

Original Research Article

Analysis of the effects of agency costs on Financial Performance of commercial banks listed at the Nairobi securities exchange in Mombasa County, Kenya

Abstract

Agency costs result from a principal-agent relationship's conflicting interests. The relationship develops because the principal may not be able to manage the business since they are technologically illiterate, numerous, and geographically spread; as a result, they hire the agent. In a commercial bank, there are various relationships that show principal agent relationships, with the most prevalent one being the link between the shareholders and the management. Agency fees are paid with the intention of aligning the agents' and principal's ambitions in order to realize the principal's overarching intentions. Therefore, the perseverance of this study was to analyze agency costs and their effects on financial performance. In this study, the agency cost on financial performance of public commercial banks was analyzed. Specific objectives were; to establish how monitoring cost affect the financial performance of quoted commercial banks in Mombasa County, to assess the effect of bonding cost on financial performance of listed commercial banks in Mombasa county, to examine the extent to which residual loss affect the financial performance of commercial banks in Mombasa county and to determine the effects of restructuring cost on financial performance of listed commercial banks in Mombasa County- directed the study. Theories supporting this study were as follows; agency theories, free cash flow and stakeholder's theory. Descriptive design is a kind of research methodology which establishes the connection between variables. It was used in this study to identify both the broad and the detailed study goals. A census of the 10 listed commercial banks in Mombasa County was conducted as part of the work and purposive sampling was used. This study adopted qualitative and quantitative analysis. Pilot test was used to test validity and reliability. Validity was tested through interview while reliability was tested using Cronbach alpha. The data was analyzed using inferential statistics like regression and correlation and descriptive statistics like mean and standard deviation using the Statistical Package for Social Science (SPSS) Version 22.0. The results were presented using cross tabulation, frequency tables, and charts. Findings indicated that there was substantial effect of monitoring cost on financial performance ($\beta = 0.011$, $p < 0.05$). There was a positive and significant association between bonding cost and financial performance ($\beta = 0.008$, $p < 0.05$). The link between residual loss and financial performance was negative and significant ($\beta = -0.003$, $p < 0.05$). The relationship between restructuring cost and financial performance was positive and significant ($\beta = 0.006$, $p < 0.05$). The report suggests implementing an efficient internal control system by listed commercial bank management. This will assist in cutting down on the cost of auditing, administrative costs, and wasteful and unneeded spending, Managers should be paid more and attaching monetary or share bonuses or option entitlements to particular firm performance and to adopt a type of restructuring that will align with the relevant strategy and objectives

1. Introduction

According to Pankaj Chaudhary (2022), the principal-agent relationship is the source of agency fees. The two parties are involved in a legal contract where the primary appoints the agent of the other party to act on its behalf. Every time the interests of the two parties are out of sync and agency expenses result, the problem will come up. As a result, agency costs are described as in-house business expenses incurred when an agent's interests and the principal's collide.

2. Statement of the problem

The performance of banking sector in the last five years have not been consistent because some banks have been recording good performance while others have been recording declining performance. Some banks have steady growth while some have been recording mixed results every year. For example, Equity bank recorded 5.6% in ROA in the year 2018 and 4.7% in ROA in the year 2022. The same case was reported by Diamond Trust bank which recorded 3.3% in ROA in 2018 and 1.8% in ROA in 2022. National bank has been struggling over the last five year and in the year 2022 they reported a very low ROA of 0.6%. It is the same case at Housing finance Corporation which has also been reporting wanting performance and in 2022 they recorded ROA of 0.2% (CBK Supervisory report 2018- 2022).

Abdulrahman (2014) looked at the connection in agency costs and the NSE-listed companies' financial performance. Results showed that agency costs significantly improve financial performance. Rather, Njenga (2012) investigated the impact of agency charges on the financial performance of Saccos in the Githunguri District that were registered with Fosa. The findings were in disagreement with those of Abdirahman (2014).

3. Objectives of the study

The following were the specific objective of the study:

- i. To examine the extent to which residual loss affect the financial performance of commercial banks in Mombasa County
- ii. To assess the effects of bonding cost on the financial performance of commercial banks in

Mombasa County

- iii. To establish how monitoring cost affect the financial performance of commercial banks in Mombasa County
- iv. To assess how restructuring cost affect the financial performance of commercial banks in Mombasa County.

4. Literature Review

The research was based on three theories. Agency theory was the first theory.

Agency theory aims to offer a solution to issues that develop in the connection amid principal and agent and therefore it is suitable for explaining monitoring cost. The foundation of agency theory, according to Nasrin, Rasiah, Baskaran, and Masud (2017), is the notion that corporations ought to put maximizing shareholder value first. The theory is useful for the present study since it encourages commercial bank management to emphasize on procedure than on structural issues that can maximize profitability. (Mishkin, 2016).

The second theory used was free cash flow. Narwal and Jindal (2015) defined free cashflow as the amount of liquid left over after projects with positive net present values were finished. Free cash flows are frequently referred to as idle cash flows because they are allocated by the company's management. Excessive management spending brought on by an excess of cash flow may affect company's financial performance negatively at the end of the financial term and also in return to shareholders.

Stakeholder theory was the last theory to be used. Stakeholders are important people who affect an organization's performance, continuation, and existence (Ronzoni and Valentini 2015). Stakeholder theory is a structural theory of business and management ethics that considers various sectors that are affected by businesses, including suppliers, employees, creditors, local communities, and others (Lin and Tom 2018). Stakeholder theory also takes into account various kinds of stakeholders in addition to the relationship between managers and shareholders (Nwaobia and Jayeoba 2016).

5. Methodology

For this study, a descriptive research design was adopted. A descriptive research design, according to Cooper and Schindler (2014), seeks to determine the who, what, where, when, and how of a study

problem. The descriptive research project was appropriate because the study's focus was on examining the effect of agency costs on the financial performance of commercial banks listed in Mombasa County, Kenya, on the Nairobi Securities Exchange.

10 listed commercial banks from Mombasa County were the main target of this study. Three managers such as Regional managers, Branch managers and operation managers from each bank were purposefully selected to provide a sample of 30 respondents. Validity and reliability tests were done to ensure the planned content, consistency and accurate results were achieved. In this inquiry, both qualitative and quantitative analyses were applied. The data was assessed, edited, and sorted to make sure that all of the study questions had been addressed and that the collected data were comprehensive.

The fact that the data was encoded implies that it was converted into numerical codes that stand in for the attributes or measurements of the variables (Mugenda and Mugenda 2013). The data was analyzed using both inferential statistics, such as regression and descriptive statistics, such as mean and standard deviation.

The following is description of the multiple regression model:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + e$$

Where; Y = Financial performance of the firm, X_1 = Monitoring cost of the firm, X_2 = Bonding cost of the firm, X_3 = Residual loss of the firm, X_4 = Restructuring cost, e = error term

The requested information was collected in a way that was permitted by law. No respondent was coerced or compensated into providing information. The investigator requested authorization from the commercial banks to undertake the investigation. Respondents vouched for confidentiality and anonymity, and the collected data was applied for this study only, never in a way that jeopardizes the interviewees' wellbeing.

6. Research Findings and Description

Out of 30 questionnaires that were distributed 25 were completed and successfully returned, translating to rate of 83.33 percent. This feedback rate met the requirement for the investigator to come up with satisfactory deductions from the study

7. Descriptive Statistical analysis

Monitoring cost

The research needed to establish, on a scale of 1 to 5, how applicable certain claims about cost monitoring in their companies were to the human subjects.

Table 1: Descriptive Statistics for Monitoring cost

	N	Minimum	Maximum	Mean	Std. deviation
Staffing cost are high	25	3.00	4.00	4.0800	.27689
Cost of budget control are high	25	3.00	5.00	3.9927	.40000
Auditing cost are high	25	3.00	4.00	3.0400	.20000
Compensatio n costs are high	25	2.00	3.00	3.9600	.20000
Directorship costs are high	25	2.00	3.00	3.8800	.33166
Valid N (listwise)	25				

Source: Research data 2023

From the previously mentioned table 2, (Mean = 4.0800, SD= 0.27689) indicating that staff costs are high. The respondents also indicated that the cost of budget was high (Mean= 3.9927, SD= 0.4000).

Again, the study sought the view of the participants' on how high were auditing cost. Majority of the participants showed that auditing cost are high (Mean= 3.04, SD= 0.2000). Meaning auditing cost is not known whether it affects financial performance negatively or positively. The participants indicated that compensation cost is high (Mean= 3.96, SD= 0.2000). The respondents indicated that the directorship cost was high. (Mean= 3.88, SD= 0.33166). This indicates that directorship cost negatively affects financial performance. On aggregate, most respondents agreed that monitoring cost were high (Mean= 4.1600, SD = 1.46287).

Bonding cost

The study asked wanted to understand on how participants would rate the relevance of various bonding cost statements to their own organizations. The result is shown in Table 2 below.

Table 2: Descriptive Statistics for Bonding cost

	N	Minimum	Maximum	Mean	Standard deviation
The advertising expenditure are high	25	3.00	5.00	3.7200	.61373
The license fee is high	25	4.00	5.00	4.2800	.45826
The accounting cost is minimal	25	2.00	3.00	3.8000	.40825
The travel and vehicle costs are high	25	3.00	5.00	3.6800	.61373

The maintenance and repair cost are high	25	3.00	5.00	3.7400	.711811
Valid N (listwise)	25				

Source: Researcher 2023

From table 2, it was enquired on whether the advertising expenditure were high. The majority of responders (Mean = 3.72, SD = 0.61373) agreed that advertising expenditure was excessive. Again, most agreed that license fee to a great extent was high (Mean= 4.28, SD= 0.45826). Most of the participants were in agreement that minimal were their accounting cost (Mean=3.8, SD= 0.40825). Thus, it can be argued that accounting costs have no effect on financial performance of listed commercial banks in Mombasa County. Therefore, there is a feeble correlation amid the two variables. Most participants agreed that to a great extent their travel and vehicle expenses were high (Mean = 3.68, SD= 0.61373). The majority of human subjects (Mean=3.74, SD=0.71181) concurred that their maintenance and repair expenses were excessive to a considerable degree. On aggregate, most human subject concurred that bonding cost were high (Mean= 3.9200, SD = 1.70587).

Residual loss

The opinion of respondents from the commercial banks in Mombasa County were sought in relation to residual loss. Their views are summarized in Table 3 below

Table 3: Descriptive Statistics for Residual loss

N	Minimum	Maximum	Mean	Standard deviation
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Perks beyond remuneration package	25	2.00	3.00	2.8800	0.33166
The firm has expanded workforce	25	2.00	4.00	4.0800	0.40000
The firm has expenses considered wasteful	25	1.00	3.00	3.5200	0.71414
Interest expenses are a concern in the firm	25	2.00	5.00	4.2000	0.76376
There is high debt ratio	25	1.00	5.00	3.7200	0.84261
Valid N (listwise)	25				

Source: Research Data (2023)

Participants were asked to rate the extent to which the management received incentives beyond compensation on a 5-point scale, based on table 3. The majority of participants (Mean= 2.88, SD = 0.33166) were neutral in their opinion that the management received high-quality benefits beyond compensation. This suggests that benefits provided to the management have a zero impact on the financial performance of listed commercial banks in Mombasa County. The majority concurred that their company had increased its personnel (Mean= 4.08, SD= 0.4000). Increased labor force is a sign of agency costs. The majority of participants (Mean=3.5200, SD=0.71414) agreed that certain firm expenses were largely deemed wasteful. The majority of respondents (Mean = 4.200, SD = 0.76376) agreed that interest expense was a worry in their cranialization. The majority of respondents (Mean= 3.72, SD= 0.84261) agreed that debt ratios were excessive in most cases. On aggregate, most respondents agreed that residual loss were high (Mean= 4.3400, SD = 1.49666).

Restructuring cost

Regarding restructuring costs, the survey asked specific employees of Mombasa County's listed commercial banks for their opinions. Table 4 displays the pertinent findings.

Table 4: Descriptive Statistics for Restructuring cost

	N	Minimum	Maximum	Mean	Standard deviation
You have added more products/services	25	4.00	5.00	4.8800	0.33166
Diversified your product offering	25	3.00	5.00	4.8400	0.55377
Modified some products to match with customer needs	25	2.00	5.00	4.4000	0.91287
Downsized the organization by shutting down some branches	25	1.00	3.00	3.56	0.71181
Laid off some employees	25	1.00	3.00	2.4000	0.91287
Valid N (listwise)	25				

Source: Research Data (2023)

Based on table 4, the majority of respondents agreed that companies have significantly increased the number of products they offer (Mean = 4.8800, SD = 0.33166). Once more, the majority concurred

that the companies have greatly diversified their product offerings (Mean= 4.84, SD= 0.55377). The majority of respondents (Mean=4.4000, SD=0.91287) concurred that their company has changed its products. The majority of respondents (Mean = 3.5600, SD = 0.71181) agreed that their firm had significantly reduced staff. The majority of respondents (Mean = 2.4000, SD = 0.91287) disagreed that their percentage of laid-off employees was high.

Financial performance

The study's objective was to analyze the impact of agency costs on the financial performance of commercial banks in Mombasa County that are listed on the Nairobi Securities Exchange. As indicated in Table 5, the data was collected from the poll respondents as well as the CBK reports and financial report of the specific bank.

8 Inferential statistics

Model Summary

The model summary includes the correlation coefficient (R) and the determination coefficient (R²). The determination ratio (R²) demonstrates how changes in independent factors (monitoring cost, bonding cost, residual loss, and restructuring cost) forecast changes in dependent variables (financial performance), while the ratio (R) indicates the kind and intensity of the link between the variables.

Table 5: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.692 ^a	.479	.457	.21658

a. Predictors: (Constant), monitoring cost, bonding cost, residual loss, restructuring cost

Source: Research data (2023)

Table 5's findings demonstrate that there was a positive association (R = 0.692) between financial performance and the forecasting factors (monitoring cost, bonding cost, residual loss, and restructuring cost). According to the corrected R-square (0.457), monitoring, bonding, residual loss, and restructuring costs accounted for 45.7% of the variations in financial performance. There was a 54.3% shift in financial performance (from 100 to 45.7) due to factors not covered in this study.

Analysis of Variance (ANOVA)

To ascertain the model's power to explain the link between the dependent variable (financial performance) and the independent variables (monitoring cost, bonding cost, residual loss, and restructuring cost), the research team performed an ANOVA, as indicated in Table 6. Significance F in the table indicates the adoption of a retrospective model with a significance level of 5%. The financial performance of the study and its financial management strategies are demonstrated to be significantly correlated if the p value is smaller than the alpha.

Table 6: ANOVA

Model	Sum of Squares	df	Mean square	F	Sig
Regression	.022	4	.005	.116	.975
Residual	.938	20	0.047		
Total	0.960	24			

Source: Researcher data 2023

Table 6's findings demonstrate that, at a 5% significance level, the model was significant ($P = 0.975$) in explaining the relationship between changes in financial performance and the costs of monitoring, bonding, residual loss, and restructuring. The findings indicate that changes in financial performance can be predicted using at least one of the variables taken into consideration (monitoring cost, bonding cost, residual loss, and restricting cost). The regression relationship was significant in predicting how monitoring, bonding cost, residual loss, and restricting cost affected listed commercial banks' financial performance, as indicated by the likelihood value of 0.047.

Coefficients^a

Table 7: Coefficients^a

Model	Unstandardized Coefficients	Standardized Coefficients	T	Sig.
	B	Std. Error Beta		

(Constant)	2.954	.151		19.618	.000
Monitoring cost	.011	.041	0.078	.258	.000
Bonding cost	.008	.0.040	0.065	.190	.000
Residual loss	-0.003	.041	-0.022	-0.072	.000
Restructuring cost	.006	.039	0.055	0.162	.000

a - Dependent Variable: Financial Performance

Source: Research Data (2023)

Results from Table 7 demonstrate that the constant was 2.954 units. This means that the financial performance would be 3.212 units if the costs associated with monitoring, bonding, residual loss, and restructuring were all constant. The study's model of choice was;

$$Y = 2.954 + 0.011X_1 + 0.008X_2 - 0.003X_3 + 0.006X_4 + \epsilon.$$

Table 7 demonstrates that there was a substantial effect ($\beta_1 = 0.011$, $p < 0.05$) of cost of monitoring on banks' financial performance. The findings indicate that a one-unit shift in monitoring costs will cause the financial performance of commercial banks listed in Mombasa County to vary negatively by one unit, or 0.011. The findings indicate that increases in monitoring expenses will result in decrease in listed commercial's financial performance (Quayes 2015)

The bonding cost and financial performance of listed commercial banks have a positive and significant association. ($\beta_2 = 0.008$, $p < 0.05$). Thus, this finding validates or establishes the second goal, which was to evaluate whether bonding expenses and financial performance among Mombasa County's listed commercial banks are related.

Residual loss has noeffect on Financial performance as shown in Table 7 ($\beta_3 = -0.003$, $p < 0.05$). A 0.3% drop in financial performance would result from a unit change in residual loss. Cost monitoring has a statistically minor impact on an entity's financial performance at the 5% significance level. The aforementioned figures show a significant correlation between Mombasa County's listed commercial banks' financial performance and residual loss. According to the interpretation, Mombasa County's listed commercial banks' financial performance is adversely affected by residual loss.

Restructuring cost indicate a positive and significant effect on financial performance ($\beta_4 = 0.006$, p

< 0.05). This suggests that favorable adjustments to restructuring costs will have a positive impact on the listed commercial banks in Mombasa County's financial performance. The analysis indicates that 0.006 units' financial performance will vary significantly in response to positive adjustments in restructuring cost per unit.

9. Summary, Conclusions and Recommendations

Summary of findings

Monitoring cost were high – this was the agreement by most respondents. This suggests a connection between listed commercial banks' financial success and cost monitoring. This suggests that expense monitoring has a detrimental impact on listed commercial banks' financial performance, supporting the study's main finding.

Evaluating the impact of bonding costs on the financial performance of Mombasa County's listed commercial banks was the study's second goal. The inference is that bonding costs have a detrimental impact on listed commercial banks' financial performance.

Examining the impact of residual loss on the financial performance of Mombasa County's listed commercial banks was the other study goal. The modified R squared value was 0.457, indicating that changes in residual loss caused a 45.7% shift in financial performance. At the 5% significance level, changes in residual loss explained 45.7% of the variation in financial performance. There is a high positive correlation between the residual loss and financial performance, as indicated by the R value of 0.692.

The final goal was to evaluate the impact of restructuring costs on Mombasa County's commercial banks' financial performance. The majority concurred that the companies have greatly broadened their product offerings. The results indicate that financial performance and product diversification are positively correlated. The majority of respondents concurred that their company has changed its product offerings. It is reasonable to conclude from this assessment that there is a favorable correlation between some product modifications and financial performance. The purpose of the study was to find out from the participants how much their company has shrunk by closing certain branches. The majority of respondents agreed that there has been significant downsizing at their company. The majority of respondents said that they had fired a significant number of employees.

This research suggests a substantial yet favorable correlation between Mombasa County's listed commercial banks' financial performance and their decision to fire certain personnel.

Conclusion

Examining the impact of monitoring expenses on the financial performance of Mombasa County's listed commercial banks was the first goal. According to the study, monitoring expenses did, in fact, have a statistically significant impact on listed commercial banks' financial performance. This can be because the strict monitoring systems deter managers and employees from misappropriating funds.

The study's second goal was to determine how bonding expenses affected the financial performance of Mombasa County's listed commercial banks. It was discovered that financial performance was impacted by bonding costs. This is explained by improved awareness of the numerous human resource difficulties, sharing, and interpersonal relationships. This can lessen the strain and exhaustion that could cause employees to cheat.

Determining the impact of residual loss on the financial performance of listed commercial banks in Mombasa County was the other goal. Financial performance was found to be statistically strongly impacted by residual loss. This might be the result of less funding available for expansion, which could increase future profitability and, consequently, financial performance.

The final goal was to evaluate the impact of restructuring costs on Mombasa County's commercial banks' financial performance. Restructuring costs were determined to have a favorable impact on financial performance. The study concludes that effective communication and the careful application of specific tactics are necessary to avoid negative outcomes.

Recommendations

The study's findings provide clear evidence that the financial performance of Mombasa County's listed commercial banks is significantly correlated with agency costs such as monitoring, bonding, residual loss, and restructuring. Therefore, in light of these findings, the study suggests that:

1. Effective internal control systems should be implemented by listed commercial bank management. This will assist in cutting down on the cost of auditing, administrative costs, and wasteful and unneeded spending.

2. Even the most challenging companies should make an effort to improve their performance. Leveraging cash flow, paying managers more, or attaching monetary or share bonuses or option entitlements to particular firm performance targets can all serve as positive incentive mechanisms, reduce agency costs, and enhance firm performance.
3. Restructuring should be a method used by the banks to increase productivity and competitiveness. Banks that are eager to undergo restructuring must carefully analyze the type of restructuring they must do, such as financial, portfolio, and organizational restructuring. These modes address various needs to align with the relevant strategy and objective, each with its own set of implications.

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