CORPORATE GOVERNANCE PRACTICES AND PERFORMANCE OF AFYA SACCO SOCIETY LIMITED

By

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DECLARATION

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

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

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DEDICATION

This research project is dedicated to my beloved wife Gladys Mwikali, and daughter Cynthia Mutheu

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LIST OF ABBREVIATIONS

ADC: - Annual Delegates' Conference

AGM: – Annual General Meeting

ANOVA: - Analysis of Variance

BOD: - Board of Directors

CCG: Centre for Corporate Governance

CEO: Chief Executive Officer

CIPE: – Center for International Private Enterprise

CMA: - Capital Markets Authority

FOSA: – Front Office Service Activity

GMT: - Governance Monitoring Tool

KEMRI: – Kenya Medical Research Institute

KETRI: – Kenya Trypanosomiasis Research Institute

KMTC: – Kenya Medical Training College

KNH: – Kenyatta National Hospital

MTRH: – Moi Teaching and Referral Hospital

NHIF: – National Health Insurance Fund

OECD: – Organization for Economic Co-operation and Development

PSCGT: – Private Sector Corporate Governance Trust

ROA: - Return on Assets

SACCOs: - Savings and Credit Co-operative Societies

SMT: - Senior Management Team

SPSS: - Statistical Package for the Social Studies

WOCCU: – World Council of Credit Unions

ABSTRACT

The aim of this study was to determine the relationship between corporate governance practices and performance of Afya Sacco Limited. The study was a case study and considered Afya Sacco Limited as the unit of analysis. Performance measures used were taken from the WOCCU's PEARLS performance analysis system under the subheading of 'rates of return and costs' and included the gross margin as a percentage of average total assets and net income as a percentage of average total assets (ROA). Corporate governance scores were generated from the WOCCU's worldwide accepted governance monitoring tool (GMT) by keying corporate governance practices related information into the GMT which using predetermined formulae impended in the tool computed the governance scores.

The period of the study was ten years from 1999 to 2008. The study used secondary data which was obtained from the annual reports for the study period, AGM's minute books, board's attendance registers and employees' master roll. Data was analyzed using linear regression analysis technique and was aided by entering the data into SPSS. Corporate governance was found to be positively related to performance. The study recommended that Afya Sacco should strive to improve on its corporate governance practices by constantly benchmarking itself against the WOCCU's 'GMT' with a view to taking improvement measures on those areas it is not doing good enough, which in turn will have a positive impact on its performance

The rest of the paper is organized as follows: chapter one covers introduction to the study by addressing issues related to background to the study, statement of the problem, study objective and the significance of the study; chapter two focuses on literature review; chapter three is about the research methodology; chapter four covers data analysis, presentation and discussion of findings; and lastly chapter five addresses conclusion, recommendation, limitation of the study and suggestions for future research.

CHAPTER ONE

INTRODUCTION

1.1 Background to the study

Corporate governance refers to the private and public institutions, including laws, regulations and accepted business practices, which together govern the relationship, in a market economy between corporate managers and entrepreneurs ("corporate insiders") on one hand and those who invest resources in corporations on the other. Investors can include suppliers of equity finance (shareholders), suppliers of debt finance (creditors), suppliers of relatively firm-specific human capital (employees) and suppliers of other tangible and intangible assets that corporations may use to operate and grow (Oman, 2001). Good corporate governance is founded upon the attitudes, ethics, practices and values of the society. It enhances accountability, power sharing, representation and owner participation. It also defines the sense of right and wrong, fair and just, work ethics and continuing social responsibility (Murungi and Maina, 2004). OECD (2004) principles, which have been accepted the world over, identified the following principles as the six key elements of a strong corporate governance system; ensuring the basis for an effective corporate governance framework; the rights of shareholders; the equitable treatment of shareholders; the role of stakeholders in corporate governance; disclosure and transparency; and responsibilities of the board of directors

Solomon and Solomon's (2004) study of the case of Enron's downfall illustrates the importance of good corporate governance. They say that all the checks and balances within the corporate governance system have the ultimate aim of controlling and monitoring company management. Corporate governance mechanisms cannot prevent unethical activity of top management, but they can act as a means of detecting such activity. Bosch (2002) states that 'good governance is desirable and important' for two reasons: firstly, investor protection has increased with the enormous surge in share ownership; and secondly good governance can 'increase the creation of wealth by improving the performance of honestly managed and financially sound companies.' Zabihollah (2003) stated that good corporate governance promotes relationships of accountability among the primary corporate participants and this may enhance corporate performance. It holds management accountable to the board and the board accountable to

shareholders. A key function of board is to ensure that quality accounting policies, internal controls and independent and objective outside auditors are in place. This may deter fraud, anticipate financial risks, and promote accurate, high quality and timely disclosure of financial and other material information to the stakeholders. Claessens (2003) mentions better access to external finance, lower costs of capital and better firm performance as significant benefits that are linked to higher corporate governance standards in the private sector.

Corporate performance is an important concept that relates to the way and manner in which financial resources available to an organization are judiciously used to achieve the overall corporate objective of an organization, it keeps the organization in business and creates a greater prospect for future opportunities (Kajola, 2008). According to Dahya, McConnell and Travlos (2000), performance is measured using both accounting earnings and stock returns data. Specifically, they used return on assets (ROA) as a measure of accounting earnings. Bhagat and Bolton (2007) relied on accounting performance measures.

All financial institutions, regardless of structure, are expected to operate in a transparent manner, comply with regulatory and prudential standards and be held accountable to the public (WOCCU, 2005).

The current study is designed to examine the relationship between corporate governance practices and performance of Afya Sacco. The corporate governance practices to be studied are the general assembly (AGM), board of directors (BOD), senior management team (SMT), and employees. Other areas include the use and misuse of power as well as economic and financial information. Afya Sacco was registered on 8th May 1971 by some twenty employees of the ministry of health to promote thrift among members by affording them an opportunity to save and borrow for provident and productive purposes. Today its membership has grown to over 40,000 members and opened its common bond from its original ministry of health to include Nurses and Midwives Council of Kenya, KEMRI, KETRI, KNH, NHIF, KMTC, MTRH, civil servants in other ministries, Parastatals, and any other person employed by an organization registered in Kenya capable of making regular contribution to the society and fulfils loan repayment requirement as set out in the society's lending policy. In April 2000, the society launched FOSA services in Nairobi to provide its members with banking services necessitated by

the fact that commercial banks then were out of reach of low income people who form the majority of the society's members. Since then the society has expanded the FOSA network to other towns such as Mombasa, Kisumu, Kisii, Kakamega, Eldoret, Nakuru, Nyeri and Meru

The society has 103 branches countrywide mainly at the district hospitals. Members in those branches elect three representatives per branch to serve for a term of three years though they are eligible to seek re-election after the expiry of the term. The representatives hold monthly meetings to deliberate on matters of their branches in addition to attending annual delegates' conference (ADC) in Nairobi as delegates representing their members. At the ADC the delegates elect the members of the management board, nominate auditors, receive and adopt accounts, as well as pass other resolutions on how they want the society to be managed. The elected board implements the decisions of the ADC through a secretariat constituted by the chief executive officer and other employees.

1.2 Statement of the problem

The institutions of corporate governance serve two indispensable and ultimately indissociable objectives: enhance performance and ensure the conformance of corporations (Oman, 2001). They facilitate and stimulate the performance of corporations by creating and maintaining a business environment that motivates managers and entrepreneurs to maximise firm's operational efficiency, returns on investment and long-term productivity growth. They ensure corporate conformance with investors' and society's interests and expectations by limiting the abuse of power, the siphoning-off of assets, the moral hazard and the significant wastage of corporate-controlled resources (so-called "agency problems") that the self-serving behaviour of managers and other corporate insiders can be expected to impose on investors and society in their absence. Simultaneously, they establish the means to monitor managers' behaviour to ensure corporate accountability and provide for the cost-effective protection of investors' and other stakeholders' interests vis a vis corporate insiders.

Despite the importance of good corporate governance in enhancing corporate performance and conformance, research on corporate governance applied to financial intermediaries is scarce (Prowse, 1997). This shortage is confirmed by Oman (2001); Goswami (2001); Lin (2001);

Malherbe and Segal (2001); and Arun and Turner (2002). They hold a consensus that although the subject of corporate governance in developing economies has recently received a lot of attention, it is still not yet rooted enough.

Here in Kenya, studies on corporate governance in financial intermediaries have concentrated on other forms of financial institutions such as banks and insurance firms. For instance, studies by Wambua (1999) and Okungu (2006) looked at corporate governance in banks; Maina (2007) studied corporate governance in the insurance industry; Wainaina (2003) studied corporate governance in microfinance sector and Osambo (2006) looked at corporate governance in FOSAs. Moreover, many of these studies never looked at the relationship between corporate governance and firm performance except Okungu (2006) who studied corporate governance and performance in banks and concluded that there was significant positive relationship between good corporate governance practices and financial performance in the Kenyan banking sector. There is no research study on corporate governance and performance known to the researcher that has been carried out on Afya Sacco Limited thus setting the stage for the need for studying and examining how corporate governance practices as applied by Afya Sacco relates with its performance.

1.3 Objective of the study

To determine the relationship between corporate governance practices and performance of Afya Sacco Limited.

1.4 Significance of the study

The study was important to the following groups of people:

1.4.1 Afya Sacco management

The study was significant to Afya Sacco management in that it would provide them with an opportunity for self appraisal in terms of the level of observing good corporate governance practices and how it related with the performance on looking at the coefficients, which would motivate the management to embrace the best business practices to be able to perform better.

1.4.2 Afya Sacco members and other stakeholders

As both owners and customers, Afya Sacco members would benefit from the study as it would help the management put in place strategies of observing good corporate governance practices aimed at improving performance as well as customer service. Observance of best business practices would also imply satisfying other stakeholders such as employees, suppliers, creditors and the general public.

1.4.3 Researchers and academicians

Very few studies have been carried out in the area of corporate governance and how it relates with performance in SACCOs. The study would therefore contribute to the existing knowledge on the relationship that exist between corporate governance mechanisms and firm performance in SACCOs and act as a reference point for future research.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter presents a review of the related literature on the subject under study as presented by various researchers, scholars, analysts and authors. The review has drawn materials from several sources that are closely related to the theme and objective of the study. The chapter contains six areas as follows: first, definition of corporate governance; second, principles of good corporate governance; third, theoretical framework covering agency theory and stakeholder theory; fourth, corporate governance mechanisms; fifth, empirical studies and sixth, literature review summary and conclusions.

2.2 Definition of corporate governance

Though corporate governance is not a new issue according to Vinten (1998), there is no universally accepted definition of corporate governance. A number of definitions have been put forward. The Cadbury Committee (1992) adopted a broad definition that 'corporate governance is the system by which companies are directed and controlled.' This involves the establishment of structures and processes through which management is accountable to shareholders with the objective of enhancing shareholder value. This definition is in line with the submission of OECD (1999).

Cochran and Warwick (1988) defined corporate governance as: "... an umbrella term that includes specific issues arising from interactions among senior management, shareholders, boards of directors, and other corporate stakeholders." Monks and Minow (1996) defined corporate governance as the relationship among various participants in determining the direction and performance of corporations. It was defined as dealing with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment (Shleifer and Vishny, 1997)

The OECD (2004) definition is that "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined." Good

corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interest of the company and its shareholders and should facilitate effective monitoring. The Capital Markets Authority (CMA) in 2002 defined it as "the process and structure used to direct and manage business affairs of the company towards enhancing prosperity and corporate accounting with the ultimate objective of realizing shareholders' long-term value while taking into account the interests of other stakeholders".

Essentially governance addresses the leadership role within the institutional framework (PSCGT, 2002). Woccu (2002) defines governance as the system designed to control and distribute power within an organization. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as boards, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs (Clarke, 2004).

2.3 Principles of good corporate governance

Good corporate governance is founded upon the attitudes, ethics, practices and values of the society. It enhances accountability, power sharing, representation and owner participation. It also defines the sense of right and wrong, fair and just, work ethics and continuing social responsibility (Murungi and Maina, 2004). OECD (1999), PSCGT (2000), and CIPE (2002) all focused on fairness, transparency, accountability and responsibility as the four central tenets upon which corporate governance is founded. Corporate governance is about promoting fairness, transparency and accountability (Wolfensohn, 1999).

The Cadbury Committee (1992) stated that the foundation of any structure of corporate governance is disclosure. Openness is the basis of public confidence in the corporate system, and funds will flow to the centers of economic activity that inspire trust (Iskander and Chamlou, 2000).

2.4 Theoretical framework

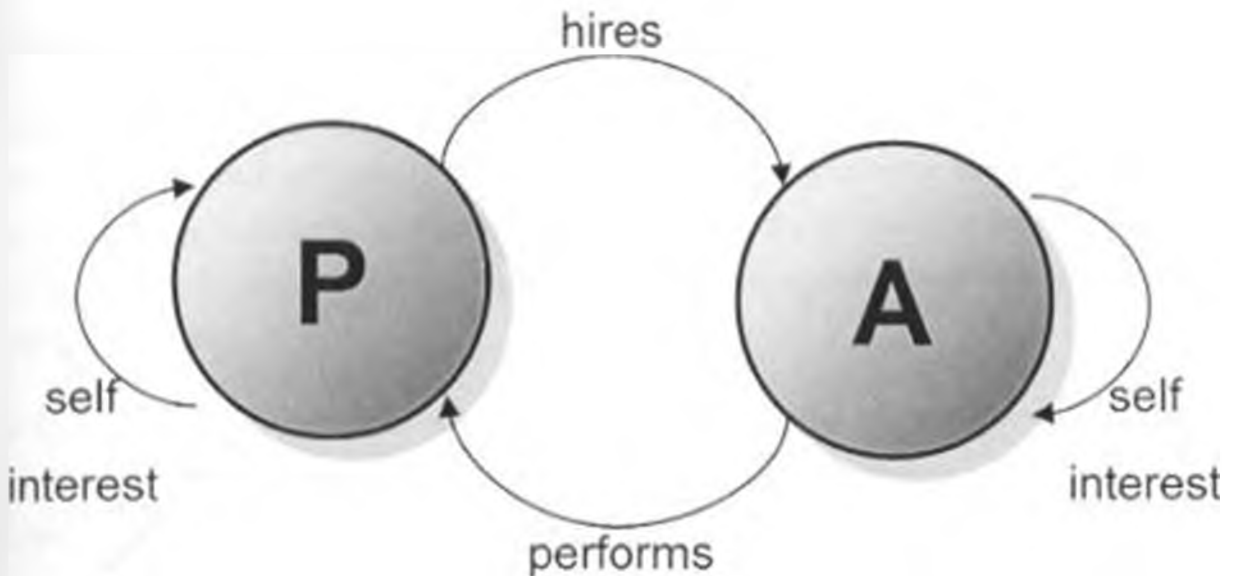
2.4.1 Agency theory or shareholder model

It has been argued that the divorce of ownership and control has led to the 'agency problem.' Berle and Means (1932) found that dispersed shareholding led to a separation of ownership and control. The agency problem was first explored in Ross (1973), with the first detailed theoretical exposition of agency theory being presented by Jensen and Meckling (1976). They defined the managers of the company as the 'agents' and the shareholders as the 'principal.' Fama and Jensen (1983) argued that an organization is the nexus of contracts, written and unwritten, among the owners of factors of production and customers. These contracts or internal "rules of the game" specify the rights of each agent in the organization, performance criteria on which agents are evaluated, and the payoff functions they face. According to Fama and Jensen (1983) agency problems arise because contracts are not costlessly written and enforced.

According to Hart (1995), corporate governance issues arise in an organisation wherever two conditions are present. First, there is a conflict of interest or agency problem, involving members of the organization such as owners, managers, workers or customers. Second, the conflict of interest or agency problem cannot be dealt with through a contract. Hart observes that there are several reasons why contracting to overcome the agency problem might not always be possible. In particular, it is not possible to contract to cover all events. In addition, there are costs associated with negotiating contracts and enforcing them.

Claessens, Djankov and Lang (2000) found that separation of ownership and control and thus agency problem depended on the size of the business and concluded that the agency problem was minimal in small firms. The other factor influencing agency problem was found by Claessens and Fan (2003) to be the ownership structures. They concluded that the nature of a corporation's ownership structure will affect the nature of the agency problems between managers and outside shareholders. On the other hand, when ownership is concentrated to a degree that one owner has effective control of the firm, the nature of the agency problem shifts away from manager-shareholder conflicts to conflicts between the controlling owner (who is often also the manager) and minority shareholders.

The agency relationship is diagrammatically represented by the diagram below:



Source: Wikipedia

The principle – agent relationships exist in SACCOs (Mudibo, 2005). Corporate governance regulates the relationship between members of the Sacco, the board of representatives that advises management on behalf of members and management that has the care and control of the Sacco

Agency relationships in SACCOs take the following forms:

2.4.1.1 Members versus board of directors

The board of directors is a critical link between members of the Sacco and the managers. Among the key functions are establishing performance targets, the employment and dismissal of management, definition and validation of remuneration policy, and oversight of overall Sacco

operations. It is possible that members of the board of directors would advance their own interests (World Bank, 2006).

The role cohesion, solidarity and integrity of the board of directors are essential elements for the performance and relevance of the Sacco within the market place and its broader social setting. Therefore it is key to have clear procedures for the selection and election of directors, plus to provide induction programs and on-going training and professional development to align directors' performance to members' interests (CCG, 2007).

2.4.1.2 Members/boards versus managers

Members of the board of directors in the pursuit of their own interest or that of members they represent may be inclined to interfere with the responsibilities of managers on a regular basis, thus depriving the latter of the required autonomy to execute efficiently their responsibility (World Bank, 2006).

On the other hand, if directors are not full-time positions, lack the relevant education to exercise their functions, cannot read and interpret balance sheets, etc., managers can exploit these gaps to advance selfish interests (CCG, 2007).

Managers can get away with abuse if they exercise unchecked powers. Here, external directors play a fundamental role in terms of bringing commercial acumen and a challenging ability to management actions and decisions (CCG, 2007).

2.4.1.3 Members versus supervisory committee

The supervisory committee oversees that the board of directors performs the functions that it is expected to carry out, and reports its findings to shareholders (CCG, 2007). However, candidates who are appointed to the supervisory committee as a rule seek office to the board of directors, which points to the perceived inferiority of their oversight office in relation to the management function of the board of directors (CCG, 2007).

In addition supervisory committee members may collude with the board members to protect one another (WOCCU, 2002) thus hurt the shareholders' interests.

2.4.1.4 Members versus branch representatives

Members in a given branch elect three representatives to champion their interests. The branch representatives so elected constitute the branch committee and hold monthly meetings to discuss affairs of the branch. Additionally, the branch representatives attend the annual delegates' conferences (ADC) as delegates representing their branch where they collectively transact the business of the ADC. The agency problem arises in the views and the decisions they make either during their branch meetings or at the ADC, as such decisions may not always be in the members' interests. The representatives are paid sitting allowances thus their objective may be to maximize those allowances as opposed to making quality decisions aimed at improving members' welfare.

2.4.1.5 Net borrowers versus net savers

Some members have more loans than savings, while others are in the exact opposite situation; this is what makes them net borrowers or net savers. Both the net borrowers and net savers are the members of the Sacco, and as such, they all have the same rights to influence the management of the structure through the one member-one vote system. This can generate two main types of conflicts: in the first, the net borrowers tend to dominate; in this case, the board may tend to prefer too favourable conditions in the providing of loans, which can affect the viability of the Sacco. In the second, the net savers tend to dominate; in which case, the board may create restrictive conditions for allowing credits (in order to protect their savings). Of course, both cases are sub-optimal and better governance can be achieved when there is a balance between net savers and net borrowers. It is crucial to protect both savers and borrowers preventing board of directors to become borrower controlled (World Bank, 2006).

2.4.2 Stakeholder theory

Stakeholder theory, also referred to as stakeholder model, has developed gradually since the 1970s. One of the first expositions of stakeholder theory, couched in the management discipline, was presented by Freeman (1984), who proposed a general theory of the firm incorporating corporate accountability to a broad range of stakeholders. Stakeholders include shareholders, employees, suppliers, customers, creditors, communities in the vicinity of the company's operations and the general public (Solomon and Solomon, 2004). According to OECD (2004) corporate governance framework should recognize the rights of stakeholders established by law

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or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

A basic issue for stakeholder theory is that companies are so large and their impact on society so pervasive that they should discharge accountability to many more sectors than solely shareholders (Solomon and Solomon, 2004). Stakeholder theory has its origins in the social entity conception of a corporation. The modern corporation has a large scale and scope that requires distinctive professional management expertise and a great amount of capital investment. Since corporations are involved in many aspects of social life and affect many people in both welfare and potential risks, a public corporation should be conscious of its social obligations such as fairness, social justice and protection of employees (Letza et al., 2004).

Agency theory is focused on shareholder rights and the separation of ownership from control. However, stakeholder theory further extends the purpose of the corporation from maximizing shareholders wealth to delivering wider outputs to a range of stakeholders and emphasizes corporate efficiency in a social context (Letza et al., 2004). Therefore both theories will be more comprehensive as they involve all the elements of corporate governance.

2.5 Corporate governance mechanisms

Corporate governance is the mechanism that is used to govern directors and managers to ensure that actions they take are consistent with the interests of stakeholder groups. A number of corporate governance mechanisms have been identified analytically and empirically. These according to Agrawal and Knoeber (1996) may be broadly classified as internal and external mechanisms which enhance good corporate practices. WOCCU (2002) also talks about both internal and external mechanisms in its publication on principles of governance for credit unions. According to WOCCU (2002), internal governance defines the responsibilities and accountability of the general assembly, the board of directors, management and other staff. The responsibilities include achieving an appropriate governing structure of the credit union, preserving the continuity of future credit union operations, creating balance within the organization and remaining accountable for their actions. External governance addresses the issues that credit unions face as participants in the financial marketplace.

According to Moldoveanu and Martin (2001) shareholders should enact ratification, monitoring and sanctioning mechanisms to reward conformance to shareholders' interest and punish non-conformance. They defined ratification mechanisms as those used for validating the decisions of the agent, in giving final approval or veto for an initiative or directive or actionable plan of the agent. Monitoring mechanisms are designed for observing, recording and measuring the output of the efforts and strivings of the agent. Sanctioning mechanisms are designed for providing selective rewards and punishment to the agents for the purpose of motivating them to exert in directions that are aligned with the interests of the shareholders.

2.5.1 The annual general meeting (AGM)

Delegates elected at the branch level act as the representatives of members and form the general meeting of a society (Kattambo, 1992). Kattambo further argues that a SACCO society must convene an annual general meeting each year within one month of the date of receipt from the board or management committee of the report on the audit of the accounts of the society. A fifteen clear days notice should have been given of the intention to hold the meeting. The annual general meeting of the general assembly should be adequately promoted to ensure sufficient member participation (WOCCU, 2002). This meeting is the backbone of the internal governance system and is the highest decision making. By providing a forum for the general assembly of members to interact with the board, the annual general meeting of members serves as a check on the power of the board and management. However, the meeting cannot provide this check if members are not aware of it.

The annual general meeting should also be an opportunity for the directors to receive feedback and guidance from their fellow members (WOCCU, 2002). The board should encourage dialogue with general members at the annual general meeting, because it is the ultimate duty of the board to represent the wishes of the general assembly of members. Members at the AGM exercise their power through voting at least according to (Clark, 1986). Shleifer and Vishny (1997) mention that shareholders can exercise their basic rights by being involved in the voting process of a firm, especially on several important corporate decisions such as, election of the board of directors, and mergers and liquidations. OECD (2004) states that shareholders should have an opportunity to participate effectively and vote in general shareholder meetings and should be informed of the

rules, including voting procedures, that govern general shareholder meetings. The Cadbury Committee (1992) observed that voting rights represent an asset which should be used.

OECD (2004) stated that a well structured corporate governance framework and the codes of good governance might help in protecting shareholder rights and ensuring equitable treatment.

2.5.2 The board of directors

Corporations have board of directors (Denis and McConnell, 2003). The board exists primarily to hire, fire, monitor and compensate management, all with an eye towards maximizing shareholder value (Denis and McConnell, 2002). Dahya, McConnell and Travlos (2002) concluded that an important oversight role of boards of directors is the hiring and firing of top management. As such, it is the official first line of defense against managers who would act contrary to shareholders' interest. Mallin (2004) mentions that the board makes a bridge between managers and investors by taking a leadership role. Mallin further suggests that an evaluation of the board can help establish performance criteria that can be used to achieve the corporate objective and to align the performance of the directors with the interest of the shareholders.

Board members should have a background in business or management (Woccu, 2002). Pease and McMillan (1993) stated that for a board to be effective, it must be composed of individuals who have a diverse range of skills and backgrounds appropriate to the needs of the company. Each board member should be able to assess the financial condition and the operational quality of the Sacco. The board should not be reliant on operational management to interpret financial data and other information received. The board must be independent and able to question management about issues they do not understand or are unclear. WOCCU (2002) recommends that consideration should be given to the rotation of directors to encourage fresh viewpoints to enter the boardroom without the potential loss of organisational knowledge. The credit union may consider devising a formal training program to prevent the depletion of organisational knowledge.

Denis and McConnell (2003) observe that while the board is an effective corporate governance mechanism in theory, in practice its value is less clear. Board of directors include the very insiders who are to be monitored; in some cases they represent a majority of the board. In

addition, it is not uncommon that the CEO is also the chairperson of the board. Finally, the nature of the selection process for board members is such that management often has a strong hand in determining who the other members will be.

a. **Board size**

Yermack (1996) argues that large boardrooms tend to be slow in making decisions, and hence can be an obstacle to change Ayogu (2001) suggests that the market penalizes large boards. In the case of small board size, directors rarely criticize the policies of top managers and that this problem tends to increase with the number of directors (Lipton and Lorsch, 1992). Denis and McConnell (2003) regard a smaller board as an important determinant of corporate governance and firm performance

Yermack (1996) proposed an optimal board size of ten or fewer. WOCCU (2002) argued that the board consists of an odd number of directors and recommended that the number be not less than five or more than nine directors to prevent tied votes. WOCCU further stated that if the board has fewer than five members, it may be difficult for the board to adequately represent its diverse member body, while more than nine members may make consensus achieving difficult and may increase logistical problems The membership of the management committee of a Sacco society must not exceed nine (Kattambo, 1992).

b. **Board composition**

Board composition refers to the number of non-executive directors to the total number of directors. Fama and Jensen (1993) established that the composition of the board of directors is a critical factor in entrenching the effectiveness of the board as an objective monitor of the management. The Cadbury Committee (1992) recommended that boards of corporations include at least three outside directors. CMA (2002) recommended that independent non-executive directors make up a least one third of corporate boards. Woccu (2002) stated that the composition of the board should aim to adequately reflect the demographic makeup of the Sacco's members and balance the financial service demands of members.

The independent directors who are also non-executive are supposed to possess diverse skills or expertise in order to ensure that no individual or small group of individuals can dominate the

boards' decision making (CMA, 2002). According to Fama (1983a), non-executive directors act as a reliable mechanism to diffuse agency conflicts between managers and owners. Kaplan and Minton (1994) found that outside directors are effective corporate governance mechanism. They are viewed as providing the necessary checks and balances needed to enhance board effectiveness (Franks et al., 2001). Solomon et al. (2003) and Tsui and Gul (2000) opine that the outside or non-executive directors play an important governance role in relation to the welfare of the investors, especially non-controlling shareholders. The presence of outside directors improves the degree of corporate accountability and creates a balance of power between the CEO and the board.

c. Board committees

The CMA (2002) recommended that the board should establish relevant committees and delegate specific mandates to such committees. The committees help the board ensure that the company is soundly managed. All committees derive their powers from what the board wishes to assign to them; the board may delegate but can never abdicate its responsibility. The board has to establish each committee's terms of reference. It is also for the board to name the chairman and members, and to arrange how the committees should report and to monitor the committees' effectiveness (CCG, 2000). Sacco boards establish committees such as executive committees, central management committees, staff advisory committees, credit committees, tender committees and audit committees.

d. Position of chairman and chief executive officer

The Cadbury committee (1992) recommended that the positions of chairperson and chief executive officer be held by different individuals. A scenario also advanced in Kenya by the CMA (2002) to ensure a balance of power of authority and provide for checks and balances such that no one individual has unfettered powers of decision making. Finkelstein and D'Aveni (1994) argued that the same person should not hold the CEO and chairman roles simultaneously as this would reduce the effectiveness of the board's monitoring. The issue of CEO duality (the CEO and board chairperson being the same individual) appears to constrain board independence.

because there is a possibility of conflict of interests. Daily and Dalton (1997) mention that separate board structure can enhance board independence and shareholder value.

According to agency theory, the combined functions (unitary leadership structure) can significantly impair the board's most important function of monitoring, disciplining and compensating senior managers. It can also enable the CEO to engage in opportunistic behavior because of his or her dominance over the board. Fama and Jensen (1983) observed that combined chair and CEO positions signals the absence of separation of decision management and decision control.

2.5.3 Senior management team

Aside from monitoring the executive management, the board is also responsible for designing the management contract that minimizes the degree of agency conflicts. Prowse (1994) mention that a management contract aligns personal interest of the managers with that of the shareholders and provides managers with the incentives to maximize firm value. It is suggested that a value enhancing management contract should include: basic salary components, performance-based cash bonuses and profit-based salary revisions, pension rights, performance-based dismissal provisions, and long-term incentive plans.

2.5.4 Employees

The OECD (2004) outlines several principles of corporate governance that acknowledge the roles and rights of the stakeholders such as the employees and society as a whole. It is stated that the stakeholders' rights, as established by the legal system of the country or through mutual agreements and co-operation, need to be recognized by a firm for maximizing the well-being of its employees, creating wealth and welfare for society, and maintaining sustainability of the enterprises and financial systems. OECD (2004) further observes that performance-enhancing mechanisms for employee participation should be permitted to develop. Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this. Mallin (2004) suggests that a preferential treatment to the shareholders, whilst taking into account the interests of the stakeholders, can enhance both shareholder and stakeholder values.

2.5.5 Transparency and accountability

Transparency and accountability are two closely related issues that are crucial, not only in enhancing the disclosure and auditing standards of a firm, but also in developing the regulatory organ's capacity to monitor and discipline the firm's governance practices. Therefore, it is imperative for a firm to make its financial and non-financial information available and easily accessible to outsiders in order that everyone can make informed decisions (Barako, 1997). Effective disclosures enable existing as well as prospective investors, to evaluate the management's past performance, forecast the firm's future cash flow (Gilson, 2000), and to decide whether the risk profile of a firm is within an acceptable level (Fok, 2000). Mallin (2002) mention that information to shareholders is one of the most important aspects of corporate governance, as it reflects the degree of transparency and accountability of the corporation towards its shareholders. The quality of a firm's disclosures tends to be determined by the development of the capital market and the standards of accounting and auditing practices of a country. Claessens and Fan (2002) emphasize the quality auditing and professional integrity of the external auditors, it is commented that weak enforcement of accounting and auditing standards restrains quality auditing. OECD (2004) state that an annual audit should be conducted by an independent, competent and qualified auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company of the company in all material respects. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.

2.6 Empirical studies and knowledge gap

Generally research on corporate governance applied to financial intermediaries is indeed scarce (Prowse, 1997). This shortage is confirmed by Oman (2001); Goswani (2001); Lin (2001); Malherbe and Segal (2001) and Arun and Turner (2002). They hold a consensus that although the subject of corporate governance in developing economies has recently received a lot of attention, it is still not yet rooted enough. Arun and Turner (2002) contend that there exist narrow approaches to corporate governance which views the subject as the mechanisms through which shareholders are assured that managers will act in their interest.

There is no study on the relationship between corporate governance and firm performance in Kenya known to the researcher that has been carried on Afya Sacco for instance. A few of the studies on corporate governance that have been carried out have concentrated on other forms of organizations. Wambua (1999) carried out a study on corporate governance in the banking industry and concluded that there was an overwhelming interest on the need for care for shareholders, strategic planning and resource allocation. Okungu (2006) examined the depth of corporate governance in Kenyan banking industry and contended that there was significant positive relationship between good corporate governance practices and financial performance in the Kenyan banking sector. Wainaina (2003) in his discourse on corporate governance in microfinance sector concluded that lack of regulatory framework in the sector had led to the low levels of good corporate governance practices in that sector. Mucuvi (2002) found that there was generally a high level of awareness about corporate governance among the motor industry in Kenya. Her results indicated that a large number of firms in motor industry had taken deliberate steps to implement the corporate governance policies.

Maina (2007) studied corporate governance practices in insurance industry in Kenya and revealed that there were some weaknesses in the corporate governance among the insurance companies in Kenya. Osambo (2006) studied corporate governance systems in SACCO's Front Office Services Activities (FOSA) and found that corporate governance systems in FOSAs were generally satisfactory.

Thus there exist a knowledge gap in the research on the relationship between corporate governance and firm performance in Kenya. This study intends to contribute towards reducing the gap by looking at the relationship between corporate governance practices and performance of Afya Sacco. Specifically, the study intends to investigate the relationship between an integrated governance score generated from individual scores of various corporate governance mechanisms such as the general assembly (AGM), the board of directors (BOD), senior management team (SMT) and employees and the performance of Afya Sacco over a period of ten years between 1999 and 2008 in order to determine how corporate governance practiced by Afya Sacco over the years has influenced performance.

2.7 Literature review summary and conclusions

Though corporate governance has been variously defined, the definition by OECD 2004 is in line with the theme of this study. It is defined as "corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined". Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interest of the company and its shareholders and should facilitate effective monitoring. Good corporate governance is founded upon four tenets which are fairness, transparency, accountability and responsibility.

The concept of corporate governance has been elaborated with the use of two theories. Firstly, the agency theory which explains the relationship between company owners (principals) and management (agents). In SACCOs, where elected directors and staff run the affairs of the Sacco on behalf of the members, agency relationships take the form of members versus board of directors; members/directors versus managers; members versus supervisory committee; members versus branch representatives; and lastly net borrowers versus net savers. Secondly, the stakeholder theory which states that a firm is accountable to a broad range of stakeholders not just shareholders. These other stakeholders include employees, suppliers, customers, creditors, communities in the vicinity of the company's operations and the general public.

Corporate governance mechanisms used to mitigate against the problems arising from the interrelationships among the different players in a firm are the general assembly; the board of directors; senior management; employees; and transparency and accountability.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter covered matters related to design of the study, data and data source and data analysis techniques and procedures. It described in detail all the steps involved in conducting the study to arrive at proper conclusions regarding the impact of corporate governance practices of Afya Sacco on its performance.

3.2 Research design

The research design for the study was a case study. A case study design was most appropriate for the study as it entailed intensive or in-depth investigation of factors that accounted for the behaviour-patterns of a given unit as an integrated totality (Kothari, 2004). Eisenhardt (1989) argue that a case study is a research strategy which concentrates on perceiving the dynamics present within single settings. A case study is particularly good for examining "why" as well as "how" and "what" (among question series: "who", "what", "where", "how", and "Why"), which are enquiries about a contemporary set of events over which the investigator has little or no control (Saunders et al., 2007). Especially, the "how" question is suitable for a case study because this question deals with operational links needed to be traced over time, rather than mere frequencies or incidence (Yin, 2003). The research study was about the impact of corporate governance practices of Afya Sacco as a unit on its performance. The governance practices studied included the general assembly (AGM), the board of directors (BOD), senior management team (SMT) and the employees and how they impacted on performance over time.

3.3 Data and data source

3.3.1 Required data

For the purpose of the study, secondary data on performance and corporate governance practices of Afya Sacco were obtained. These data were quantitative in nature.

3.3.2 Data source

The data were obtained from the annual reports of Afya Sacco that contained audited financial statements and statistical information, AGM minutes file, board's meetings attendance registers as well as employees' master register. The data gathered were for a period of ten years from 1999 to 2008 aimed at comparing how the governance practices under consideration impacted on the performance over time.

3.3 Data analysis

Since the data were quantitative in nature, quantitative technique was used to analyze data. The technique used was linear regression analysis using SPSS. The researcher considered performance indicators of gross margin as a percentage of average total assets and net income as a percentage of average total assets (ROA) ratios as recommended in the WOCCU's 'PEARLS' performance monitoring system. These two performance ratios appear under the subheading of 'rates of return and cost' as R8 and R12 respectively. PEARLS stand for:

P = Protection

E = Effective financial structure

A = Asset quality

R = Rates of return and cost

L = Liquidity reserves/savings deposits

S = Signs of growth

R8: Gross margin as a % of average total assets performance ratio

This ratio measures the ability of a credit union to generate sufficient income to cover all operating expenses and allowances for loan losses and provide for adequate increases in institutional capital (WOCCU). To compute it, the following information is considered:

a. Loan interest income

b. Liquid investment income

c. Financial investment income

d. Non-financial investment income

e. Other income

f. Interest cost of savings deposits

g. Dividends or interest cost of member shares

h. Interest cost of borrowed funds

i. Total assets as of current year-end

j. Total assets as of last year-end

FORMULA: $\{(a+b.....+e) - (f+g+h)\}/\{(i+j)/2\}$

R12: Net income as a % of average total assets (ROA)

This ratio measures the adequacy of earnings and also, the capacity to build institutional capital (WOCCU). For its computation the following information is considered:

a. Net income (after dividends)

b. Total assets as of current year-end

c. Total assets as of last year-end

FORMULA: $a/\{(b+c)/2\}$

The above performance ratios were computed for each of the ten years from 1999 to 2008.

The researcher then used the WOCCU's worldwide accepted 'Governance Monitoring Tool' (GMT) to compute the corporate governance scores for each of the ten years from 1999 to 2008. The tool required one to key in information relating to the general assembly, the board of directors, senior management team, employees and use or misuse of power and then automatically computed the corporate governance scores.

Both the computed results of the performance ratios and the governance scores were then keyed in to SPSS for regression analysis to finally determine whether the governance scores had an impact on each of the performance ratios.

3.4 Model specification

The regression model used in this study was given as:

$$Y = a + bX$$

Where, Y is the dependent variable; a is a constant, b is the coefficient of the explanatory variable (corporate governance score) and X is the explanatory or independent variable (corporate governance score).

3.5 Variable description

Table 1a and 1b below show the variables and their description as used in this study.

Table 1a: Dependent variable description

Variable	Description
Gross margin to average total assets	(Gross margin/average total assets)*100%
ROA	(Net income/average total assets)*100%

Table 1b: Independent variable description

Variable	Description
Corporate governance scores	Generated from information on AGM attendance; AGM expenses as a percentage of total operating expenses; percentage of women attending the AGM; board size; years board directors have served; number of board meetings in a given year; boards' financial matters regarding delinquent loans; board's related expenses as a percentage of total operating expenses; percentage of women in the board; education qualifications of board directors; qualifications of senior management team; percentage of CEO's emoluments as a percentage of total operating expenses; percentage of women in the senior management team; years of service of senior management team; senior management team's financial matters regarding delinquent loans; employees' years of service; employees' annual turnover; use of products and services; and institutional decision making all keyed in to WOCCU's governance monitoring tool to compute one integrated governance score.

CHAPTER FOUR

DATA ANALYSIS, PRESENTATION AND DISCUSSION OF FINDINGS

4.1 Introduction

This chapter focuses on the results of data analysis, presentation and discussion of findings. It addresses issues such as the computation of the performance ratios inform of gross margin as a % of average total assets ratio and net income as a % of average total assets (ROA) ratio; the corporate governance scores generated by keying in the required information into the WOCCU's governance monitoring tool (GMT) for the period of the study 1999 to 2008; and lastly the coefficients of correlation between and the governance scores and the two performance ratios respectively obtained from analyzing data related to the two performance ratios as dependent variables and the governance scores as independent variables for the period of the study using the SPSS. Data analysis results were presented using tables.

4.2 Gross margin as a % of average total assets

Table 2 below shows results of the computation of the gross margin as a percentage (%) of the average total assets ratio for the period of the study form 1999 to 2008. The annual ratios were computed from information on the gross margin or total income minus rebates to members as well as interests on borrowed funds and the average of opening assets balance and closing assets balances for the years of study. The information was obtained from the annual audited financial statements of Afya Sacco. The results show a rising performance trend from 4.02% in 1999 to 7.33% 2005 after when performance sharply declined to 5.01% in 2006. The performance then rose again to 6.06% and 6.29% in 2007 and 2008 respectively.

Table 2: Results of computation of gross margin as a % of average total assets

year	gross margin	current year assets	previous year assets	average assets	RATIO
1999	80,061,637.00	2,198,127,145.00	1,789,583,369.00	1,993,855,257.00	4.02
2000	94,949,240.00	2,513,033,981.00	2,198,127,145.00	2,355,580,563.00	4.03
2001	137,791,068.00	2,759,991,578.00	2,513,033,981.00	2,636,512,779.50	5.23
2002	181,316,297.00	2,971,250,221.00	2,759,991,578.00	2,865,620,899.50	6.33
2003	228,840,346.00	3,708,565,916.00	2,971,250,221.00	3,339,908,068.50	6.85
2004	287,493,826.00	4,440,990,285.00	3,708,565,916.00	4,074,778,100.50	7.06
2005	343,530,115.00	4,927,309,561.00	4,440,990,285.00	4,684,149,923.00	7.33
2006	243,005,710.00	4,769,149,234.00	4,927,309,561.00	4,848,229,397.50	5.01
2007	282,578,429.00	4,561,888,970.00	4,769,149,234.00	4,665,519,102.00	6.06
2008	291,067,391.00	4,692,537,834.00	4,561,888,970.00	4,627,213,402.00	6.29

Source: audited financial statements of Afya Sacco for ten years from 1999 to 2008

4.3 Net income as a % of average total assets (ROA)

Table 3 below presents results of the computation of net income as a percentage (%) of the average total assets ratio (ROA). The annual ratios were computed from information on net income after all operating expenses and average of opening assets balance and closing assets balance for each of the years in the period of the study. It measured the earning adequacy of Afya Sacco as well as the capacity to build institutional capital. The results showed an erratic performance pattern with the ratio rising steadily from 0.11% in 1999 to 0.44% in 2002. It declined to 0.31% in 2003 rising thereafter to 0.41% in 2004. The ratio then sharply declined to

0.19% in 2005, remaining in the same level in 2006 and rising to 0.23% in 2007. It however declined to a low of 0.10% in 2008.

Table 3: Results of computation of net income as a % of average total assets (ROA)

Year	net income	current year assets	previous year assets	average assets	ROA
1999	2,100,760.00	2,198,127,145.00	1,789,583,369.00	1,993,855,257.00	0.11
2000	4,379,895.00	2,513,033,981.00	2,198,127,145.00	2,355,580,563.00	0.19
2001	7,724,703.00	2,759,991,578.00	2,513,033,981.00	2,636,512,779.50	0.29
2002	12,534,615.00	2,971,250,221.00	2,759,991,578.00	2,865,620,899.50	0.44
2003	10,208,235.00	3,708,565,916.00	2,971,250,221.00	3,339,908,068.50	0.31
2004	16,613,289.00	4,440,990,285.00	3,708,565,916.00	4,074,778,100.50	0.41
2005	8,980,511.00	4,927,309,561.00	4,440,990,285.00	4,684,149,923.00	0.19
2006	9,091,229.00	4,769,149,234.00	4,927,309,561.00	4,848,229,397.50	0.19
2007	10,659,618.00	4,561,888,970.00	4,769,149,234.00	4,665,519,102.00	0.23
2008	4,490,727.00	4,692,537,834.00	4,561,888,970.00	4,627,213,402.00	0.10

Source: audited financial statements of Afya Sacco for ten years from 1999 to 2008

4.4 Corporate governance scores

Table 4 below shows the results of annual corporate governance scores generated after keying information on corporate governance practices of Afya Saco Limited in to the WOCCU's governance monitoring tool. The results show an improving Afya Sacco's corporate governance practice trend of 48.28% to 58.62% for years 1999 to 2003 benchmarked against the WOCCU's, standard, in 2004 and 2005 the governance scores remained at 58.62% before declining to 55.17 in both 2006 and 2007 respectively. The score however improved by rising back to 58.62% in 2008.

Table 4: Results of computation of corporate governance scores

Year	Score
1999	48.28
2000	51.72
2001	51.72
2002	55.17
2003	58.62
2004	58.62
2005	58.62
2006	55.17
2007	55.17
2008	58.62

Source: generated from WOCCU's "GMT" by answering governance related questions with information on Afya Sacco's corporate governance practices.

4.5 Regression results - gross margin as a percentage of average total assets ratio as a dependent variable

The table below shows the result of the coefficient estimate of gross margin as a percentage of average total assets as a dependent variable. Corporate governance scores have a coefficient of 0.902, an indication of a positive relationship between them and gross margin as a percentage of total average total assets.

Table 5a: Coefficient – gross margin as a % of average total assets ratio as a dependent variable

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig
		B	Std. Error	Beta	B	Std. Error
1	(Constant)	-10.549	2.776		-3.800	.005
	VAR00002	.297	.050	.902	5.908	.000

Dependent Variable: gross margin as a % of average total assets

Source: table 2 and table 4

The table below shows the analysis of variance (ANOVA) of the variables. With F-value of 34.907 (sig 0.000) for gross margin as a % of average total assets as a performance proxy, it clearly shows that there is a strong relationship between the dependent variable (gross margin as a % of average total assets) and the independent variable (corporate governance scores).

Table 5b: ANOVA – gross margin as a % of average total assets ratio as a dependent variable

Model		Sum of Squares	Df	Mean Square	F	Sig
1	Regression	10 467	1	10.467	34.907	000(a)
	Residual	2 399	8	300		
	Total	12.865	9			

Predictors: (Constant), corporate governance scores
Dependent Variable: (gross margin average total assets)*100%

Source: table 2 and table 4

4.6 Regression results - net income as a % of average total assets ratio (ROA) as a dependent variable

The table below shows the result of the coefficient estimate of net income as a percentage of average total assets (ROA) as a dependent variable. Corporate governance scores have a coefficient of 0.283. This indicates a positive relationship between the governance scores and ROA.

Table 6a: Coefficient – ROA as a dependent variable

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig
		B	Std Error	Beta	B	Std Error
1	(Constant)	- 250	.596		- 419	686
	VAR00002	009	011	283	834	429

Dependent Variable ROA

Source: table 3 and table 4

The table below shows the analysis of variance (ANOVA) of the variables. With F-value of 0.695 (sig 0.429) for ROA as a performance proxy, it clearly shows that there is a strong relationship between the dependent variable (ROA) and the independent variable (corporate governance scores).

Table 6b: ANOVA – ROA as a dependent variable

Model		Sum of Squares	Df	Mean Square	F	Sig
1	Regression	.010	1	.010	.695	.429(a)
	Residual	.110	8	.014		
	Total	.120	9			

Predictors: (Constant), corporate governance scores
Dependent Variable: ROA

Source: table 3 and table 4

CHAPTER FIVE

CONCLUSION, RECOMMENDATION, LIMITATION AND SUGGESTIONS FOR FUTURE RESEARCH

5.1 Introduction

This chapter focused on the conclusion of the study, recommendation, limitation of the study as well as suggestions for future research.

5.2 Conclusion

The aim of the study was to determine the relationship between corporate governance practices and performance of Afya Sacco Limited. This was accomplished by using regression analysis to test the relationship between the corporate governance scores for ten years from 1999 to 2008 and two performance proxies, gross margin as a percentage of average total assets and ROA or net income as a percentage of average total assets. The study revealed that there was a positive and significant relationship between corporate governance scores and gross margin as a percentage of average total assets with a coefficient of 0.902. The study also revealed that there is a positive and significant relationship between corporate governance scores and ROA with a coefficient of 0.283.

Thus the level of corporate governance practices has a bearing on the firm performance in the case of Afya Sacco Limited.

5.3 Recommendation

Afya Sacco should strive to improve on its corporate governance practices which in turn will have a positive impact on its performance. To this end, it should constantly benchmark itself against the WOCCU's governance monitoring tool to find out those areas where it is not doing good enough with a view to taking improvement measures. This in turn will translate to improved and better performance and better treatment of other stakeholders such as employees.

5.4 Limitation of the study

The study was a case study and analysed the relationship between corporate governance practices and performance of Afya Sacco as the unit of analysis. The data gathered for the purpose of the study was about Afya Sacco Limited. It is therefore imperative to note that the

study findings and conclusion relates to Afya Sacco and care should be exercised when drawing generalization or extending the conclusion to cover the entire SACCO sector in Kenya.

However, the above limitation present an opportunity for future research.

5.5 Suggestions for future research

The study was a case study and used Afya Sacco as the unit of analysis and found a positive relationship between corporate governance and performance. To determine the scenario in the SACCO sector, this study can be replicated in future to cover more SACCOs to determine the relationship between governance practices and performance across a number of SACCOs or in the SACCO industry.

The study also, using the WOCCU's governance monitoring tool, integrated the scores of various corporate governance mechanisms to obtain one grand governance score and studied the relationship between the grand governance scores and the performance of Afya Sacco. It may be important to study the individual corporate governance mechanisms such as the general assembly, the board of directors, senior management team and employees separately to find out how they relate with performance either of many SACCOs or of one SACCO across time.

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