CORPORATE GOVERNANCE REFORMS AND PERFORMANCE OF COMPANIES LISTED AT THE NAIROBI STOCK EXCHANGE

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A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF MASTER OF BUSINESS ADMINISTRATION DEGREE OF THE UNIVERSITY OF NAIROBI

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DECLARATION

I Sophia Mukoba declare that this study is my original work and has not been presented for academic purposes in any other institution of learning.

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SUPERVISOR

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

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DEDICATION

To my entire family:
Brains and hard work are important ingredients to success, but without your love, support, inspiration and encouragement, I would not have made it this far in the pursuit of knowledge.

ACKNOWLEDGEMENT

My heartfelt gratitude goes to my supervisor Mr Moses Anyangu whose guidance and encouragement has enabled me to successfully complete this project.

To Mr Lishenga and Mr Lelei for their critical and constructive input when I needed it most.

To all the senior management team in the various Organisations who spared their time to complete the questionnaires.

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LIST OF ABBREVIATIONS

NSE: NAIROBI STOCK EXCHANGE

CEO: CHIEF EXECUTIVE OFFICER

MIMS MAIN INVETMENT MARKET SEGMENT

AIMS ALTERNATIVE INVESTMENT MARKET SEGMENT

ABSTRACT

The study sought to establish the correlation between corporate governance reforms and performance of companies quoted at the Nairobi Stock Exchange. The study targeted all the forty-nine companies listed at the Nairobi Stock Exchange under the Main Investment Market Segment (MIMS) and the Alternative Investments Segment (AIMS). A questionnaire was administered to all these companies. Forty-four companies responded giving a response rate of eighty-nine percent which was considered adequate for the study.

Attributes of the companies that responded were obtained from the audited financial statements covering the period 1994 to 2003. Correlation analysis was used to establish the strength of the relationships between the various corporate governance attributes and company performance.

From the study it is evident that the type of executive compensation used by a company greatly impacts on the performance of the company. Mixed results were obtained for the correlation between the size and composition of the board and company performance. But going per the trends and the guidance issued by the Capital Markets Authority, most the companies have average sized boards of between five and ten members. The Chief Executive Officer is also not the chairman of the board of directors.

CHAPTER ONE

1.0 INTRODUCTION

1.1 Background

1.1.1 Meaning and importance of corporate governance

Corporate Governance refers to the manner in which the power of a corporation is exercised in the stewardship role of the corporation's total portfolio of assets and resources with the objective of maintaining and increasing shareholder value and satisfaction of other stakeholders in the context of its corporate mission (Private Sector Corporate Governance Trust (2000)). It is concerned with creating a balance between economic and social goals and between individual and communal goals while encouraging efficient use of resources, accountability in the use of power and stewardship and as far as possible to align the interests of individuals, corporations and society.

According to Magretta (1998), corporate governance is increasingly being recognized as an important element for sustainable development in all sectors, both public and private. Good corporate governance practices bring about wealth creation, generation of economic growth and expansion of employment opportunities, and thus contributing to alleviation of poverty. At the corporate level, corporate governance aims at creating corporations that are governed transparently, accountably, responsibly, responsively, efficiently, and effectively and with highest levels of integrity.

There are various measures of company performance. Company performance can be measured using such measures as profit after tax, return of assets, return on equity, earnings per share and stock prices. The choice of the performance measure used is dependant on the purpose for which the measure is intended to be used for.

Much of the controversy surrounding corporate governance tends to focus on whether corporate governance is related to corporate performance. Several studies have been carried out on corporate governance but they have shown conflicting results on the relationship between good corporate governance practices and company performance. Agrawal and Knoeber (1996) find that more outside directors on the board negatively affect performance. On the other hand, Schellenger et al (1989) observe a positive relationship between outside director representation and corporate financial performance.

In her study on corporate governance, Jebet (2001) found that good corporate encourages additional investment and lowers the cost of capital. Good governance procedures keep managers accountable so as to reduce conflict of interest between management and shareholders. It ensures that the personal interests of the management work for and not against those of the company at large. Transparency through the improved disclosure of accurate and timely information on corporate performance ensures that proper decisions are made. This reduces the chances of poor investment decisions that could lead to huge losses. It enhances responsibility of the corporation to obey the law and to act with regard to the needs of other corporate stakeholders, i.e. profit maximization and shareholder wealth maximization.

Companies with good governance tend to have higher values in the market. With this the company can secure a substantial market share and the ability to manipulate prices. Good governance also enables firms to attract institutional investors due to availability of loan security. Funding obtained from institutional investors can be used for expansion of business operations.

Empirical evidence shows a close correlation between application of good corporate practices and performance in corporations. Several studies have concluded there is a 'governance premium' for companies, which conform to local standards of best practice on corporate governance. Closely monitored companies often outperform their counterparts that have poor governance. Schellenger et al (1989) observe a positive relationship between outside director representation and corporate financial performance. Agrawal and Nagarajan (1990) unfolded the relationship between corporate control ownership, control and performance of the firm. Their study conclusively evidenced the fact that all equity firms have greater family involvement and higher liquidity than their levered counter-parts. They also have greater control of the corporate voting rights. They find corporate control to be a good substitute for corporate governance. Basle (1996) concluded that increased disclosure allows sophisticated counterparts to understand the risks involved in trading with financial institutions.

1.1.2 Review of recent corporate governance reforms

With the increased recognition of corporate governance all over the world, some reforms have recently been implemented to enhance governance of both private and public firms. Laws on corporate governance have been put in place to guide in the running of companies. On a global perspective, we have the Sarbanes Oxley Act which was enacted in 2002 following a spate of failures from big corporations arising from poor governance. Committees have been formed to come up with guidelines on the best practices on corporate governance. Such guidelines include Cadbury report (1992), Hampel report (1998), Turnbull report (1999) and most recently the Higgs report (2003). On the Kenyan scene, the Capital Markets Authority has taken the lead in issuing guidelines on corporate governance of quoted companies. The CMA has given guidelines relating to role of directors, their appointment and mechanisms, role of the audit committees, disclosure of information to the public and others. The Private Sector Corporate Governance Trust has taken the lead in issuing governance guidelines and best practices in the private sector.

Companies have formed internal audit departments which regularly review the internal controls and procedures in place to ensure that they are operational all the time. The department is also charged with the responsibility of following up with management to ensure that their recommendations are implemented in order to strengthen the internal controls in place. The internal audit department reports to the board of directors in order to enhance their independence and avoid conflict of interest.

Boards of directors are taking a more activist role in the running of the companies than in the past. The boards have formed various committees to monitor the various aspects of the companies. Boards of directors are composed of different individuals with experience of different areas. Due to the diversity of the skills and experiences in the board, boards of directors have taken to forming board committees charged with responsibilities in different areas of the organization. Some of the committees that have been formed recently include the audit committee, the finance committee and the human resource committee. The Audit committee is the most key and significant of these committees as far as corporate governance is concerned. This is the committee that is charged with the responsibility of ensuring that the recommendations of the internal and external auditors are followed through and implemented. The finance committee is charged with the responsibility of vetting the company's investments and expenditure and also approving high level expenditure. The human resources committee is charged with the responsibility of approving the recruitment of company executives, compensation and also dealing with other issues that affect staff in the organization.

Disclosure of corporate information by firms has increased compared to the past. This has been due to the regulations put on place, as well the initiative of various companies to enhance their corporate governance mechanisms. The CMA requires every board of directors to disclose in its annual report, its policies for remuneration, including incentives for the board and senior management, a list of the ten major shareholders, share options and other forms of executive compensation that have to be made or have been made during the course of the financial year and aggregate directors' loans.

1.2 Problem Statement

In the last ten years, a series of shock waves in the once staid realm of corporate governance has ignited a re-examination of the most basic of governance questions. Large institutional investors are no longer content to be passive owners. At the same time, boards are stepping up sometimes under pressure to claim a more activist role. Magretta (1998).

A lot of audit scandals have been unearthed in the recent past. The most memorable cases are the ones of Enron, World Com and Pamalat. The failing of these companies has all been attributed to poor corporate governance practices other than economic decline. The discovery of these cases took the rest of the world by storm and as such almost all corporations have embraced corporate governance reforms aimed at addressing these problems.

Studies carried out before have shown conflicting results on the relationship between good corporate governance practices and company performance. For example, Baysinger and Butler (1985) found weak evidence that firms with a higher percentage of outsiders on the board had a higher industry-adjusted return on equity. Agrawal and Knoeber (1996) find that more outside directors on the board negatively affect performance. On the other hand, Schellenger et al (1989) observe a positive relationship between outside director representation and corporate financial performance. Agrawal and Nagarajan (1990) find that all-equity firms have greater corporate voting rights and higher liquidity than their levered counterparts. However, Hickman et al (1996) finds that levered firms benefit from the discipline of debt. More cash flows are paid out as fixed charge hence reducing discretionary expenditure. In such cases, profitability will increase, hence the firm's value. Shleifer and Vishny (1997) argued that as the control –ownership disparity increases, controlling shareholders appropriate more firm resources as they have an incentive to pursue their own private benefits. Jensen and Meckling (1976) argue that the tendency increases when the controlling shareholders own less. In the Kenyan environment, have the corporate governance reforms had any impact on company performance?

1.3 Objective of the Study

To identify the relationship, if any, between corporate governance reforms and performance of companies listed at the Nairobi Stock Exchange.

1.4 Significance of the Study

The principal goal of all firms is maximization of shareholders' wealth. The formulation and implementation of most policies in the firm are aimed at achieving this goal. This study explores extensively the various corporate governance reforms that have been implemented in the last ten years and how they have impacted company performance. The study will therefore benefit:

Company executives and policy makers

In order to meet the principal goal of shareholders' wealth maximization, company executives need to know which policies and reforms they need to implement in order to achieve this goal. This study will go a long way in assisting the company executives in steering their organizations to high levels of profitability and growth.

The Academic community

This study will provide a body of knowledge on the correlation between various corporate governance reforms and company performance. This is an emerging area which has not been researched on extensively in the past.

Investors

The objective of all investors is to maximize the returns on their investments. Most investors are risk averse and as such would be comfortable investing where they are assured of a good return. This study will equip investors with the knowledge they require to identify and evaluate companies that are well governed hence worth investing in.

Students of research

The study will expand their knowledge base and form the basis for further research.

The public

The study will create awareness on the issues of governance of both public and privately owned companies.

CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Nature of corporate governance reforms

Dunham (2004) categorizes corporate governance reforms into two main classes. There are internal and external governance mechanisms. These are discussed below.

2.1.1 Internal governance mechanisms

These include the mechanisms and policies that are in a company's power to control and implement in order to enhance corporate governance. Some of the internal governance mechanisms include:

Board of directors:

These are individuals who are responsible for representing the firm's owners by monitoring top-level managers' strategic decisions. In order to enhance corporate governance, the shareholders have recently been increasing the diversity of board members' backgrounds. This is to ensure that good quality decisions are made all the time. The internal management and accounting control systems have also been strengthened to ensure that the board gets the all the information they require on a timely basis in order to make decisions. Formal processes for evaluation of the board's performance have also been established. They include the firm's profitability, the share price etc. Many studies have shown a correlation between board size, composition, independence and company performance. Schellenger et al (1989) observed a positive relationship between outside director representation and corporate financial performance. Yermack (1996) concluded that small boards were more effective.

Executive compensation:

This includes the use of salary, bonuses, and long-term incentives to align managers' interests with shareholders' interests. Executive decisions are complex and non-routine. Many factors intervene, making it difficult to establish how managerial decisions are directly responsible for outcomes. Though incentive systems do not guarantee that managers make the "right" decisions, they do increase the likelihood that managers will do the things for which they are rewarded. Lewellen and Huntsman (1970) suggest that there is a significant correlation between performance and executive pay levels. Murphy (1985) concludes that corporate performance as measured by the shareholders' realized returns, is strongly and positively related to executive compensation.

Ownership concentration:

Large block shareholders have strong incentive to monitor management closely. Large stakes make it worth the time, effort, and expense to monitor closely. They may also obtain board seats, which enhance their ability to monitor effectively. Mitton (2002) argues that firms with higher ownership concentration tend to perform better. He believes the benefit of concentrated ownership does not extend to concentrated ownership by managers. Shleifer and Vishny (1997) conclude that high outside-ownership concentration is associated with high performance because outside owners with large stakes in the firm will monitor and change management whenever necessary.

2.1.2 External governance mechanisms

These include the governance mechanisms that are out of a company's control. They include policies and mechanisms that are controlled by powers external to the company. Some of the external governance mechanisms include:

Market for corporate control:

This is the purchase of a firm that is underperforming relative to industry rivals in order to improve its strategic competitiveness. Firms face the risk of takeover when operated inefficiently. Many firms begin to operate more efficiently as a result of the "threat" of takeover, even though the actual incidence of hostile takeovers is relatively small. The market for corporate control acts as an important source of discipline over managerial incompetence and waste. Many authors view markets for corporate control as an effective instrument for disciplining poor managerial performance. Manne (1965) observes that as shareholders respond to poor managerial performance through exit, the lower share prices creates incentives for outsiders to accumulate control rights, replace management team and restructure the underperforming firm. These outsiders recoup their investments through a share price premium.

Separation of ownership and control:

The basis of the modern corporation acts as a governance mechanism on its own. Shareholders purchase stock, becoming residual claimants. They reduce risk by holding diversified portfolios. On the other side, professional managers are contracted to provide decision-making. Modern public corporation form leads to efficient specialization of tasks, risk-bearing by shareholders and strategy development and decision-making by managers. Fama and Jensen (1983) contend that the separation of decision making and risk bearing functions benefits organization due to the specialization of management and the effective common approach to controlling the implied agency problems.

2.2 Major corporate governance reforms in Kenya

2.2.1 Capital Markets Authority corporate governance guidelines

In response to the growing importance of governance issues both in emerging and developing economies and for promoting growth in domestic and regional capital markets, the Capital Markets Authority has developed guidelines for good corporate governance practices by public listed companies in Kenya. Capital Markets Authority (2002). It is also in recognition of the role of good governance in corporate performance, capital formation and maximization of shareholders value as well as protection of investors' rights. Whilst these guidelines have been developed for public listed companies and issuers of fixed income securities and debt instruments in Kenya's capital market, companies in the private sector are also encouraged to practice good corporate governance. It is important that the extent of compliance with these guidelines should form an essential part of disclosure obligations in the corporate annual reports. It is equally important the extent of non-compliance be also disclosed.

Some of the principals of good corporate which are recommended by the Capital Markets Authority include the following:

Directors:

Every public listed company should be headed by an effective board to offer strategic guidance, lead and control the company and be accountable to its shareholders. The board should compose of a balance of executive directors and non-executive directors (including at least one third independent and non-executive directors) of diverse skills or expertise in order to ensure that no individual or small group of individuals can dominate the boards' decision-making processes. There should be a formal and transparent procedure in the appointment of directors to the board and all persons offering themselves for appointment, as directors should disclose any potential area of conflict that may undermine their position or service as director. The board should establish relevant committees and delegate specific mandates to such committees as may be necessary. The board shall specifically establish an audit and nominating committee.

The directors' remuneration should be sufficient to attract and retain directors to run the company effectively and should be approved by shareholders. The executive directors remuneration should be competitively structured and linked to performance. The non-executive directors' remunerations should be competitive in line with remuneration for other directors in competing sectors. Companies should establish a formal and transparent procedure for remuneration of directors, which should be approved by the shareholders.

Every person save a corporate director who is a director of a listed company shall not hold such position in more than five public listed companies at any one time to ensure effective participation in the board and in the case where the corporate director has appointed an alternate director, the appointment of such alternate shall be restricted to three public listed companies, at any one time, subject to the requirements under the Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002. All directors except the managing director should be required to submit themselves for re-election at regular intervals or at least every three years. Executive directors should have a fixed service contract not exceeding five years with a provision to renew subject to regular performance appraisal and shareholders approval. Disclosure should be made to the shareholders at the annual general meeting and in the annual reports of all directors approaching their seventieth (70^{th}) birthday that respective year. Resignation by a serving director should be disclosed in the annual report together with the details of the circumstances necessitating the resignation.

Role of Chairman and Chief Executive

There should be a clear separation of the role and responsibilities of the chairman and chief executive, which will ensure a balance of power of authority and provide for checks and balances such that no one individual has unfettered powers of decision making. Where such roles are combined a rationale for the same should be disclosed to the shareholders in the annual report of the Company. Every person who is a Chairperson of a public listed company shall not hold such position in more than two public listed companies at any one time, in order to ensure effective participation in the board, subject to the requirements under the Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002.

Approval of Major Decisions by Shareholders

There should be shareholders participation in major decisions of the Company. The board should therefore provide the shareholders with information on matters that include but are not limited to major disposal of the Company's assets, restructuring, takeovers, mergers, acquisitions or reorganization. The board should provide to all its shareholders sufficient and timely information concerning the date, location and agenda of the general meeting as well as full and timely information regarding issues to be decided during the general meeting;

The board should make shareholders expenses and convenience primary criteria when selecting venue and location of annual general meetings; and The directors should provide sufficient time for shareholders questions on matters pertaining to the Company's performance and seek to explain to the shareholders their concern.

Accountability and Audit

The board should present an objective and understandable assessment of the Company's operating position and prospects. The board should ensure that accounts are presented in line with International Accounting Standards. The board should maintain a sound system of internal control to safeguard the shareholders investments and assets. The board should establish a formal and transparent arrangement for shareholders to effect the appointment of independent auditors at each annual general meeting. The board should establish a formal and transparent arrangement for maintaining a professional interaction with the Company's auditors.

Public disclosure

There shall be public disclosure in respect of any management or business agreements entered into between the Company and its related companies, which may result in a conflict of interest.

2.2.2 Private Sector Corporate Governance Trust Kenya

The Private Sector Corporate Governance Trust Kenya is a non –commercial Trust established in September 2000 to facilitate the administration of the private sector initiative in Kenya. The Initiative was conceived as an all-inclusive coordinating council bringing together regulatory authorities, the private sector and representatives of various stakeholder groups acting jointly to promote good corporate governance to achieve sustainable wealth creation, increased employment opportunities and overall improvement in the quality of life for the people of Kenya.

In an effort to contribute to the propagation and promotion of the democratic principles of transparency, fairness, accountability and responsibility in the Kenyan private sector, the Private Sector Corporate Governance Trust (PSCGT) has launched a project to mobilize the Kenyan public to understand and demand good corporate governance. Through training and education, research and development, monitoring and evaluation, as well as advocacy and communication, this project aims at motivating shareholders and community leaders to embrace and promote good corporate governance principles and good economic governance for sustainable development. The PSCGT also aims to facilitate the creation of a non-governmental association that defends shareholders rights in Kenya.

2.3 Global trends in corporate governance

The Sarbanes-Oxley Act of 2002 (SOA) is the most sweeping legislation affecting corporate governance, disclosure and financial accounting in over a generation. It requires that CEO's, CFO's and independent auditors and committees:

- Certify the accuracy of financial statements and disclosures

- Indicate in each periodic report whether or not there were significant changes in internal controls or related factors since their most recent evaluation and disclose all deficiencies in the design or operation of internal controls
- Provide auditor's attestation to, and report on, management's assessment of the internal controls and procedures for financial reporting.
- Report that controls and procedures for financial reporting and disclosure have been evaluated for effectiveness.

The Act requires an annual evaluation of internal controls and procedures for financial reporting. Under this scheme, a corporation must document its existing controls that have a bearing on financial reporting, test them for efficacy, and report on gaps and deficiencies. Furthermore, the company's independent auditor must issue a report, to be included in the company's annual report, that attests to management's assertion on the effectiveness of internal controls and procedures and financial reporting. The key area covered the Act include the following:

Control Activities

Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.

Information and Communication

Pertinent information must be identified, captured and communicated in a form and timeframe that enable people to carry out their responsibilities. Information systems produce reports, containing operational, financial and compliance-related information, that make it possible to run and control the business. They deal not only with internally generated data, but also information about external events, activities and conditions necessary to informed business decision-making and external reporting. Effective communication also must occur in a broader sense, flowing down, across and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as customers, suppliers, regulators and shareholders.

Monitoring

Internal control systems need to be monitored — a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties.

The Act also calls for heightened auditor independence. Non-audit services have been restricted in order to limit conflict of interest. The external auditor is required to report to the Audit Committee and there should be rotation of audit partners every five years. There is an Independent auditor oversight board to regulate auditors and audits.

2.4 CORPORATE GOVERNANCE REFORMS AND COMPANY PEFORMANCE

2.4.1 Corporate ownership and control and company performance

Agrawal and Nagarajan (1990) in their research on over 100 corporations listed on major U.S. stock exchanges unfolded the relationship between corporate ownership, control and performance of the firm. They compared financial, managerial, and ownership characteristics of a sample of publicly held all-equity firms and a control sample of levered firms. They defined all-equity firms to be firms, which use no long-tem debt over a continuous five-year period. Similarly, levered firms were defined as firms, which maintain a ratio of book value of long-term debt to firm value of at least 5% in each of the years from 1979 to 1983. Their study conclusively evidenced the fact that all-equity firms exhibit greater levels of managerial stockholdings, more extensive family relationships among top management, and a higher liquidity positions than a matched sample of levered firms. Further, top managers of all-equity firms with family involvements in corporate operations have greater control of corporate voting rights than managers of all-equity firms without family involvement. Those findings are consistent with the interpretation that management control of voting rights and family relationships among senior managers are important factors in the decision to eliminate leverage. It is therefore equally consistent with the interpretations that corporate control is a perfect substitute of corporate governance.

Hickman et al (1996) in their study asserted that managers of large companies with widely dispersed ownership are less likely to be held closely accountable for their actions, because no single stockholder owns enough stock to present a threat to incumbent management. When combined, free cash flow and widely dispersed ownership are ingredients forecasting wasted resources. However, these firms may benefit from the discipline of debt.

Pressure will be put on management to perform effectively and efficiently. More free cash flow is guaranteed to be paid out as fixed claims increases, reducing the potential for discretionary expenditures like excessive perquisites. In such cases, this will increase the firm's profitability hence its value. Their study therefore affirms the fact that there is a relationship between corporate control and profitability. Shleifer and Vishny (1997) argued that as the control –onwership disparity increases, controlling shareholders appropriate more firm resources as they have an incentive to pursue their own private benefits.

Jensen and Meckling (1976) argue that the tendency increases when the controlling shareholders own less. This is consistent with the premise that most small shareholders don't easily oppose the controlling shareholders. Hence, shareholders exercise control far beyond their onwnership and inadequate monitoring by institutional shareholders, hence affect profitability. Lim (1989) argued that in over 80% of large firms, the largest and controlling shareholder or family members are among the top excutives. Claessens et al, (2000) argued that other 20% are likely to be state – controlled enterprises and financial institutions. Both affirm that even when a hired professional CEO manages the firm, his decision–making power and scope are often quite limited. This is consistent with the fact that corporate governance and ownership control both impact on the performance (profitability) of the firm since they impact alot on the extent of discretional decision-making by the management. For instance, professionalism in management is very low where onwership and control is highly charged/exercised by shareholders.

2.4.2 Board composition, size, independence and company performance

Boards of directors can reduce agency costs by separating the management and control aspects of decision making where control involves ratification and oversight of decisions made by management (Fama and Jensen (1983a, 1983b)). Thus while management has the authority to initiate and implement various decisions, it is the board that has the control and authority to ratify and monitor major policy initiatives and to hire, fire and set the compensation of top level managers. The ability of the board to limit managerial actions that reduce shareholder wealth such as perquisite consumption is conditional on the extent that the board members are beholden to management. In this regard, board composition becomes important as the primary responsibility in maintaining objectivity depends largely on outside disinterested members of the board.

There has been a lot of research to find out if having more outside directors is associated with better firm performance. Unfortunately, there is a lack of consistent evidence of a significant relationship between board composition and firm performance. Researchers have reported positive, negative and insignificant associations that largely appear to be conditional upon how the relationship is modeled. Baysinger and Butler (1985) found weak evidence that firms with a higher percentage of outsiders on the board in 1970 had a higher industry-adjusted return on equity in 1980. Schellenger et al (1989) also observe a positive relationship between outside director representation and corporate financial performance. In contrast, Agrawal and Knoeber (1996) argue that board composition is one of a number of endogenously determined corporate governance mechanisms, including the use of the debt, the lab market for managers, the market for corporate control, insider shareholdings, institutional shareholdings, block holdings and the use of independent board members. They find that more outsiders on the board negatively affect performance. They argue that outsiders are added on boards for political reasons and they reduce performance directly or proxy for the underlying political constraints that led to their board memberships.

A number of studies have failed to find a significant relation between board composition and firm performance. Hermalin and Weisbach (1991) analyse the differences in firm performance caused by board composition and owner structure. They fail to find any significant relationship between percentage of outsiders in the board and performance. Similarly, Bhagat and Black (2000) report insignificant relations between accounting performance measures and the fraction of outside directors on the board. Franks et al (1999) point out that non-executive directors in the UK have fewer obligations than in the US and primarily perform an advisory function. Not surprisingly, they do not find evidence of a link between the proportion of non-executives directors on the board and firm performance.

Chaganti et al (1985) studied using matched pair approach 21 failed and non-failed retail companies. The results indicated that non-failed companies had larger boards and that the number of outsiders in the board was not varying between the groups. Anyhow, Eilon (1986) discussed later in his comment the approach that was used by Chaganti et.al. and considered that in the analysis the research problem was simplified too much. Despite of this caution a growing body of failure prediction research followed this approach. Daily and Dalton (1994) applied logistic regression analysis to study 57 bankrupt corporations and their matched pairs. The results indicated that dual structures (CEO is also the Chairman) were found in 37% non-failing firms when the corresponding figure for failing companies was 53.8%. Furthermore, 44.9% of the directors in survivor firms were affiliated. For the failing companies the figure was 59.5%.

Boeker (1992) studied 67 organizations over a 22-year period. He found out that poorly performing organizations in which the proportion of inside to outside board members is high will be less likely to dismiss the chief executive than in poorly performing organizations in which the proportion of inside to outside board members is low. Boeker and Goodstein (1993) studied the successor choice in a firm and found out that organizations with poor performance and high proportions of inside board members are more likely to choose inside chief executive successors than those with low proportions of insiders. Similar results were achieved by Borokhovich et al (1996), who stated that the likelihood that an executive from outside the firm is appointed CEO increases monotonically with the percentage of outside directors.

In the study of Judge and Zeithaml (1992) 114 board members were interviewed. The results indicated that board size and levels of diversification and insider representation were negatively related to board involvement, and organizational age was positively related to it. They also found that after controlling for industry and size effects, board involvement was positively related to financial performance. Goodstein et al (1994) studied the effects of board size and diversity on strategic change. They found evidence that large and diverse board may have limitations in their strategic functions.

Borokhovich et al (1996) suggested that stock returns around succession announcements, on average, associated with the appointment of outsiders as CEO is over three times as great as that connected for inside appointments. Rechner and Dalton (1991) studied the effect of leadership stability on the performance of a firm using accounting-based measures. They found that firms with separate CEO and Chairman outperformed firms with combined titles. Pi and Timme (1993) found that for firms with separate titles had lower costs and higher return on assets. In the study of Baliga et al (1996) little evidence was found that separate titles lead to improved firm performance. Brickley et al (1997) studied 535 U.S. firms with combined and 93 U.S. firms with separated titles. Opposite to earlier findings they found no evidence that firms with same person as CEO and Chairman are associated with inferior accounting and market returns. In addition to this, they find that changes in leadership structures have no systematic effects on stock-prices.

Yermack (1996) suggested that small boards of directors are more effective. This was based on an inverse association between board size and firm value in his sample of 452 U.S. companies. He found that companies with small boards exhibited better values for financial ratios. Mallette and Fowler (1992) found evidence that the impact of board leadership on poison pill decisions depends on the tenures of a firm's independent directors. Mayers et al (1997) provided evidence that mutual companies employing more outside directors have lower costs. This evidence was especially clear when salary expenditures were included into the cost measure.

There are several potential explanations for the conflicting results of the various studies. Hermalin and Weisbach (1991) argue that a failure to find a significant cross-sectional relation suggests that boards are optimally weighted between insiders and outsiders; in this sense, an insignificant relation should be expected. Another answer may be that simultaneity between key variables of interest confounds the interpretation of results in studies that focus on a direct relation. Hermalin and Weisbach (1998) argue that performance and board characteristics such as composition are jointly endogenous.

Firm performance is a function not only of the past board independence, but also a predictor of the future board structure. In addition variety of studies contend that board characteristics are jointly determined with other corporate governance mechanisms so that treating board composition as an exogenously determined variables results in biased single equation estimates. Shivdasani (1993) examines the characteristics of the board of directors and the ownership structure of the firm that receive hostile take over bids and finds that outside directors have lower ownership stakes and fewer additional directorships, suggesting that outside directors and the external takeover market are substitute corporate governance mechanisms.

Brickley and James (1987) report a negative relation between ownership concentration and the number and proportion of outside board members in states where acquisition is restricted. Bathala and Rao (1995) find that the use of outside directors is negatively correlated with the proportion of managerial share ownership, the dividend payout ratio, and the proportion of long term debt. Similarly, Barnhart and Rosenstein (1998) examine firm performance, managerial ownership and board composition within a three-equation simultaneous system and conclude that these variables are jointly determined.

Unlike studies that attempt to directly link board composition to firm performance, indirect evidence has been documented in research concerning the relationship between board composition and the incidence of particular events that affect shareholder wealth. Weisbach (1998) finds that performance measures are more highly correlated with the CEO turnover for firms in which outsiders dominate the board than for firms in which insiders dominate, and concluded that outsider-dominated boards increase firm value by monitoring poorly performing CEOs.

Byrd and Hickman (1992) examine the association between the characteristics of the board directors of bidding firms and the shareholder wealth effects of tender offer bids. They document that less negative returns to shareholders are associated with boards in which the majority of directors are independent and conclude that their evidence is consistent with the claim that independent boards of directors benefit shareholders. In a similar vein, Lee Rosenstein and Davidson (1992) find that outside-dominated boards are associated with higher abnormal returns in management buyout situations. McConnell (2003) points out that it is not clear whether the board's composition is dictated by market forces, recognizing that a particular action will be appropriate at some time in the future.

Despite the inconclusive results of the empirical literature on the effectiveness of outside directors on the board, an international movement advocating independent boards continues to strengthen. Much of this trend was influenced by the publication of The Report of the Committee on the Financial Aspects of the Corporate Governance, Chaired by Sir Adrian Cadbury on 1 December 1992. The Cadbury report consists of a formal code ('The Code of Best Practice') and extensive comments and recommendations for publicly held UK firms. The primary aim of the Cadbury report is to recognize the paramount importance of effective board monitoring, and to suggest ways of achieving that goal by codifying a regulatory framework by corporate governance.

The Cadbury Report contains a variety of specific recommendations concerning board structure and responsibilities. Among these are two key guidelines to insure board independence, namely that boards including at least three non-executive directors and that the position of the chief executive officer and chairman of the board be separate. Compliance with the Cadbury recommendations is voluntary. Companies are required to state whether they complied with the report and give reasons for not doing so. The Cadbury Report was followed by the Hampel Report (1998), the Turnbull Report (1999) and most recently the Higgs Report (2003). The Higgs Report took the original Cadbury recommendations concerning board composition a step further by recommending that at least half of the members of the board, excluding the Chairman, should be independent and non-executive directors.

The consequences of the Cadbury guidelines have recently been explored by Dahya et al (2002), who study whether compliance with the |Cadbury Report two recommendations concerning board composition and CEO duality results in more effective monitoring. Specifically, they hypothesise if corporate performance is systematically related with managerial quality and hiring and firing of CEOs is an important oversight role of board of directors, the CEO turnover should be higher at poorly performing companies that became compliant with the Cadbury guidelines as compared to those that did not. Dahya et al find that the relation between top management turnover and firm performance within a sample of 460 UK firms is significantly related to both and after the advent of the Cadbury Report guidelines. More importantly, they find that sensitivity of this relationship significantly increased following Cadbury for companies that adopted the guidelines. They conclude that these results are consistent with, and support the argument that the Cadbury recommendations have improved the quality of board oversight in the UK.

2.4.3 Executive compensation

The principal goal of all firms is the maximization of shareholder's wealth. The executive compensation scheme in place in an organization plays a major role attaining this goal. Companies that are well governed perform better than their poorly governed counterparts. Executive compensation is one of the ways of enhancing good corporate governance. An early investigation by Lewellen and Huntsman (1970) suggests that there is a significant correlation between performance and executive pay levels. Murphy (1985) concludes that corporate performance, as measured by shareholders' realised returns, is strongly and positively related to executive compensation. Similar results are obtained by Coughlan and Schmidt (1985), who identify a positive relationship between the real rate of change in executive salary plus bonus and share price performance. Abowd (1990) shows that the sensitivity of executive compensation to corporate performance in one year is positively related to corporate performance in the next year.

Mehran (1995) documents a positive relationship between corporate performance using 153 US manufacturing firms and the percentage of equity-based compensation received by managers over 1979 and 1980. Main et al (1996) employ a broad measure of executive pay and include data on the share options for executives in 60 of the largest companies in the United Kingdom (UK) during the 1980s. They find executive compensation to be significantly sensitive to corporate performance. McKnight and Tomkins (1999) find that a pronounced link existed between performance and pay over both the short- and long-term for their sample of 109 UK companies over the period of 1991 to 1995.Changes in the value of executive share options is found to be strongly and significantly associated with shareholder returns.

This relationship is found to be much stronger for market measures of performance than for accounting measures. Lewellen et al (1992) find that the total compensation of the three highest-paid officers is positively related to differences in both the common share returns and operating profitability of the firms. Although the studies above provide evidence supporting the link between executive compensation and corporate performance, other studies report the opposite findings. Jensen and Murphy (1990) examine the sensitivity of pay of 1,688 US executives to corporate performance over the period of 1974 to 1986. They suggest that executive pay rose (and fell) by about $3 per every $1000 change in the wealth of a firm's shareholders and interpret their findings as evidence of inefficient compensation arrangements.

Leonard (1990) examines the effects of executive compensation policy and organizational structure on the performance of 439 large corporations in the US between 1981 and 1985. He finds that accounting measures of corporate success are not significantly related to the level of, or degree of equity in, executive pay, or to the steepness of pay differentials across executive ranks. Gregg et al (1993) utilise a market-based measure of returns to equity-holders (ROE) to study the relationship between executive compensation and corporate performance on 288 UK companies over the period of 1983-1991. Their results do not suggest a distinct relationship between performance and pay.

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

The study investigated the correlation between corporate governance reforms and company performance for the companies listed at the Nairobi Stock Exchange.

3.1 Population and sample

The study targeted all the 49 companies listed at the Nairobi Stock Exchange as at 31 December 2003 representing the different sectors namely the Agricultural, Commercial and Services, Finance and Investments and Industrial and Allied sectors. It covered companies both in the Main Investment Market (MIMS) and Alternative Investments Market (AIMS).

The period of study was from 1994 to 2003. The choice of this period of ten years was considered reasonable because this is the time that corporate governance began to take root in Kenya and also due to availability of necessary data.

3.2 Data Collection

The study made use of both primary and secondary data. Primary data was collected using questionnaires to determine which companies had implemented corporate governance reforms, what reforms they had implemented and their impact on the company performance.

Secondary data, which covered company attributes and performance, was obtained from the audited financial statements of individual companies sampled. This was supplemented with data collected from the Nairobi Stock Exchange. Data collected included board composition, structure and ownership and financial performance for each of the 10 years.

3.3 Data Analysis

The study used financial ratio analysis as well as the link between various aspects of corporate governance and company performance. Correlation analysis was used to determine the nature of the relationship. Company performance was measured using such ratios as Profit Before Tax (PBT) and Earnings Per Share (EPS).

The period of the study was divided into two parts. The period 1994 to 1998 was considered the pre-reform period while the period 1999 to 2003 was considered the post-reform period. Even though the various companies listed at the Nairobi stock exchange started initiating reforms at different times, most of the companies started initiating reforms around the year 2000 following an initiative spearheaded by the Capital Markets Authority Performance for the two periods, that is, the pre-reform and the post-reform periods was then compared to determine if the initiation of the corporate governance reforms had impacted on the performance.

Spearman's correlation coefficient was used to find out if there is an association between the corporate governance reforms like corporate ownership and board composition on the performance of the company.

Spearman's correlation coefficient uses an ordinal scale where two variables are ranked then we determine the strength of the association of the two variables.

Spearman's correlation coefficient is given by:

$$Rs = 1 - (6 \sum Di * Di / (n*n*n-n))$$

Where rs= Strength of the relationship

Di=Yi-Xi

N= no of paired observations

Yi= The first variable (average performance of the company for five years period)

Xi= The second variable (Corporate governance attribute being measured)

CHAPTER FOUR

4.0 DATA ANALYSIS AND FINDINGS

4.1 Background information on respondents

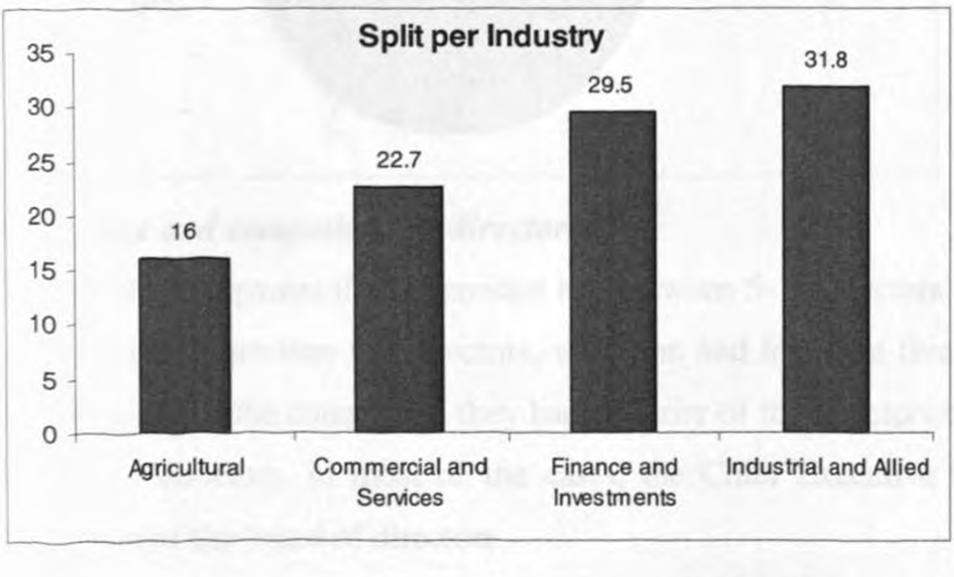
4.1.1 Ownership and sector analysis

The censor targeted the 49 companies listed on the Nairobi Stock Exchange. Out of the 49 companies, 44 companies responded. Responses from these firms were obtained over a period of two month. The tables and graphs below show the composition of the respondent firms.

TABLE 1: TYPES OF RESPONDING FIRMS

Industry	Frequency	Percentage
Agricultural	7	16
Commercial and Services	10	22.7
Finance and Investments	13	29.5
Industrial and Allied	14	31.8
Total	**44**	**100**

GRAPH 1: SECTOR ANALYSIS

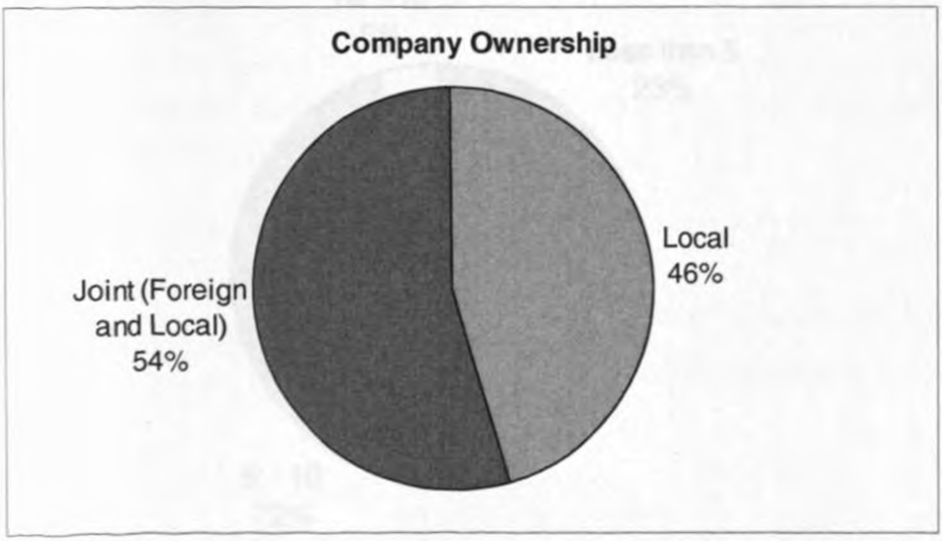


Of the companies that responded, 20 of them are local companies while the remaining 24 companies are jointly owned by local and foreign investors. None of the companies are fully foreign as there is a requirement by the Capital Markets Authority that for any company to be listed at the Nairobi Stock Exchange, it must have at least 20% local ownership. This distribution is shown in the table and pie chart below.

TABLE 2: OWNERSHIP STRUCTURE

Ownership	Frequency	Percentage
Local	20	45.5
Joint (Foreign and Local)	24	54.5
Total	**44**	**100**

PIE CHART 2: COMPANY OWNERSHIP STRUCTURE



4.1.2 Size and composition of directors

72% of the companies that responded had between 5-10 directors. Only two of them had more than ten directors, while ten had less than five directors. For majority of the companies, they had majority of the directors being non-executive directors. In most of the cases, the Chief Executive is not the Chairman of the board of directors.

Most of the companies have been trying to follow the CMA regulation that clearly separates the role of the Chief Executive and the chairman of the board of directors. The number and distribution of the directors are represented in the tables and graphs below:

TABLE 3: SIZE OF THE BOARD OF DIRECTORS

Number of Directors in the company		
Less than 5	10	23.3
5' - 10	32	72
10' - 15	2	4.7

PIE CHART 2: ANALYSIS OF THE BOARD SIZE

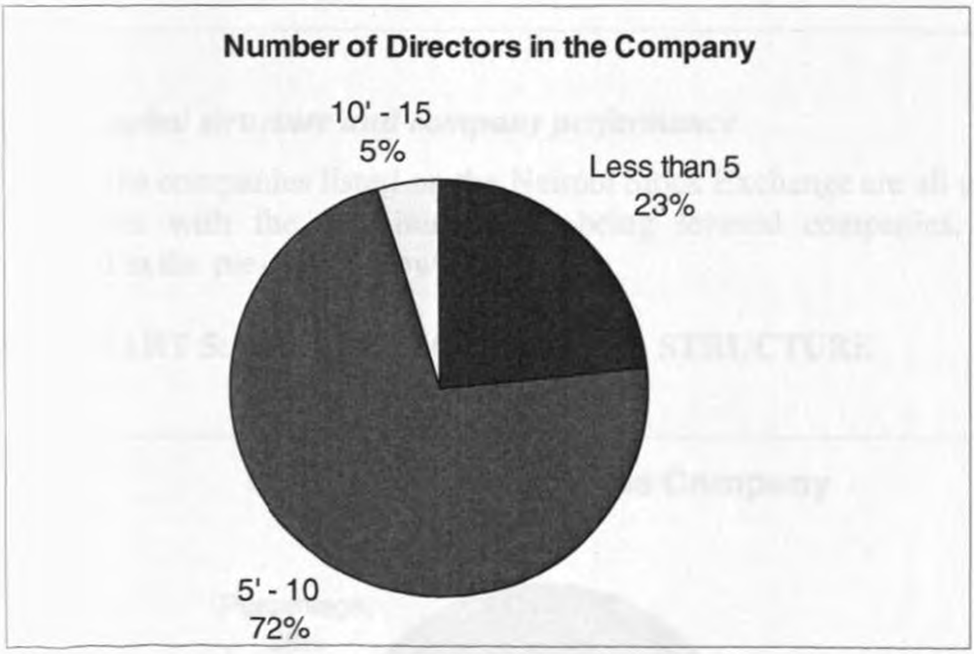
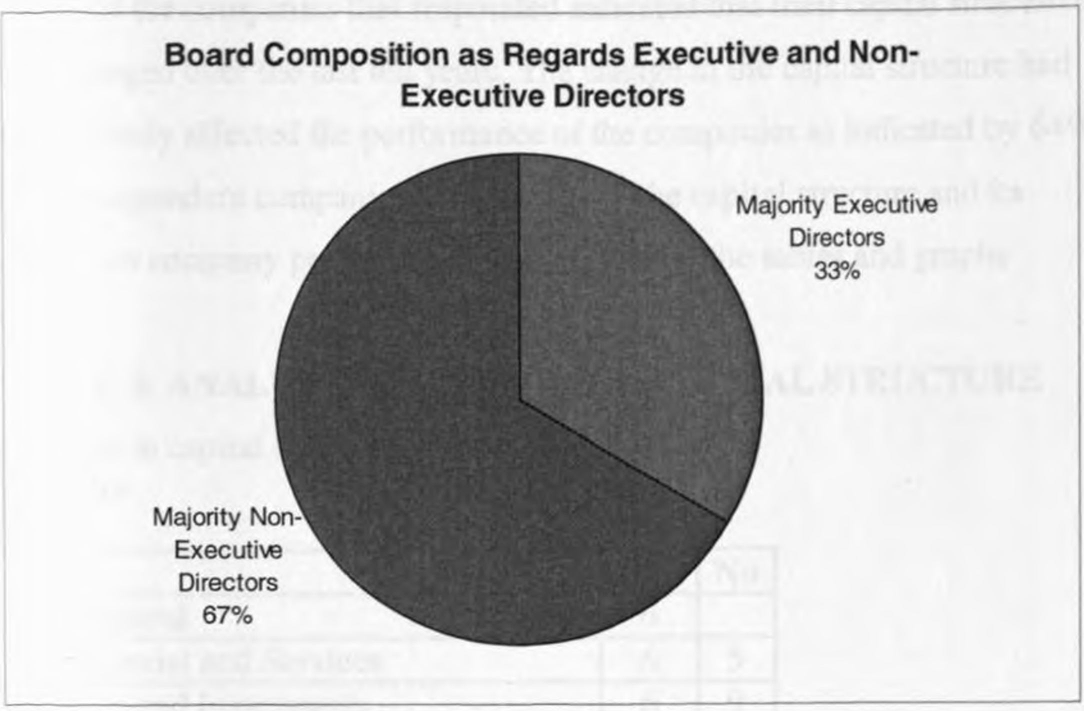


TABLE 4: ANALYSIS OF BOARD COMPOSITION

Composition of the Board

	Frequency	Percentage
Majority Executive Directors	15	33.3
Majority Non-Executive Directors	29	66.7

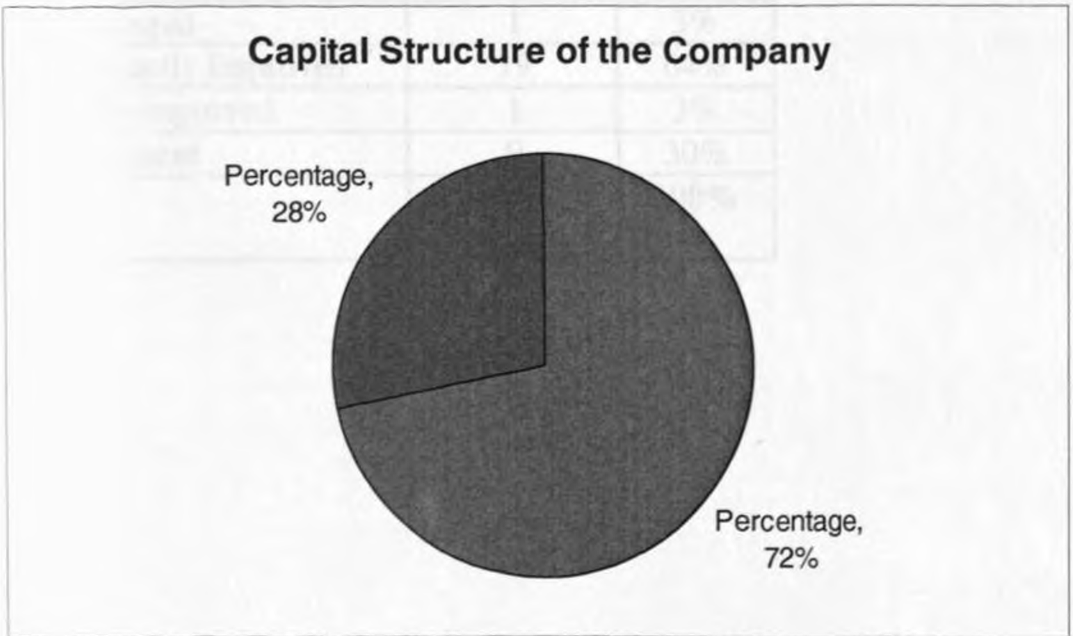
PIE CHART 4: ANALYSIS OF BOARD COMPOSITION



4.1.3 Capital structure and company performance

72% of the companies listed on the Nairobi Stock Exchange are all-equity companies with the remaining 28% being levered companies. This is depicted in the pie-chart below:

PIE CHART 5: ANALYSIS OF CAPITAL STRUCTURE



Thirty of the companies that responded indicated that their capital structures had changed over the last ten years. The change in the capital structure had significantly affected the performance of the companies as indicated by 64% of the respondent companies. The change in the capital structure and its impact on company performance are indicated in the tables and graphs below:

TABLE 5: ANALYSIS OF CHANGES IN CAPITAL STRUCTURE

Change in capital structure in the last 10 years by industry

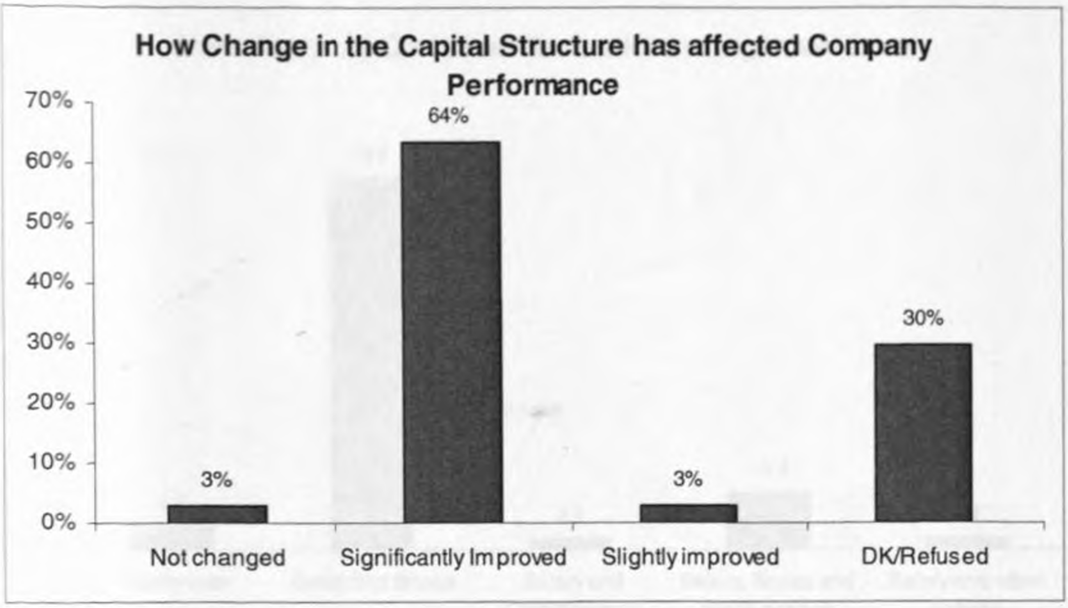
	Yes	No
Agricultural	6	
Commercial and Services	6	5
Finance and Investments	6	9
Industrial and Allied	12	
Total	**30**	**14**

TABLE 6: EFFECTS OF CHANGES IN CAPITAL STRUCTURE

How change in capital structure affected performance of the company

	Frequency	Percent
Not changed	1	3%
Significantly Improved	19	64%
Slightly improved	1	3%
No comment	9	30%
Total	**30**	**100%**

GRAPH 6: EFFECTS OF CHANGES IN CAPITAL STRUCTURE



4.1.4 Executive compensation

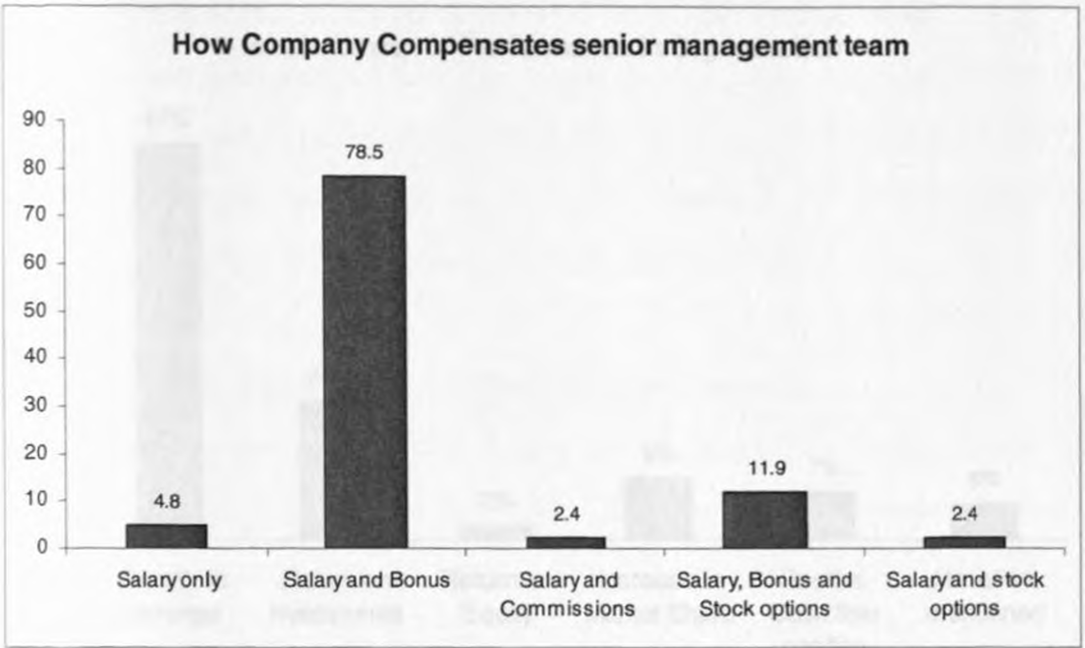
78% of the companies used salary and bonuses as compensation for their executive staff. Bonuses were to motivate management to perform better since they are tied to the company performance. Only 2% of the companies used stock options as a means of compensating their executive staff. The types of compensation used by the various companies are depicted in the table and graph below:

TABLE 7: ANALYSIS OF EXECUTIVE COMPENSATION

How company compensate senior management team

	Frequency	Percentage
Salary only	3	4.8%
Salary and bonus	33	78.5%
Salary and commissions	1	2.4%
Salary, bonus and stock options	5	11.9%
Salary and stock options	2	2.4%
Total	**44**	**100%**

GRAPH 7: ANALYSIS OF EXECUTIVE COMPENSATION



4.1.5 Measures of companies performance

Almost 60% of the respondents used growth in earnings as a measure of company performance. This was due to the fact that most investors look at a company's profitability as an indication of its potential. The various measures of company performance used are shown below:

TABLE 8: MEASURES OF COMPANY PERFORMANCE

Measurement of Performance in Organization

Measure of performance	**Frequency**	**Percentage**
Growth in Earnings	25	57%
Return on Investments	9	20%
Return on Equity	1	2%
Increase in Market Share	4	9%
Positive Cash flow position	3	7%
None/not mentioned	2	5%
Total	**44**	**100**

GRAPH 8: MEASURES OF COMPANY PERFORMANCE

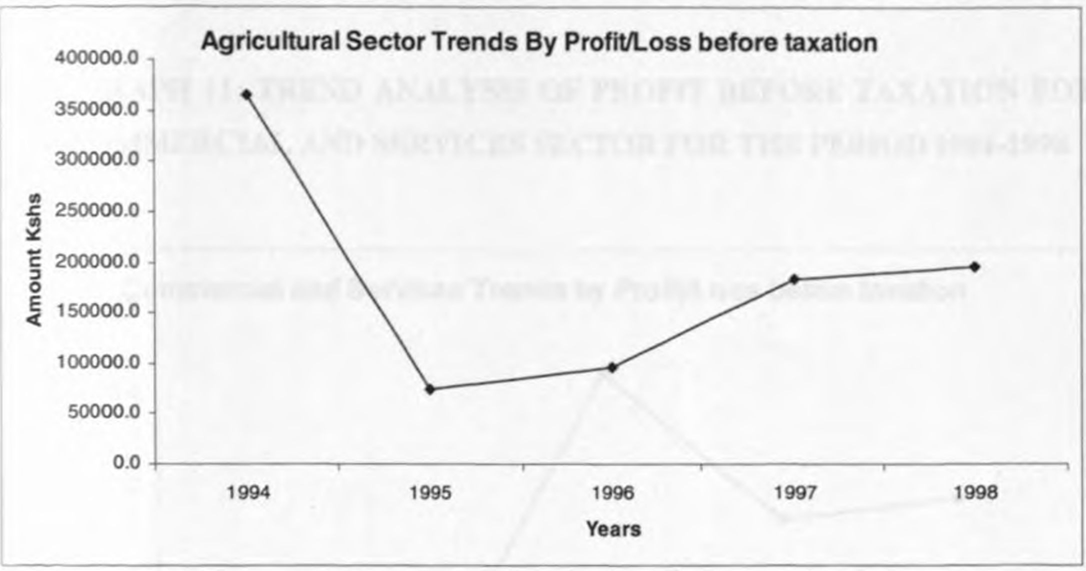
4.2 TREND ANALYSIS OF COMPANY PERFORMANCE

Averages of Profit Before Tax and Earnings Per Share have been used to establish the trend in performance for the two periods for the various sectors. Trend analysis has been done on a sectorial basis as the different sectors were going through different circumstances over the period.

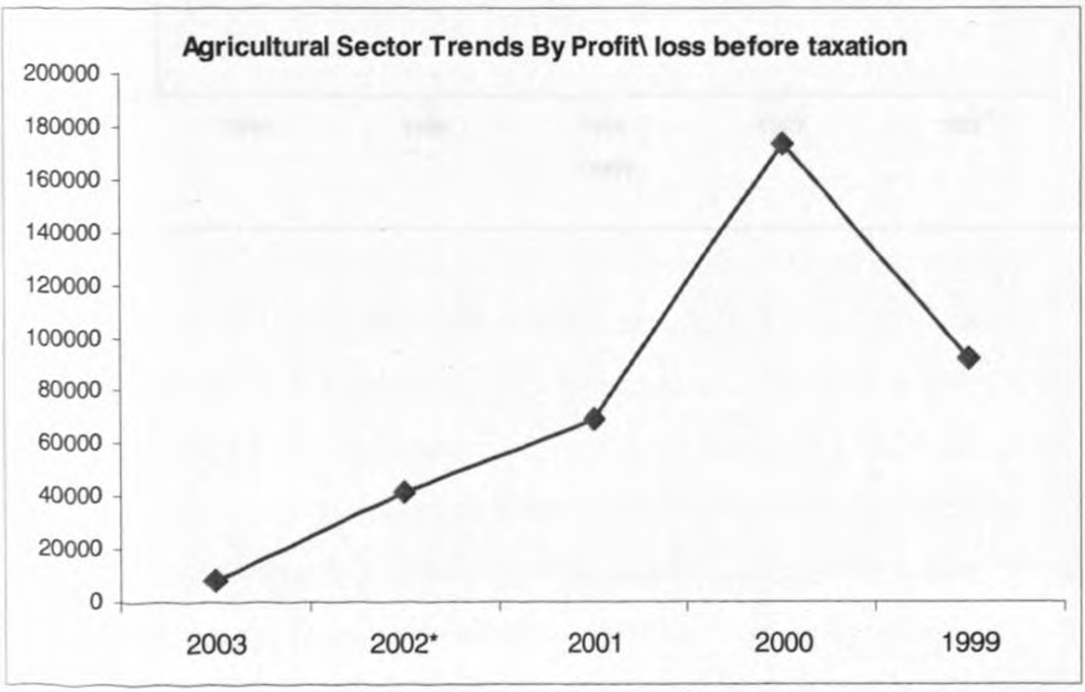
4.2.1 Trend analysis based on Profit Before Taxation

Performance in the agricultural sector has continued to decline over the years despite the introduction of reforms. 2003 registered the lowest average profit before taxation for the sector. This is due to the effects of political influences which have been affecting the sugar industry, high production costs which have led to textile industries being closed down hence making sisal farming not attractive to many people. Liberalisation of the economy has also led to influx of cheaper imports making the local products not less attractive due to high prices. In cases where the government is involved in the marketing of the agricultural products, this has not been very efficient and it takes long for the farmers to be paid hence there is no incentive to continue investing in the sector. The performance of the sector over the two periods is depicted on the trend charts below.

LINE GRAPH 9: TREND ANALYSIS OF PROFIT BEFORE TAXATION FOR THE AGRICULTURAL SECTOR FOR THE PERIOD 1994-1998

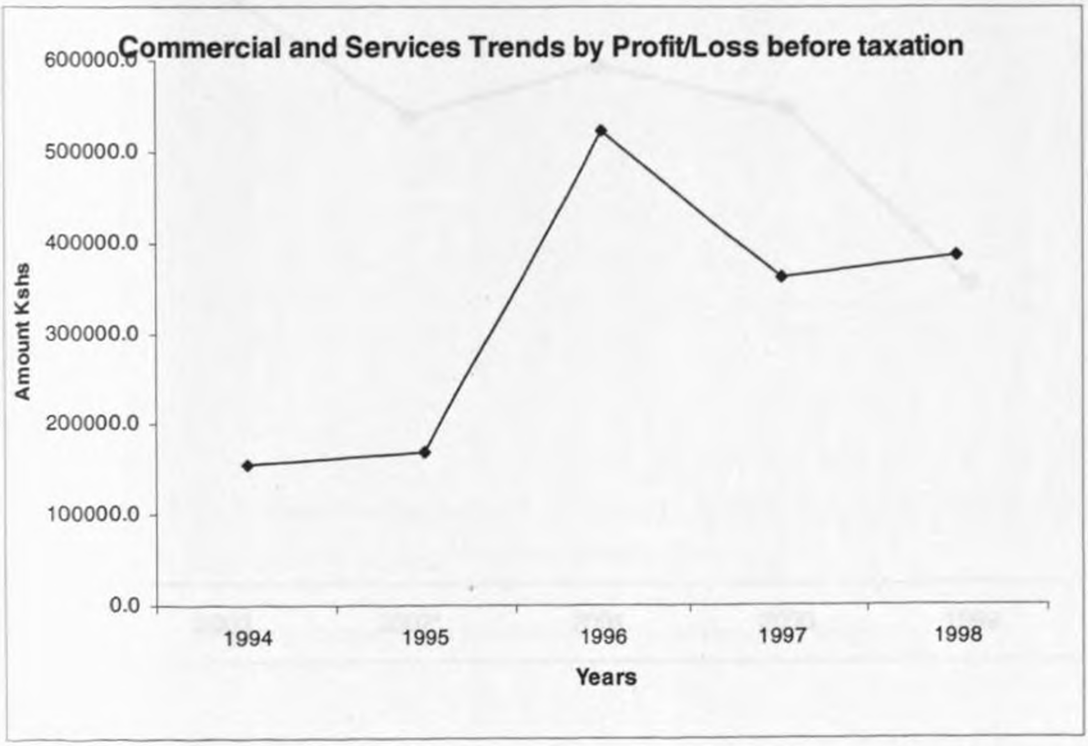


LINE GRAPH 10: TREND ANALYSIS OF PROFIT BEFORE TAXATION FOR THE AGRICULTURAL SECTOR FOR THE PERIOD 1999-2003

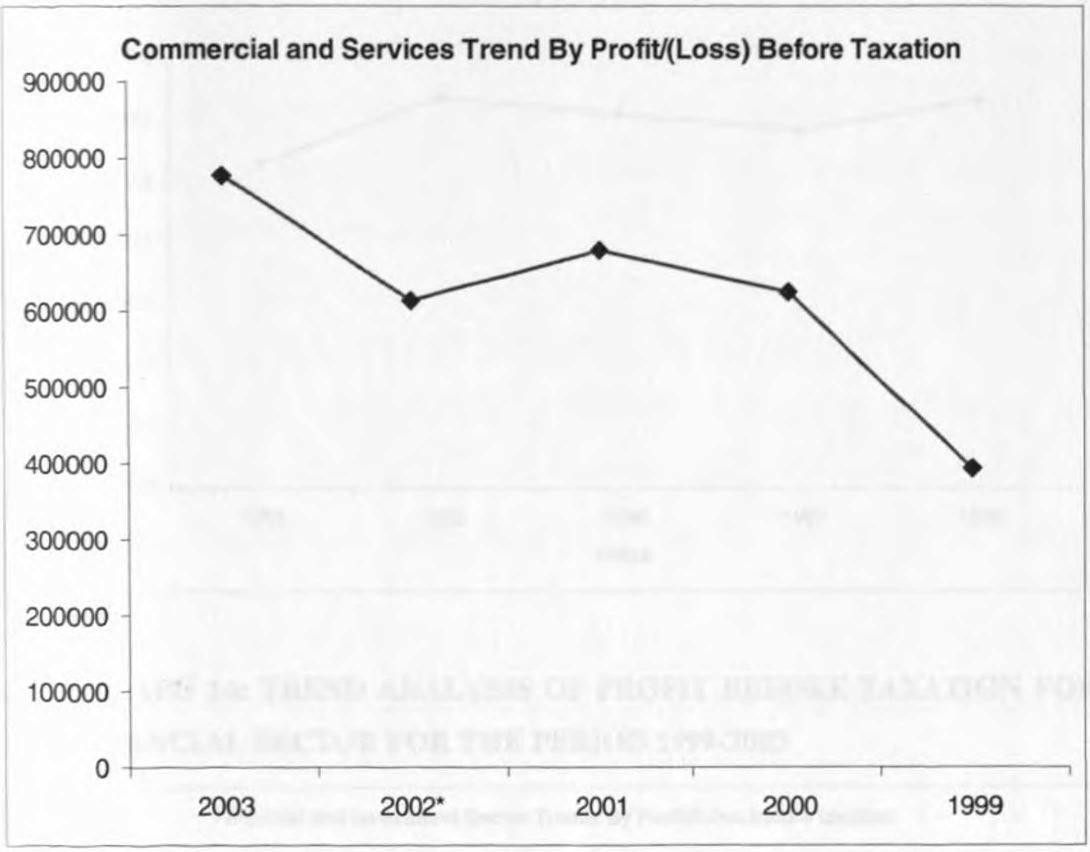


The commercial and services sector continued to improve its performance over time. The profit before taxation continued to rise over the years with the post-reform period recording the highest profits. This is due to the fact that with the liberalization of the economy, most of the organizations are owned by private investors and hence are managed by the private sector principles which ensure there are a lot of efficiency, accountability and transparency.

LINE GRAPH 11: TREND ANALYSIS OF PROFIT BEFORE TAXATION FOR THE COMMERCIAL AND SERVICES SECTOR FOR THE PERIOD 1994-1998

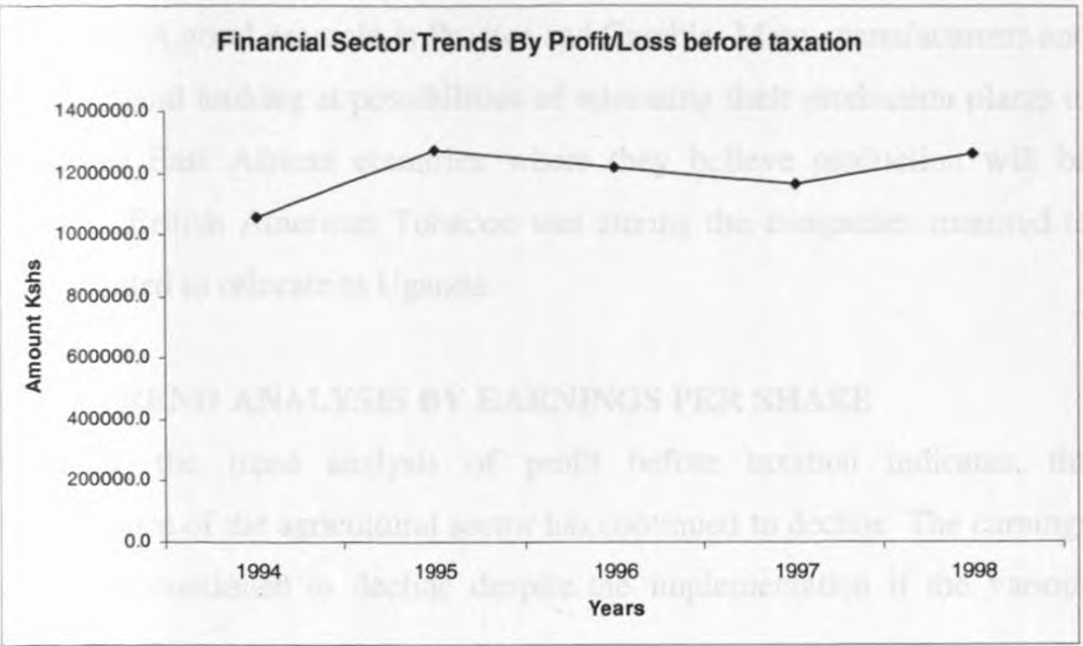


LINE GRAPH 12: TREND ANALYSIS OF PROFIT BEFORE TAXATION FOR THE COMMERCIAL AND SERVICES SECTOR FOR THE PERIOD 1999-2003

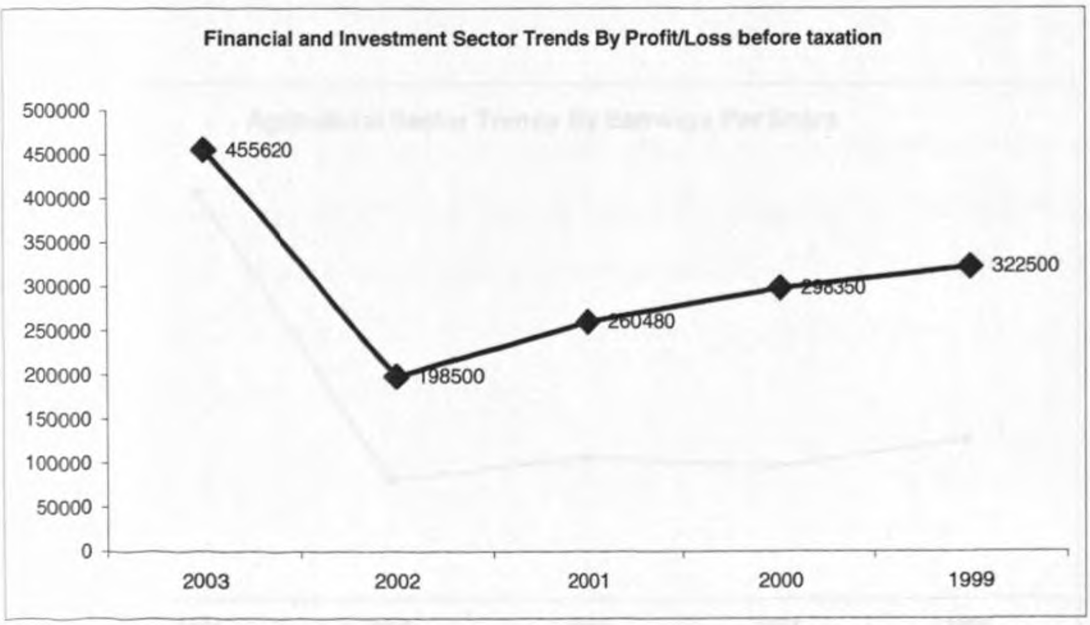


Performance of the financial sector was steady during the period 1994 to 1998. However in the period 1999 to 2002, the performance of the sector declined. 2003 took a dramatic turn in the sector as evidenced by the profits before taxation which were more than double the amounts recorded in 2002. The performance of the sector has been greatly affected by the economic growth of the country. When the economy is performing poorly, then people do not borrow from financial institutions and this leads to the poor performance of the sector. With the change in the government in 2002, the economy recorded an increased growth rate compared to the pervious years, hence the increased fortunes for the financial sector.

LINE GRAPH 13: TREND ANALYSIS OF PROFIT BEFORE TAXATION FOR THE FINANCIAL SECTOR FOR THE PERIOD 1994-1998



LINE GRAPH 14: TREND ANALYSIS OF PROFIT BEFORE TAXATION FOR THE FINANCIAL SECTOR FOR THE PERIOD 1999-2003



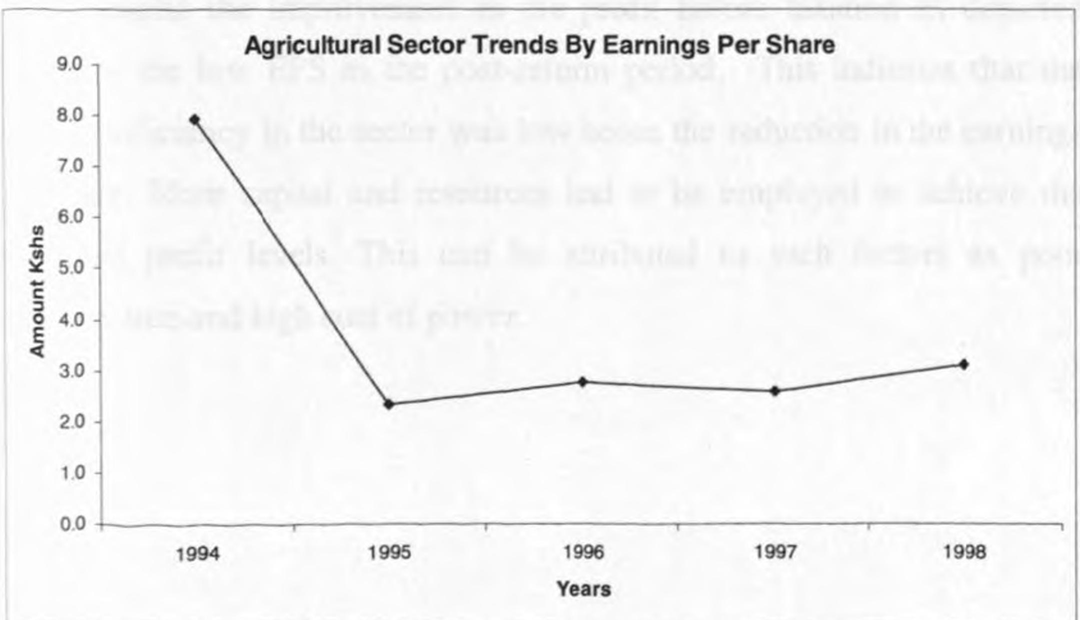
The industrial and allied sector has also suffered declining profits over the years. In the year 2000, the sector realized a net loss of over 200,000. This poor performance is linked to issues such as high cost of production and poor infrastructure.

We have witnessed many industries closing shop as far as production is concerned. The Kenyan outfits are just left to be marketing and distribution channels. A good example is Proctor and Gamble. Many manufacturers and investors and looking at possibilities of relocating their production plants to the other East African countries where they believe production will be cheaper. British American Tobacco was among the companies rumored to have wanted to relocate to Uganda.

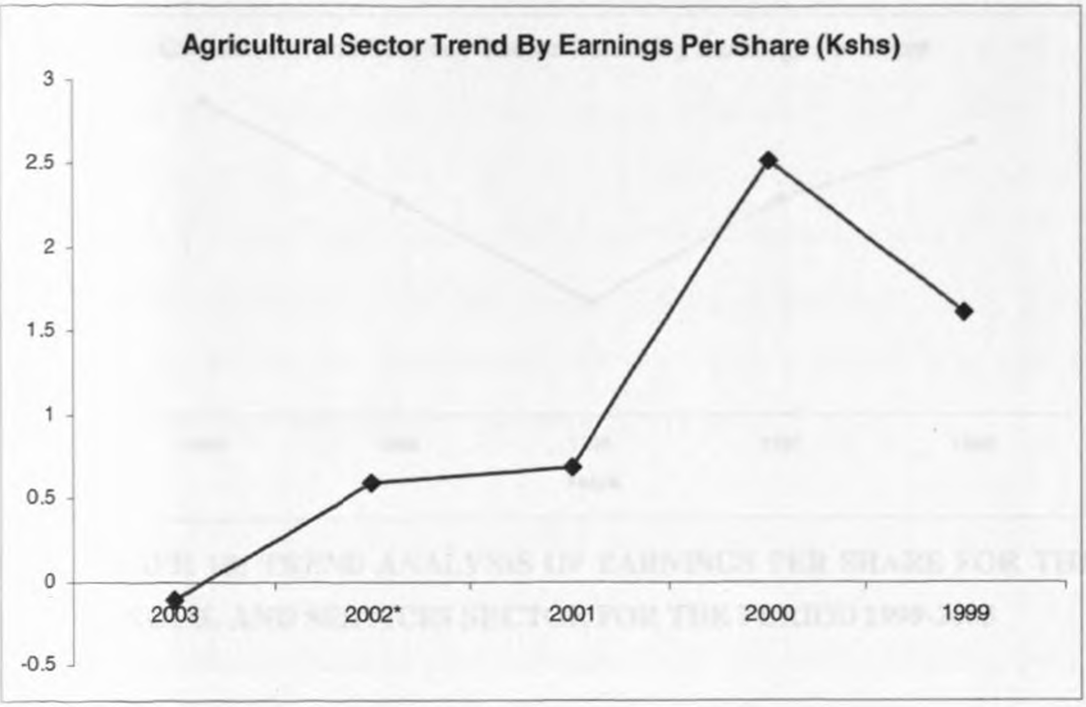
4.2.2 TREND ANALYSIS BY EARNINGS PER SHARE

Just like the trend analysis of profit before taxation indicates, the performance of the agricultural sector has continued to decline. The earnings per share continued to decline despite the implementation if the various reforms.

LINE GRAPH 15: TREND ANALYSIS OF EARNINGS PER SHARE FOR THE AGRICULTURAL SECTOR FOR THE PERIOD 1994-1998

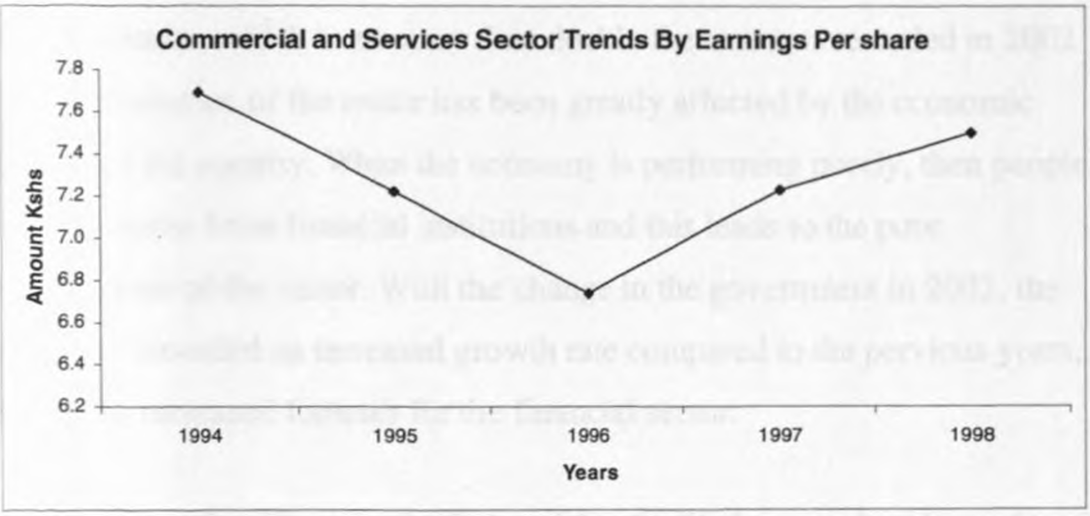


LINE GRAPH 16: TREND ANALYSIS OF EARNINGS PER SHARE FOR THE AGRICULTURAL SECTOR FOR THE PERIOD 1999-2003

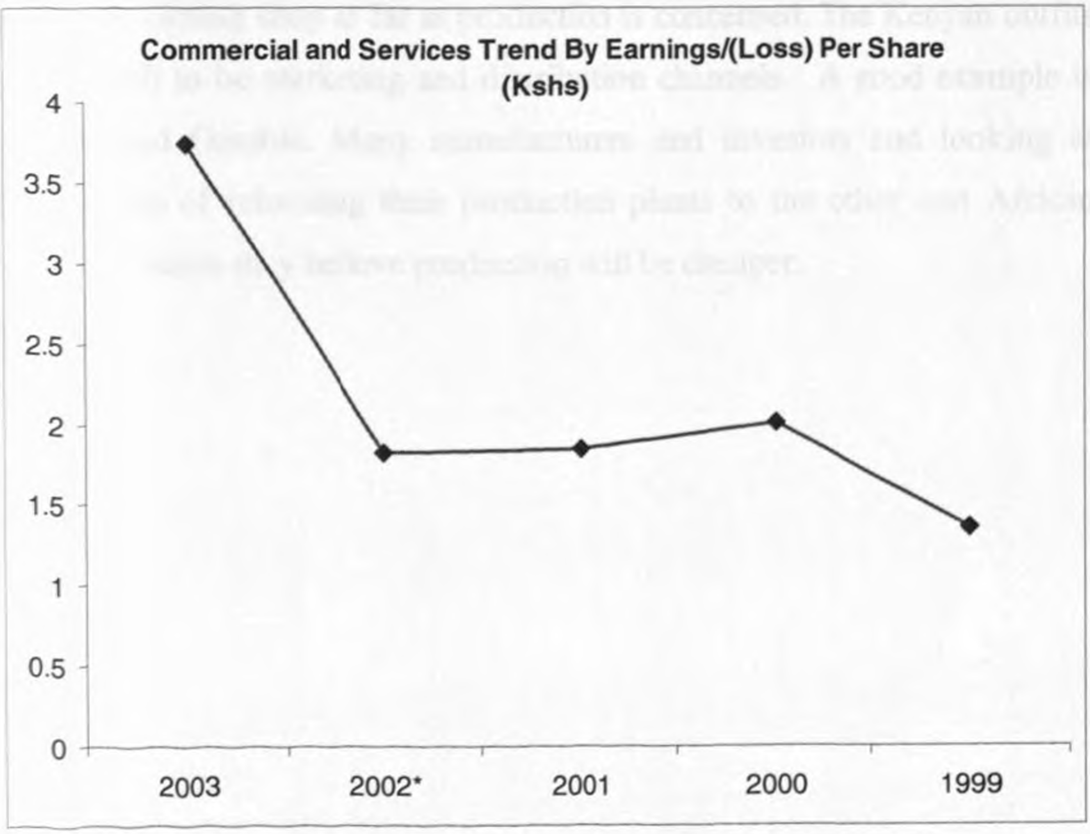


The average Earnings Per Share continued to decline in the commercial sector despite the improvement in the profit before taxation as depicted below by the low EPS in the post-reform period. This indicates that the level of efficiency in the sector was low hence the reduction in the earnings per share. More capital and resources had to be employed to achieve the improved profit levels. This can be attributed to such factors as poor infrastructure and high cost of power.

LINE GRAPH 17: TREND ANALYSIS OF EARNINGS PER SHARE FOR THE COMMERCIAL AND SERVICES SECTOR FOR THE PERIOD 1994-1998



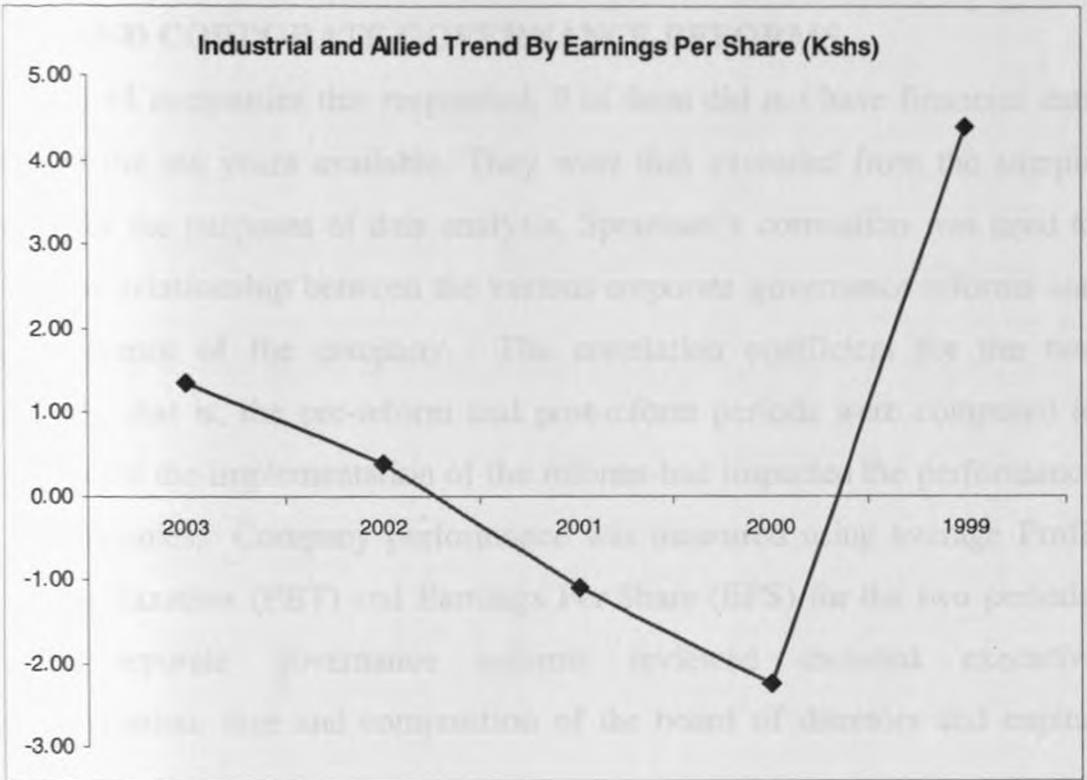
LINE GRAPH 18: TREND ANALYSIS OF EARNINGS PER SHARE FOR THE COMMERCIAL AND SERVICES SECTOR FOR THE PERIOD 1999-2003



Performance of the financial sector was steady during the period 1994 to 1998. However in the period 1999 to 2002, the performance of the sector declined. 2003 took a dramatic turn in the sector as evidenced by the profits before taxation which were more than double the amounts recorded in 2002. The performance of the sector has been greatly affected by the economic growth of the country. When the economy is performing poorly, then people do not borrow from financial institutions and this leads to the poor performance of the sector. With the change in the government in 2002, the economy recorded an increased growth rate compared to the pervious years, hence the increased fortunes for the financial sector.

The Earnings Per Share in the Industrial and allied sector deteriorated over the years as shown below. This poor performance is linked to issues such as high cost of production and poor infrastructure. We have witnessed many industries closing shop as far as production is concerned. The Kenyan outfits are just left to be marketing and distribution channels. A good example is Proctor and Gamble. Many manufacturers and investors and looking at possibilities of relocating their production plants to the other east African countries where they believe production will be cheaper.

LINE GRAPH 19: TREND ANALYSIS OF EARNINGS PER SHARE FOR THE INDUSTRIAL AND ALLIED SECTOR FOR THE PERIOD 1999-2003



4.3 CORRELATION BETWEEN COMPANY PERFORMANCE AND CORPORATE GOVERNANCE REFORMS

Of the 44 companies that responded, 9 of them did not have financial data for all the ten years available. They were thus excluded from the sample used for the purposes of data analysis. Spearman's correlation was used to find the relationship between the various corporate governance reforms and performance of the company. The correlation coefficient for the two periods, that is, the pre-reform and post-reform periods were compared to find out if the implementation of the reforms had impacted the performance of companies. Company performance was measured using average Profit Before Taxation (PBT) and Earnings Per Share (EPS) for the two periods. The corporate governance reforms reviewed included executive compensation, size and composition of the board of directors and capital structure.

4.3.1 Correlation between executive compensation and company performance

Correlation between executive compensation and profit before tax from 1994 to 1998				
			Compensation to senior management team	Profit before tax up to 1998
Spearman's rho	Compensation to senior management team	Correlation Coefficient	1.000	-0.156
		Sig. (2-tailed test)	.	0.37
		N	35	35
	Profit before tax up to 1998	Correlation Coefficient	-0.156	1.000
		Sig. (2-tailed test)	0.37	.
		N	35	35

Correlation between executive compensation and profit before tax from 1999 to 2003				
			Compensation to senior management team	Profit before tax up to 2003
Spearman's rho	Compensation to senior management team	Correlation Coefficient	1.000	0.84
		Sig. (2-tailed test)	.	0.598
		N	35	35
	Profit before tax up to 2003	Correlation Coefficient	0.84	1.000
		Sig. (2-tailed test)	0.598	.
		N	35	35

Correlation between executive compensation and Earnings Per Share from 1994 to 1998

			Compensation to senior management team	Profit before tax up to 1999
Spearman's rho	Compensation to senior management team	Correlation Coefficient	1.000	-0.211
		Sig. (2-tailed test)	.	0.147
		N	35	35
	Profit before tax up to 1998	Correlation Coefficient	-0.211	1.000
		Sig. (2-tailed test)	0.147	.
		N	35	35

Correlations between executive compensation to Earnings Per Share from 1999 to 2003

			Compensation to senior management team	Profit before tax up to 2003
Spearman's rho	Compensation to senior management team	Correlation Coefficient	1.000	0.36
		Sig. (2-tailed test)	.	0.87
		N	35	35
	Profit before tax up to 2003	Correlation Coefficient	0.36	1.000
		Sig. (2-tailed test)	0.87	.
		N	35	35

Compensation to senior management was found to be highly positively correlated to the performance of the company using both Profit Before Taxation and Earnings Per Share as indicated by the Correlation Coefficients shown above. The post-reform period showed higher positive correlation than the pre-reform period for both Profit Before Taxation and Earnings Per Share. In the post-reform period, the correlation coefficient of Profit Before Taxation to company performance was 0.598 compared to 0.37 in the pre-reform period, while that of Earnings Per Share was 0.87 and 0.147 for the post-reform and pre-reform periods respectively.

4.3.2 Correlation between board size and composition and company performance

Correlation between board composition and Profit Before Tax from 1994 to 1998

			Number of board members	Profit before tax up to 1999
Spearman's rho	Number of board members	Correlation Coefficient	1.000	-0.43
		Sig. (2-tailed test)	.	0.43
		N	35	35
	Profit before tax up to 1999	Correlation Coefficient	-0.43	1
		Sig. (2-tailed test)	0.43	.
		N	35	35

Correlation of number of board members to profit before tax up to 2003

			Number of board members	Profit before tax up to 1999
Spearman's rho	Number of board members	Correlation Coefficient	1.000	-0.218
		Sig. (2-tailed test)	.	0.218
		N	35	35
	Profit before tax up to 2003	Correlation Coefficient	-0.218	1.000
		Sig. (2-tailed test)	0.218	.
		N	35	35

Correlation between board composition and Earnings Per Share from 1994 to 1998

			Number of board members	Earnings per share up to 1999
Spearman's rho	Number of board members	Correlation Coefficient	1.000	-0.360
		Sig. (2-tailed test)	.	0.218
		N	35	35
	Earnings per share up to 1999	Correlation Coefficient	-0.360	1.000
		Sig. (2-tailed test)	0.218	.
		N	35	35

Correlation between board composition and Earnings Per Share from 1999 to 2003

			Number of board members	Earnings per share up to 2003
Spearman's rho	Number of board members	Correlation Coefficient	1.000	0.614
		Sig. (2-tailed test)	.	0.216
		N	35	35
	Earnings per share up to 2003	Correlation Coefficient	0.614	1.000
		Sig. (2-tailed test)	0.216	.
		N	35	35

There is a low correlation between board composition and company performance as indicated by the low correlation factors above. It is not possible to conclude if board composition impacts on company performance. As seen above, the correlation factors in both the pre-reform period and the post-reform period are almost the same.

The correlation coefficient of board composition and Profit Before Tax was 0.43 for the pre-reform period and 0.218 for the post-reform period while that of board composition and Earnings Per Share is 0.218 and 0.216 for the pre-reform and post-reform period respectively.

4.3.3 Correlation between capital structure and company performance

Correlation between capital structure and Profit Before Tax from 1994 to 1998				
			If capital structure of the company has changed in the last 10 years	Profit before tax up to 1999
Spearman's rho	If capital structure of the company has changed in the last 10 years	Correlation Coefficient	1.000	-0.317
		Sig. (2-tailed test)	.	0.317
		N	40	40
	Profit before tax up to 1998	Correlation Coefficient	-0.317	1
		Sig. (2-tailed test)	0.317	.
		N	40	40

Correlation between capital structure and Profit Before Tax from 1999 to 2003				
			If capital structure of the company has changed in the last 10 years	Profit before tax up to 1999
Spearman's rho	If capital structure of the company has changed in the last 10 years	Correlation Coefficient	1.000	-0.512
		Sig. (2-tailed test)	.	0.512
		N	40	40
	Profit before tax up to 2003	Correlation Coefficient	-0.512	1.000
		Sig. (2-tailed test)	0.512	.
		N	40	40

Correlation of changes in capital structure to earnings per share up to 1998)				
			If capital structure of the company has changed in the last 10 years	Earnings per share up to 1999
Spearman's rho	If capital structure of the company has changed in the last 10 years	Correlation Coefficient	1.000	-0.233
		Sig. (2-tailed test)	.	0.143
		N	40	40
	Earnings per share up to 1999	Correlation Coefficient	-0.233	1.000
		Sig. (2-tailed test)	0.143	.
		N	40	40

Correlation of changes in capital structure to earnings per share up to 2003)				
			If capital structure of the company has changed in the last 10 years	Earnings per share up to 2003
Spearman's rho	If capital structure of the company has changed in the last 10 years	Correlation Coefficient	1.000	0.596
		Sig. (2-tailed test)	.	0.118
		N	40	40
	Earnings per share up to 2003	Correlation Coefficient	0.596	1.000
		Sig. (2-tailed test)	0.118	.
		N	40	40

There was mixed results as far as correlation between the capital structure and company performance as shown by the correlation factors above. Whereas the correlation coefficients above indicate a high positive correlation of capital structure and Profit Before Tax, they depict a low correlation between capital structure and Earnings Per Share.

The correlation coefficient of capital structure and Profit Before Tax was 0.317 for the pre-reform period and 0.512 for the post-reform period while that of capital structure and Earnings Per Share is 0.143 and 0.118 for the pre-reform and post-reform period respectively.

CHAPTER FIVE

5 CONCLUSIONS, RECOMMENDATIONS AND LIMITATIONS OF THE STUDY

5.1 Summary and conclusions

From the above study, it is evident that executive compensation is highly positively correlated to the performance of the company using both Profit Before Taxation and Earnings Per Share. This is clearly supported by the high correlation coefficients in the post-reform period. Most companies use salaries and bonuses as a means of compensating their senior management. Very few companies use stock options as a means of compensating their executive. This can be attributed to the fact that the options market is not well developed in the country and this cannot be traded at the stock exchange. There are no rules and regulations to govern the options market.

Due to the mixed results obtained from the study on the relationship between capital structure, board size and company performance, it is not possible to reach a conclusive opinion on the relationship between these two factors and company performance. However, despite this, most companies have between 5 and 10 directors with the majority of the board by constituted by non-executive directors.

Growth in earnings is the most popular measure of company performance. Very few companies use Return on equity as a means of measuring company performance. Increase in market share and positive cash flows are also not highly regarded as means of measuring company performance.

5.2 Recommendations

- From the study, executive compensation has been found to be highly correlated to company performance. As such, companies should pursue the use of performance-linked compensation methods such as bonuses and stock options as a way of compensating the executive.
- Companies should have average sized boards with between five and ten members. Small boards lead to the members being overwhelmed by work hence they may not be very effective. On the other hand, when the board is too large, decisions may take long to be made, hence reducing the efficiency of the boards.
- Companies should consider changing their capital structures to suit the current circumstances and take advantage of the structure to improve their performance.

5.3 Limitations of the study

- It was difficult to access quoted companies that have their head offices up-country, hence restricting the study.
- Some companies considered some of the questions in the questionnaire confidential, too sensitive and against their company policy hence did not respond to these questions.
- Most people have a negative attitude towards filling questionnaires and treat them with a lot of suspicion hence reducing the response rate.
- In some of the companies, it was difficult to get the senior staff in finance department to fill the questionnaires. The junior staff that filled in the questionnaires did not have a very good understanding of the issues addressed in the questionnaires; hence some of the answers given may not be accurate.

- For some of the companies the financial statements for all of the ten years selected for study were not available

5.4 Suggestions for further study

- The use of stock options as a means of compensating senior management in the Kenyan market.
- How corporate governance issues affect investor attitude and investment decision in Kenya.

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APPENDICES

APPENDIX 1: QUESTIONNAIRE

Relationship between corporate governance reforms and company performance

This study seeks to establish if there is a relationship between corporate governance reforms and the performance of companies. The information obtained will be confidential and will be used for academic purposes only.

SECTION 1: Background information on the firm

1. Name of company: ______________________________

2. Industry: (Please tick as appropriate)

   a) Agricultural ( )

   b) Commercial and services ( )

   c) Finance and investments ( )

   d) Industrial and allied ( )

   e) Others (Please specify) ( )

3. Nature of business: ______________________________

4 Company Ownership (Please tick as appropriate)

   a) Local ( )

   b) Foreign ( )

   c) Joint (foreign and local) ( )

5. Name of the largest shareholder and the percentage of the shares held by them.

____

SECTION 2

1) How do you measure performance in your organization? (Please tick as appropriate)

a) Growth in earnings ( )

b) Return on investment ( )

c) Return on equity ( )

d) Increase in market share ( )

e) Positive cash flow position ( )

f) Others (Please specify) ( )

2) How many directors does the company have? (Please tick as appropriate)

a) Less than 5 ( )

b) 5 – 10 ( )

c) 10 – 15 ( )

3) How is the board composition as regards executive and non –executive directors? (Please tick as appropriate)

a) Majority executive directors ( )

b) Majority non-executive directors ( )

4) Is the Chief Executive of the company the chairman of the board of directors? (Please tick as appropriate)

a) Yes ( )

b) No ( )

5) Does the company have an Audit Committee? (Please tick as appropriate)

a) Yes ( )

b) No ( )

6) What other committees does the board of directors have? Please indicate if any

7) How is the capital structure of the company? (Please tick as appropriate)

a) All equity ( )

b) Levered ( )

8) Has the capital structure of the company changed in the last 10 years? (Please tick as appropriate)

a) Yes ( )

b) No ( )

9) If your answer to the above question 5 above is (a), how has the change in the capital structure affected company performance? (Please tick as appropriate)

a) Not changed ( )

b) Significantly improved ( )

c) Significantly reduced ( )

d) Slightly improved ( )

e) Slightly decreased ( )

10) How does your company compensate the senior management team? (Please tick as appropriate)

a) Salary only ( )

b) Salary and Bonus ( )

c) Salary and Commissions ( )

d) Salary, Bonus and Stock options ( )

e) Salary and stock options ( )

e) Others (Please specify) ( )

11) Is the compensation scheme ticked in 7 above related to the performance measure ticked in question 1 above? (Please tick as appropriate)

a) Yes ( )

b) No ( )

12) How effective has the performance measure used by your firm been in evaluating manager performance and compensation. Please tick the effectiveness in order of importance starting with I,2,3…..

a) Very effective ( )

b) Effective ( )

c) Moderately effective ( )

c) Not effective at all ( )

Thank you for your time and effort in filling this questionnaire.

Position in the Organization ____________________

Signature ____________________

APPENDIX 2: COMPANIES LISTED ON THE NAIROBI STOCK EXCHANGE

- **Main Investment Market Segment (MIMs)**

Agricultural

1. Brooke Bond Ltd Ord 10.00
2. Kakuzi Ltd Ord 5.00
3. Rea Vipingo Plantations Ltd Ord 5.00
4. Sasini Tea and Coffee Ltd Ord 5.00

Commercial and Services

1. Car and General (K) Ltd. Ord 5.00
2. CMC Holdings Ltd. Ord.5.00
3. Hutchings Biemer Ltd Ord.5.00
4. Kenya Airways Ltd. Ord.5.00
5. Marshals (E.A) Ltd. Ord.5.00
6. Nation Media Group. Ord.5.00
7. Tourist Promotion Services Ltd. Ord.5.00
8. Uchumi Supermarket Ltd. Ord.5.00

Finance and Investment

1 Barclays Bank Ltd Ord. 10.00
2 CFC Bank Ltd. Ord 5.00
3 Diamond Trust Bank Kenya Ltd. Ord.4.00
4 Housing Finance Co. Ltd Ord.5.00
5 I.C.D.C Investments Co. Ltd. Ord.5.00
6 Jubilee Insurance Co. Ltd. Ord.5.00
7 Kenya Commercial Bank Ltd Ord.10.00
8 National Bank of Kenya Ltd. Ord.5.00
9 NIC Bank Ltd. Ord.5.00
10 Pan African Insurance Ltd. Ord.5.00
11 Standard Chartered Bank Ltd. Ord.5.00

Industrial and allied

1 Athi River Mining Ltd Ord. 5.00
2 BOC Kenya Ltd. Ord 5.00
3 Bamburi Cement Ltd. Ord.4.00
4 British American Tobacco Kenya. Ltd Ord.5.00

5 Carbacid Investments Investments Co. Ltd. Ord.5.00
6 Crown Berger Ltd. Ord.5.00
7 Dunlop KenyaLtd Ord.10.00
8 E A Cables Ltd. Ord.5.00
9 E A Portland Cement Ltd. Ord.5.00
10 East African Breweries Ltd. Ord.10.00
11 Firestone East Africa Ltd. Ord.5.00
12 Kenya Oil Company Ltd. Ord.5.00
13 Mumias Sugar Company Ltd. Ord.2.00
14 Kenya Power and Lightning Co Ltd. Ord.5.00
15 Total Kenya Ltd. Ord.5.00
16 Unga Group Ltd Ord.5.00

Alternative Investment Market Segment

1 A Baumann and Company Ltd Ord. 5.00
2 City Trust Ltd. Ord 5.00
3 E A Packaging Ltd. Ord.4.00
4 Eaagads Ltd Ord.5.00
5 Express Ltd. Ord.5.00
6 Williamson Tea Kenya Ltd. Ord.5.00
7 Kapchorua Tea Company Ltd Ord.10.00
8 Kenya Orchards Limited Ord 5.00
9 Limuru Tea Co Limited Ord. 20.00
10 Standard Newspapers Group Ord 5.00

APPENDIX 3: LIST OF RESPONDENTS

- **Main Investment Market Segment (MIMs)**

Agricultural

1. Brooke Bond Ltd Ord 10.00
2. Kakuzi Ltd Ord 5.00
3. Rea Vipingo Plantations Ltd Ord 5.00
4. Sasini Tea and Coffee Ltd Ord 5.00

Commercial and Services

1. Car and General (K) Ltd. Ord 5.00
2. CMC Holdings Ltd. Ord.5.00
3. Hutchings Biemer Ltd Ord.5.00
4. Kenya Airways Ltd. Ord.5.00
5. Marshals (E.A) Ltd. Ord.5.00
6. Nation Media Group. Ord.5.00
7. Uchumi Supermarket Ltd. Ord.5.00

Finance and Investment

1 Barclays Bank Ltd Ord. 10.00
2 CFC Bank Ltd. Ord 5.00
3 Diamond Trust Bank Kenya Ltd. Ord.4.00
4 Housing Finance Co. Ltd Ord.5.00
5 I.C.D.C Investments Co. Ltd. Ord.5.00
6 Jubilee Insurance Co. Ltd. Ord.5.00
7 Kenya Commercial Bank Ltd Ord.10.00
8 National Bank of Kenya Ltd. Ord.5.00
9 NIC Bank Ltd. Ord.5.00
10 Standard Chartered Bank Ltd. Ord.5.00

Industrial and allied

1 Athi River Mining Ltd Ord. 5.00
2 BOC Kenya Ltd. Ord 5.00
3 Bamburi Cement Ltd. Ord.4.00
4 British American Tobacco Kenya. Ltd Ord.5.00

5 Carbacid Investments Investments Co. Ltd. Ord.5.00
6 Crown Berger Ltd. Ord.5.00
7 E A Cables Ltd. Ord.5.00
8 E A Portland Cement Ltd. Ord.5.00
9 East African Breweries Ltd. Ord.10.00
10 Firestone East Africa Ltd. Ord.5.00
11 Kenya Oil Company Ltd. Ord.5.00
12 Mumias Sugar Company Ltd. Ord.2.00
13 Kenya Power and Lightning Co Ltd. Ord.5.00
14 Total Kenya Ltd. Ord.5.00
15 Unga Group Ltd Ord.5.00

Alternative Investment Market Segment

1 E A Packaging Ltd. Ord.4.00
2 Eaagads Ltd Ord.5.00
3 Express Ltd. Ord.5.00
4 Williamson Tea Kenya Ltd. Ord.5.00
5 Kapchorua Tea Company Ltd Ord.10.00
6 Kenya Orchards Limited Ord 5.00
7 Limuru Tea Co Limited Ord. 20.00
8 Standard Newspapers Group Ord 5.00

APPENDIX 4 -RATIOS

1) Earnings per share = Earnings attributable to shareholders/ No of outstanding shares.