

**THE EFFECT OF CORPORATE GOVERNANCE ON FINANCIAL  
PERFORMANCE OF STATE OWNED CORPORATIONS IN THE SERVICE  
INDUSTRY IN KENYA**

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## DECLARATION

This research project is my original work and has not been presented for a degree in any other university.

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This research project has been submitted for examination with my approval as the university supervisor.

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## **DEDICATION**

I dedicate this research project to my loving mum Florence Kazungu Kilongole (Madam Fondo) for her measureless support all through this programme. May God bless you mum.

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## **LIST OF ABBREVIATIONS**

<b>AC</b>	Audit Committee
<b>AOA</b>	Articles of Association
<b>ANOVA</b>	Analysis of Variance
<b>BS</b>	Board Size
<b>BC</b>	Board Composition
<b>BOD</b>	Board of Directors
<b>CBK</b>	Central Bank of Kenya
<b>CED</b>	CEO Duality
<b>CEO</b>	Chief Executive Officer
<b>CG</b>	Corporate Governance
<b>CMA</b>	Capital Market Authority
<b>GoK</b>	Government of Kenya
<b>IMF</b>	International Monetary Fund
<b>IC</b>	Independent Committees
<b>Ksh</b>	Kenyan Shilling
<b>NSE</b>	Nairobi Security Exchange
<b>OECD</b>	Organization for Economic Cooperation and Development
<b>ROA</b>	Return on Asset
<b>ROE</b>	Return on Equity
<b>SOCs</b>	State Owned Corporation
<b>SPSS</b>	Statistical Packages for Social Sciences



## **ABSTRACT**

Corporate governance has recently gained much focus in Kenya following a series of banks collapsing and poor financial performances of the state air carrier considered to be the biggest in Central and Eastern Africa as many studies look at the effect of corporate governance on financial performance of firms. State owned corporations have constantly been hit by inefficiencies and financial mismanagement to the extent of becoming a burden to the government instead of meeting their objectives with good corporate governance practices being highly advocated for as a measure to revitalize them and enhance their performance. This study looked at the correlation between corporate governance and financial performance of state owned corporations in the service industry in Kenya. Financial performance of the state owned corporations was measured return on assets while the corporate governance attributes used included board composition, board size, independence of committees and duality. The study used descriptive research design. The study population was 127 state owned corporations and a sample of 50 was selected for the study. Data were obtained from 35 out of the 50 selected corporations and analyzed using descriptive statistics and multiple regression analysis between the months of September 2016 and November 2016. In summary, the study found a positive correlation between corporate governance and financial performance of state owned corporations. The financial performance was measured using return on assets. This means that practicing good corporate governance enhances the financial performance of state owned corporations. The government using all its policy agencies must therefore ensure that the state owned corporations practice good corporate governance in order to enhance their performance. This study suggests that further studies should cover more corporate governance attributes so that a conclusive analysis of this study can be done. It also suggests that a sensitization of the organizations and firms be done on the importance of research so that resistance during data collection can be reduced.

# CHAPTER ONE: INTRODUCTION

## 1.1 Background of the Study

Due to the many corporate scandals that continue hitting the world since the year 2000, corporate governance has become major topic of discussion not only in the developed but also in the developing countries (Kumudin, 2011). Many scholars have therefore come up with various ways of defining corporate governance based on the characteristics of the organization under study. The Kenya Capital Market Act (Cap 485A) on corporate governance guidelines to public companies in Kenya, defines corporate governance as a process and structure that helps in directing and managing the activities of the organization with an ultimate goal of maximizing shareholders wealth while taking into account of other stakeholders' interests. According to Heremans, (2007) financial performance refers to the application of financial indicators in finding out whether an organization has achieved its objectives. It is the general financial health measure of an organization that can be compared to another organization with similar characteristics (Hales, 2005).

Numerous studies have been done on the effect of corporate governance on the financial performance of organizations as scholars try to address the collapse of corporate organizations in the world. There however still a mixed up of findings on how best those institutions could have been governed to avoid their collapse. While many have come to the conclusion that good corporate governance results in better financial performance of an organization (Charkham, 1995; Kihara, 2006) there are some like Jarrell et al. (1998) who found out that financial performance of organization is negatively influenced by corporate governance. Lamport et al. (2010) found out that there is no difference on the financial performance between firms with poor and good corporate governance.

State Corporations play significant roles to any country's economy. Like in most countries, in Kenya the provision of goods and services like health, water and energy is bestowed on the state owned corporations (SOCs) despite the fact that they are often hit by huge loses, inefficient operations and poor provision of goods and services (Atieno, 2009). This results to huge budgetary burdens on the government running into billions of shillings every year. According to the Central Bank of Kenya (CBK) the government has in the year 2016 spent a total of 23.1 billion Kenya shillings in bailing out the Kenya Airways, the Mumias Sugar

Company and the restructuring of Uchumi super market. Although much emphasis of corporate governance is given to the private sector, Yener (2001) argues that corporate governance is a vital tool in combating corruption which is the biggest problem in these SOC's. This research therefore tries to look at the effect of corporate governance on the performance of SOC's in the country that are under the service industry.

### **1.1.1 Corporate Governance**

The convention on the Organization for Economic Co-operation and development 2004(OECD) defines corporate governance in terms the relationships between the organizations directors, the management and all stakeholders.' In other forums corporate governance has been defined as a combination of both processes and systems used to direct and control organizations as well as making them accountable. Corporate Governance therefore, can be looked at as the way in which firms exercise their mighty in the stewardship of the organizations assets and resources with the aim of maximizing shareholders' wealth while taking into consideration of other stakeholders in the context of SOC's (PSCGT, 1999).

In a more elaborate way corporate governance is a combination of regulations, practices and processes by which organizations are directed and controlled as they strives to balance the interest of all their stakeholders. According to Bauer et al. (2004) corporate governance involves directing and managing the activities of the organization with the aim of maximizing the shareholders' wealth while putting into consideration other stakeholders' interests.

Corporate governance may thus be perceived as the set of rules and regulations that govern the corporations' management behavior on a daily basis. These rules include individual organizational culture and other practices that allow it to maintain good governance practices even in the absence of strong monitoring institutions. The practices among others include the following; the corporation's board of directors' characteristics, the ownership structure of the corporation, financial transparency and information disclosure (Wasike, 2012).

Governance refers to the act of exercising power in the management of socioeconomic resources of an organization in order to have sustainable human development. It helps in achieving order and equality in the society as it facilitates production of goods and services in an efficient manner. Governance brings accountability in the use of power, the protection of the citizens' rights and more so their freedom. Governance can help in maintaining a conducive corporate environment that enable people to fully participate in contributing towards finding innovative solutions to issues that affect everyone. (PSCGT, 2000).

### **1.1.2 Financial performance**

Financial performance refers to the extent to which an organization attains its financial goals and objectives. It simply means measuring the organizations policies and operations in monetary terms. It is the general financial health measure of an organization that can be compared to another organization with similar characteristics (Hales, 2005). According to Rutagi (1997) financial performance of an organization is how well that organization is performing while Namis, (2002) defined performance as the extent to which organizations meets its targets.

This type performance is also measured in terms of solvency, profitability, liquidity, financial efficiency and how fast the organization repays its obligations (Brealey et al., 2009). The financial performance measure used for this study is the return on assets (ROA). ROA measures how an organization converts its assets into earnings. It shows how efficient the management is in using the organizations assets to generate revenues. The formula used to calculate ROA is given by dividing the organizations net profit by the average total assets. In most cases ROA is expressed as a percentage and a higher percentage means the more earnings a company has generated from few assets (Pandey, 2010).

Different organizations measure financial performance differently; some organizations measure their financial performance by comparing themselves with another organization in the same industry and of same size among other characteristics. Other organizations undertake financial ratio analysis while other use their budgets to measure their financial performance. It is also possible for an organization to use a mix of methodologies in measuring its financial performance. According to Foestor and Huen (2004) it is the size of the institution, its management of the assets and the efficiency of the organizations operations that affect the financial performance of the organization.

### **1.1.3 Corporate Governance and Performance**

A lot of attention has been given to corporate governance due to the belief that corporate governance has an effect on the performance of the organization, put differently firms with good governance should perform better than those that are badly governed. This argument holds that the governance structure of an organization affects its ability to respond to its external environment which affects its performance and therefore good corporate governance is essential for any organization (Brown and Caylor, 2004). Claessens et al. (2003) argues that a good corporate governance structure benefits the organization in easily accessing cheap financing thus increasing its performance. They also argue that organizations with weak corporate governance often result to poor performance. Donaldson (2003) says that good corporate governance leads to an increase in the investors' confidence on the organization and also improves its market liquidity.

Up to date numerous studies have this study providing varied results. One argument by Masibo (2005) is that good corporate governance positively affects the financial performance of state owned corporations through board effectiveness. Nam et al (2002) argues that good corporate governance increases the organizations performance due to reduced agency costs and better supervision of the management. They continue arguing that poor corporate governance on the other hand brings about corruption and poor financial performance of the organizations. Different findings have also been documented with some like in Gompers et al. (2003) who found no correlation between an organizations' corporate governance and its operating performance. Piesses (2005) also came up obtained conflicting results on his empirical research on this topic of study.

### **1.1.4 State Owned Corporations in Kenya**

According to the State Corporation Act Cap 446 (1987) a parastatal is defined as a state corporation (SC) or a corporate body established by or under an Act of parliament; or by the order of the president to perform the functions specified in that order; and whose a bigger percentage of the shares are owned by the government. The corporations may be inform of a bank, a financial institution or any organization formed under the Act. (Government of Kenya, 1987). The government of Kenya sessional paper number four (GoK-Sessional Paper no 4, 1991) stipulates that state owned corporations (Parastatals) are

formed for many reasons including ; promoting socioeconomic development, to enable more people to get involved in the economy, to bring equal economic development in all the regions of the country among others.

According to the GoK-Sessional Paper No. 10, (1965) SOCs were mainly formed to encourage more Kenyans in participating in the economy since most institutions were by then still owned by the white settlers a process that was called indigenization of the Kenyan economy. This therefore followed a series of formation of the SOCs whose number rose to 240 by 1995. Today however there are 127 SOCs in the country after a series of restructuring them to place them in align with the countries developments.

Philip Armstrong senior advisor, corporate governance Finance Corporation says that the importance of state owned corporations cannot be overestimated: in Africa, Kenya included state owned corporations contribute fifteen percent of its revenue. The value of the state owned corporations is in their ability to offer affordable, accessible and standard goods and services in important sectors such as energy and health and transport. They require massive capital input private sectors cannot afford. State owned corporations if well managed can significantly improve the citizens' welfare as well as promoting inclusive growth (Philip, 2016).

Theoretically state owned corporations are created for the citizens to benefit. In reality though state owned corporations are only accountable to the government in power at the expense of the common citizens'. The fundamental problem with Kenyan SOCs is in their poor governance structures created within the SOCs, mismanagement of funds, lack of close monitoring from the relevant regulatory (Gok-Sessional Paper No. 4, 1991). This has led to overburdening of the Government, in the year 2016 alone it has spent Ksh. 23.1 billion to the Kenya Airways, Uchumi Supermarket and Mumia Sugar Company to help them in restructuring following a series of loss making (CBK, 2016)

Poor financial management and lack of good governance structures make it difficult for the SOCs to constantly underperform thus lagging behind the private sectors. Due to this the services of these SOCs have been substandard and unreliable leading to lack of confidence by the citizens in them.

## **1.2 Research Problem**

Corporate governance has recently gained much focus in Kenya following a series of banks collapsing and poor financial performances of the state air carrier considered to be the biggest in Central and Eastern Africa with much studies looking at the impact of corporate governance on financial performance of the firm. Corporate governance refers to a general set of organizational practices and policies that are aimed to achieve certain set of goals and objectives of the organization with a view of maximizing shareholders' wealth while taking into consideration of other stakeholders' interest. While it is the desire of every organization in today's modern corporate world to increase its financial performance, the issues on whether corporate governance affects the financial performance of the organization remains a hot topic of research (Guzeh, 2012).

Atieno (2000) notes that most SOCs in Kenya are often hit by inefficiencies, losses and poor provision of products and services. These characters are effects of bad corporate governance practices, poor financial management by the state-owned corporations as well as pilferage in the management of finance leading to heavy burdens to the governments as a result of which the IMF and World Bank called for privatization of state-owned corporations in Kenya. While several studies have been done on the effect of corporate governance on firm performance coming up with different findings, many have concluded that good corporate governance results in better financial performance of the firm (Charkham, 1995; Bebchuk, Cohen & Ferrell, 2004; Stanwick and Stanwick 2002, Kamung'a, 2000; Wambua, 2009, Kihara, 2006); yet, other studies including Lamport et al (2010) have found no significant difference in the performance of firms with poor corporate governance practice and those with excellent quality of governance practices. Hence, no significant relationship exists between the variables. Jarrell et al., (1998) found out that corporate governance negatively correlates with the performance of the organization. Piesses, (2005) also obtained conflicting results on his empirical research on corporate governance and firm performance. These varied findings therefore imply that the relationship between corporate governance and financial performance may not be consistent across firm specific context or for all types of corporate governance structures.

There a number of research studies that have been done in Kenya, mentioning a few, Ng'etich (2015) did a study of on the effect of corporate governance and the performance of state owned corporations focusing on the water companies in Kenya while Guzeh (2012) also did a study on the effect of corporate governance of financial performance of Kenyan Parastatals generalizing all state- owned corporations. A few other studies have been in financial services sector and quite a number focusing on specific institutions, however very few studies have been done on the categorization of the industry in which the state-owned corporations fall. Therefore, this research will seek to answer the following question: How does corporate governance influence the financial performance of the state-owned corporations in the service industry in Kenya?

### **1.3 Research Objectives**

The study sought to establish the effect of corporate governance on the financial performance of state owned corporations in the service industry in Kenya.

#### **1.3.1 Specific Objectives**

The study sought to:

1. Establish the effect of the board size on the financial performance of the state owned corporations in the services industry in Kenya.
2. Establish the effect of the board composition on the financial performance of the state owned corporations in service industry in Kenya.
3. Establish the effect of CEO duality on the financial performance of the state owned corporations in the service industry in Kenya.
4. Establish the effect of the independent committees on the financial performance of state owned corporations in Kenya.

### **1.4 Value of the Study**

The findings of this research helped policy makers to gain value added information on corporate governance as a key to policy formulations that helped the government in the running of the SOCs in better way. The government of Kenya was able to understand how politics plays a significant role on the corporate governance of state-owned corporations. This helped the government to improve on areas that negatively impact corporate governance in SOCs in Kenya.



Scholars and academicians made use of the findings of this research to carry out more research on the topic as they try to fill the research gaps of this research. It also helped them in understanding the corporate governance practices of SOCs and why politics always had an impact on their governance. This helped them in carrying out more research on the kind of corporate governance SOCs need to practice to minimize political influence on their existing governance structures.

To the practitioners this research helped them understand and appreciate the role of corporate governance on the financial performance of SOCs. This helped them to govern the SOCs in a better way than before. It also helped them in understanding the role of independent committees in those organizations and their significant influence on the financial performance of the organization. To the managers, this research helped them to adopt the corporate governance practices in their operations thus improving the performance of the SOCs.

## **CHAPTER TWO: LITRATURE REVIEW**

### **2.1 Introduction**

The chapter briefly presents relevant theories that support and explain various issues in corporate governance and provides an insight of corporate governance attributes significant to the study, as well as reviews some of the empirical studies that have been done on the topic which have explained the relationship between both the corporate governance attributes and practices and the firm's financial performance. A summary of the empirical studies and that of literature review concludes this chapter.

### **2.2 Theoretical Review**

This section reviews significant theories in corporate governance which are relevant to this study. The relevant theories include agency theory, stewardship theory, stakeholder theory and resource dependency theory.

#### **2.2.1 Agency Theory**

Agency theory was developed by Berle and Means (1932) and became widely accepted when Jensen and Meckling (1976) formulated the agency problems in the governance of firms. According to this theory managers sometimes act in their self-interests rather than in the interests of the shareholders of the organization. Jensen and Reeback (2003) argue that managers will at times use excess cash flows for their own needs instead of maximizing the shareholders wealth. Himmelberg (1999) says that agency problem results when there is laxity in the supervision of the managers activities by the owners of the organization who are the shareholders. They add that solution to agency problem is to give managers shareholding in the company as a way of realigning their interests to those of the shareholders of the organization.

Grawal and Knoeber (1996) say that in addition to giving equity stake to managers, use of debt financing is also a solution to agency problem. To them they use of debt will shift the supervision role or rather share it with the lenders of money who will always monitor the actions of the managers to ensure that their investment decisions are profitable enough to pay back their loan with interest. Jansen (1983) also believes that agency cost such as audit of managers' work can also significantly minimize the conflict. It is however very crucial

to understand the nature of the organization, its operations and the environment that it operates in since different agency solving mechanisms may work to some organization and not in others (McColgan, 2001).

### **2.2.2 The Stewardship Theory**

This theory was first contributed to by Donaldson and Davis (1991). According to this theory managers are trustworthy individuals who are motivated by achievements and freedom endorsed to them in running the affairs of the organization. Therefore managers will always strive to maximize the shareholders wealth by making sure they register maximum profits in the organization. Managers in this theory fear failing as it destroys their reputation.

According to Donaldson (1995) executive directors perform better than non-executive directors since they understand the organizational affairs in a broader spectrum than their counterparts. Pfeffer (1972) adds that external directors have more influence on other stakeholders of the organization than on shareholders. They will for example make sure that the organization follows all regulations governing it to ensure survival and going concern. Argyris (1964) notes that close monitoring advocated for in the agency theory to resolve conflict cannot be applied to this theory because it will erode managers' freedom in decision making thereby demoralizing them in their work thus will not maximize the value of the organization.

### **2.2.3 Stakeholder Theory**

This is a theory developed by Freeman (1984). In his view the firm has a broader objective of maximizing the wealth of all stakeholder rather than just shareholders. He advocated for Corporate Social Responsibilities (CSR) by the organization a topic that would hit the corporate world many years later. Clarkson (1994) add that it is the responsibility of the firm to empower all its stakeholders who provide and control resources to it by turning their stake in the firm into value. Keasey (1997) supports the theory by arguing that ethical treatment of all stakeholders will benefit the organization because of stronger trust relationship that will be developed among stakeholders.

According to Blair (1995) organizations should realign their objectives of maximizing the shareholders' interests with those of outside passive shareholders (other stakeholders) who also contribute to the performance of the organization by giving them ownership-like incentives. An idea supported by Freeman et al (2004) who said that goal of the company should be to flourishing the company together with all its principal stakeholders.

#### **2.2.4 Resource Dependence Theory**

Resource dependence theory was first contributed by Penrose (1959) with Chandler (1962) making significant contributions to it. These scholars argued that organizational resources are critical and significantly affect the organizations performance by creating a competitive advantage over the other firms. Jonson et al. (1996) says that the theory is based on the idea that external directors to the company bring valuable expertise to the organization. According to him the organization significantly benefits for free of charge or at lower fee the expertise that it would otherwise highly paid for to get. For example an external director who is a lawyer offering free legal advice to the firm.

Hilman et al. (2000) says that directors play an important role in accessing resources that are critical to the firm through their linkages to the external environment. According to his argument directors appointed to the firm should be on the basis of what advantage are they bringing to the firm. Peace et al. (2012) argue that it is in the firms directors that organizational competitiveness can be achieved and sustained while Eisenhardt and Martin (2000) add saying that an organization can only be competitive if its resources are valuable, unique in the sense that cannot be replicated and non-substitutable. According to them it is this competitive advantage that brings the difference on performance of various organizations in the same industry.

#### **2.3 Determinants of the Financial Performance of State-owned Corporations**

Prior research documented that corporate governance play a significant role in the financial performance of SOCs. Consequently the performance of SOCs to a greater extent reflects the performance of a nation. Several determinants have been used by different scholars to determine the financial performance of a firm. Guzeh (2012) looked at board size, multiple directorship and ownership structure while (Njuguna, 2012) looked at the independence of directors, independence of committees, board size, duality problem and board meetings. This research will focus on four governance attributes; board size, board composition, independence of committees CEO duality and the size of the firm

### **2.3.1 Corporate Governance**

Many studies that look at the performance of an organization would never fail to mention of corporate governance. This is due to the believe that the quality corporate governance structure of an organization affects its financial performance. Gompers, Ishi and Metric (2003) in their study of 1500 us firms in the 1990s built an index for measuring corporate governance. They found that the quality of corporate governance positively affects the financial performance of the firm.

This study will look at the effect of corporate governance on the financial performance of state owned corporations in the service industry in Kenya. The key corporate governance attributes namely; board size, board composition, independence of committee and CEO duality will be used as independent variable in this study.

#### **2.3.1.1 Board size and Firm Performance**

The Kenya Companies Act does give guidelines on the maximum number of company directors but rather gives a node to a minimum of two directors. However the CMA guidelines on corporate governance practices states that the size of the board should not be too large to extent that fruitful discussions during meeting cannot be realized. It also cautions on very small boards of directors because such boards may not have the necessary experience and expertise to run on the affairs of that particular organization.

Research on the effect of body size on firm performance has documented mixed views from various scholars. Most of the scholars found out that there is a negative relationship between the financial performance of a firm and its body size, (Lipton and Lorch, 1992; Yermack, 1996; Sundgren and Wells, 1998). These scholars argue that too many members on a board may create agency problem, and some members may be considered free rider without corresponding impact to relevant decision making. They hold the notion that larger boards are disadvantageous and expensive to the firm. Dalton and Dalton (2005) however concluded that concluded that smaller board may lack the expertise, experience and wise decision that would have otherwise been available around a table of more board members.

### **2.3.1.2 Board composition and performance**

According to the CMA corporate governance guidelines (2002) an effective board should at least contain one third independent and non-executive directors of diverse skills and expertise to achieve independence and objectivity in the boards' decision making process. The CMA guidelines are based on the fact that executive directors can easily be influenced by the CEO.

According to John and Senbet (1998), increasing in the number of Non-executive directors in the board increases the boards' independency. Ochola (2013) found out that proportion of insider to outsider directors negatively affects the Return on Equity (ROE) of fund managers in Kenya. Sheppard (1994) argue that non-executive directors increases the flexibility of the board towards external environmental changes a major reason to corporate decline. Non-executive directors mostly will act towards maximization of shareholders interest thus shielding the owners from managers' self-interests (Berle and means, 1932) and Williamson (1935).

### **2.3.1.3 Independence of committee and firm performance**

Independence refers to being uninfluenced by other interested parties or being free from any kind of influence that would restrict anyone from taking the right course of action. It is the ability to stand strong without giving in to inappropriate influences and thus be able to make the decisions given an issue (CMA, 2002). The board of directors within the mandate of Articles of Association (AOA) can delegate its functions to independent committees made up of board members and or managerial staff whose actions shall be binding on them. These committees may include: Audit committee, Ethics Committee, Nomination Committee, Remuneration and Corporate Governance Committee e.t c depending on many factors of the organization.

According to Klein (1998) and Senbet (1998) independent monitoring committees are more effective in their mandates. Shivdasani and Yermack, (1999) found out that reactions on appointment of independent directors on stock market are more positive if the process viewed independent of any interference from the CEO. Klein (2002) shows that earnings management in an organization is likely to be reduced with the formation of an independent

audit committee. He further argues that independence of the organizations board of directors is significantly interfered with when the CEO is part of the members of the nominating committee.

#### **2.3.1.4 Chairman –CEO Duality and Performance**

The term “duality” refers a situation where the Chief Executive Officer (CEO) is still the Chairperson of the Board of Directors. Although duality is still common in some developing countries it is prohibited in other developed economies. In organizations with two-tier board structure, there is clear separation of roles between the chairman and the CEO of the organization since the chairman is not the head of management. The duality problem is practiced in organizations with the unitary board structure.

The issue of whether organizations should have a unitary or two –tier board structure has been controversial. Baling, Moyer and Rao (1996) argue that duality interferes with the affairs of the management and may hinder the ability of the board to function as an independent organ of the organization since one of the chairpersons’ responsibility is to monitor the top management activities. Jensen (1993) argues that duality is not in the shareholders' interest. Similarly, large firms that separate the two functions are viewed to be more valuable and have a higher return on investments’ and cost efficiency ratios than firms practicing duality (Yermack, 1996)

According to Shivdasani and Zenner (2004) duality strains the power of the board to replace a non performing CEO thus reducing the flexibility of the board to address declines in performance. Other scholars such as Brickley et al. (1997) have argued that there is no significant effect on company performance in separating the two roles and sees it as a mere reward to performing CEO and separation of the two roles is a deprivation of the boards an important tool of motivation. Ochola (2013) on research on the effect of corporate governance on the financial performance of fund managers in Kenya found out that the roles of the Chairperson and those of the CEO were separate and distinct. However a half of the respondents stated that they were not sure whether the division of the responsibilities of the Chairman and those of the CEO were clearly set out in writing.

### **2.3.2 Firm Size**

Firm size has always been associated with firm performance. This is because bigger firms have the advantage to diversify their operations in order to gain an advantage over small firms. Larger firms also have the advantage to buy on large scale earnings great quantity discounts and therefore reducing the unit cost of production which consequently lowers the sale price unlike small firms. Larger firms also have the capability of employing exemplary human resources that can boost the performance of the firm (Penrose, 1959). According to Majocchi et al. (2005) people give small firm a higher risk of perception than larger firms because of the limited resources like man power, access to capital among other things the fact that their economies of scale are much lower than those of competing larger firms.

Other scholars like Mansfield (1962) argue that due to the economies of scale larger firms poses they usually enjoy higher negotiation power over their competitors and suppliers. In addition they can easily access credit or investment capital, attract bigger numbers of competitive human personnel and may gain greater strategic diversification. Small firms on the other side have less agency problems and a flexible non-bureaucratic structures which are critical in changing business environments (Yang and Chen, 2009). Small size of an organization may significantly affect the capacity of the managers to implement strategies crucial to the organization thus posing a challenge to the going concern nature of the organization (Amstrong et al., 1998).Lack of economies of scale by small firm significantly affects their performance in sectors where they have to incur a lot of fixed and sunk costs. In addition their ability to hire few competitive human personnel may also affect to a large extent the firms' procurement options (Castello and Ozawa, 1999).

### **2.4 Empirical Review**

Numerous studies have been done on the relationship between of corporate governance and the financial performance of organizations. Kalungu (2008) did a study on the impact of corporate governance practice on financial performance of the commercial banking industry in Kenya. The study was based on a five year period between years 2006 to 2010 and was a census of all the bank`s in Kenya. The findings of this study indicate that there exists is a positive effect of corporate governance on the financial performance of banks. It also revealed that there is a positive correlation between composition of directors and the



financial performance of Kenya commercial banks. According to regression analysis results of this study both board composition and board size affect the financial performance of the bank. The board composition attribute positively affects the ROA while board size has a negative effect on ROA. From this study there was no duality in all banks except one.

Otieno (2010) studied the effect of corporate governance on the performance of companies listed at the Nairobi Securities Exchange (NSE), found out that there is a positive relationship between performance and board composition, governance disclosure issues, shareholder rights and compensation.

Opiyo (2011) looked at the relationship between Corporate Governance and financial performance of Sacco's operating in Nairobi, Kenya. The sample size was of this study was ninety eight Saccos from a total population of one hundred and thirty one. The governance attributes examined under this study were number of board meetings, gender board composition, chief executive officer duality and the audit committee which were independent variables. The dependent variables used this study were the return on assets and return on investments' while the analysis was done using regression analysis. The study findings indicate that there exists no significant effect of corporate governance on return on assets but found a significant correlation between corporate governance used in the study with return on investments'. Among the governance attributes the study found out that audit committee recorded the highest positive correlation with return of investments' while number of board meetings registered a negative relationship with ROI.

Maranga (2012) did a study on the effect of corporate governance on financial performance of small and medium enterprises in Nairobi County, Kenya. Specifically, the study examined existence of the various corporate governance practices in the sampled SMEs in Nairobi County such as CEO duality, size of the board, number of board sub-committees, and number of subcommittee meetings and size, age of the SMEs and how they affect their financial performance. The population included all the SMEs in Nairobi County operating as at 30th December 2013 and a sample from each category of business was identified and used to collect information. Using primary data collected using the questionnaires and analyzed using a multiple linear regression model, the study revealed the following. There is a significant strong relationship between the SME's financial performance and corporate

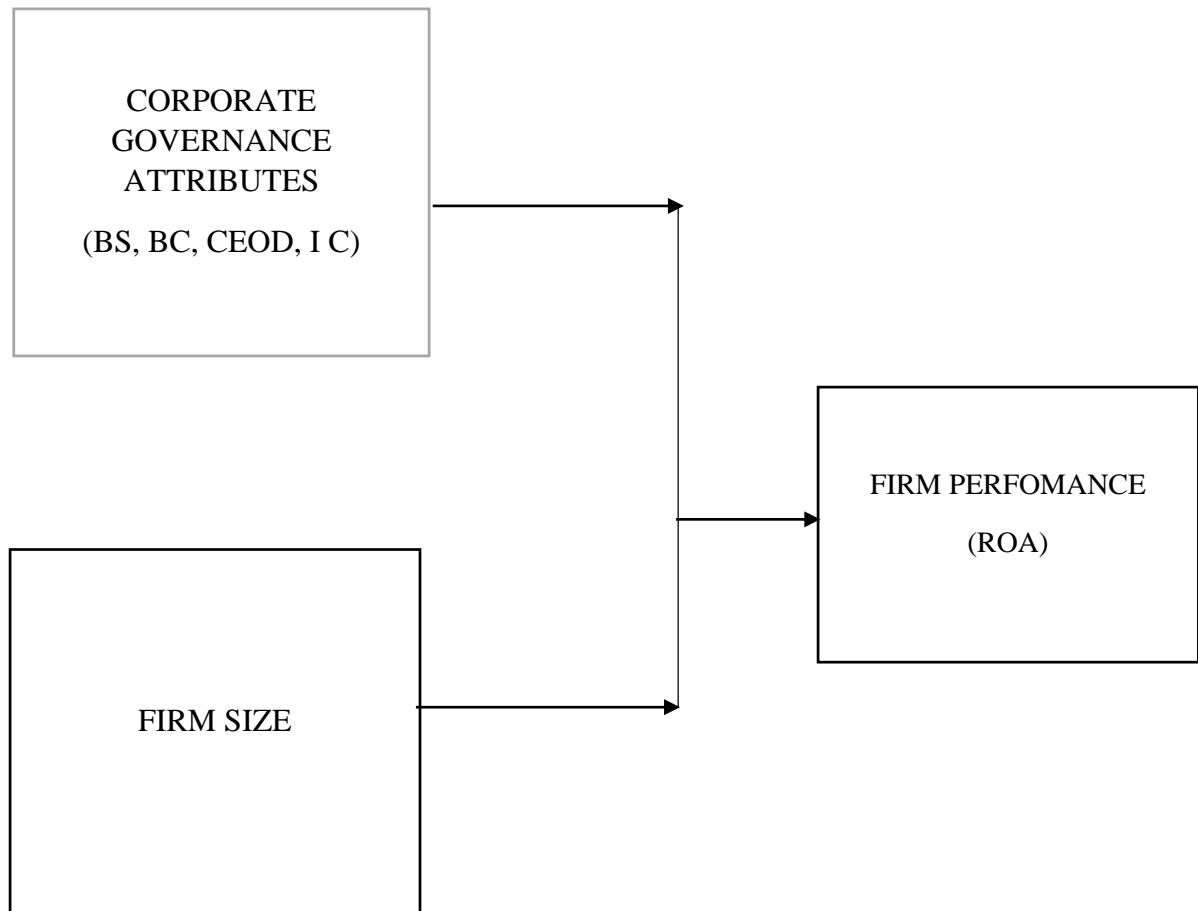
governance. The number of Board meetings, number of board sub-committees' meetings, and the size and age of the SMEs were found to significantly affect the financial performance of SMEs in a positive direction. The CEO duality was however noted to be common in most SMEs.

Akeyo (2012) in his study on the effect of corporate governance on performance of International Non-Governmental in Somalia found a positive relationship between corporate governance and their performance. The objective of his study was to establish the corporate governance practices and their impact on performance. The study found out that most of the INGOs practiced various governance practices. The study analyzed each of the four corporate governance practices (audit committee, transparency and disclosure, board meetings, board size and board composition) separately and all of them together. Separately, the study revealed that, there is positive correlation between corporate governance and performance of the INGOs, however the correlation was insignificant. However together the four corporate governance practices had a weak positive relationship with performance. Based on the findings she came to the conclusion that lack of good corporate governance structures leads to mismanagement of resources, earnings management, incompetency and lack of transparency.

Ochola (2013) on his study on the relationship between corporate governance and financial performance of fund managers in Kenya, a study of 16 managers revealed the following; most of the fund managers have separated the roles of the Chief Executive Officer from those of the chairman, on average the size of board of directors was 5, board meetings were between 4 and 6 and lastly insider shareholding by managers on average was at 82% in 2009 which was the highest and a lower share of 54% by 2011. In his conclusion he said that corporate governance significantly influenced the performance of fund managers and that failing to implement corporate governance would negatively affect their performance.

Kemboi (2013) did a study on the effect of corporate governance on revenue collection in Kenya revenue authority, a state owned enterprise (SOE). The study found out that board size negatively affects revenue collection while board effectiveness, board roles, policy and decision making positively affects revenue collection. This study concluded that corporate governance positively affects revenue collection.

## 2.5 Conceptual Framework



### Independent Variables

Board size is simply means the number of directors who constitute the board of an organization. According to Lipton and Lorch (1992) there exists a negative correlation between board size and firm performance. In this context the more the number of directors the smaller the value of ROA thus low financial performance of the firm.

Board composition is measured on the number of outside directors to inside directors sitting on the board. Sheppard (1994) proposes that non-executive directors provide flexibility to the board management towards its external environment and its ability to change. Berle and Means (1932) also noted that board dominated by non-executive directors is more likely to act in the best interests of the shareholders by safeguarding them from managers' personal interests indicating a positive relationship between the number of non -executive directors sitting on the board and the performance of the firm.

### Dependent Variable

CEO duality is measured as to whether the organization has a different chairperson from the CEO. According to Bailing et al (1996) duality is likely to hinder management accountability and may inhibit the boards' ability to function properly independently because the role of the chairman is usually to monitor the activities of the top management. The resultant effect of that is a low ROA brought about by low performance of the organization.

Independent committees is measured by the number of independent committees an organization has for example audit committee and nomination committee. Empirical evidence reports from Klein (1998) and Senbet (1998) suggest that presence of independent committees positively affects the performance of the firm. Firm size will be measured on the organizations asset base. According to Gabitas and Gretton (2003) the bigger the firm the higher the financial performance of the organization due to some size competitive advantages.

## **2.6 Summary of the Literature Review**

There is evidence from the various empirical studies reviewed that corporate governance practices have an influence on the financial performance any of organizations. However the level of relationship varies from one organization/ industry to another. It is also noted from the review that having the chief executive and chairman of the board as one individual makes it difficult to remove a non performing CEO thus reducing the flexibility of the board in addressing performance declines. The studies also revealed that small size board size seems to be more effective as it tend to make efficient use of board members whose expertise are required by the firm in an effective manner rather than a large number of board membership which may breed ineffectiveness and may provide additional cost to the firm without a corresponding productivity level as the issue of free rider may exist. The review also reveal that boards are more independent when the number of non- executive directors increase. On the issue of independence of committees the review shows that the presence of independent board committees such as the audit committee brings to the organization more oversight.

Although many studies have been done both in Kenya and the rest of the world as scholars try to establish whether there is a relationship between corporate governance and financial performance of firms, none of the studies has looked at the relationship of corporate governance and the financial performance of SOCs in Kenya on industry level. Further, the previous studies have come up mixed findings due to different analytical approaches, difference in the countries where the studies have been done, the type of governance attributes examined, difference in type of data and its source and the kind of methodology used in each study.

## **CHAPTER THREE: RESEARCH METHODOLOGY**

### **3.1 Introduction**

This chapter discusses the methodology that was used in this research to achieve the stated objectives. The methodology includes the research design, the target population, the sampling design and the sample size, the data collection instruments, data reliability as well as the data analysis techniques are covered.

### **3.2 Research Design**

Descriptive research design was used to address this research problem. A descriptive study aims at finding out the what, where and how of a phenomenon (Cooper and Schindler, 2003). The appropriateness of this design is that it allowed the researcher to use both qualitative and quantitative data in trying to establish the effect of corporate governance on the financial performance of SOCs in Kenya. Descriptive survey designs were used by the researcher to gather information, summarize, present and interpret it in order to obtain more clarification on issues. The researcher chose descriptive survey research design because his interest was primarily on the state of affairs already existing in the field rather than manipulating variables. This study therefore was able to generalize the findings to the whole population of study. Despite the fact that the focus of this study is quantitative, in order to have an in depth understanding of the issues and also to have a qualitative approach was also used in order to obtain a better understanding and a more insightful interpretation of the results from the quantitative study.

### **3.3 Population of the Study**

Saunders, Lewis and Thorn (2003) refer a population as to a group of people, objects, persons or items on which a sample is extracted for analysis and from which generalization can be made of the whole population. The total number of SOCs currently operating in Kenya is 127. The entire 127 formed the target population for this study. It is from the 127 that the researcher sampled the ones considered for the study.

### **3.4 Sample Size and Sampling Procedures**

The study consisted of a sample size of 50 SOCs operating under the service industry and have offices in Nairobi and operate from in the service industry. The researcher randomly selected 100 respondents from the 50 SOCs for the study. Simple random sampling was applied in selecting the respondents.

### **3.5 Data Collection**

The study used both primary and secondary data. Secondary data on financial performance, corporate governance and firm size was obtained from the financial statements and other annual published reports for the five year period. The primary data was collected by use of structured questionnaires using the Likert Scale. The targeted respondents in this study were; board members, managers and senior staff of the sampled SOCs. This is because they are involved in the management of the organizations and have a broad understanding of the affairs of the organizations

### **3.6 Validity and Reliability of Data**

Validity of a research instrument is concerned with the accuracy with which the instrument measures what it is supposed to. This study used a questionnaire and test its validity by use of content validity, which is a process of logical analysis that involves careful and critical examination of items in the research questionnaire. A few managers from selected SOCs will be given the questionnaires to fill in order to ensure that they carry valid content.

The research questionnaire used in this study gave reliable information that was used in decision making. It should therefore be able to produce the same results if used by other researchers. To determine the reliability of the research questionnaire, a pre-test of the same was done among few SOEs.

### **3.7 Data Analysis**

Two methods of data analysis were adopted to enable the researcher conducted a comprehensive analysis. The descriptive data was analyzed using Statistical packages for social sciences (SPSS) while the qualitative data was analyzed by content analysis and visualized by Tableau Software version 10.0. Multiple regression analysis was used to analyze the quantitative data since it involves one dependent variable and multiple independent variables. The findings from the quantitative data were presented in tables.

#### **3.7.1 Analytical Model**

The study sought to establish the relationship between corporate governance as an explanatory variable and ROA as a dependent variable. Because the relationship involved one dependent variable (ROA) which was determined by multiple independent variables (corporate governance attributes and firm size, the model used to determine such

relationship was the multiple regression model. Multiple regression analysis is designed to establish the relationship between multiple independent variables and one dependent variable. Depicted below is the multiple regression model.

The equation used to establish the relationship was as follows:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \varepsilon$$

Where;

Y = Financial performance measured by ROA.

$\beta_1, \beta_2, \beta_3, \beta_4$  represent the co-efficient of corporate governance and  $\beta_5$  firm size

$X_1$  = CEO–Chairman Duality (Measured by the separation of the two positions)

$X_2$  = Board size (Measured by the number of directors sitting in a board)

$X_3$  = Independent committees (Measured by the number of committees in the organization)

$X_4$  = Board composition (Measured by the proportion of insider directors to outside directors)

$X_5$  = Firm size =  $\log$  (Total Assets)

$\alpha$  = Constant term representing other factors other than the above corporate governance which are not defined in the model.

$\varepsilon$  = Error term

### **3.7.2 Inferential Statistics**

F -test (ANOVA-analysis of variance) and t-test were used at 95% confidence level to establish the statistical significance of the whole model and the significance of the independent variables. The researcher also performed a correlation analysis on the independent variables to find out if they had any significant relationship among themselves at 5% level. The purpose was to ensure that no multi co-linearity existed between the variables with the aim of including them in the multiple regression analysis as well as determining the ones that had significant influence on ROA the financial performance dimension used in the study.



## CHAPTER FOUR: INTRODUCTION

### 4.1 Introduction

This chapter covers the data analysis, results and discussion of the findings on relationship between corporate governance and financial performance of SOCs in the service industry in Kenya. The chapter concludes with a summary and interpretation of the findings.

The research targeted 50 SOCs operating in Nairobi. The questionnaires were self-administered; however, Table 4.1 shows that out of the 50 questionnaires distributed; 35 questionnaires were received back completely filled, making a response rate of 70.0% which according to Mugenda and Mugenda (1999) was good for reporting and analysis.

**Table: 4.1 Response Rate**

Questionnaires	Frequency	Percentage
Returned completely filled	35	70
Returned Partially filled	5	10
Un Returned	10	20
Distributed	50	<b>100</b>

### 4.2 Descriptive Statistics of Explanatory Variables

Descriptive statistics analysis was carried out to determine the mean, maximum and minimum values of each variable and also to determine the extent that the variables deviate. The dependent variable which is ROA was determined by the formula below;

$$ROA = \frac{M(TPA)}{M(TA)}$$

From the formula above M (TPA) was the mean total profit after tax while M (TA) was the mean total assets of the corporations selected from the study. This data was obtained from the state owned corporations financial statements.

**Table 4.2 Descriptive Statistics for Explanatory Variables**

**Descriptive Statistics**

	N	Minimum	Maximum	Mean	Std. Deviation	Variance
BOARD SIZE	35	3.8000	11.1333	9.377710	2.7869129	7.767
CEO DUALITY	35	.0000	0.0000	0.0000	0.0000	0.0000
BOARD COMPOSITION	35	0.000	11.2333	7.649987	7.1623800	51.300
BOARD COMMITTEE	35	1.0000	3.6000	2.416667	1.3112773	28.210
RETURN ON ASSETS	35	.0000	.0440	.029000	.0165650	.000
SIZE OF THE FIRM	35	.0000	12.1926	10.092692	4.9447160	24.450
Valid N (list wise)	35					

From the table 4.2 above board size had a maximum value 11.33 and minimum of 3.8. This means that the maximum number of directors sitting on the board was 11 and the minimum was 4. On average the state owned corporations had 9 board members.

CEO duality refers to whether the chief executive officer of the corporation is still the chairman to the board of directors to that very corporation. The study used a dichotomic variable for this parameter. The researcher assigned 1 to every duality scenario and 0 to where there is a separate CEO and chairman of the board. From the results above, the minimum and maximum values are zero meaning that duality is not practiced in the Kenyan state owned corporations.

Board composition was measured on the ratio of Non- executive directors to executive directors. The minimum value of board composition is zero meaning there is at least one corporation where all board members are executive while the maximum value is 11.233. On average the ratio of non-executive directors to executive directors was 8:1 meaning for every 8 non-executive directors there is one executive director.

Board committees were measured by the number of committees the board had established each organization. According to the table above the minimum number of board committees was 1 while the maximum was 4. On average the state owned corporations had two independent committees established by the board.

The return on assets has a minimum value of zero and a maximum of 0.0440 meaning that the state owned corporations maximum ROA was four percent of the assets. The mean return on assets for all state owned corporations under study was 0.029 meaning that the average return on assets of the state corporations under study was 2.9% which is fairly low.

Firm size was used as a control variable. It was measured by the natural log of average assets for the selected state owned corporations under study for the period under study. The corporations had a minimum of zero to a maximum of 12.1926. On average though, the corporations registered a mean of 10.09.

#### **4.3 Relationship between Corporate Governance and Financial Performance**

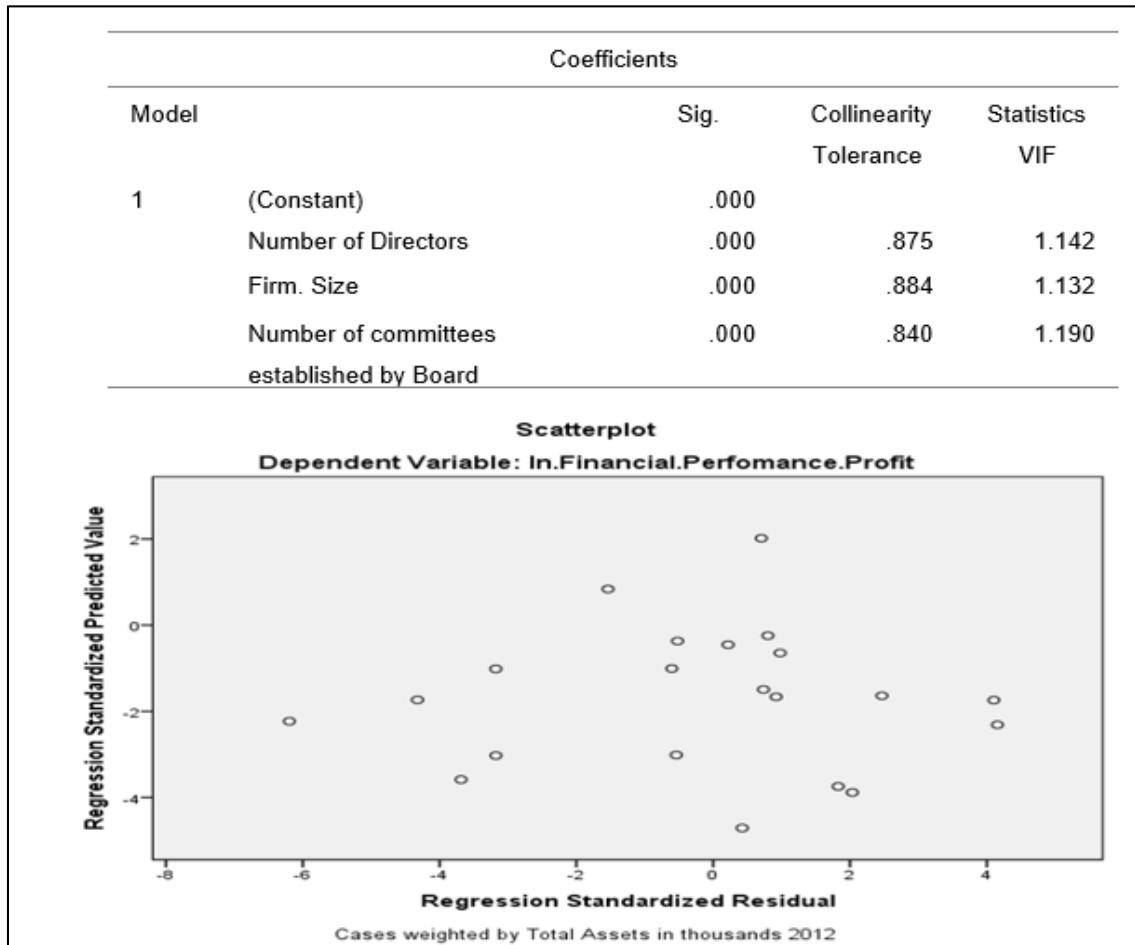
Multiple linear regression analysis was done in order to establish the relative effect of each independent corporate governance attribute under study on ROA for the selected corporations during the period of study. The regression model was as shown below

$$Y = \alpha + \beta_1 (\text{Board Size}) + \beta_2 (\text{Board Composition}) + \beta_3 (\text{Independent Committees}) + \beta_4 (\text{CEO Duality}) + \beta_5 (\text{Firm Size}) + \varepsilon$$

Under the multiple linear regression analysis, correlation, coefficient of determination and analysis of variance (ANOVA) were also produced. Correlation determines the nature of the relationship between the dependent and independent while coefficient of determination show the strength of the relationship. ANOVA was done to determine any significant mean difference between dependent and independent variables. This was done at 95% confidence level.

### 4.3.1 Assumptions for Multiple Linear Regression

**Table 4.3: Multi-Collinearity and homoscedasticity**



From the table above its clear that the Variance Inflation Factor (VIF) is utmost 1.190 which is less than 2.5 an indication that Multi-Collinearity between independent variables is negligible. From the scatter plot above its clear that the correlation between standardized residual and standardized predicted value is almost negligible an indication of constant variance of the error term.

**Table 4.4 Model Summary**

#### Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.909 <sup>a</sup>	.826	.128	.0154695

a. Predictors: (Constant), Size of the Firm, Board Size, Board Composition, Board Committee

The results shown above in table 4.4 show a Pearson correlation value (R) of 0.909 meaning that there is linear dependence of ROA on corporate governance. R square of 0.826 implies that 82.6% of ROA is influenced by the corporate governance attributes under study and that only 17.4% is influenced by other factors outside the model. An adjusted R- Squared of 0.28 means that Board size, Board Composition, Independence committees also explain 12.8% of the variations in ROA due to a unit change in corporate governance practice and 87.2% is explained by other factors outside the model. The standard error of 0.0154 shows that the model has only an error of 1.54% which is good for the model.

**Table 4.5 Analysis of Variance**

**ANOVA<sup>a</sup>**

Model	Sum of Squares	Df	Mean Square	F	Sig.
1 Regression	.001	4	.000	1.183	.0036 <sup>b</sup>
Residual	.000	31	.000		
Total	.001	35			

a. Dependent Variable: Return on Assets

b. Predictors: (Constant), Size Of The Firm, Board Size, Board Composition, Board Committee

From the above ANOVA table the P-value is 0.0036 which means that the model is statistically significant since the P-value is less than 0.005. This depicts the significance of the regression analysis done at 95% confidence level.

**Table 4.6 Regression Coefficient Results**  
**Coefficients<sup>a</sup>**

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	.009	.037		.240	.050
BOARD SIZE	-.001	.003	-.137	-.263	.137
BOARD COMPOSITION	.021	.005	.547	.263	.036
BOARD COMMITTEE	.011	.008	.310	.122	.023
SIZE OF THE FIRM	.003	.003	.896	.981	.506

a. Dependent Variable: Return on Assets

Linear regression analysis was conducted by the researcher to establish the effects of independent variables (Board Size, Board Composition, Board Committee and Firm size) on the dependent variable which is ROA. As per the regression generated in the above table 4.5 the equation;

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$$

takes the form: **ROA=0.09-0.01\* Body Size + 0.021\* Board Composition + 0.011\* Independent Committee + 0.03\* Firm Size**

According to the results in the above table, when all the governance attributes in the model assume the value of zero then the return on assets of the organization will be 0.09. The error term was 0.037. The beta value of board size (-0.01) show that the board size of the organization negatively affects the ROA of the organization. It further means that the larger the board size, the lower the ROA of the state owned corporations.

Table 4.6 also depicts that board composition positively influences the ROA of the organization. This further explains that the higher the ratio of non-executive directors to executive directors the higher the ROA of the organization. This is attributed to the

experience and expertise that outside directors bring from their areas of work and also by reducing the CEO domination of the board thereby increasing oversight role on the organization. The board committee has a beta value of 0.011 meaning that it also positively impacts on the ROA of the corporations. This means that the more the number of board independent committee formed the higher the ROA of the organization. This is due to the ability of the independent committees to mitigate agency conflicts within the organizations as propounded by Jansen and Meckling. The size of the firm too has a fairly low positive influence on the ROA of the organization.

The data findings analyzed also shows that if all other independent variables assumed the value of zero, a unit increase in the board composition ratio will lead to a 0.020 increase in ROA of the state owned corporations in Kenya; a unit increase in the number of board committees number will lead to a 0.011 increase in ROA of the state owned corporations in Kenya, a unit increase in board size will lead to a 0.01 decrease in ROA, a unit increase in organizations size will lead to a 0.03 increase in ROA of the state owned corporations in Kenya. This means that board composition commands the most positive influence on the ROA of the state owned corporations in Kenya. It however important to note that from the results of the regression above none of the attributes command a strong positive influence of the ROA of the state owned corporations in Kenya.

At 5% level of significance and 95% confidence level, board size had a 0.137 level of significance, board composition had 0.036 level of significance and board committee had 0.023 level of significance while size of the firm posted 0.506 meaning its significance is almost negligible. From the results above board committee is the most significant attribute followed by board composition, board size and firm size the least.

#### **4.4 Correlation Analysis**

Correlation was done to determine the existence of any relationship between two variables. The variables used are board composition, board committee, size of the firm and independence of committees.

**Table 4.7 Correlation Analysis**

	RETURN ON ASSETS	BOARD SIZE	BOARD COMPOSITION	BOARD COMMITTEE	
Pearson Correlation	1.000	.032	.756	.883	
		1.000	.070	.089	
			1.000	.957	
				1.000	
					.735

From the table 4.7 none of the correlations was beyond 1 at 5% significance level meaning that the independent variable were not serially correlated and that multiple regression analysis fit to analyze the data. The table shows that board size has a positive association with board composition, independent committees and a negative association with size of the firm. Board composition has a positive association with all other variables. Board committee too has a positive association with all other variables under study while size of the firm posted a negative association with board size and a positive association with the rest of the variables.

#### **4.5 Summary and Interpretation of Findings**

According to the research findings the parameter estimates for the size of the board indicate that there is a significant but weak negative influence on ROA, meaning that an organization with a larger board is most likely to have a lower ROA which is consistent with most previous research. According to previous research larger boards contain 10 members and above while smaller boards contain less than 8 members. The study supported that smaller boards enhance firm performance indicating a negative relationship between board size and organizational performance. The researcher explained that a firm with a larger board of directors will have to deal with more conflicts between the board members and, thereby making it difficult to reach a consensus. A firm with a larger board



size also encounters the problem of free riding which negatively affects the board in providing better governance. This finding is similar previous findings by deferent researchers who came to the conclusion that the size of the board negatively correlate to the performance of the firm. (Lipton and Lorch, 1992; Yermack, 1996; Sundgren and Wells, 1998).

On the issue of CEO Duality the study reveals that Kenyan State owned corporations do not practice Duality. These results are similar to those by Guzeh (2012). The study also revealed that separating the CEO and COB won't increase the monitoring function of the board on the management activities if the board is already weaker. According to the research findings there still exists no distinct roles of the CEO and COB on a few of the SOCs despite the fact that they have a different chief executive and chairman of board. Since there was no duality the impact on duality on ROA could not be established. According to previous research however CEO duality leads to agency conflict where the CEO holding both positions could easily act in his own interests rather than in the interests of the shareholders of the company (Bailing et al.; 1996).

The study revealed that the average number of independent committees set up by the board was three with one being the minimum and four the maximum. In all SOCs there was an established independent, competent and financially literate audit committees which was effective and central in the financial performance of firm through taking an oversight role in the corporate governance. The study also found that presence of independent committees positively correlates with ROA. The independent committees have a crucial role in monitoring the company's operation and internal control systems and governance practices with the aim of protecting the interest of the shareholders in this case of SOCs the citizens. As a result the findings of the study indicated that an effective audit committee would focus on increasing the performance of the organization. (Fatma and Jensen, 1983). The results of this study are also consistent with earlier studies done by both Murage (2010) and Guzeh (2012) which show that there exists a positive relationship between the audit committee and the financial performance of state parastatals in Kenya.

The study found out that the boards of SOCs in Kenya are made up of mostly non-executive directors drawn from various ministries with some organizations having more than 80% non-executive directors. The analysis also shows that there is a positive correlation between the ratio of non-executive to executive directors on ROA which is consistent with the findings of Ochola (2013) that proportion of insider to outsider directors have a negative and significant effect on the Return on Equity (ROE) of fund managers in Kenya. The study also revealed that non-executive directors bring independence to the board by reducing CEO domination on the board (John and Senbet, 1998).

## **CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATION**

### **5.1 Introduction**

This chapter covers a summary of the findings of the study, a conclusion on the findings ending with a revised conceptual frame work of the model used in the study and ends with recommendations for further studies.

### **5.2 Summary of Findings**

State owned corporations are established by the government to provide goods and services to the citizens that the private sector cannot provide or at a much lower cost than those provided by the private enterprises. Although state owned corporations are meant to be self-sustainable as they contribute to the national development they have always been constantly hit by massive loses and inefficiencies in the production of goods and services. These corporations have become a liability to the government through allocation of subsidies every budget allocation. The poor performance of these corporations have been attributed to poor financial management, inefficiencies and poor corporate governance practices.

Corporate governance has been viewed as a major approach in reviving these corporations. This involved massive restructuring of the corporate practices of the organization such as the board size, its structure, composition among others to ensure that these state owned corporations achieve their intended objectives. This study found out that corporate governance plays an important role in the performance of the state owned corporations, to be precise good corporate governance practices positively influences the performance of state owned corporations in Kenya.

The study found out that there is a negative relationship between board size and the financial performance of the state owned corporation. This study therefore agrees with the literature review that there exist a negative relationship between the board size and performance of the firm (Lipton and Lorch, 1992; Yemarch, 1996; Sungren and Wells, 1998). It is however important to note that the study established a very weak negative relationship of a beta -0.001.

From the findings of the study, the effect of board composition on the financial performance of firms again agrees with the literature review that increasing number of non-executive directors in the board positively affects the performance of the firms. This is because non-executive directors will shield the shareholders from self-interests decisions made by the managers (Ochola, 2013; Berle and Means, 1932).

The findings on the effect of the CEO duality on the performance of the firms cannot agree neither refute the literature review since the study found out that there is no duality being practiced in the state owned corporations due to the change on the laws governing Kenyan state owned corporations. On the independency of committees the study found a very strong positive relationship between the number of independent committees and the financial performance of the corporations. This is in alignment with the literature review that are more effective in their mandates and that they also help reduce earnings management in the organizations (Klein, 2002; Senbet 1998).

The study found out a very weak but positive relationship between the size of the firm and its performance thereby agreeing with the literature review that bigger organizations take advantage of economies of scale and therefore perform better than their smaller competitors (Mansfield, 1962). This finding however is against the findings of Yang and Chen (2009) who said that organizations that are small in size have less agency problems and a flexible non- bureaucratic structure which is critical in changing business environment thus performing better than bigger organizations.

## **5.2 Conclusions**

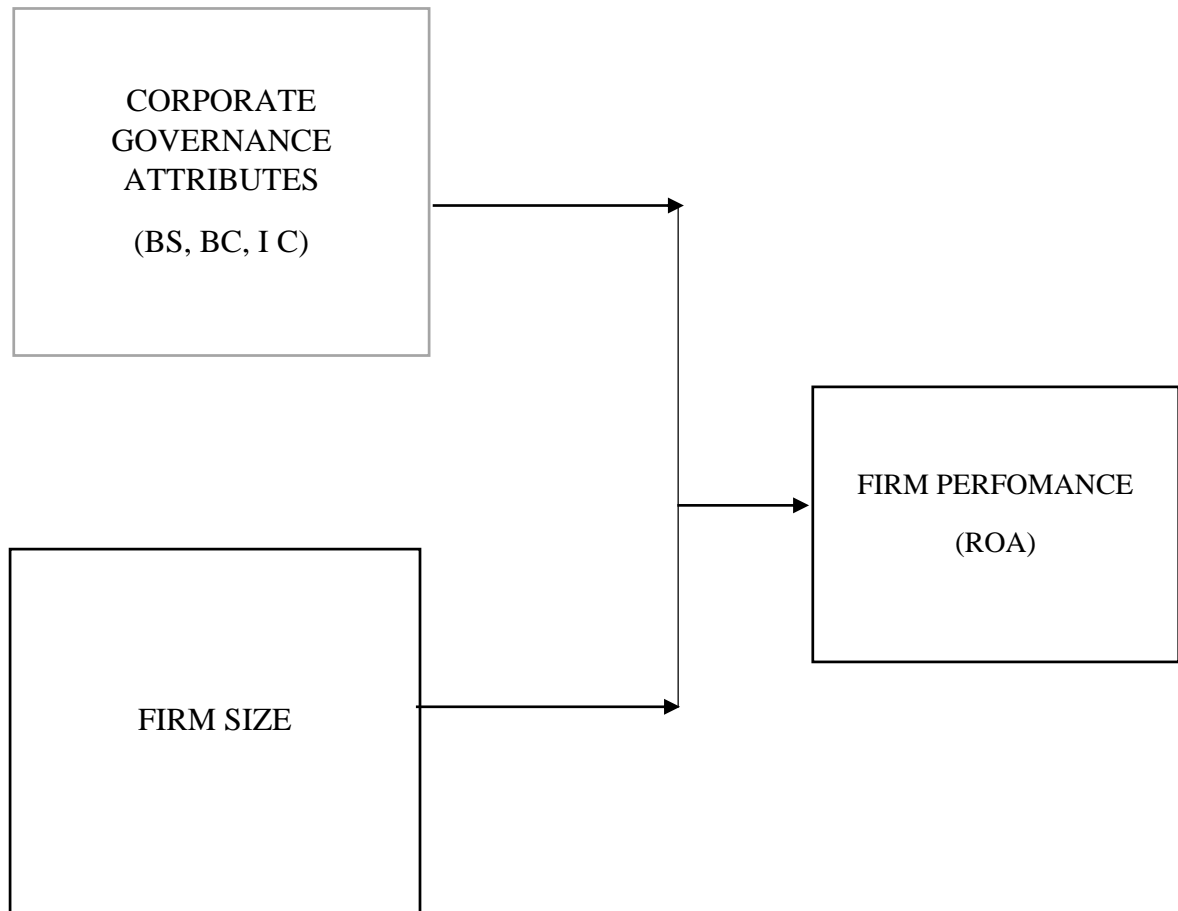
The study focused on the relationship between Corporate Governance and Financial Performance of SOCs in the service industry in Kenya. The Corporate governance attributes used in this study include board size, board composition, CEO duality and Independent committees.

The findings of the study revealed that there is a positive correlation between corporate governance and the return on asset of state owned corporations. On independent attributes examined, board composition showed a positive correlation on return on assets; thus outside directors bring in expertise and experience from other working areas contribute on

improving performance. All organizations cited not practicing duality. This can be attributed to the new laws that have come up governing corporate governance in Kenya especially in the state owned corporations. No analysis could therefore be done to determine the effect of CEO duality on ROA to determine this relationship. The study also found that independent committees are important elements of the board in monitoring both the financial and operational activities of the management to ensure that the interests of the shareholders are well taken care of. The results of the study showed a positive correlation of this attribute to financial performance of the organization. The study also showed that is a negative correlation between board size and the organizations performance while firm size has a positive correlation to firm performance.

The study therefore concludes that good corporate governance practices are positively correlated to the financial performance of SOCs in the service Industry in Kenya. These governance attributes are good predictor of financial performance, however caution must be exercised and consider other factors that could significantly affect the financial performance of SOCs outside governance practices.

### 5.3 Revised Conceptual Framework



#### Independent Variables

The study found out that CEO Duality is not practiced in the state owned corporations. The independent variables affecting the ROA of the state owned corporations are three corporate governance attributes that is board composition , board size and independence committees while firm size was used as a control variable.

#### Dependent Variable

The study found out that there is there is a positive relationship between corporate governance and the ROA of the state owned corporations. Board size negatively impacts ROA while board composition, independent committees and firm size all have a positive influence on the ROA.

#### **5.4 Recommendations**

To the theory of this study; There is need to carry out more studies on other sectors of the state owned corporations to test whether the theory that corporate governance positively affects the financial performance of state-owned corporations. It would be of great importance to test the model of this study in countries where duality is still being practiced.

To the policy formulation agencies; Good corporate governance practice is an important characteristic of every successful organization either owned by the state or fully private, profit making or non-profit. The government of Kenya through all its regulatory agencies has therefore a crucial role in improving the performance of these SOCs by ensuring that independent committees such as audit, nomination and remuneration are fully empowered to effectively carry out their duties.

To the State owned corporations; the study revealed that outside directors have a positive relationship to financial performance, the researcher recommends that only individuals with proven records of relevant education, experience or expertise and innovation to be appointed to the boards of state owned corporations. This is because the board plays a crucial role in the performance of these organizations. It is evident from the findings of this study that CEO duality is no longer a practice of the Kenyan SOCs however appointments of the chairman of the board should be done on merit basis to allow people with the required level education, relevant experience and proven leadership skills chair the boards.

#### **5.5 Limitations of the Study**

One limitation of this study was that it was difficult to get of data. The study targeted fifty (50) State Owned Corporations. Apart from those that post their annual report, it was difficult in obtaining the financial data from the others directly even after following all the required procedures citing sensitivity of the data. This affected the time taken for the study to be completed. The researcher however managed to have obtained data on 30 out of the 50 SOCs.

Second, the target respondents for the study were managers, directors and corporate secretaries who had a wide scope of the organizations governance practices, however due to their busy schedule it took long for the researcher to get the data from them with some taking more than two months prompting the researcher to proceed with the analysis without data from other organizations due to time constraints.

Finally, findings generated as a result of the study are not in themselves all conclusive as the study focused only on four corporate governance attributes determined necessary for the study by the researcher. Therefore caution should be exercised in generalizing the results since the performance of these SOCs does not solely rely on the four governance attributes.

### **5.6 Suggestions for Further Studies**

Future researchers should focus in their study on more corporate governance attributes other than just the four used on this project so that a conclusive analysis on the effect of corporate governance on firm performance can be done.

More time should be given for the data collection to allow the respondents of this topic enough time to give their views on corporate governance due to their high positions in the organizations and the tight schedule they are exposed to. There is need for sensitization by the university to the organizations and firms on the importance of research to reduce the low response rate of data given by those organizations especially financial data as most of them refuse citing confidentiality even after researchers all the letters of introduction to data collection from all authorizing institutions.

Future studies should be done on more respondents who work with the state owned corporations other than the top management and directors to see if the findings of this study will still hold.



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# APPENDICES

## APPENDIX I: QUESTIONNAIRE

### Introduction

This questionnaire is designed to collect data on corporate governance and financial performance of state owned corporations in service industry in Kenya from the year 2000 up to 2015. Information provided herein will be used solely for academic research purpose.

**Name of the Corporation (Optional):** \_\_\_\_\_

### Questions

To what extent do you agree with the following statements on the corporate governance practices as observed in your organization? Please indicate so by marking an X or a check mark (√) in the column that appropriately fits your organization.

**Key: 5 strongly agree; 4 agree; 3 undecided; 2 disagree; 1 strongly disagree;**

### Section A: Board Size

#### 1. Number of Directors ..... (Please indicate)

	1	2	3	4	5
Smaller boards enhance firm performance					
Board of directors that is larger in size may need to deal with more conflicts among board members and, thereby, have difficulty reaching consensus					
Larger size boards are more adept at providing resources					
Larger boards benefit firms by providing effective oversight of management and available necessary resources so that larger boards may help in improving performance of an organization					

	1	2	3	4	5
Large boards improve board performance by reducing CEO domination of the board					
A larger board will bring more expertise and experience to the board					
<b>SECTION B: CEO DUALITY</b>					
The CEO is the chairman of the Board of Directors					
The Chairman is a separate person from the CEO					
There is an established clear job description for the board chair and members which is different from those of the CEO and Management					
Separating the CEO and COB roles does not necessarily guarantee a strong monitoring function if the collective board is otherwise weak					
Separating the CEO and COB boards of an important tool to motivate And reward new CEOs					

**SECTION C: BOARD COMPOSITION**

1. Number of Non-executive Directors sitting the Board.....(Please Indicate)

	1	2	3	4	5
The number of Non-executive directors is higher than that of Executive directors					
The number of executive directors is higher than that of Non-Executive Directors					
The board is more independent when the proportion of outside directors increases					

Non- Executive directors can add value to firms by helping to broaden the executives' expertise and perspective.					
Executive directors are better placed in handling the affairs of the organization since they have a deeper understanding of the organizations Operations.					
<b>Section D: Board Committee(s)</b>					
<b>Number of committees established by the Board.....(please indicate)</b>					
There is an audit committee established on the board					
Independent committees would focus on improving the company performance and competitiveness					
The audit committee is independent, competent, financially literate, adequately resourced and properly compensated					
Audit committees are expected to oversee corporate governance, financial reporting, internal control structure, internal audit functions, and external audit services					
Audit committee are not effective against risk they are just overloaded					
The existence of independent committees enhances financial performance Of the organization					

**THANK YOU VERY MUCH FOR YOUR TIMELY RESPONSE**

## **APPENDIX II: PARASTATALS IN THE SERVICE INDUSTRY IN KENYA**

1. Kenya Veterinary Vaccines Production Institute
2. Rural Electrification Authority
3. Kenya National Library Services
4. National Water Conservation and Pipeline Corporation
5. Geothermal Development Company Ltd
6. Lake Victoria North Water Services Board
7. Water Services Trust Fund
8. Sports Stadia Management Board
9. National Campaign Against Drug Abuse Authority
10. Kenya Tourist Board
11. National Council for Persons with Disabilities
12. Kenya Institute of Education
13. National Commission on Gender and Development
14. National Coordinating Agency for Population and Development
15. Constituency Development Fund
16. Higher Education Loans Board
17. Lake Victoria South Water Services Board
18. Kenya Accountants and Secretaries National Examinations Board
19. Rift Valley Water Services Board
20. Tana Water Services Board
21. Kenya Forest Service
22. National Aids Control Council
23. Kenya National Examinations Council
24. Brand Kenya Board
25. Kenya Ferry Services Ltd.
26. Athi Water Services Board
27. Privatization Commission of Kenya
28. Kenya ICT Board



29. Bomas of Kenya
30. Agricultural Development Corporation
31. Kenya Medical Supplies Agency
32. Local Authorities Provident Fund
34. Moi Teaching and Referral Hospital
35. Teachers Service Commission
36. Northern Water Services
37. National Council for Children
38. Kenya National Highways Authority
39. Tanathi Water Services Board
40. Kenyatta National Hospital
41. Water Resources Management Authority
42. Kenya National Bureau of Statistics
43. Kenya Institute of Special Education
44. Kenya Yearbook Editorial
45. Kenya Ordinance Factories Corporation
46. Coast Water Services Board Water and
47. Kenya Industrial Property Institute
48. Centre for Mathematics Education
49. Kenya Wildlife Service Tourism
50. University of Nairobi Enterprise Services Ltd

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