THE EFFECT OF CORPORATE GOVERNANCE ON THE FINANCIAL PERFORMANCE OF LISTED FIRMS ON THE NAIROBI SECURITIES EXCHANGE

GITU TITUS KIBUNG’A

D63/82895/2015

RESEARCH PROJECT PRESENTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF DEGREE OF MASTER OF SCIENCE IN FINANCE, SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI

2017
DECLARATION

I declare that this research project is my original work and has not been presented for an award of a degree in this or any other university.

Signature……………………………………….. Date……………………………………..

TITUS K. GITU   D63/82895/2015

Supervisor

Signature……………………………………….. Date……………………………………..

DR. CYRUS MWANGI

SCHOOL OF BUSINESS

UNIVERSITY OF NAIROBI
ACKNOWLEDGEMENTS

I wish to sincerely thank and acknowledge my supervisor Dr. Cyrus Iraya for his guidance and insight into this project. The patience he has shown and the guidance throughout the project was of immense help and his wide knowledge of corporate governance.

Am pleased to also acknowledge and thank my employers for giving me this chance to be able to pursue the course unconditionally and allowing me extra time to work on my studies.

I would also like to acknowledge the support accorded to me by my classmates during the research process, my love Eva, my family and my colleagues at work for standing with me and I thank you all and may the Lord bless you abundantly.
DEDICATION

I dedicate this project to my family and friends who have contributed to the success of this research project. I also dedicate this to my love Eva who has been with me supporting me all through the research process. I also thank the lord for bringing me this far and gifting me good health and the energy to see me through this academic journey.
# TABLE OF CONTENTS

DECLARATION .......................................................................................................................... ii

ACKNOWLEDGEMENTS ......................................................................................................... iii

DEDICATION ............................................................................................................................... iv

LIST OF TABLES ....................................................................................................................... vii

LIST OF FIGURES ..................................................................................................................... viii

LIST OF ABBREVIATIONS ...................................................................................................... ix

ABSTRACT ................................................................................................................................. x

CHAPTER ONE: INTRODUCTION .............................................................................................. 1

1.1 Background of the Study ..................................................................................................... 1

1.1.1 Corporate Governance ............................................................................................... 3

1.1.2 Financial Performance .............................................................................................. 4

1.1.3 The effect of Corporate Governance on Financial Performance ................................. 5

1.1.4 Firms Listed at the Nairobi Securities Exchange .......................................................... 6

1.2 Research Problem ............................................................................................................ 7

1.3 Research Objective .......................................................................................................... 8

1.4 Value of Study ................................................................................................................... 9

CHAPTER TWO: LITERATURE REVIEW ................................................................................. 10

2.1 Introduction ...................................................................................................................... 10

2.2 Theoretical Review ......................................................................................................... 10

2.2.1 The Agency Theory .................................................................................................. 10

2.2.2 Stewardship Theory ............................................................................................... 10

2.2.3 Resource Dependency Theory ................................................................................ 11

2.2.4 Stakeholder Theory ................................................................................................. 12

2.3 Determinants of Firms Performance ............................................................................. 12

2.4 Empirical Studies ............................................................................................................. 14

2.5 Conceptual Framework ................................................................................................. 15

2.6 Summary of Literature Review ..................................................................................... 16

CHAPTER THREE: RESEARCH METHODOLOGY ................................................................... 18

3.1 Introduction ...................................................................................................................... 18

3.2 Research Design .............................................................................................................. 18

3.3 Population ......................................................................................................................... 18

3.4 Data Collection ................................................................................................................. 18

3.5 Data Analysis ................................................................................................................... 19
LIST OF TABLES

Table 4.2.1: Variance Inflation Factors..............................................................22

Table 4.2.2: Normality Test..............................................................................23

Table 4.2.3: Stationarity Test...........................................................................24

Table 4.3.1: Board size....................................................................................25

Table 4.3.2: NED Summary............................................................................25

Table 4.3.3: ED Summary.................................................................................26

Table 4.3.4: CEO Duality Summary.................................................................27

Table 4.3.5: Board Committees Summary......................................................27

Table 4.3.6.1: ROA Summaries......................................................................28

Table 4.3.6.2: Average ROA Summaries.......................................................28

Table 4.3.7: Board Composition Summary....................................................29

Table 4.4: Correlation Analysis......................................................................30

Table 4.5.1: Linear Regression Analysis.........................................................30

Table 4.5.2: ANOVA Analysis.........................................................................31
LIST OF FIGURES

Figure 2.5: Conceptual framework ................................................................. 16

Figure 4.2.2: Normality test ........................................................................... 23

Figure 4.3.1: Board size graph ....................................................................... 25

Figure 4.3.2: NED summary .......................................................................... 25

Figure 4.3.3: ED Summary ............................................................................ 26
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AGM</td>
<td>Annual General Meeting</td>
</tr>
<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
</tr>
<tr>
<td>CFO</td>
<td>Chief Financial Officers</td>
</tr>
<tr>
<td>CMA</td>
<td>Capital Markets Authority</td>
</tr>
<tr>
<td>EBIT</td>
<td>Earnings before interest and taxes</td>
</tr>
<tr>
<td>ED</td>
<td>Executive Directors</td>
</tr>
<tr>
<td>EPS</td>
<td>Earnings per Share</td>
</tr>
<tr>
<td>EVIEWS</td>
<td>Econometrics Views</td>
</tr>
<tr>
<td>KNBS</td>
<td>Kenya National Bureau of Statistics</td>
</tr>
<tr>
<td>KQ</td>
<td>Kenya Airways</td>
</tr>
<tr>
<td>NED</td>
<td>Non-Executive Directors</td>
</tr>
<tr>
<td>NSE</td>
<td>Nairobi Securities Exchange</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Cooperation and Development</td>
</tr>
<tr>
<td>ROA</td>
<td>Return on Assets</td>
</tr>
<tr>
<td>ROCE</td>
<td>Return on Capital Employed</td>
</tr>
<tr>
<td>ROE</td>
<td>Return on Equity</td>
</tr>
<tr>
<td>VIF</td>
<td>Variance Inflation Factor</td>
</tr>
</tbody>
</table>
ABSTRACT

The research project was done with an objective of establishing the effect of corporate governance on the financial performance of listed companies in the NSE. The dependent variable used was ROA as a financial performance measure. The independent variables used denoting corporate governance were board composition which was a ratio of the total of NEDs and the independent directors to the total board size, CEO duality, the number of board committees and the number of EDs. A census of all the listed companies was done and secondary data was acquired from the NSE and company websites for the period of study which was 2010-2016. Data was analysed using Eviews software and a regression model was solved using OLS. The analysis of the regression model showed that all the variables had a positive linear relationship with the independent variable but they were insignificant. The findings contradicts other previous findings like Kigotho (2014) hence need for more research.
CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

The words Corporate Governance have attracted a lot of attention since the mid-1980s according to David and Sahla (2011) and that initially The Anglo-Americans provided a set of good corporate governance codes. The OECD and the World Bank also came up with their own set of standards and recommendation. The set of regulations were added on top of various existing laws. After these milestones were achieved we still experienced high profile corporate scandal that shook the financial industry with far wide reaching consequences like the Enron in the USA. Due to the effects of theses Corporate Governance failures it became central to most companies. Investors started demanding high corporate governance standards to help achieve better returns. This forms the study topic which seeks to study how corporate governance affects the performance of listed companies.

The Agency conflict exists between shareholders and the managers of the organisations and corporate governance will reduce agency conflicts and increase the firm’s financial performance. The organisation through increased corporate governance will seek to promote accountability, integrity, professionalism and safeguarding stakeholders’ rights. The resource dependency advanced by Aldrich (1976) states that directors are very helpful in an organisation and the organisation depends highly on their input to increase performance.

After the major corporate scandals in the United State including Enron and WorldCom Sarbanes Oxley Act (2002) was enacted. This was after accounting scandals that led to the folding of one of the big five Audit firms Arthur Andersen LLP in the United States of America. The firm voluntarily surrendered all its licences in 2002 after it was held culpable in the manipulation of Enron accounts. Enron was involved in manipulating its books and was a
big scandal in the USA that led to its bankruptcy. Corporate governance has greatly improved from the major scandals of the Enron and WorldCom Era that led to improved regulation through enactment of laws with stiffer penalties to offenders. In the NSE we had experienced corporate failures which have led to huge erosion of investor wealth and also delisting of firms like Uchumi Supermarkets Ltd 2006. Good Corporate Governance was noted to be critical since it will encourage investors both local and foreign to invest with an assurance that their investments are safe and efficiently managed. This will also create competition between firms and corporations which will improve the financial performance of listed organisations. It also promotes prudent use of resources of the corporation and the CMA (2002) guidelines gave the shareholder the right to have the final say in an AGM as the top decision maker organ in the organisation while the managers are there to implement. In Kenya the CMA through the CMA Act 2002 set out corporate governance rules for listed companies. Corporate Governance deals with the relationships that bind all its stake holders. Different cultures have various practices hence various jurisdiction have set own set of rules and regulations that geared towards achieving good corporate governance. It is believed that increased corporate governance leads to increased performance of the firms through various studies like Murage (2010) in his study on the effect of corporate governance on the financial performance of parastatals in Kenya he got to conclude that large boards that were dominated by NEDs and this enhanced performance of the parastatals’ and increased firm value. Due to the changing environment the CMA has repealed the CMA corporate governance guidelines (2002) to the CMA code of corporate governance practices for issuers of securities to the public (2015) gazetted on 4 March 2016. The study will be done prior to the new enactment.
1.1.1 Corporate Governance

According to OECD corporate governance was defined as a set of relationships between the shareholders, management, board and other stakeholders. It can also be defined as a process through which objectives are set, how to achieve and monitor them. The Cadbury Committee (1992) defined it as a system through which organizations are controlled and directed. The CMA ACT (2002) has defined Corporate Governance as a process and a structure under which companies to manage and direct their business towards improved prosperity and accountability with a view of achieving shareholders long term goal taking into account the interests of all the stakeholders. According to Gompers (2003) governance provides a way of monitoring the decisions and policies of organisations.

The CMA (2002) further identifies a number of principles that form critical values and virtues of corporate governance. It recommends that all listed companies be headed by Boards and that the board shall establish various committees to help it run the organization. The board should create relevant committees and delegate its duties. Among the committees set up there must be the Remuneration, Audit and Nominating Committees which are critical in the running of the organization. The Audit committee ensures that financial reports are accurate and should be headed by an independent director. The Directors remuneration should be good enough to ensure it retains them and run the company effectively but their remuneration should be approved during the AGM. The Directors’ remuneration should be competitive to be able to retain them and also performance based for the EDs. For the Non-executive their remuneration should be in line with other director’s remuneration from other sectors. The Act also advocates for CEO duality; it states that companies listed in the NSE should have a CEO and a Chairman to avoid having too much power on one individual. According to Aduda, Chogii and Magutu (2013) in their study on the effect of corporate governance Theories on the performance of firms listed at the NSE they found out that the
board size, board composition having more independent directors and CEO duality were important predictors of firm performance. This shows that good corporate governance improves financial performance of companies.

### 1.1.2 Financial Performance

Chashmi and Fadaee (2016) financial performance measurement entails using key performance indicators among them ROE, ROA and EPS to evaluate performance. It helps in making decisions thereby promoting efficiency and the survival of businesses. Every firm needs to know what’s happening and if things are going as per the way they should and its Success is usually based from its Performance over a period of time. This will help in knowing if there is any Improvement. Brown and Davison (2010) noted that ROE is a good measure but can be exploited by the management. Brown and Davison (2010) went ahead and noted that comparative measures of performance would be good to avoid exploitation like he noted with ROE. A firm’s financial liquidity can be measured by the firm’s ability to meet its obligations when they fall due. It can also be measured by its ability to generate positive cash flows and this one helps an organization to be able to meet its financial obligations to run the organization paying its staff, paying its suppliers. A firm’s performance can also be measured using the ability of an organisation to generate profits.

There are a number of profitability ratios that can be applied to measure financial performance; Tobin’s q ratio usually measures the total market values to book values of firms. This theory was devised by Jones Tobin who said that the stock value of a firm in a market should be about equal to the replacement cost of the stock. It was hypothesized that the combined market value should be the same as the replacement cost or the total assets of the organisation. If the value is below 1 the stock is undervalued and if it is above 1 it’s overvalued and thereby makes an investment decision. It is measured by dividing the total
The stock value of the firm in the listed market is calculated by dividing earnings before interest and tax (EBIT) with the total asset value of the firm. The return on capital employed is calculated by dividing earnings before interest and tax (EBIT) with the capital employed. Higher ROCE indicates more efficient use of capital. ROCE should be higher than the cost of capital of the company or else the organisation is not prudent on employing its capital. This ratio is derived by dividing the net income with the total assets. This shows how an organization efficiently uses its assets to generate profits. A higher ratio shows better returns. The return on capital employed is calculated by dividing earnings before interest and tax (EBIT) with the capital employed. Higher ROCE indicates more efficient use of capital. ROCE should be higher than the cost of capital of the company or else the organisation is not prudent on employing its capital. This ratio is derived by dividing the net income with the total assets. This shows how an organization efficiently uses its assets to generate profits. A higher ratio shows better returns. The Earnings per share (EPS) shows the amount of profit allocated to each outstanding share. It is calculated by dividing the net profit less the dividend owed to preference shareholders with the average outstanding shares. A higher EPS shows a higher financial performance by the firm. ROE is a measure of how much an organisation makes from shareholders equity. ROA is derived by dividing the net income with the total assets. This shows how an organization efficiently uses its assets to generate profits. A higher ratio shows better returns according to Heikal, Khaddafi and Ummah (2014).

1.1.3 The effect of Corporate Governance on Financial Performance

Shareholders in an organization have their main objective as wealth maximization when the managers want better perks according to the agency theory. This has led to the growth of corporate governance and ways of mitigating agency conflict like aligning managers pay to financial performance. This has led to increase performance of firms as managers also benefit from the increased performance through huge benefits and end of year bonuses. Agency conflicts affect the performance of firms through monitoring costs. The stewardship theory states that managers act as stewards to the shareholders. This was achieved by ensuring that their salaries and other perks are tied to the performance of the firm. This ensured that they always want the best for the company and will give their best as the stewards. This showed that it had a positive effect on the financial performance of the firm. The resource dependence
theory states that organisations depend heavily on their directors to provide the expertise and the knowhow to run the organization. This helped in improving the value of the firm.

Aduda Chogii and Magutu (2013) found a positive relationship on board composition and financial performance. Lack of CEO duality was also a factor that was positive to the financial performance of the listed companies. CMA (2002) guidelines on corporate governments also conform to these findings. Firms that had poor governance structures performed poorly as we have seen CMC and Uchumi. Kashif and Sardar (2008) also emphasizes on the need to have a large board which the study showed that it increased the financial of firms as they had a positive relationship.

1.1.4 Firms Listed at the Nairobi Securities Exchange

The NSE was founded in the year 1954 and it is based in Nairobi, Kenya. It was formerly called the Nairobi Stocks Exchange but was changed to security Exchange. The NSE is regulated by the CMA (government regulator) that is charged with regulating and licensing the Capital Markets in Kenya. The NSE provides a trading platform for the listed securities and it oversees its member firms. The NSE plays a major role in the economy by encouraging investors to save and invest and also provides a good platform for local and international companies to access capital. This is done through a diverse products and services ranging from debt, equity and derivatives.

The CMA ACT (2002) corporate governance guidelines which has been replaced by the CMA code of corporate governance practices for issuers of securities to the public (2015) has set the corporate governance guidelines for the public listed companies in the NSE so as to reduce false financial reports, illegal ways of working with stockbrokers with the aim of defrauding investors. There are various disclosure requirements for all listed companies which improve on corporate governance. They are either voluntary or involuntary.
Companies are required by law to issue profit warnings, change of key management as involuntary disclosures etc. by the CMA.

The NSE went public and traded on its own bourse. The IPO was done in 2014 and NSE shares started trading on the 9th of September 2014. The NSE is governed by an eleven member board with Samuel Kimani and Geoffrey Ochacho as chairman and CEO respectively. The board and management of the NSE comprise of the best professionals in capital markets in Africa focused on innovations and diversifications. The NSE is a very active house with a market capitalisation of over 2 trillion Kenya Shillings and over 60 firms listed on it.

1.2 Research Problem

Most studies have not been able to explain why despite tight regulations and reporting guidelines we still find listed companies failing like Uchumi, Mumias Sugar company, KQ and CMC. All of them directors have been held not to have acted in good faith. The research was driven by a wave of corporate failures both locally and abroad. KQ was once a blue chip stock on the NSE and was performing well financially yet today it’s being bailed out by the government after suffering tens of billions of shillings in losses. Mumias Sugar company once the economic jewel of Western Kenya has also suffered huge losses whereby the directors and senior managers have been alleged to commit massive fraud that have left Mumias sugar unable even to pay farmers cane according to CMA reports. The company had stopped production at some point and the situation doesn’t look like getting any better.

According to Lipman (2017) article on lessons learnt from the big corporate failures it was noted that all those companies failed to have established whistle bowing channels that could have averted the huge losses had the independent directors been reached. In the USA after Enron and WorldCom scandals tough measures were taken through the enactment of the
Sarbanes Oxley Act (2002). This has not stopped corporations from failing and hence the need for more studies on corporate governance. Recently Volkswagen was hit by fines in the USA for using devices that cheated on Carbon emissions’ which led to sacking of the disgraced CEO. Closer home the CMA has adopted a new code of governance to try to be at par with the global standards.

The study attempted to answer the following research questions. What is the effect of corporate governance on financial performance of firms? The failing firms have not been studied as much yet we see many firms failing in the NSE. The CMA code of practice for issuing securities in the NSE, (2015) gives the bare minimum requirements but recommends directors to do more than just the minimum. In this regard we might be able to examine some corporate failures in the NSE and make analysis of whether this was adhered to.

Most studies done on the effect of corporate governance and effects of financial performance have not looked at the committees yet the CMA recommends that firms must have and Audit and a nominating committee. Aduda Chogii and Magutu (2013) it focuses on the board composition and size whereby it finds a positive relationship with financial performance. Munene (2007) also did a study on board composition and financial performance. Kigotho (2014) study was also on the board but did not look at the committees which is the gap that I had identified. Most of the corporate failures have been fraudulent and the Audit committee if properly constituted and independent can be able to wade off some of these corporate failures.

1.3 Research Objective

The objective of this study was to determine the effects of corporate governance on the financial performance of listed firms on the Nairobi Securities Exchange.
1.4 Value of Study

The study will tried to have a better understanding of the relationship between corporate governance and financial performance of listed firms in the NSE. It would be of great benefit to the shareholders of listed companies as they would be enlightened on best practices of corporate governance and how they affect corporate governance. This would also help them in making informed decisions on the securities to buy based on this study.

This study will enlighten investors and also help people those who are seeking to understand the relationship between the performance of a company and the corporate governance. To the policy makers they will aim at ensuring corporate governance standards are upheld if the study will determine that corporate governance aids in firms performance. This will ensure that the policy makers and regulators ensure strict adherence to corporate governance to safeguard stakeholders’ interests. The study will be attempting to fill a research gap that has already been identified. This will be invaluable to future studies and academicians in furthering the study.
CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

There have been extensive research studies done around corporate governance effect on the firm’s performance that are reviewed. There are also a number of theories on corporate governance reviewed to help in the study.

2.2 Theoretical Review

Theoretical review is a review of the theories touching on the study.

2.2.1 The Agency Theory

Jensen and Meckling (1976) explained that there is an agency relationship that exists between shareholders (Principals) and the company directors/managers. It usually deals with problems that arise between the Shareholders and Directors due to their differences. It also helps in handling various levels of risk whereby a Director may have less or no risks in decision making but which may have a big impact on the shareholder.

An agency problem arises when there is conflict of interest between the parties. Corporate governance tries to minimize agency conflicts through monitoring the agents and also through performance based remuneration. Performance based remuneration also has its downside as it forces managers to ensure that they report high profits which at times is done through creative accounting case in point is Uchumi supermarkets under Ciano and led to Jonathan Ciano being fined KES five million by the CMA for his acts that also included being one of the largest supplier with Uchumi creating a conflict of interest.

2.2.2 Stewardship Theory

According to Donaldson (1991) the Stewards Theory says that a steward protects and maximises shareholder wealth through firm performance to maximise steward’s functions.
This theory explains that the steward’s satisfaction is increased when the organization performs. The theory explains that the stewards’ reputation is on line if they fail to act for the interest of the organizations. This theory calls for professionalism. It encourages corporate accountability to all stakeholders.

The stewardship theory tries to reduce the agency conflicts in the agency theory. This is done by ensuring the managers pay is tied to performance of firms hence they will strive to have better results as they also benefit. The managers also get rewarded with shares to assume a sense of ownership and this makes them feel more obliged to give better results to maximise the wealth of the shareholders. Most listed companies in the NSE have employee stock options whereby they offer stock to their employees.

### 2.2.3 Resource Dependency Theory

According to Aldrich (1976) Pfeffer and Salancik (1978) states that the board of directors should be resourceful people and their networks should help the organization through the linkages to the external environment. This helps in bringing diversity and the needed diverse expertise in the boardroom. An organization with experts from all fields is likely to make better decisions as the directors have diverse views. This reduces the cost of services like when we have lawyers sitting in the board we may be able to get legal services cheaply as the lawyer may use his bargaining powers in his expert field. This may also help in identifying experts in various fields.

According to Sharif and Yeon (2014) the study found out that listed family controlled firms in Malaysia with directors who were politically connected improved the financial performance of the firms.
2.2.4 Stakeholder Theory

Freeman (1984) advanced the theory by criticizing the traditional view of wealth maximization. It holds that all stakeholders’ interests should be taken into account for the company to thrive. This one ensures that the company takes care of its internal stakeholders in the company and those without (external) According to Jones and Wicks (1999) who furthers it with corporate social responsibility was seen as a way through which increased economic performance was achieved. This theory conflicts the saying that firms main objective is shareholders wealth maximization but emphasizes that all stakeholders must be taken to account when setting the objectives of a firm.

Most of the listed companies on the NSE have corporate social responsibility programs aimed at improving the interests of its stakeholders. Safaricom has a Safaricom foundation where it channels money. It also sponsors sports activities and technology challenges to increase innovation. This one helps in creating an environment where the environment is receptive of the company’s products while at the same time criticized as it eats into the revenues. The managers have to balance the stakeholders’ interests and also balance this with those of shareholders.

2.3 Determinants of Firms Performance

According to Tricker (2015) he says that all entities need governing to achieve their set objectives. It was also found out that there needs to be a separation of ownership from the firms operations. There was also need to have a board to guide the operations of the organization which should not be too small and again not too big to ensure that decision making is not done by a few people. The board also needs to be diverse according to the resource dependency theory that states that the directors should bring the resources in the company. We should have finance, law and other industry experts to ensure that the board is
balanced. It was also noted that boards with greater independence and that higher number of independent and NEDs performed better.

The CMA ACT (2002) says that organisations shall establish board committees that will help in running the organization. There was no set number of committees however it was noted that there shall be an audit committee to ensure that the financial reports are credible. The audit committee also ensures that the financial reports are published at least annually. The board should also introduce a nominating committee which sets out the procedure for nominating directors of the company. According to Hillman and Dalziel (2003) study on board members and firm performance; integrating the agency and resource dependency theories. The study found out that the board plays two important roles of monitoring the management and providing resources. It concludes that the board incentives help moderate these relationships. One of the objectives of corporate governance is shareholder wealth maximization according to Kashif and Sardar (2008). The study found out that a bigger board and information efficiency had a value impacting effect on the firm.

Other Determinants of Financial Performance

According to Modigliani and Miller Theory commonly referred to as Capital structure irrelevance Theory. It was noted that when there are no taxes capital structure is irrelevant to the value of the firm. When taxes were introduced there was an added tax shield which suggests that the optimal capital structure is all debt. Capital structure can be defined as the ratio of debt to equity. This theory is unreliable as more debt increases the risk of financial distress as we have seen highly indebted companies like Nakumatt holdings Ltd have too much debt and are unable to even pay their staff. According to Brown and Davidson (2010) too much debt can cause financial distress especially when there is a recession or business low season. Debt is generally cheaper but the policy of the organisations capital structure has to be observed. According to Mirza and Javed (2013) in their study they found out that a
higher debt ratio led to higher profits. Debt is cheap but it comes with debt covenants and interest obligations which must be observed. From the above studies and theories they all conclude that an optimal capital structure is essential in firms’ financial performance.

According to Classical Economies of scale the size of an organization does not affect the profitability as it reduces the cost of production due to mass production. Thus large organizations enjoy economies of scale. According to Luqman, Bamidele and Fatai (2017) the size of firm affects the performance of a firm only if the parameter used to measure the size was the sales while it turned out negative on the size of the firm parameter being total assets. It pointed out that a company might have a lot of assets but do not use the assets optimally to generate profits. The studies show conflicting results on the effects of firm size to financial performance.

Inflation is a general rise in prices of both goods and services. When this is sustained it reduces the purchasing power creating economic distortions. Adrangi et al (1999) increased inflation affects real returns and finally lead to unemployment and increased interest rates which will affect the financial performance of firms negatively. According to CBK Monetary policy a low and stable inflation ensures price stability. High inflation rates have negative effects on financial performance of listed firms. The inflation rate needs to be maintained at a certain rate hence most central banks have a target inflation to be able to have optimal results according to their policies.

2.4 Empirical Studies.

We have a number of previous studies done on the effect of corporate governance on financial performance. According to Mirza and Javed (2013) found out there exists a positive relationship between corporate governance and financial performance. This one explains that improved corporate governance increases the performance of firms. It calls for increased
transparency and the protection of shareholders rights and those of all stakeholders. Aduda, Chogii and Magutu (2013) they found out that the board size, CEO duality and having independent directors had a positive relationship with financial performance of firms. Firms that showed better financial performance had better corporate governance structures.

Kitui (2013) in his study also found out that the composition of the board based on their age, gender, independence and their ethnicity had a positive relationship with financial performance. When the board was diverse according to those variables the returns were better. These all studies show that corporate governance improves financial performance of firms.

2.5 Conceptual Framework

According to Miles and Huberman (1994) defines a conceptual framework as a written or visual product either in narrative or a diagram showing the key variables their relationships and the control variables. This one is explained by figure 1.0 below.
Most of the studies and theories showed that there is a need for improved information efficiency, big but adequate boards, and adoption of nominating, remuneration and audit committees and use of both NED and independent directors to help increase on corporate governance.

From the studies done it was clear that corporate governance theories that there is need for improved corporate governance and theories do not show or explain how best to improve performance. We have seen NSE listed firms which are highly scrutinized and high reporting
standards that still falling to bad corporate governance. We have KQ, Uchumi and other firms in the NSE that have failed due to poor corporate governance.
CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter shows how the study was done, where and how it was done, the samples studies and the data analysis methods that were employed to achieve the purpose of the study.

3.2 Research Design

The study aimed at establishing a relationship between the effects of corporate governance on the financial performance of firms listed in the NSE. The study was done on listed firms in the NSE done on a specific period. The study was done through a descriptive research to try and describe the characteristics of the variables of interest.

3.3 Population

The population was the entire group of individuals on objects that has the same characteristics. The population was all the listed companies in NSE. The study involved only listed companies due to availability of the information of listed companies due to the CMA disclosure requirements. Currently we have a total of 64 listed companies. A census of all the listed companies was the population from the year 2010-2016.

3.4 Data Collection

It involved collecting evidence or gathering information to gain more insight. The method of data collection was secondary data sources. The firms in the population and that were sampled were listed companies whose information was publicly available. The information was available on the NSE websites and publications, company websites and annual reports of the specific companies. There will be a table that was filled from the information gathered from secondary data.
3.5 Data Analysis

Qualitative and quantitative data analysis methods were used. To ensure that data was analysed in quantitative data the data must be changed to numerical codes representing the attributes. Firm’s performance was given in quantitative forms. Quantitative data analysis was extensively used in this study. Descriptive statistics attempted to predict values while inferential statistics attempted to generalize the results.

A regression model was derived and solved to help in solving the relationship of corporate governance and firm’s performance of listed companies in the NSE. This helped analyse the relationships between the independent and dependent variables. The variables were also subjected to correlation to show if they have positive or negative correlation.

3.5.1 Diagnostic Tests

A number of diagnostic tests were carried out on the data namely multicollinearity test, stationarity test and a normality test as shown below.

3.6.1.1 Multicollinearity Test

Kothari, (2004) explains multicollinearity as a situation whereby the independent variables exhibit a high degree of correlation. A mix of VIF and correlation co-efficient was used to measure multicollinearity. Multicollinearity distorts a regression model hence the need to take the test. Gujarati (2003) study had recommendations that the co-efficient with 0.8 and a VIF of 5 or more exhibited multicollinearity. A VIF of above one is moderately correlated but a near five or above five will be problematic to solve the regression model while a correlation of below one is perfect in regression.
3.6.1.2 Stationarity Test

Stationarity is exhibited in a sample data when the mean, autocorrelation and variance do not change over time according to Gujarati, (2003) and a stationarity test ensures that regression results are not spurious. The study also found out that non-stationarity distorts t-ratios leading to invalid significance tests. The Augmented Dickey Fuller test was used to test for non-stationarity. It tests the null hypothesis of whether a unit root is exhibited in an autoregressive model. This will be done using the EVIEWS software.

3.6.1.3 Normality Test

Normality tests were done on the data to check if the data is well modelled by a normal distribution and that a random variable exhibits the same. Greene, (2008) in his study found out that if data exhibited non-normality it never affected the consistency of estimators but only affected its efficiency thereby invalidating and distorting the statistical tests. The study went on to conclude that this only will affect a small sample size but will not be a bother for samples that are over fifty. Our data had over fifty items and then it was not affected by this.

3.5.2 Analytical Model

The multiple linear regression models below was be solved using EVIEWS software.

\[ Y_i = \beta_0 + \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \beta_4 x_4 + \epsilon \]

Where Yi is the dependent variable of firms’ performance shown by ROA

X1= Board Composition

X2= CEO Duality

X3= No of board committees

X4 = Executive directors
The control variables were the company size, inflation rate and the capital structure.

et is the error term with control variables (inflation, size of firm and capital structure).

### 3.5.3 Test of Significance

A number of tests of significance were also carried out on the data namely the F test and the T test.

#### 3.6.3.1 F Test

Liang and Pan (2006) noted that while testing the significance of the regression model the F-test is used to assess multiple coefficients in a regression model. Kigotho (2014) states that F test check various coefficients whether they were different from zero at a significance level of 5% while the P value was used in testing the null hypothesis of the coefficients of the regression models. An alternative hypothesis of the regression model shows that the coefficients are not equal to zero Kigotho (2014).

#### 3.6.3.2 T Test

Liang and Pan (2006) in their study states that the T test is used to test the significance of a regression model through assessing any two coefficients in the model. The confidence levels were applied at 5% according to Kigotho (2014).
CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the findings of the data collected from the annual reports of NSE listed companies from the year 2010 – 2016. The 2015-2016 NSE handbook and annual reports of the companies were the source of the secondary data. The information was analysed using the EVIEWS software. The findings of the study on the effect of corporate governance on financial performance of firms listed in the NSE.

4.2 Data Validity

Data was tested for validity using the following tests:-

4.2.1 Multicollinearity Test

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient Variance</th>
<th>Uncentered VIF</th>
</tr>
</thead>
<tbody>
<tr>
<td>B_COMPOSITION</td>
<td>0.001640</td>
<td>6.944035</td>
</tr>
<tr>
<td>ED</td>
<td>0.000208</td>
<td>4.345006</td>
</tr>
<tr>
<td>CEO_DUALITY</td>
<td>0.010961</td>
<td>1.168051</td>
</tr>
<tr>
<td>COMMITTEE</td>
<td>6.22E-05</td>
<td>5.885434</td>
</tr>
</tbody>
</table>

Table 4.2.1 Variance inflation factors

The VIF of CEO duality and executive directors are below five which means that they exhibit low multicollinearity or moderately correlated. According to Gujarati (2003) a VIF of one to five was moderate and from our variables the model will be moderately correlated. A VIF of below five did not affect our study for the two variables.
According to Ghasemi and Zahediasl (2012) the probability of violating the normality was not be a major cause of worry as sample size exceeds thirty like in our case hence the data passes the normality test Greene, (2008).
4.2.3 Stationarity Test

Null Hypothesis: Unit root (individual unit root process)
Series: A_ROA, B_COMPOSITION, ED, CEO_DUALITY, COMMITTEE
Date: 11/13/17   Time: 21:50
Sample: 1 64
Exogenous variables: Individual effects
Automatic selection of maximum lags
Automatic lag length selection based on SIC: 0
Total number of observations: 248
Cross-sections included: 4 (1 dropped)

<table>
<thead>
<tr>
<th>Method</th>
<th>Statistic</th>
<th>Prob.**</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADF - Fisher Chi-square</td>
<td>138.235</td>
<td>0.0000</td>
</tr>
<tr>
<td>ADF - Choi Z-stat</td>
<td>-10.8115</td>
<td>0.0000</td>
</tr>
</tbody>
</table>

** Probabilities for Fisher tests are computed using an asymptotic Chi-square distribution. All other tests assume asymptotic normality.

Intermediate ADF test results UNTITLED

<table>
<thead>
<tr>
<th>Series</th>
<th>Prob.</th>
<th>Lag</th>
<th>Max Lag</th>
<th>Obs</th>
</tr>
</thead>
<tbody>
<tr>
<td>A_ROA</td>
<td>0.0000</td>
<td>0</td>
<td>10</td>
<td>63</td>
</tr>
<tr>
<td>B_COMPOSITION</td>
<td>0.0000</td>
<td>0</td>
<td>10</td>
<td>63</td>
</tr>
<tr>
<td>ED</td>
<td>0.0000</td>
<td>0</td>
<td>10</td>
<td>63</td>
</tr>
<tr>
<td>CEO_DUALITY</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>COMMITTEE</td>
<td>0.0000</td>
<td>0</td>
<td>10</td>
<td>59</td>
</tr>
</tbody>
</table>

Table 4.2.3 Stationarity Test

The model had a null hypothesis meaning that it has no unit root. This showed that the data passed the stationarity test which is essential in that it ensures that regression results are not erroneous according to Gujarati (2003).

4.3 Descriptive Test

A number of descriptive tests were carried out as shown below:
4.3.1 Board Size

The average board size was observed to be eight, a median of eight, maximum of nineteen and a minimum of three. The CMA 2002 guidelines recommend that boards should neither be too large or too small to deny the inclusion of needed expertise to effectively run the organisation.

4.3.2 Non-Executive Directors
The NEDs were observed to have a mean of seven members with a minimum of one and maximum of eighteen. The CMA guidelines require that the board have an adequate number of NEDs which should be at least two thirds of the entire board. It was noted that some companies were non-compliant during the period of study.

### 4.3.3 Executive Directors

The NSE had a mean of one ED and a maximum of four. The EDs are responsible for the day to day running of the companies. Most of the EDs were the CEO, CFO or the financial directors of the listed companies in the NSE. The ED is responsible for implementing the decisions of the board.

<table>
<thead>
<tr>
<th></th>
<th>EXECUTIVE...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>1.593750</td>
</tr>
<tr>
<td>Median</td>
<td>1.000000</td>
</tr>
<tr>
<td>Maximum</td>
<td>4.000000</td>
</tr>
<tr>
<td>Minimum</td>
<td>1.000000</td>
</tr>
<tr>
<td>Std. Dev.</td>
<td>0.750000</td>
</tr>
<tr>
<td>Skewness</td>
<td>1.042124</td>
</tr>
<tr>
<td>Kurtosis</td>
<td>3.354432</td>
</tr>
<tr>
<td>Jarque-Bera</td>
<td>11.91924</td>
</tr>
<tr>
<td>Probability</td>
<td>0.002581</td>
</tr>
<tr>
<td>Sum</td>
<td>102.0000</td>
</tr>
<tr>
<td>Sum Sq. Dev.</td>
<td>35.43750</td>
</tr>
<tr>
<td>Observations</td>
<td>64</td>
</tr>
</tbody>
</table>

Table 4.3.3 ED Summary      Figure 4.3.3 ED Summary

The NSE had a mean of one ED and a maximum of four. The EDs are responsible for the day to day running of the companies. Most of the EDs were the CEO, CFO or the financial directors of the listed companies in the NSE. The ED is responsible for implementing the decisions of the board.
4.3.4 CEO Duality

<table>
<thead>
<tr>
<th></th>
<th>CEO_DUALITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>0.015625</td>
</tr>
<tr>
<td>Median</td>
<td>0.000000</td>
</tr>
<tr>
<td>Maximum</td>
<td>1.000000</td>
</tr>
<tr>
<td>Minimum</td>
<td>0.000000</td>
</tr>
<tr>
<td>Std. Dev.</td>
<td>0.125000</td>
</tr>
<tr>
<td>Skewness</td>
<td>7.811266</td>
</tr>
<tr>
<td>Kurtosis</td>
<td>62.01587</td>
</tr>
<tr>
<td>Jarque-Bera</td>
<td>9938.498</td>
</tr>
<tr>
<td>Probability</td>
<td>0.000000</td>
</tr>
<tr>
<td>Sum</td>
<td>1.000000</td>
</tr>
<tr>
<td>Sum Sq. Dev.</td>
<td>0.984375</td>
</tr>
<tr>
<td>Observations</td>
<td>64</td>
</tr>
</tbody>
</table>

Table 4.3.4 CEO Duality Summary

The study results show that most of the firms observed the CMA 2015 code of governance recommendation that listed firms should not have CEO duality but the roles should be separate to ensure no one person has all the powers in decision making and promotes accountability. Agency theory advocates for the separation of the role of CEO and chairman as this will improve board monitoring. In 2016 Limuru Tea company CEO doubled up as a Chair of the board contravening the CMA corporate guidelines.

4.3.5 Board Committees

<table>
<thead>
<tr>
<th></th>
<th>COMMITTEES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>3.500000</td>
</tr>
<tr>
<td>Median</td>
<td>3.000000</td>
</tr>
<tr>
<td>Maximum</td>
<td>7.000000</td>
</tr>
<tr>
<td>Minimum</td>
<td>0.000000</td>
</tr>
<tr>
<td>Std. Dev.</td>
<td>1.610348</td>
</tr>
<tr>
<td>Skewness</td>
<td>0.282415</td>
</tr>
<tr>
<td>Kurtosis</td>
<td>2.800846</td>
</tr>
<tr>
<td>Jarque-Bera</td>
<td>0.896738</td>
</tr>
<tr>
<td>Probability</td>
<td>0.638669</td>
</tr>
<tr>
<td>Sum</td>
<td>210.0000</td>
</tr>
<tr>
<td>Sum Sq. Dev.</td>
<td>153.0000</td>
</tr>
<tr>
<td>Observations</td>
<td>60</td>
</tr>
</tbody>
</table>

Table 4.3.5 Board Committees Summary
Good corporate governance calls for board committees to help the board in the running of the companies. CMA guidelines and internationally accepted code for corporate governance requires all companies listed to have an audit committee that is chaired by an independent board member. The listed companies most had board committees with independent audit committees but we still had a number of them that had no board committees at all. The listed companies had an average of four board committees and a maximum of seven.

### 4.3.6 Return on Assets

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>0.067916</td>
<td>0.072992</td>
<td>0.056552</td>
<td>0.058450</td>
<td>0.032574</td>
<td>0.008143</td>
<td>0.031416</td>
</tr>
<tr>
<td>Median</td>
<td>0.055653</td>
<td>0.054824</td>
<td>0.049685</td>
<td>0.049294</td>
<td>0.038079</td>
<td>0.031474</td>
<td>0.036822</td>
</tr>
<tr>
<td>Maximum</td>
<td>0.233750</td>
<td>0.392430</td>
<td>0.398361</td>
<td>0.231555</td>
<td>0.241509</td>
<td>0.448536</td>
<td>0.241060</td>
</tr>
<tr>
<td>Minimum</td>
<td>-0.048533</td>
<td>-0.440063</td>
<td>-0.296084</td>
<td>-0.203341</td>
<td>-0.418239</td>
<td>-1.243639</td>
<td>-0.636968</td>
</tr>
<tr>
<td>Std. Dev.</td>
<td>0.056102</td>
<td>0.117269</td>
<td>0.096209</td>
<td>0.073088</td>
<td>0.108742</td>
<td>0.208899</td>
<td>0.117460</td>
</tr>
<tr>
<td>Skewness</td>
<td>0.996957</td>
<td>-0.924118</td>
<td>-0.079953</td>
<td>-0.343797</td>
<td>-1.645584</td>
<td>-3.533213</td>
<td>-3.043325</td>
</tr>
</tbody>
</table>

<p>| | | | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Jarque-Bera</td>
<td>9.057451</td>
<td>106.3430</td>
<td>59.82474</td>
<td>18.39888</td>
<td>103.0104</td>
<td>1113.786</td>
<td>716.0446</td>
</tr>
<tr>
<td>Probability</td>
<td>0.010794</td>
<td>0.000000</td>
<td>0.000000</td>
<td>0.000101</td>
<td>0.000000</td>
<td>0.000000</td>
<td>0.000000</td>
</tr>
<tr>
<td>Sum</td>
<td>2.784570</td>
<td>3.722615</td>
<td>3.223448</td>
<td>3.507026</td>
<td>2.052171</td>
<td>0.513015</td>
<td>1.916349</td>
</tr>
<tr>
<td>Sum Sq. Dev.</td>
<td>0.125898</td>
<td>0.687605</td>
<td>0.518344</td>
<td>0.315170</td>
<td>0.733136</td>
<td>2.705600</td>
<td>0.827808</td>
</tr>
<tr>
<td>Observations</td>
<td>41</td>
<td>51</td>
<td>57</td>
<td>60</td>
<td>63</td>
<td>63</td>
<td>61</td>
</tr>
</tbody>
</table>

Table 4.3.6.1 ROA Summaries

### Average ROA

<table>
<thead>
<tr>
<th></th>
<th>AV_ROA</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>0.038994</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Median</td>
<td>0.040647</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maximum</td>
<td>0.239288</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimum</td>
<td>-0.457235</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Std. Dev.</td>
<td>0.098624</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Skewness</td>
<td>-2.031155</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kurtosis</td>
<td>11.96596</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jarque-Bera</td>
<td>258.3754</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Probability</td>
<td>0.000000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sum</td>
<td>2.495626</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sum Sq. Dev.</td>
<td>0.612776</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Observations</td>
<td>64</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 4.3.6.2 Average ROA Summaries
During the period of study 2010 to the year 2016 listed companies had a mean average ROA of 0.038994 or 3.89%, a high of 0.2392 and a low of -0.457. This shows an average positive growth which is lower than the average GDP growth for the period which the World Bank puts at an average of 5.5% meaning the NSE was underperforming. Yearly analysis shows that 2011 had the best mean with an average ROA of 7.2% and 2015 was the worst with a 0.8% average ROA. The study will help to establish the effect of corporate governance on performance of the listed companies using the ROA. According to the CBK and the KNBS the average inflation for the period was 7.6% which is good for GDP growth and not too high to affect the shilling.

4.3.7 Board Composition

<table>
<thead>
<tr>
<th>B_COMPOS...</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>0.790344</td>
</tr>
<tr>
<td>Median</td>
<td>0.818182</td>
</tr>
<tr>
<td>Maximum</td>
<td>0.947368</td>
</tr>
<tr>
<td>Minimum</td>
<td>0.250000</td>
</tr>
<tr>
<td>Std. Dev.</td>
<td>0.118781</td>
</tr>
<tr>
<td>Skewness</td>
<td>-1.824046</td>
</tr>
<tr>
<td>Kurtosis</td>
<td>8.150471</td>
</tr>
<tr>
<td>Jarque-Bera</td>
<td>106.2291</td>
</tr>
<tr>
<td>Probability</td>
<td>0.000000</td>
</tr>
<tr>
<td>Sum</td>
<td>50.58204</td>
</tr>
<tr>
<td>Sum Sq. Dev.</td>
<td>0.888860</td>
</tr>
<tr>
<td>Observations</td>
<td>64</td>
</tr>
</tbody>
</table>

Table 4.3.7 Board Composition Summary

The board composition is number of NEDs divided by the board size given as a ratio. According to the CMA 2002 corporate governance guidelines boards should comprise of at least a third as NED and the independent directors. Most of the firms listed during the period of study were found to have complied with this as they had a mean of 0.79. The boards’ members were found to have diverse skills and according to Resource Dependency Theory this helps brings or avails more resources to the companies in terms of expertise. It was also
discovered that companies incorporated highly rated professionals like retired Audit partners in the big audit firms to their boards to help improve on diversity and transparency.

### 4.4 Correlation Analysis

<table>
<thead>
<tr>
<th></th>
<th>B_COMPOS...</th>
<th>AV_ROA</th>
<th>CEO_DUALITY</th>
<th>COMMITTEE</th>
<th>ED</th>
</tr>
</thead>
<tbody>
<tr>
<td>B_COMPOS...</td>
<td>1</td>
<td>0.01323229</td>
<td>-0.5849047</td>
<td>0.28427639</td>
<td>-0.7681009</td>
</tr>
<tr>
<td>AV_ROA</td>
<td>0.01323229</td>
<td>1</td>
<td>0.08931056</td>
<td>0.05805276</td>
<td>0.06817197</td>
</tr>
<tr>
<td>CEO_DUALITY</td>
<td>-0.5849047</td>
<td>0.08931056</td>
<td>1</td>
<td>-0.2568788</td>
<td>0.23736265</td>
</tr>
<tr>
<td>COMMITTEE</td>
<td>0.28427639</td>
<td>0.05805276</td>
<td>-0.2568788</td>
<td>1</td>
<td>0.01647566</td>
</tr>
<tr>
<td>ED</td>
<td>-0.7681009</td>
<td>0.06817197</td>
<td>0.23736265</td>
<td>0.01647566</td>
<td>1</td>
</tr>
</tbody>
</table>

Table 4.4 Correlation Analysis

The correlation was measured using the Pearson’s coefficient and it ranges from +1 to -1. +1 means that the variables show a very strong positive correlation, 0 means no correlation and -1 show a very strong negative correlation. The ROA was slightly positively correlated with all the independent variables as all the variables range from 0.01 to 0.08 correlations. This meant that ROA increased with an increase of the variables. A slight increase in board composition increased the ROA. The board composition increase led to an increase in the number of NEDs in an organization.

### 4.5 Regression Analysis and Hypothesis Testing

Dependent Variable: A_ROA  
Method: Least Squares  
Date: 11/13/17   Time: 23:14  
Sample: 1 64  
Included observations: 62

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>B_COMPOSITION</td>
<td>0.323132</td>
<td>0.229995</td>
<td>1.404949</td>
<td>0.1655</td>
</tr>
<tr>
<td>CEO_DUALITY</td>
<td>0.188470</td>
<td>0.131239</td>
<td>1.436078</td>
<td>0.1564</td>
</tr>
<tr>
<td>COMMITTEE</td>
<td>0.000123</td>
<td>0.008186</td>
<td>0.014986</td>
<td>0.9881</td>
</tr>
<tr>
<td>ED</td>
<td>0.040424</td>
<td>0.030086</td>
<td>1.343608</td>
<td>0.1844</td>
</tr>
<tr>
<td>C</td>
<td>-0.281376</td>
<td>0.215920</td>
<td>-1.303154</td>
<td>0.1978</td>
</tr>
</tbody>
</table>

R-squared: 0.049640  
Adjusted R-squared: 0.017052  
S.E. of regression: 0.096293  
Sum squared resid: 0.528518  
Log likelihood: 59.73499  
F-statistic: 0.744312  
Prob(F-statistic): 0.565829

Table 4.5.1 Linear Regression Analysis
\[ Y = 0.323132X_1 + 0.188470X_2 + 0.000123X_3 + 0.040424X_4 - 0.281376 \]

**X1** = Board Composition which is a ratio of NEDs to the total board size

**X2** = CEO Duality

**X3** = Committee

**X4** = Executive directors

The dependent variable from the regression model (ROA) had a positive linear relationship with all the variables (board committees, board composition, CEO duality and ED) but all their coefficients were statistically insignificant. All the variables (Board committees, CEO duality and ED) had P values which were greater than 5%. In the test an alpha with a significance level of 5% was used. All the variables were insignificant and we fail to reject the Null Hypothesis. The R squared of the regression model was 0.049 which meant that coefficients of determination had a goodness of fit of 0.0049. It was used to approximate how close the regression line was to population data.

Table 4.5.2 ANOVA Analysis

**ANOVA**

<table>
<thead>
<tr>
<th>Source of Variation</th>
<th>SS</th>
<th>Df</th>
<th>MS</th>
<th>F</th>
<th>P-value</th>
<th>F crit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Between Groups</td>
<td>492.5189</td>
<td>4</td>
<td>123.1297</td>
<td>179.5603</td>
<td>79</td>
<td>2.962414</td>
</tr>
</tbody>
</table>

31
The F value was bigger than the F critic and the P value was very small means we accepted to reject the null hypothesis. This meant that the means of at least two variables were different. This meant that from our variables (ED, Board composition, CEO duality and Board committees) at least two had different means.

4.6 Discussion of Research Findings
The regression results showed a positive linear relationship between all the variables and ROA. This study contradicted other studies like Kigotho (2014) who did a five year study on the effect of corporate governance on the financial performance of listed companies in the NSE. In his study carried out between 2009 and 2013 from his descriptive statistics more than 10% of the listed companies had CEO duality. We can concluded that one of the major causes of variance was that most listed companies complied with the CMA regulations that do require companies to avoid CEO duality. According to the CMA code of corporate governance 2015 it describes corporate governance as the processes and structures used to manage and direct the affairs of a company resulting in improved business performance and increasing shareholder value. This supports the idea that improved corporate governance through the board composition, board committees and in particular the Audit committee which ensures that the financial reports are accurate and reliable. However our results did not support this and more research needs to be undertaken to explain the variances.

The new CMA code of governance also requires organisations to have the roles of the CEO and the chairman clearly defined and separate. This promotes transparency and the chairman is able to provide oversight on the company. Our findings did not uphold this school of thought in that the board composition and the committees had a positively linear relationship.
but was insignificant. The CMA requires all listed companies to have a separate CEO and a chairman.
CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction
This chapter gives a summary of all the findings in chapter four based on the set objective of establishing the effect of corporate governance on the financial performance of listed companies in the NSE. The corporate governance variables in the study include CEO duality, the number of board committees, the board composition and the executive directors in the board against ROA as the dependent variable. The conclusion drawn from the study, the recommendations based on this study, the study had its limitations which were discussed in this chapter and also the suggestions of areas that need further research.

5.2 Summary of Findings
The study was done on all the listed companies in the NSE and the population was 64 firms and the period of study was between 2010 and 2016. The NSE hand book 2015-2016 and the financial reports of the various companies accessed from their websites was the data used. The data used was secondary data. From the results findings it was noted that corporate governance had a positive correlation with financial performance as many research studies have previously shown. The study was done on the effect of corporate governance (Board composition, CEO duality, number of board committees and the number of executive directors in the board) on the financial performance (ROA). A multiple regression model with OLS as the method of estimation was used to analyse it.

A good mix of NEDs with diverse attributes according to the resource dependency theory has a positive impact on the decision making of the board and definitely leads to improved financial performance. The CMA code of governance has put the recommended ratio of NEDs and independent directors at two thirds and from our findings all the listed firms had a
mean of 0.79. This was quite impressive but nevertheless we still experienced poor financial performance from firms with very impressive corporate governance scores.

There was a positive correlation between board committees and ROA as the study shows which means that boards that were better in delegating some of their functions to well-structured committees had a better financial performance. The presence of audit committees which was made mandatory and independent NED chair the same was found to be adhered to. The number of board committees was used and also incorporated the presence of an audit committee as a variable. Most of the companies had board committees that were operational and had qualified people sitting on them. There results were insignificant which meant that board committees did not influence firm’s performance.

The study findings showed that CEO duality was positively correlated to the firms’ performance with a coefficient of 0.188 and T-statistic being insignificant due to the fact that most of the listed companies had zero score as they held CEO and Chairman Positions with different roles. The number of executive directors was positively correlated to firms’ performance as shown in the correlations between the dependent variables and the independent variables.

5.3 Conclusions

Corporate governance in the company and by large the listed companies in the NSE is growing with increased legislation like the new code of corporate governance by the CMA. Corporate governance is integral to business prosperity and by far safeguarding shareholders wealth. The entire world over big corporate failures like the Enron led to strict surveillance by the regulators and enactment of laws aimed at improving corporate governance. In the USA they came up with the Sarbanes Oxley Act. The new legislations have tightened corporate governance reporting requirements but still we are faced with failures of listed
companies due to poor governance perpetrated by the directors who hold fiduciary duties to safeguard shareholder wealth.

The study was able to establish its objective of the effect of financial performance on corporate governance. The findings show that improved corporate governance does not necessarily lead to improved financial performance of listed companies and in our case it was insignificant. With the enactment of the new code of corporate governance we saw increased compliance in corporate governance in the year 2016 which may have partly impacted on the increase of ROA means from the year 2015. The effect of CEO duality was insignificant but it had a positive correlation with ROA according to the findings in chapter four. According to previous studies the effects of CEO duality have been adverse to financial performance and the CMA requires all companies to avoid CEO duality.

An increase in board committees was seen to have a positive correlation with ROA but was however insignificant from the results of the regression model. The composition of board committees and in essence having an audit committee was critical to ensuring that the financial reports are accurate and can be relied upon. The audit committee through the internal audit function should be well informed and vigilant on the financial reporting process and the internal controls of the organisation. Although the acts requires a board to delegate some duties to the committees it doesn’t specify the maximum or the ultimate number of committees but for the study an increased number as long its viable and just improves the ROA of the listed companies. Further studies ought to be done to establish why the study was insignificant.

During the period of study we experienced and came across companies that had good corporate governance ratings on the face value but it was later revealed through filings with the CMA and forensic reports that directors had failed through lack of mandatory disclosures,
mismanagement and fraud. The result of this was massive losses and shrinking of shareholder wealth like witnessed in the case of Uchumi supermarkets whereby they had a balanced board composition with a good mix of directors. They also had an audit committee but the directors committed fraud and the CMA have banned some of them from holding directorship in listed companies for a number of years and imposing hefty fines.

5.4 Recommendations

The board composition should include more NEDs and independent directors to improve on the independence of the board and also increase the financial performance of the organisation as the board composition had a positive coefficient of 0.33. The board should comprise of people with diverse skills to improve on decision making. The companies should ensure that they have their board delegate some duties to the committees. They should ensure that the committees are properly constituted and have people with relevant skills sitting on those committees. The audit committee must be chaired by an independent NED and at least one member must have auditing or accounting skills. This will improve corporate governance and also compliance with the regulators although our findings were insignificant.

The NSE and the regulator should increase the mandatory disclosures by the listed firms to include material subversion of corporate governance in the financial reports. This will greatly improve reporting as it will be a deterrent. A naming and shaming of convicted directors, hefty fines and bans imposed. It’s mandatory for all companies listed to file quarterly reports and due to the increased fraud we should incorporate fraud experts in audits to assess the fraud risk as we are well aware that annual audits are not necessarily liable for negligence if fraud is detected after an audit as they apply sampling.
5.5 Limitations of Study

The study encountered challenges on time available and the amount of data required as the study was to be done on all listed companies from the year 2010 to 2016. There was limited time to look into all the corporate governance aspects for all the firms in the time given. The data collection method employed was secondary and there was no single place to get all the information as you had to check on accounts filled with NSE and company websites which some had not made public. The information that was available online was limited and could not allow the researcher to do an in-depth analysis of corporate governance as some information was not available online.

We relied on information provided by the companies thus an issue of self-report arose whereby the reports only provided in the corporate governance area was only what they had complied with not what was wanting. This will have an effect on the results as they will not reflect the true position of the company like we have reports of the CMA fining many companies for non-disclosure i.e. profit warnings or lack of disclosing management changes but the researcher couldn’t get that from the reports. Some companies have misrepresented their financial statements in the past only to be restated there after forensic audits have discovered the same puts a risk on the validity of the financial reports used in the study.

There was a shortage of funds needed to access some information that was not available to the public which would have made the research more successful. Some data from the NSE needs to be bought and the budget the researcher had been constrained leaving him with no option other than using the only available information. The research will definitely contribute to the literature on the topic of the effect of corporate governance on financial performance but the research should compare with the developed world where there is improved corporate governance.
5.6 Suggestion for Further Research

From the study it was established that companies with impressive corporate governance scores were doing badly financially only for the same companies to be discovered later that there were serious corporate governance issues. We have companies like KQ, Mumias and Uchumi who had been doing well only for them to plunge into the red financially. We need more research on the corporate failure gaps that allowed the directors to conceal all the mess which was only unearthed by forensic auditors. This will be good to help the regulators enact laws that will be punitive and deterrent while at the same time promoting more disclosures of corporate governance by the listed companies. The findings negate most studies done on the NSE and more studies should be done during the period of study 2010 to 2016.
REFERENCES


Private Sector for Corporate Governance Trust, Principles for Corporate Governance in Kenya, Nairobi (1999)


The CMA ACT (2002) corporate governance guidelines

The CMA ACT (2015) code of corporate governance practices for issuers of securities to the public

The Sarbanes Oxley ACT (2002)

## APPENDICES

Data Collection Form

<table>
<thead>
<tr>
<th>COMPANY</th>
<th>ROA</th>
<th>CEO DUALITY</th>
<th>BOARD COMPOSITION</th>
<th>BOARD COMMITTEES</th>
<th>ED</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Population list

Listed Companies

1. EAAGADS LIMITED
2. KAKUZI LIMITED
3. KAPCHORUA TEA LTD
4. LIMURU TEA LTD
5. SASINI TEA LTD
6. WILLIAMSON TEA KENYA
7. CAR AND GENERAL COMPANY LTD
8. MARSHALLS (E.A) LTD
9. SAMEER AFRICA LTD
10. BARCLAYS BANK OF KENYA LIMITED
11. CFC STANBIC HOLDINGS LIMITED
12. DIAMOND TRUST BANK
13. EQUITY BANK
14. HF GROUP LTD
15. I&M HOLDINGS LIMITED
16. KENYA COMMERCIAL BANK
17. NATIONAL BANK OF KENYA
18. NIC BANK
   STANDARD CHARTERED BANK KENYA
19. LIMITED
20. CO-OPERATIVE BANK
21. ATLAS DEVELOPMENT SERVICES
22. DEACONS KENYA LTD
EXPRESS KENYA LTD
KENYA AIRWAYS LTD
LONGHORN PUBLISHERS LIMITED
NAIROBI BUSINESS VENTURES LTD
NATION MEDIA GROUP LTD
STANDARD GROUP LTD
TPS EASTERN AFRICA LIMITED
UCHUMI SUPERMARKET LIMITED
WPP SCANGROUP LTD
ATHI-RIVER MINING LIMITED
BAMBURI CEMENT LIMITED
CROWN PAINTS
EAST AFRICAN CABLES LTD
EAST AFRICA PORTLAND CEMENT COMPANY
KENGEN
KENOLKOBIL LIMITED
KENYA POWER AND LIGHTING COMPANY LIMITED
TOTAL KENYA LTD.
UMEME
BRITAM HOLDINGS LIMITED
CIC INSURANCE GROUP LIMITED
JUBILEE HOLDINGS LIMITED
KENYA REINSURANCE CORPORATION LIMITED
LIBERTY KENYA HOLDINGS LIMITED
PAN AFRICA INSURANCE HOLDING (SANLAM)
THE NAIROBI SECURITIES EXCHANGE
CENTUM INVESTMENT COMPANY
HOME AFRIKA
KURWITU VENTURES LTD
OLYMPIA CAPITAL HOLDINGS LIMITED
TRANSCENTURY LIMITED
BOC KENYA LIMITED
BRITISH AMERICAN TOBACCO LTD
CARBACID
EAST AFRICAN BREWERIES LTD
EVEREADY EAST AFRICA LIMITED
FLAME TREE GROUP HOLDINGS LTD
KENYA ORCHARDS LTD
MUMIAS SUGAR COMPANY LTD
UNGA GROUP LTD
SAFARICOM LIMITED
STANLIB FAHARI IREIT