent on the institution</i>	.564			
<i>The board committee of our institution is responsible for recruiting the Chief Executive Officer</i>	.457			
<i>All members on the audit committee have experience in our business</i>		.874		
<i>Within our institution, internal controls are updated regularly</i>		.865		
<i>Our audit committee advises management on the risky areas of the business</i>		.667		

<i>The audit committee of our institution has powers to make decisions pertaining risk areas of the business</i>	.659		
<i>The audit committee approves the internal control policies and procedures of the institution</i>	.592		
<i>In our MFI, there is no conflict of interest between the board and management</i>		.904	
<i>In our board meetings, resolutions are reached by universal consensus</i>		.877	
<i>Our C.E.O has exclusive control over the board proceedings</i>		.779	
<i>The title of chairman of the committee and manager is held by the same person</i>		.674	
<i>Some of the committee members in our institution are also board members of other financial institutions</i>			.830
<i>Board committee members are knowledgeable about microfinance services</i>			.644

<i>The size of the board is adequate for effective execution of their roles and responsibilities</i>				.644
Eigen Values	4.793	4.308	3.586	3.266
% of Variance	18.436	16.567	13.793	12.563
Cumulative %	18.436	35.004	48.797	61.36

Extraction Method: Principal Component Analysis. Rotation Method: Varimax with Kaiser Normalization. a. Rotation converged in 6 iterations.

Key: Component 1 = Board independence, Component 2 = Audit committee, Component 3 = C.E.O duality, Component 4 = Board composition

Source: Primary Data

Results from Table 10 above show that board independence contributed 18.436%, audit committee invested 16.567%, CEO duality invested 13.793%, and board composition invested 12.563% to the variance in the level of corporate governance, which overall in MFIs was 61.36%. The results thus indicate that board the declaration of independence, which also symbolized the highest Eigen Value (4.793), is the most significant indicator of corporate responsibility within MFIs, highlighting that MFIs that need to improve ecological sustainability should make sure that the board is sufficiently independent from the executive leadership of these organizations. The results also further indicated that pertinent aspects to boosting board independence were ensuring that the board freely sets policies for management (.834) and also ensuring that there is no interference from management while board is taking decisions (.830) as this would improve corporate governance and increase sustainability of firms.

Factor analysis for financial risk management

In this area, data reduction was used to identify factors that explain each construct in the study variables. Factor analysis was used to extract factors that measure financial risk management using the principal Component Analysis and Varimax Rotation Methods.

Table 2: Rotated Component Matrix for Financial Risk Management

	Component			
	1	2	3	4
<i>All staffs within our institutions have different roles they play</i>	.899			
<i>Within our MFI, employees are frequently rotated</i>	.843			
<i>The MFI changes software after a specified period</i>	.587			
<i>All transactions are sanctioned before they are effected</i>	.543			

<i>Access to MFI resources is possible after following acceptable policies and procedures</i>	.441			
<i>The MFI trains staff on how to handle different forms of risks faced by financial sector</i>	.430			
<i>The management implements recommendations arising from risky assessments</i>		.768		
<i>Risk analysis is carried out on a daily basis</i>		.679		
<i>Everyone is involved in the control and monitoring of the risks</i>		.652		
<i>Everyone within the MFI is knowledgeable about risk identification</i>			.797	
<i>We use historical information from similar activities to provide valuable insight into future risks</i>			.652	
<i>The management team works closely with the users to establish key performance parameters</i>			.421	
<i>We use historical information from similar activities to provide valuable insight into future risks</i>				.752
Eigen Values	8.329	3.748	2.172	1.719

% of Variance	34.706	15.615	9.049	7.161
Cumulative Variance	34.706	50.321	59.370	66.531

Extraction Method: Principal Component Analysis. Rotation Method: Varimax with Kaiser Normalization. a. Rotation converged in 12 iterations.

Key: Component 1=Control Activities, Component 2=Monitoring, Component 3=Risk Identification, Component 4=Risk Assessment

Source: Primary Data

According to the findings of the above table, the control activities' management of financial risks component generated 34.706%, surveillance provided 15.615%, recognizing risks provided 9.049%, and risk assessment provided 7.161% to the overall variance in financial risk management, which was 66.531%. The aforementioned findings thus showed that control actions in financial risk administration were the most significant and largest contribution to any fluctuations within the variable, with Eigen Value (8.329). The remaining elements weren't as crucial.

The findings also showed that changing the duties that every staff member in our organizations plays would increase control activities by (.899) and that rotating employees often would improve management activities by (.843).

Therefore, it is important that whereas MFIs concentrate on the control activities, such issues are also considered as important for a strong financial risk management system in place.

Relationship between variables

Correlation analysis measures the degree of relationship between two or more variables. Correlation analysis was done to determine the relationships among the

independent variables that is; corporate governance and financial risk management and the dependent variable; sustainability of MFIs. The zero-order correlation was used to establish the relationship between variables. The Pearson correlation test was employed to execute this.

Table 3: Correlation analysis for study variables

	<i>CG</i>	<i>CEO D</i>	<i>BI</i>	<i>BC</i>	<i>AC</i>	<i>FRM</i>	<i>RI</i>	<i>RA</i>
<i>Corporate Governance</i>	1.000							
<i>CEO Duality</i>	.668**	1.000						
<i>Board Independence</i>	.419**	-.060	1.000					
<i>Board Composition</i>	.313**	-.136*	.353**	1.000				
<i>Audit Committee</i>	.369**	-.002	-.075	-.149*	1.000			
<i>Financial Risk Management</i>	.261**	.052	-.185**	-.273**	.731**	1.000		
<i>Risk Identification</i>	.142*	.120	-.337**	-.274**	.637**	.488**	1.000	
<i>Risk Assessment</i>	.375**	-.016	-.032	.040	.714**	.872**	.234**	1.000
<i>Control Activities</i>	.155*	-.041	-.456**	.158*	.608**	.437**	.422**	.627**
<i>Monitoring Risks</i>	.314**	.131*	.022	-.209**	.482**	.857**	.436**	.740**

Sustainability	.958**	.401**	.901**	.413**	.885**	.291**	.046	-.057
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******. Correlation is significant at the 0.01 level (2-tailed).

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

Key: BI=Board Independence, BC=Board Composition, AI=Audit Committee, MR=Monitoring Risk, RI=Risk Identification, RA=Risk Assessment, CA=Control Activities, FRM=Financial Risk Management, CG=Corporate Governance

Source: Primary Data

Relationship between corporate governance and sustainability of MFIs

Results from table 3 above showed a substantial positive correlation ($r=0.958^{**}$, $p0.01$) between corporate management and MFI longevity. The CEO Duality ($r=.401^{**}$, $p0.01$), board independence ($r=.901^{**}$, $p0.01$), board membership ($r=.413^{**}$, $p0.01$), and audit committee ($r=.885^{**}$, $p0.01$) were also determined to be true organizational governance elements. The findings suggested that improvements in corporate strategy would result in a 95.8% increase in the environmental performance of MFIs. The outcomes further showed the importance of all corporate governance elements, such as board autonomy, audit committees, composition of boards, and CEO duality, in establishing sound corporate governance, which would lead to the sustainability of businesses. It is therefore important for the components of corporate governance that were reflected in the conceptual framework are closely monitored to ensure strong corporate governance within MFIs.

Relationship between financial risk management and sustainability of MFIs

*According to the correlation chart above, financial risk administration and MFI sustainability are significantly and favorably correlated ($r = 0.291^{**}$, $p0.01$). This suggests that a change in financial management of risks at MFIs would result in a 29.1% increase in the long-term viability of MFIs. Therefore, in order to preserve the long-term viability of their operations, MFIs must make sure that they have adequate financial risk administration in place. The findings also showed that factors of control actions ($r=0.295^{**}$, $p0.01$) and monitoring risks ($r=0.736^{**}$, $p0.01$) towards sustainability had substantial positive associations. These results therefore imply that much emphasis by MFIs should be put on control activities as well as monitoring risks in order to improve financial risk management which would later improve sustainability of MFIs by 29.1% margin.*

Relationship between corporate governance and financial risk management of MFIs

*A substantial positive association between corporate responsibility and monetary handling of risks was shown in table 12 above ($r=.261^{**}$, $p0.01$). The findings suggested that enhancing corporate responsibility inside MFIs will result in a 26.1% increase in management of financial risks. The CEO Duality ($r=.668^{**}$, $p0.01$), board independence ($r=.419^{**}$, $p0.01$), board membership ($r=.313^{**}$, $p0.01$), and audit Committees ($r=.369^{**}$, $p0.01$) were also shown to be true among the corporate governance characteristics. This suggests that corporate responsibility would only be important in maintaining financial risk control if MFIs ensure that the board's the declaration of independence, membership, and audit committees are all in place. It is therefore important for MFIs to ensure good corporate governance in order to ensure that financial risk management within such firms is improved by over 26.1%.*

Regression analysis

Regression analysis measures the strength of the relationship between variables. Regression analysis was used to determine the strength of the relationship to which each of the independent variables (corporate governance and financial risk management) determined the significance in the variance in the dependent variable (sustainability of MFIs) as well as establish the extent to which the independent variables predicted variances between themselves. The Pearson correlation test was employed to execute this as indicated in table 13 below.

Table 4: Regression analysis between corporate governance, financial risk management and sustainability

Model Summary						
<i>Model</i>	<i>R</i>	<i>R Square</i>	<i>Adjusted R Square</i>	<i>Std. Error of the Estimate</i>		
1	.991 ^a	.981	.981	.08332		
<i>a. Predictors: (Constant), Financial Risk Management, Corporate Governance</i>						
Coefficients						
<i>Model</i>		<i>Unstandardized Coefficients</i>		<i>Standardized Coefficients</i>	<i>T</i>	<i>Sig.</i>
		<i>B</i>	<i>Std. Error</i>	<i>Beta</i>		
1	(Constant)	.152	.063		2.420	.016
	Corporate Governance	.035	.019	.017	1.806	.000

	Financial Risk Management	.873	.008	.986	106.360	.000
a. Dependent Variable: Sustainability						

Source: Primary Data

The regression analysis for the variables of indicated (Adjusted $r^2=0.981$) between the three variables of corporate governance, financial risk management and sustainability. This therefore implies that a combination of corporate governance, financial risk management and sustainability predicted a 98.1% variance in sustainability of MFIs in Jinja Municipality while other factors outside the model predicted 1.9%. The table also indicated (Beta=0.017, sig<0.05) for corporate governance and financial risk management (Beta=0.986, sig<0.05). Therefore, it is important for MFIs to put much emphasis on corporate governance and financial risk management if they are to register improvements in sustainability.

Conclusion

It is clear that there is a strong positive correlation between corporate management and environmental responsibility when it comes to the sustainability of MFIs. A change in corporate governance would result in a major prediction in the variations in sustainability that MFIs can experience, according to the study's findings that also showed a significant association exists between these two variables. Additionally, it was found that board autonomy was the most important quality that MFIs should consider in order for the board to freely determine policy guidelines and be free from any form of interference from administration while making decisions. Although this is the case, it is important that internal controls are updated regularly and that there is no conflict of interest between the board and management as well as promoting universal consensus when erecting resolutions and have a committee where some of the members are also board members of other financial institutions.

Recommendations

Basing on the above findings, the study recommends the following

- *MFIs should ensure independence of their boards if their sustainability is to improve. Independent boards are able to undertake all decisions without fear or favour. Being the top decision makers within the management structure for companies, they hold the failures and successes of firms, which is only achievable through proper decision-making. Board independence can be achieved by clearly separating the powers of the board from those of management, as this will minimize influence peddling in the affairs of the MFI.*
- *More importantly, all MFIs should ensure that the board enjoys its rights of hiring and firing management. In execution of its mandate of management oversight, the board should be allowed to terminate staffs who contravene the approved policies and procedures. This will increase management commitment towards achievement of objectives, which will increase the chance for sustainability of such firms.*

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