RELATIONSHIP BETWEEN AGENCY COSTS AND CORPORATE GOVERNANCE MECHANISMS:
EVIDENCE FROM LISTED COMPANIES AT NAIROBI STOCK EXCHANGE IN KENYA

BY

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Declaration

I, the undersigned, declare that this is my original work and has not been submitted to any other college, institution or university other than University of Nairobi for academic credit;

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This project proposal has been presented for examination with my approval as the University supervisor;

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Acknowledgement

My foremost gratitude goes to our almighty God for enabling and guiding me through my academic life.

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To my entire family; you all stood by me throughout this programme and inspired me immensely.
Dedication

To my beautiful, beloved daughters:

Caroline Nthambi

Sylvia Kasikwa

Stephanie Mutheu
Abstract

Agency costs result from the conflict of interest between managers and shareholders. Corporate governance is the mechanism to resolve agency problems; therefore, corporate governance is the system by which companies are directed and controlled, and thus is concerned primarily with management and stewardship issues. However, this has not been the case. Even with institutionalisation of good corporate mechanisms in companies there is evidence of collapse of some of companies. Therefore, the purpose of this study was to examine the relationship between corporate governance mechanism and agency cost for firms listed in Nairobi Stock Exchange. Specifically, the study established whether there is relationship between the dependent variable i.e., agency cost measured by return on assets and the independent variable corporate governance mechanism measured by auditors fees, board remuneration and size of board, management fees and ownership by directors.

The descriptive research methodology was adopted in this study. The population of interest in this study consists of all 47 quoted companies in the main investment market segment, NSE between 2007 and 2008. The study purposively sampled 20 companies in the main investment market segment, four from each segment. Data was obtained from financial statements of the twenty companies to be covered, and is also published by NSE. Descriptive statistics were used to describe the data. Graphical, correlation and regression analysis were used to analysis to achieve the study objective in data analysis.

Graphical presentation of variables revealed that, first, institutionalization of corporate governance seems to inversely influence agency cost. Correlation matrix showed that there is a strong correlation between agency costs and good corporate governance. Institutionalisation of good corporate governance costs: audits fees, management fees and director ownership were highly related with return on asset as a measure of agency costs. Regression results revealed that institutionalization of good corporate governance costs: audits fees, management fees and director ownership have strong and significance marginal effects on returns on asset and hence they were found to mitigate to agency costs.
Thus institutionalization of good corporate governance costs: audits fees, management fees and director ownership have strong and significance marginal effects on returns on asset and hence they were found to mitigate to agency costs. Thus, there exists negative relationship between corporate governance mechanisms and agency cost for the firms studied. From the study, it can be concluded that the institutionalization of good corporate governance can help reduce (mitigate) the agency costs resulting to high return on asset for the companies quoted on the Nairobi Stock Exchange. The study also reveals that good corporate governance does not increase the agency costs. Therefore the study concludes that there is no financial burden in institutionalizing corporate governance.
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CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

Agency costs are cost to the a firm due to self-serving behaviour on the part of managers focused on status or empire-building objectives, excessive perquisite consumption, non-optimal investment decision-making or acts of accounting mismanagement or corporate fraud (Jensen, 2000). The adverse implications of these actions are then felt in the form of the destruction of shareholder wealth and wider impacts on other corporate stakeholders, such as debt providers, employees and society in general. The realisation of the consequences flowing from the incidence of agency problems have led to emphasis being placed on the importance of competitive markets for managerial labour and corporate control as monitoring mechanisms designed to limit the degree of agency divergence, the role of institutional shareholders as substitute agency devices and the development and enforcement of codes of corporate governance practice to enhance director and management oversight and create desirable incentive structures within firms (Jensen, 2000). According to Jensen (2000) corporate governance mechanisms are found to lowers the level of agency costs and that internal governance and external shareholding influences are substitute agency-mitigating mechanisms.

The operation of companies involves agency relationship between shareholders and managers. A company’s objective should be the maximisation of shareholders’ wealth, however in practice, the separation of shareholders’ ownership and managerial control of daily business decision making can lead to a conflict of interest in that managers may pursue their own objectives rather than acting in the best interest of shareholders (Jensen and Meckling, 1976).

The separation of ownership and control in modern corporations gives rise to agency costs. Ownership structure has been widely debated since Berle and Means (1932). According to Jensen (2000), ownership structure is significant in determining firms’
objectives, shareholders wealth and the discipline of manager. Both managers and shareholders should have a single objective of maximizing firm value.

However, managers have other interests that may not be in line with those of the shareholders’ thus causes agency problems that eventually lead to poor firm performance. Fama and Jensen (1983) explained that separating control from management helps mitigate agency problems and facilitate specialization of management. Jensen and Meckling (1976) suggested that family-controlled businesses should be more efficient than professionally-run firms because the costs of monitoring are less in family firms as compared to non-family firms. Further, family relationships among owner-managers should also reduce agency costs since family members can monitor and disciple managers (Fama and Jensen, 1983).

Agency problems are increasingly inherent in the modern-day corporation, owing to the widening separation of ownership and control responsibilities, growing business diversification and segmentation across industry and business lines, and investor emphasis on near-term performance and return outcomes. Agency costs can manifest in various forms under these circumstances, including self-serving behaviour on the part of managers focused on status or empire-building objectives, excessive perquisite consumption, non-optimal investment decision-making or acts of accounting mismanagement or corporate fraud. The adverse implications of these actions are then felt in the form of the destruction of shareholder wealth and wider impacts on other corporate stakeholders, such as debt providers, employees and society in general. The realisation of the consequences flowing from the incidence of agency problems have led to emphasis being placed on the importance of competitive markets for managerial labour and corporate control as monitoring mechanisms designed to limit the degree of agency divergence, the role of institutional shareholders as substitute agency devices and the development and enforcement of codes of corporate governance practice to enhance director and management oversight and create desirable incentive structures within firms.
Corporate governance has been identified as one of the important tools needed to deal with agency problems in managing any organization including corporation. Corporate governance has been defined in several ways. This study essentially will use the definition of corporate governance by the Organization for Economic Cooperation & Development (OECD), which defines good corporate governance as the rules and practices that govern the relationship between the managers and shareholders of corporations, as well as stakeholders such as employees and creditors, which contributes to growth and financial stability by underpinning market confidence, financial market integrity and economic efficiency (OECD, 2004).

Corporate governance is the mechanism to resolve agency problems; thus one mechanism by which corporate governance may impact on earnings quality is strong corporate governance mechanisms may reduce incentives and/or opportunities for earnings management and hence reduce the level of accruals and increase earnings persistence. The institutions of corporate governance facilitate and stimulate the performance of corporations which are the principal forces behind economic wealth and growth in a society by creating and maintaining a business environment that motivates managers and shareholders to maximize a firm’s operational efficiency, returns on investment and long term productivity and growth, contends Oman (2003).

However, recently we have seen much more evidence of the opposite! Major world corporate crises have shown the weakness of existing governance mechanisms resulting in accounting scandals and corporate collapses. In response, regulated bodies have enacted new corporate governance principles to control any future conflict of interest. The biggest event is the recent series of corporate collapses in 2001/2 that led the US Congress to enact the Sarbanes Oxley Act in 2002 and highlighted the importance of corporate governance to ensure the alignment of interest between managers and shareholders (Clarke, 2004).

Over the recent years, a series of high profile public companies have experienced spectacular collapse in their share prices and substantially eroded market and public
confidence. In Kenya, cases where managers and directors have been accused of poor corporate governance include the collapse of Kenya Cooperative Creameries (recently revived), Kenya National Trading Corporation, Ramisi Sugar Company, Muhoroni Sugar Company and Pan Paper ltd, among others. The near collapses of Unga Group, Uchumi Supermarkets and National Bank of Kenya are other examples. These are all issues of corporate governance. In the recent time we have witnessed collapse of Uchumi supermarket, several stock brokers as well some banks. Wambua (1999), states that good corporate governance should translate to long-term existence of an organization and its continued generation of goods, services and profits. Corporate governance can be enhanced through various ways as mentioned earlier and they include shareholders, regulations, codes of conduct and social forces. The ultimate power in enhancing corporate governance lies with the BOD which is the legal authority mandated by law to run a company on behalf of the shareholders (Dimsdale, 1994).

1.2 Nairobi Stock Exchange

The Nairobi Stock Exchange (NSE), which was formed in 1954 as a voluntary organization of stockbrokers, is now one of the most active stock markets in Africa. The NSE has played a role in increasing investor confidence by modernizing its infrastructure. It launched the Central Depository and Settlement Corporation (CDSC), which significantly improved the settlement cycle. In 2006, the NSE installed the Automated Trading System (ATS) which has eliminated inefficiencies in allocation of shares and delays in the transfer of securities, hence enabling better price discovery on the stock market. Currently, NSE had a total of 54 listed firms.

The primary role of a stock exchange is to provide a market where financial instruments can be traded in a regulated environment without constraint (NSE handbook 2004). According to Glen et al. (1995) stock market is a vital part of any economic system in which ownership can be bought or sold. A stock exchange and its presence in an economic system can be justified by the following functions it performs- channels
savings into investments. It converts investments into cash, thus supplying market liquidity and helps in evaluating and managing securities.

The Stock Exchange is a market that deals in the exchange of securities issued by publicly quoted companies, corporate bodies and the Government. According to Glen et al. (1995) the Stock Exchange plays critical role in the process by mobilizing domestic savings thereby bringing and facilitating reallocation of financial resources from dormant to active economic agents. Through trading at the stock exchange, long-term investments are made liquid, as the transfer of securities between shareholders is facilitated. Further, trading in equities at the stock exchange creates investment opportunities, enabling investors to diversify risk and also encourages local ownership of companies. It makes it easy for companies to raise extra finance essential for expansion and development. A stock market also enhances the inflow of international capital, and is a useful tool for privatization programmes (NSE handbook 2004).

Close to five categories of dividends are declared by firms listed on NSE programmes (NSE handbook 2004). These include final, interim, bonus and special dividends. Final dividends are paid at the end of the financial year. They are usually announced by the company directors at the annual general meeting. Shareholders have the option of voting to accept or to reduce them, but they cannot increase them. Interim dividends are the form of dividends that are declared and distributed before the company's annual earnings have been calculated, they are often distributed quarterly. They are usually smaller than final dividends.

Glen et al. (1995) and Ramcharran (2001) in their empirical survey found that the patterns of dividend payout policies vary across firms. This is a true reflection of the dividend policy practices of firms listed on NSE as indicated in table 1. There are firms that only pay final dividends at the end of the financial year ending. While there are others end up only paying interim dividends at the end of the financial year. Others still pay both final and interim dividends during the same year. However, it can be noted that
final dividends are the most declared dividends as compared to interim dividends or both. This is because unlike final dividends, the award of other forms of dividends depends on the performance of the firm during the previous financial year (NSE handbook 2004).

The Kenya market is a particularly interesting environment to examine this issue, as it is perceived as potentially being prone to substantial agency-related problems. This perception is based, initially, on the NSE being considerably smaller than similar corporate sectors in the developing economies, such as Malaysia, SA, India and the Asian tigers, resulting in a market capitalisation structure that is concentrated amongst larger listed companies, lower levels of domestic, and foreign, institutional investment, a resultant reduction in the extent of analyst following across the company spectrum, and a smaller overall pool of available managerial and director labour. Following from this, Kenya also has a quite unique market for corporate control, and one that would appear to be less effective in disciplining or correcting agency-based corporate control problems (Wambua, 1999).

1.3 Statement of the Problem

Agency costs result from the conflict of interest between managers and shareholders. Sloan (2001) found that corporate governance would lower the level of agency costs and that internal governance and external shareholding influences are substitute agency-mitigating mechanisms.

However, this has not been the case in Kenya. Even with institutionalisation of good corporate mechanisms in companies we have witnessed collapse of some of these companies (Wambua, 1999). In Kenya, cases where managers and directors have been accused of poor corporate governance include the collapse of Kenya Cooperative Creameries, Kenya National Trading Corporation, Ramisi Sugar Company, Lohnro Motors East Africa, Muhoroni Sugar Company among others. The near collapses of Unga Group, Uchumi Supermarkets, National Bank of Kenya are other examples. These are all
issues of corporate governance. Thousands of shareholders lost billions of shillings as a result; this makes the subject an important area of study. This study therefore will therefore find out whether corporate governance lower the level of agency costs and that internal governance and external shareholding influences are substitute agency-mitigating mechanisms in Kenya. This the knowledge gap to be addressed by the study.

Hendrikse (2004) states that the corporate failures witnessed recently confirmed that many directors put their own interests before those of the company and shareholders and their greed and lust for personal power caused deceit and deception by themselves and executive managers and accounting tricks by accountants and auditors. In response the regulators have continuously spelt guidelines and regulations to ensure that there is prudential management in organizations.

Previous studies are on evaluation of the association between agency control mechanisms and firm performance outcomes, with positive performance effects of agency attributes intimated through their contribution to lowering agency costs (Brown and Caylor, 2006; Bebchuk, Cohen and Ferrell, 2004; Klapper and Love, 2004), Black, Jang, Kim and Park, 2005; Cremers and Nair, 2005; and Black, Jang and Kim, 2006). Others have looked at corporate governance mechanisms influence firm performance (Singh and Davidson, 2003; Gladstein, 1984; and Lipton and Lorssch, 1992). However, no previous study on corporate governance mechanisms such as board size, independent director and duality and ownership effectiveness in controlling observed agency costs and problems.

The purpose of this study was to investigate the effectiveness of corporate governance mechanisms such as board size, independent directors and duality on performance, as a tool in mitigating and controlling an agency costs and problems among companies listed in the Nairobi Stock Exchange.
1.4 Objectives of the Study

1.4.1 General objective

The main objective of this study was to evaluate whether corporate governance mechanisms reduced the magnitude of agency-related costs from a sample of companies quoted in the Nairobi Stock Exchange.

1.4.2 Specific objectives

The specific objectives were;

i. Identify the agency costs for a sample of companies quoted in the Nairobi Stock Exchange,
ii. Identify the corporate governance mechanisms employed by a sample of companies quoted on the Nairobi Stock Exchange, and
iii. Examine relationship between ownership and corporate governance mechanisms, and agency costs for a sample of companies quoted in the Nairobi Stock Exchange.

1.5 Significance of the study

The findings of the study can be useful to shareholders. The findings can provide useful information intended to sensitise shareholders the importance of ensuring that the board practice good corporate governance for the sake of maximizing their share value. They will also understand how the activities of the board determine the returns on their investments.

The findings of the study can benefit regulators (NSE and Capital Market Authority). Beyond identifying factors that are effective in minimising agency problems and costs, this analysis may also have implications for the corporate governance reform process in
Kenya, and inform in regard to the importance of ownership structure on corporate decision-making and performance, which is one aspect not directly addressed by the regulators (NSE and Capital Market Authority) in Kenya.

This study should fulfill not only the noble purpose of providing original ground breaking empirical research, but also and opens areas for further research. Researchers and academia can use its findings to further research on the subject.
CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This section reviews the relevant literature of the study. First the chapter reviews theoretical foundation of agency cost and free cash flow, and then relationship between agency costs and corporate governance mechanisms. Finally study conceptualisation framework is outlined at the end of the chapter.

2.2 Review of Theories

The core theories of this study are theories that dominate the fields to be investigated which are agency theory and free cash flow theory.

2.2.1 Agency Theory

This theory has its origins in the early 1930s when Berle & Means (1932) explored the corporate revolution. They revealed that at the early stage, corporations were managed by the founders themselves. As corporations grew, the owners sought external sources of financing. Hence, corporations issued equity. As a result, corporations became owned by external shareholders, where the evolution of separation between owners (ownership) and managers (control) commenced.

There are three types of separation of ownership and control. The first is majority control. This is where some of the shareholders own majority of shares, and the remainders are widely diffused and only hold a portion of the shares. Hence, only the remainder shareholders are separated from control. The second is minority control, where ownership is widely spread. As such, the greater part of ownership is practically without control. The third is management control. There is no existence of large minority shareholders which results directors or managers responsible in controlling the corporation. The third type of separation of ownership and control is known as Quasi-public Corporation, which
it has been resulted as the increment of owners. This happened because Quasi-public Corporation gets its supply of capital from a group of investors, known as investing public” (Berle & Means 1967). There are two types of investors, which are either as an individual, they invest directly in purchasing the corporation’s stocks or bonds, or invest indirectly by investing in insurance companies, banks and investment trusts, which will invest in corporate securities on behalf of the investors.

The separation of ownership and control has also resulted in divergence of interests between shareholders and the managers. How big or small the divergence might depend on the size of the corporation itself. As a result, managers are now responsible with regard to the shareholders, employees, customers and state. This also has ruined the unity which is known as property. Before the corporate revolution, men (owners) owned and used property by themselves, or in other words, the owners of corporation do not only own the property, but are also responsible in managing it. As such, they were entitled for the profits generated by the property. Hence, they will fully-utilised the property that they have in the corporation in generating profit. In contrast, after the corporate revolution, i.e. in the quasi-public corporation, the owners of the property will not directly used it, but they will still get the profits generated as a result of using the property. Men (managers) who control the property were only entitled to a small portion of the profits. As a result, profits were not the main objective for the owners in encouraging them to efficiently use the property, and corporation now is not operated based on the main objective which is profit maximization, which this situation has been found to contradict with the economic principle. It can be concluded that, this was the time where the owners or shareholders of corporation have started in aiming maximization of their wealth as the main objective to be achieved in the willingness of them in investing in any corporation.

In addition, as Berle assumed corporation is functioning as a state, corporation cannot treat the properties that they are using in their production as theirs, as there are silent owners of those properties, who are the shareholders of the corporation. Shareholders are those people who buy the corporation’s shares whom are also known as investors. He argued that property cannot be seen as tangible “things” that normally been viewed
before. This is due to the fact that property now is divided into two types which are consumption and productive property. The latter involved the new dimension of how property plays it roles in corporation. Part of the roles is; property will be used by corporation in its production, manufacture, sales, services etc. which will generate return not only to the firm but also to shareholders who invested in the corporation (Berle & Means 1967).

Jensen & Meckling (1976) argued that the separation of ownership and control has resulted in an agency problem as the managers who act as agents might not always act in the best interests of the shareholders or owners, who are the principals of the firm. This might be due to the interests of both parties which are not aligned. Agency problem results an agency costs, which are the costs of the separation of ownership and control. Agency costs has been defined as the sum of the monitoring expenditures by the principal, the bonding expenditures by the agent, and the residual costs; which the latter is the dollar equivalent of the reduction in welfare experienced by the principal due to the divergence of interests between the owners and managers (Jensen & Meckling 1976, p. 308). This agency costs might destroy firm value, which means it might destroy the shareholders wealth as well, as maximization of shareholders wealth will be achieved when the firm value is maximized. Hence, the agency costs are not good to the owners of the firm.

2.2.2 Free Cash Flow Theory

According to free cash flow theory of capital structure innovated by Jensen (1986), leverage itself can also act as a monitoring mechanism and thereby reduces the agency problem (hence increasing firm value), by reducing the agency costs of free cash flow. There are some consequences derived if firm is employing higher leverage level. Managers of such firm will not be able to invest in non-profitable new projects, as doing so the new projects might not be able to generate cash flows to the firm, hence managers might fail in paying the fixed amount of interest on the debt or the principal when it’s
due. It also might cause in the inability to generate profit in a certain financial year that may result in failing to pay dividends to firm shareholders.

Furthermore, in employing more leverage, managers are forced to distribute the cash flows, including future cash flows to the debt holders as they are bonded in doing so at a fixed amount and in a specified period of time. If managers fail in fulfilling this obligation, debt holders might take the firm into bankruptcy case. This risk may further motivate managers to decrease their consumption of perks and increase their efficiency (Grossman & Hart 1982). This statement has been supported by Jensen (1986) which states that from the agency view, the higher the degree of moral hazard, the higher the leverage of the firm should be as managers will have to pay for the fixed obligation resulting from the debt. Hence, it will reduce managers’ perquisites. Extensive research suggests that debt can act as a self-enforcing governance mechanism; that is, issuing debt holds managers’ “feet to the fire” by forcing them to generate cash to meet interest and principle obligations (Gillan 2006, p. 388).

Leverage might not only be able to reduce the agency costs of free cash flow, but also can increase the efficiency of the managers. This is due to the debt market that might function as a more effective capital market monitoring. In addition, in order to obtain the debt financing, managers must show their abilities and efficiencies in managing the firm. Empirically, it has been proven, among others by Byers, Fields and Fraser (2008) that leverage proxied by bank lenders, can be a substitute monitoring mechanism especially in weak corporate governance firms, but not in the more active merger environments.

In conclusion, this theory suggests that leverage is vital in playing its role as monitoring mechanism. This is due to the higher the leverage level, the higher the probability of bankruptcy, and when this happens, managers might loose their jobs. As such it might motivate managers to work harder in order to avoid this risk by fulfilling the fixed obligation to the debt holders. In addition, as a consequence, it will reduce the managers’ perquisites as they will be pressured not to waste the firm cash flows. This also will increase the efficiency of managers in making decisions especially in selecting new
profitable projects. All of these consequences will increase the firm value. Hence, these consequences will make the interests of owners and managers aligned. This might be the reason why owners or shareholders prefer high leverage level, which is contradict to managers, as managers want to avoid the consequences derived in employing more leverage. In this situation, ownership concentration can play its role in forcing managers to choose higher leverage level.

2.2.3 Irrelevancy Theory

Modigliani and Miller (1958)’s capital structure irrelevance theory states that the firm’s overall market value and the Weight Average Cost of Capital (WACC) is independent of capital structure in a perfect market without taxation. However, the tax free perfect market does not hold in the real world. Later, Modigliani and Miller (1963) proposed the modified capital structure relevance theory, which analyzed the present value of interest tax shields at the corporate level and found that the higher the debt ratio, the higher the firm value. Miller (1977) extends the MM model to personal as well as corporate taxes, and introduced the Miller theory which considered the relative tax advantage of debt over equity.

Nevertheless, over borrowing will lead to financial distress and even bankruptcy. The trade off theory balances the tax advantage of borrowing against the costs of financial distress and states that there exists the optimal capital structure. The trade-off theory states that a value-maximizing firm will pursue an optimal capital structure by considering the marginal costs and benefits of each additional unit of financing, and then choosing the form of financing that equates these marginal costs and benefits. Benefits of debt include its tax advantage and the reduced agency costs of free cash flow; costs include the increased risk of financial distress and increased monitoring and contracting costs associated with higher debt levels.
2.3 Review of Empirical Studies

One of the consequences that have risen from this situation was the importance of monitoring mechanisms, so that managers will perform in order to meet the shareholders’ objective. Hence, it will reduce the agency problem and as a result firm value will increase. Even though Ross (1973) argued that it might be difficult to monitor the managers, various monitoring mechanisms have been suggested in the literature in reducing the agency problem. It is suggested that there are three ways in monitoring firm managers which are in within the firm, outside the firm and the role play by government regulation in a country. Within the firm relates to mechanisms that the firm has greater discretion over, such as board size and composition as well as compensation.4 Outside of the firm or the external mechanism, debt or leverage, ownership concentration or large shareholders and corporate takeovers have been suggested in the literature as the monitoring mechanisms to reduce the agency problem. For the purpose of this study, ownership concentration will be used in representing the monitoring mechanism. Ownership concentration can be categorised as non-managerial owners, institutional shareholders, family-owners and state-owners.

Goergen & Renneboog (2001) argued that if there are insufficient monitoring mechanisms in a firm such as having a diffuse ownership structure (which is the opposite of the ownership concentration structure), it may lead to high managerial discretion which may increase the agency costs. As has been argued in the literature, the level of monitoring is a function of such variables as institutional ownership, block ownership by outsiders, the technology in place to monitor the managers (Bajaj, Chan & Dasgupta 1998) and forecasted profit gain derived from the monitoring (Demsetz & Lehn 1985). Bajaj et al. (1998) suggested that the monitoring by the block-holders can also control the ‘degree of moral hazard’, which is defined as a fraction of a firm’s residual cash flows which is diverted to perquisite consumption by managers. Previously, Jensen & Meckling (1976) argued that manager’s consumption perquisite will reduce firm value. This also relates to free cash flow theory.
Wambua (1999) says that corporate governance is a concept concerned with the way companies are run and it primarily aims at influencing the means through which top management achieve laid down company objectives. Lutz (2004) says that in a business, there are different players who often have different perspectives and these include investors, consumers, employees, directors, the management and indirectly the community. Oman (2003) states that corporate governance is important for national development as it help to increase the flow of financial capital to firms and to enhance financial development and hence contribute to achieving sustained productivity and growth.

In their study, Berle & Means (1967) argued that large corporations are more profitable due to the great increasing in their proportion of wealth and income. They found that corporations increased their wealth by reinvesting its earnings, by raising new capital through the sale of securities in the public markets, and by acquiring control of other corporations through purchase or exchange of securities (p. 42). In that century, they also found that industry by industry has increased its wealth, as what they called as “corporate sway”. However, they revealed that most of the corporations have growth through funding their new capital by issuing securities in the public markets. They witnessed that the tendency of the dispersion will be higher when the size of the corporation is larger. Factor that contributed to the increment of the number of stockholders during that time was the ownership offered to customers and employees. As such, dispersion has been seen as a continuous process. Means statistically revealed that in within thirty-five years, there was an increased in the number of large corporations that have been controlled by management. In contrast, there was a decreased in the corporations which was privately owned or corporations which was controlled by majority shareholders. Hence, he concluded that corporate revolution happened in form of concentration of economic power, dispersion of stock ownership, and separation of ownership and control. The dispersion of stock ownership has result a change in the wealth character itself, such as the individual and his wealth relationship, the wealth value, and the nature of the property used in the operations of the corporation (Berle & Means 1967). As such, it can be seen that the evolution of separation between owners and managers of corporations not only
happened because of the needs in finding the external sources, but also as a result of the ownership that has been widely dispersed. An interesting question can be raised here, that is, if the corporation’s external non-managerial ownership is concentrated, will the separation between owners and managers still happened?

Another main argument by Berle is the function of shares or stocks issued by corporation. He realised that stocks which are traded at the stock market are not functioning as capital provider to the corporation any more. This is due to the main functions of those stocks that are traded by investors among themselves. The stocks are now functioning as the liquidity property for those who wanted cash in the future. As such, investors who wanted stocks will buy them, and for those who wanted cash will sell them at the stock market (Berle & Means 1967). Stocks also have been functioning as a creation of wealth for shareholders who hold them for a longer period of time. For these investors, normally they are expecting to get two types of return which are current income and capital gain. Current income will be in form of dividend payment, and capital gain will be created if the shareholders bought the stocks at a lower price and sell it back at a higher price. These two types of return may increase the shareholders wealth, which will be the main goal of any shareholder in holding corporation’s stocks. Hence, the initial function of stocks that is supposed to be as one of the capital provider for corporation in funding its operations and growth is been argued. It seems that corporation will get the capital only on the day when it issued the stocks to investors. Even though after this stage, any transaction of the corporation’s stocks will not involve any direct cash flow to the corporation, it will still be affected by the performance of the corporation. As stocks have been functioning for wealth creation, investors somehow or rather will still referring to how well the corporation is performing before making decision in buying and holding the corporation’s stocks. For example, if the corporation is performing well in a certain financial year, it may pays a good amount of dividend to the shareholders, hence, it will increase the shareholders wealth by increasing the cash holding of the shareholders.

Corporate governance comprises the private and public institutions both formal and informal which together govern the relationship between those who manage corporations
(‘corporate insiders’) and those who invest resources in them and serves to enhance the performance and ensure the conformance of corporations in a country, according to Oman (2003).

The institutions of corporate governance facilitate and stimulate the performance of corporations which are the principal forces behind economic wealth and growth in a society by creating and maintaining a business environment that motivates managers and shareholders to maximize a firm’s operational efficiency, returns on investment and long term productivity and growth, contends Oman (2003).

Oman (2003) says that the institutions of corporate governance ensure corporate conformance with investors’ and society’s interest and expectations by limiting the abuse of power, the stealing or siphoning-off of corporate assets, and the significant wastage of corporate-controlled resources (‘agency problems’) that arises from losses and distortions that the self-serving behaviour of managers and other corporate insiders, can be expected to impose on investors and society in absence of sound corporate governance. Corporate governance is seen to focus on the principal – agent relationship that exists between the shareholders (the principals) and managers (the agents) and which stems from the separation of ownership and management in the large companies, posits Oman (2003).

Hendriske (2004) says corporate governance relates to the way a business is directed and governed and it deals with the strategies, policies and procedures that directly impact on organizational performance, stewardship and the business’s capacity to be accountable to its various stakeholders. Oman (2003) says that corporate governance is then seen to exist to protect the interests of shareholders because the interests of other stakeholders can adequately be protected through contractual relations with the company, leaving shareholders as the residual claimants whose interests can only be adequately protected through the institutions of corporate governance. Recent scandals associated with such names like Enron, Arthur Andersen, WorldCom, Tycon, Marconi, Vivendi and Parmalat have given further impulse to the importance of corporate governance according to Oman (2003).
Hendriske (2004) states that the following governance concepts are necessary: a) Best interests of the business implies a super-ordinate goal of success based on a business vision and mission of providing products and services that meet the needs of customers and are in the best interests of the three principal parties namely, shareholders, stakeholders and the society, b) The strategy component of the governance framework is a leadership that balances the interest of stakeholders and the society with the shareholders’ interests being primary and stakeholder and society being secondary, c) Structure is the organization that has to be put in place in the three structural areas: board of directors, management/executive/employees and committee, d) Systems are the check and balances that represent the compliance and control factors of the business and take the form of policies, procedures and systems and are supported by internal and external audits and include accounting and reporting standards and exist within the framework of the risk profile and, management of business so that system follows structure which follows strategy, and e) Synergy involves the conduct of the business at all levels and includes issues of communication, disclosure levels of authority and accounting responsibility and seeks to balance the needs of shareholders, stakeholders and society.

Oman (2003) identifies an indicative list of typical corporate governance institutions and actors as: i) Corporate law that in particular gives corporations juridical personality determines corporate chartering requirements and limits the liability of shareholders to the value of their equities, ii) Securities laws that allow and regulate the issuing and trading of equity and debt securities, iii) Government bodies like the Securities commissions or capital market authorities that have legal authority and material and human resources to regulate issuing and trading of corporate securities, including means needed to monitor and enforce compliance with securities laws, iv) Stock exchange listing requirements, v) Judiciary system with sufficient political independence and investigative and judicial powers and resources, and vi) Professional associations that exert peer pressure to attain and maintain standards of professional conduct.
Oman (2003) also says that there are two other institutions that deal with oversight and control, namely: a) Shareholder voting rights and procedures for example cumulative voting rights and anti-directors rights, b) Duties, powers and liabilities of corporate directors which include definition of what constitutes an independent director and requirements on board composition and constitution of board committees, and c) Judicial recourse for shareholders vis-à-vis managers and directors through derivative suits and class-action suits.

Oman (2003) says the other institutions and actors on good corporate governance are concerned with information disclosure and corporate transparency and include: a) Financial accounting standards and how these standards are set, b) public disclosure on financial accounts that include segmental and consolidation accounts, the level and means of remuneration of directors and top executives, compliance with specific provisions in corporate governance codes, other relevant codes, laws, regulations and self declared corporate values or objectives, and c) External audit including how the auditor is chosen.

Oman (2003) says that the institutions of corporate governance ensure corporate conformance with investors’ and society’s interest and expectations by limiting the abuse of power, the stealing or siphoning-off of corporate assets, and the significant wastage of corporate-controlled resources (‘agency problems’) that arises from losses and distortions that the self-serving behaviour of managers and other corporate insiders, can be expected to impose on investors and society in absence of sound corporate governance. Corporate governance is seen to focus on the principal – agent relationship that exists between the shareholders (the principals) and managers (the agents) and which stems from the separation of ownership and management in the large companies, posits Oman (2003).

Dimsdale (1994) however says that the shareholders have little contact with the board of directors except during the purely ceremonial Annual General Meeting which is held only once a year. According to observation, the directors are elected in the Annual General Meeting and in turn appoint a Chairman. Most corporations have a large board with directors who have little interest in the company except for the influence, allowances and
other perks they draw from being on the board. This view sees corporate governance structures as externally imposed and unrelated to the firms broader operating and financing arrangements.

Corporate governance is the rules of the game for a company in its relations with its shareholders, its lenders, other stakeholders in the business community and society at large, according to IOD (2005). According to Tenev and Zhang (2002) corporate governance is the set of instruments and mechanisms (contractual, legal and market) available to shareholders (as residual claimants) for influencing managers to maximize shareholder value and to fixed claimants such as banks and employees, for controlling the agency costs of equity.

Governance refers to the manner or method of controlling or directing the affairs of an entity. That entity may be a government, society, partnership, private business or a corporation. Corporate governance therefore refers to the ways of controlling or directing the affairs of a corporation. The issue of corporate governance has gained a lot of prominence lately and especially following the publication of the Cadbury Report in 1992 and corporate scandals that have occurred recently. As organizations became large, this resulted in the separation of ownership from control where shareholders have very little influence on the day to day running of their company, contends Dimsdale (1994).

2.3.1 Corporate Governance Monitoring Mechanism and Ownership

Mehran (1992) found that insider ownership and leverage have a positive relationship, as ownership helps in aligning the managers’ and shareholders’ interests, and with the higher leverage, managers’ exposure to the equity ownership risk are lesser. By developing a signaling model, Bajaj et al. (1998) documented that insider ownership is positively correlated with leverage level of the firm. Similar to these studies, Driffield, Mahambare & Pal (2007) also found a positive relationship between ownership concentration and leverage in family firms in Indonesia, Malaysia and Thailand. This
result suggests that ownership concentration may act as an effective monitoring mechanism.

In contrast, Mehran (1992) also found evidence that if outside monitoring is less effective; managers might also lower the leverage in order to avoid bankruptcy risk. This has been proven previously by Friend & Lang (1988) who found a negative relationship as managers want to ensure the survival of the firm by reducing the leverage level. It is also been supported by Lemmon, Roberts & Zender (2008) who found that the changes in distribution of control that occur at the time of initial public offering (IPO) of firms will not affect the capital structure of the firms.

In an attempt to investigate whether capital structure of any firm is affected by the time factor, Lemmon et al. (2008) documented that firms’ future and initial leverage ratios are closely related, as they found that leverage level of firms remain unchanged for over 20 years. Hence, they concluded that leverage varies across firms, not over time. Hitt, Hoskisson & Harrison (1991) and Jensen (1986) state that the creation of a firm’s capital structure can influence the governance structure of the firm. This suggests a reverse causality relationship from capital structure to governance structure. Hence, corporate governance monitoring mechanisms which are part of the governance structure of a firm might also be affected by the capital structure developed by the firm.

**2.3.2 Corporate Governance and Agency Costs**

There are limited studies examining the relationship between corporate governance mechanisms and agency costs. Governance is very synonymous with organizations and corporate economy. This term has been used for a long time and is very significant to business organizations, especially in light of recent misconduct in the business world. MacMillan and Downing (1999) states that corporate governance has become compulsory for a firm to perform competitively as well as in promoting a firm’s entrance to the international capital market. Therefore, there is a need to apply good governance that is induced by the market.
However, there is empirical evidence that the internal governance mechanisms play an important role as a monitoring device in restricting agency related costs. According to Pearce and Zahra (1991), large boards are more powerful and effective than small boards. They document that large board size could lead to better alignment between firms and the environment, provide better advice and counsel in the management process of decision making and improve company image. Singh and Davidson III (2003) support that argument with evidence that the board size has a positive and significant influence on the asset utilization ratio. It suggests that a higher asset utilization ratio indicates lower agency costs.

However, Beiner et al. (2004) and Eisenberg, Sundgren, and Wells (1998) claim that the larger the board, the less effective the communication skills, coordination, and decision making compared to a small board. This statement is endorsed by Florackis and Ozkan (2004) who study a large sample of publicly listed U.K. firms between 1999 until 2003. Their findings show that board size has a negative coefficient in relation to asset turnover as the agency cost proxy, indicating that a larger board size is less efficient and leads to higher agency costs.

Agency costs occur from the misalignment of interests between the firm’s managers and the firm’s shareholders. This conflict of interest between manager and shareholders is caused by the physical presence of excess cash or cash equivalents (Jensen and Meckling, 1976). There are scarce studies on examining the relationship between agency costs and certain board structure and ownership characteristics. Singh and Davidson (2003) reveal that a board with small size has a positive and significant influence on asset utilization efficiency showing that higher asset utilization efficiency indicates lower agency costs. The results are consistent with Florackis and Ozkan’s (2004) findings, which show that board size has a negative coefficient in relation to asset turnover, indicating that larger board sizes are less efficient (Beiner et al., 2004; and Eisenberg et al., 1998).
The presence of a non-executive on the board is perceived as a governance mechanism that could help in monitoring the agency problem. Consequently, Berle and Means (1932) and Jensen (1993) opened to debate whether nonexecutive directors indeed promote shareholders interest. Some researchers explained that non-executive directors are more likely to align themselves with top management rather than the shareholder. This is due to top managers have a great influence over who is on the board (Hermalin and Weishbach, 1998) and because non management directors typically hold an unimportant portion of the firm’s stock (Brickly and Coles, 1994; and Rhoades, Rechener, & Sundramurthy 2000). McKnight and Mira (2003) found that as the number of non-executive on the board increases, agency costs tends to decrease and this evidence supports that argument. The average number of additional directorships held by board members had a positive impact on firm performance (Dowen, 1995), whereas Klein (1998) acknowledged a weak relationship with performance. In addition, Florackis and Ozkan (2004) found that the smaller the board size, the higher the agency costs. Hence, previous study found that duality has no influence on agency costs (Florackis and Ozkan, 2004; McKnight and Mira, 2003).

2.4 Summary of Literature Review

There is extensive literature on corporate governance and agency costs, especially empirical studies conducted to test the theories in different economies. The literature revealed that agency costs occur from the misalignment of interests between the firm’s managers and the firm’s shareholders. According to empirical literature corporate governance has been identified as one of the important tools needed to deal with agency problems in managing any organization including corporation. The institutions of corporate governance facilitate and stimulate the performance of corporations which are the principal forces behind economic wealth and growth in a society by creating and maintaining a business environment that motivates managers and shareholders to maximize a firm’s operational efficiency, returns on investment and long term productivity and growth. However, very scanty literature on the subject exists in
developing countries, especially in Kenya. Thus, the need to carry out this study in Kenya.
CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction
This chapter outlines the general methodology used to conduct the study. It specifies the research design, target population, data collection method and instruments, and data analysis and interpretation.

3.2 Research Design
The descriptive research methodology was adopted in this study. Descriptive research involves either identifying the characteristics of an observed phenomenon or exploring possible correlations among two or more phenomena. Descriptive research examines a situation as it is, it does not involve changing or modifying the situation under investigation nor is it intended to detect cause-effect relationship. This is a major limitation of descriptive research since it cannot help determine what causes a specific behaviour, motivation or occurrence. Therefore descriptive research is justified for this study since the objective is to provide a systematic description that is factual and accurate as possible.

3.3 Population
This study targeted all companies quoted at the Nairobi Stock Exchange (NSE). There are all 54 quoted companies in NSE.

3.4 Sampling Design and Sample Size
This study employed stratified random sampling to selected sample size. Listed Companies are classified into four main sector or segment. Therefore the sector was the strata. First, the companies were stratified into four stratas (sector) and from each sector a
purposive sample of 5 companies was selected randomly as the corporate governance structures in companies are consider homogeneous. The selected sample size was 20 companies, which is over 30% of total population. The researcher considered a three year period, 2007 to 2009. This was considered appropriate as research was able to obtain the current information necessary for the study. Lewis and Thornhill (2000) state that, many researchers argue that using sampling enables a higher overall accuracy than a census. The smaller the number of cases for which you need to collect data, the more time for designing and piloting the means you can collect more detailed information (Mwatu, 2005). Focus on the twenty companies listed at the NSE enabled the researcher to have more time to check and test data for accuracy prior to analysis.

3.4 Data collection method and instruments

The study used secondary data to analysis the relationship between corporate governance mechanisms and agency costs. This data was obtained from financial statements of the eight companies to be covered. The sources of the information were the companies selected and NSE. These statistics covered the period 2007 to 2009. The data was collected using data collection guide designed to collect all necessary data and information required.

3.5 Data Analysis and Presentation

First, data collected was cleaned, sorted and collated. Then, data was entered into the computer, after which analysis was done. Analysis was done with the help of Statistical package for social scientists (SPSS version 14). Descriptive statistics was used to describe the data. The mean score, frequencies and percentages for each variable will be calculated and tabulated using frequency distribution tables, or pie charts and/or bar charts. In order to test the research hypotheses, the inferential tests used include the Pearson Product-Moment Correlation Coefficient and regression analysis.
First, Pearson Product-Moment Correlation Coefficient as measures of association was used to examine the relationship between the independent and dependent variables. The relations was explored with the use of Pearson’s correlation coefficient. Pearson’s correlation coefficient calculates a relationship between two variables. Correlation coefficient is definition as a measure of the strength of linear association between two variables. Correlation is always between -1.0 and +1.0. If the correlation is positive, we have a positive relationship. If it is negative, the relationship is negative.

Second, regression analysis was used to determine the effect of corporate governance mechanisms on the agency cost. The study used Friend and Lang (1988) regression specification. Given the three-year panel structure of the sample data to be gathered, regression analysis was conducted to investigate the relationship between the agency-mitigation attributes and the proxy dependent variables representing the extent of agency costs prevalent within sample firms. The regression model that was evaluated is represented as follows:

Regression equation will be specified as follows;

\[ \text{Agency cost}_{it} = \alpha + \beta_1 \text{directorownership}_{it} + \beta_2 \text{boardsize} + \beta_3 \text{boardremuneration}_{it} + \beta_4 \text{auditorsfees}_{it} + \beta_5 \text{managementfees}_{it} \]

Equation 1 defines the regression equation used in this study where: Agency cost\(_{it}\) = the dependent variables proxied extent of firm performance (return on asset) for firm \(i\) in year \(t\). The independent variables are defined as corporate governance mechanism defined as cost of institutionalization of corporate governance is measured by director ownership, board size, board remuneration, auditor fees and management fees. \(\alpha\) = overall intercept term; \(\beta_j\) = the firm-specific fixed effect, are the slope coefficients whose sign depict the relationship between the cost of institutionalization of corporate governance variables and returns on asset as a measure of agency costs prevalent within sample firms.
CHAPTER FOUR: DATA ANALYSIS AND PRESENTATION OF THE RESULTS

4.1 Introduction

This section presents the data analysis and findings of the study. The section is divided into two main parts. The first part deals with descriptive statistics of the variables used in the study while the other part deals with the broad objective of the study: examination of the relationship between good corporate governance and financial performance.

Out of the twenty firms targeted, all of them responded giving a response rate of 100 percent. For the purpose of showing the relationship among various variables, quantitative analysis was done using percentages and frequencies. Bar graphs, pie charts and tables were used to present the findings.

4.2 Description of Corporate Governance Structures

Here the respondents were required to give the following information; the number of executive directors, number of non executive directors, the existence external and internal audits and their associated costs.

4.2.1 Board Composition

The study established that 15 companies (75%) had three executive directors and the other five companies have two executive directors. The analysis also revealed that 75 percent of the respondent companies had 5 none executive directors. All the companies have separate Chief Executive Officers (CEOs) and Chairmen. On average for all the companies, analysis revealed that there are 3 executive board members and 5 none executive board members.
Table 4.1: Establishment of the Board

<table>
<thead>
<tr>
<th>Frequency in Companies</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>Average for all the companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executive Board Members</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Non-Executive Board Members</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>Totals</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
</tr>
</tbody>
</table>

4.2.2 Frequency of Full Board Meeting

The study sought to establish the frequency of the full board meeting in a year. The result of the analysis shows that 10 companies hold four full board meetings in a year. Another 5 companies holds three full board meetings while another five hold two full board meetings. The results of the analysis are shown in the table 4.2 below.

Table 4.2: Frequency of full board meeting

<table>
<thead>
<tr>
<th>Frequency of Full Board Members</th>
<th>Companies</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Four Full board meetings</td>
<td>10</td>
<td>50%</td>
</tr>
<tr>
<td>Three Full board meetings</td>
<td>5</td>
<td>25%</td>
</tr>
<tr>
<td>Two Full board meetings</td>
<td>5</td>
<td>25%</td>
</tr>
</tbody>
</table>

4.2.3 Internal Audit Functions

It was apparent from the findings of the analysis that all the four companies have an internal audit department. Similarly, the four companies hire external auditor who annually audit the companies. Table 4.3 reveals that 100 percent of the respondent companies indicated that there existed adequately resourced external and internal audit functions. The audited accounts are reported to the board.
Table 4.3: Existence of audit functions

<table>
<thead>
<tr>
<th>Remark</th>
<th>Frequency of Full Board Members</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Existence of internal audit department</td>
<td>20</td>
<td>100%</td>
</tr>
<tr>
<td>Outsourcing external auditors</td>
<td>20</td>
<td>100%</td>
</tr>
<tr>
<td>Auditors reporting to the boards</td>
<td>20</td>
<td>100%</td>
</tr>
</tbody>
</table>

Respondents companies indicated that external auditor provided other services like management consultancy to the companies.

4.2.4 Audited Accounts and Returns

The study sought to establish the kind of returns that the companies make to the CMA, NSE and KRA. The study established as shown in the figure 4.1 below that 100 percent of the respondent companies indicated that they make financial reports to the CMA, NSE and KRA.

Figure 4.1: Reporting of Audited Accounts and Returns

The study sought to establish the type of returns that the companies make to the CMA, NSE and KRA, and from the results of the analysis 100 percent of the respondents indicated that they make tax returns to the KRA which are mainly the Income Tax and the Value Added Tax (VAT). The tax returns are done annually. Similarly, analysis
established that 100 percent of the respondent companies indicated that the Balance Sheet and profit and Loss Account are done annually, and reported to CMA and NSE.

**Figure 4.2: Reported Audited Accounts and Returns**

![Graph showing Income Tax, Value Added Tax (VAT) and Profit and Loss Account, Balance Sheet]

**4.3 The cost of governance**

The study sought to establish if good corporate governance lead to an increase in operating costs. The findings of the analysis are summarized below.

**4.3.1 Directors and Audit fees**

The study revealed that the non executive directors were on contract (100%) while executive directors are on the payrolls. Respondents companies were asked whether requirements for good corporate governance had led to increased operating costs. The respondents unanimously indicated that requirements of good corporate governance have not increased operational costs, (100%). In regard to audit fee, the results of the analysis showed that 67 percent of the respondents indicated that it is determined by the industry rate, while 33 percent indicated that it is determined by the amount of work done.
4.3.2 Cost of Institutionalization of good corporate governance mechanisms

Partly, this study sought to verify cost of good corporate governance. Secondary data obtained from the annual reports of the four companies was used. Audited accounts of respective companies were analyzed and the yearly amount of director’s emoluments and audit fees were compared against the profit for the five years. The cost of good corporate governance included cost related to directors i.e board remunerations, audits fees and management fees. The average yearly director’s fees, management fees, Audit fees and other fees for the companies studied are summarized in the table 4.5 below;
Table 4.4: Cost of good governance versus financial performance (Dec, 2009)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fees</td>
<td>495</td>
<td>922</td>
<td>353</td>
<td>169</td>
<td>484.75</td>
</tr>
<tr>
<td>Management fees</td>
<td>3,469</td>
<td>3,186</td>
<td>2,562</td>
<td>1,867</td>
<td>2,771</td>
</tr>
<tr>
<td>Audit Fees</td>
<td>1,964</td>
<td>2,108</td>
<td>1,515</td>
<td>1,236</td>
<td>1,705.75</td>
</tr>
<tr>
<td>Other related fees</td>
<td>1,989</td>
<td>1,432</td>
<td>820</td>
<td>749</td>
<td>1,247.5</td>
</tr>
<tr>
<td>Total (Associated with CG)</td>
<td>7,917</td>
<td>7,648</td>
<td>5,250</td>
<td>4,021</td>
<td>6,209</td>
</tr>
<tr>
<td>Net Profit After Tax</td>
<td>1,890</td>
<td>2,975</td>
<td>1,910</td>
<td>2,105</td>
<td>2,220</td>
</tr>
<tr>
<td>Total Assets</td>
<td>153,076</td>
<td>140,480</td>
<td>157,928</td>
<td>124,131</td>
<td>143,904</td>
</tr>
<tr>
<td>Return on Assets</td>
<td>0.036</td>
<td>0.025</td>
<td>0.031</td>
<td>0.025</td>
<td>0.029</td>
</tr>
<tr>
<td>Cost/Total Assets</td>
<td>0.052</td>
<td>0.054</td>
<td>0.033</td>
<td>0.032</td>
<td>0.043</td>
</tr>
</tbody>
</table>

First, for all firms studied, the research established cost of good corporate governance measured as Cost/Total Assets is higher than the performance measured as return to asset ratio. The following section reports graphical representation of variables.

Figure 4.4: Graphing Cost of good governance versus financial performance

Key

<table>
<thead>
<tr>
<th>Year</th>
<th>2009</th>
<th>2008</th>
<th>2007</th>
<th>2006</th>
<th>Over Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. in Graph</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
</tbody>
</table>
4.4 Relationship between cost of good governance and performance

The analysis of existence of relationship between cost of good corporate governance and performance was first graphically done and presented in the figure 4.5 shown in the subsequent paragraph.

Figure 4.5: Graphical presentation of Relationship between cost governance and performance

From the findings presented in Figure 4.5, there is no relationship between the cost of good governance and performance. First as the cost of good governance seems to rise the performance in the same period was declining. Then, the cost of good governance seemed to decline while the performance in the same period was increasing. This means that the cost of good governance alone does not determine performance but there exist other influencing factors which are beyond the scope of this study.
To empirically determine the relationship between cost of good governance and performance of firms under review, first was correlation matrix and then regression analyses were used. The following section outlines the results of the data analysis.

### 4.4.1 Correlation matrix of variables

The correlation matrix is an important indicator that tests the linear relationship, between the variables. The matrix also helps to determine the strength of the variables that is, strength of the relationship between the dependent variable i.e., performance (return on assets) and the independent variable corporate governance mechanism measured by auditors fees, board remuneration and size of board, management fees and ownership by directors. Correlation coefficient between two variables range from 1 (highly positively correlated) and -1 (highly negatively correlated).

#### Table 4.5: Pearson correlation between return on assets and independent variables

<table>
<thead>
<tr>
<th>Variables</th>
<th>Co-efficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board Remuneration</td>
<td>.117</td>
</tr>
<tr>
<td>Size of the Board</td>
<td>.120</td>
</tr>
<tr>
<td>Auditor fees</td>
<td>.565</td>
</tr>
<tr>
<td>Management fees</td>
<td>.723</td>
</tr>
<tr>
<td>Director ownership</td>
<td>.656</td>
</tr>
</tbody>
</table>

Table 4.5 above shows that there is a weak positive correlation between return on asset as a measure of agency costs and board remuneration and size of the board of 0.117 and 0.120 respectively. However, audits fees, management fees and director ownership are highly related with return on asset as a measure of agency costs. Similarly, correlation between return on assets and audits fees, management fees and director ownership is 0.565, 0.723 and 0.656. This indicates that cost of good corporate governance measured by audits fees, management fees and director ownership mitigates the agency cost.
4.4.2 Regression Analysis Results

Table 4.3 below summarizes regression results. As indicated in the regression statistics R-squared was 0.535. This means that 54% variations from the expected and actual output of dependent variable i.e., Corporate governance mechanism (measured by return on assets) are explained by independent variable corporate governance mechanisms measured by auditors fees, board remuneration and size of board, management fees and ownership by directors. Analysis of Variance shows that f-calculated is greater that f – critical (0.965>0.438), this implies that there exist their exist relationship between dependent variable and independent variables used in study.

<table>
<thead>
<tr>
<th>Table 4.6: Summary of Regression Analysis Results</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Regression summary: Dependent variable Agency cost</strong></td>
</tr>
<tr>
<td>R Squared</td>
</tr>
<tr>
<td>Adjusted R Squared</td>
</tr>
<tr>
<td><strong>ANOVA (Analysis of Variance)</strong></td>
</tr>
<tr>
<td>Df</td>
</tr>
<tr>
<td>Regression</td>
</tr>
<tr>
<td>Residual</td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td><strong>Output of Regression</strong></td>
</tr>
<tr>
<td>Coefficients</td>
</tr>
<tr>
<td>Intercept</td>
</tr>
<tr>
<td>Auditors fees,</td>
</tr>
<tr>
<td>Size of the Board</td>
</tr>
<tr>
<td>Board remuneration</td>
</tr>
<tr>
<td>Management fees</td>
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<tr>
<td>Director ownership</td>
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* Correlation is at the 1% level of significance (99% confidence level)
The estimated regression equation is

Return Assets (agency cost) = 3.705 - 0.191 Auditors fees + 4.872 management fees - 0.114 director ownership

The estimated equation shows that there is a strong positive marginal effect of independent variable - corporate governance measured by auditors’ fees, management fees and ownership by directors on agency costs (measured by return on assets).

Regression results shows that the coefficients of corporate governance mechanism measured by auditors fees, management fees and ownership by directors are statically significance. This implies that these variables have an effect/impact on the agency costs proxied by return on assets. However, results reveal that size of board and board remuneration are not statistically significance and therefore there no relationship between both variables and agency cost (proxied by return on assets).

The coefficient of auditors’ fees is 0.191. The coefficient is positive and statistically significant; implying that the probability that hiring audit and their work in advising the company mitigates agency costs. If the cost of hiring auditors increases by 1%, then the return on assets increases by 0.19%. This can only be associated to reduction of costs associated to agencies costs mitigated by auditors. The coefficient of management fees is -4.872 which is negative and significance. This indicates that increase in management fees mitigates the agency costs. The coefficient of ownership by directors is 0.114, positive and statistically significant; implying that the probability that presence of active board member with ownership interest in firm running daily operations of the firm influences mitigates agency costs and increase returns on assets.

Thus, there exist relationship between good corporate governance mechanisms (auditors’ fees, management fees and ownership by directors) and agency costs (measured by return on assets) for the firms studied. Institutionalisation of good corporate governance helps in mitigating the agencies costs and hence increases the firm performance measured by returns on assets.
CHAPTER FIVE: SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents a summary of the findings of the study, conclusion and suggests some recommendations. At the end of the chapter, areas for further research are provided.

5.2 Summary of the findings

This study investigated examined the relationship between corporate governance mechanism and agency cost for firms listed in NSE. Specifically, the study established whether there is relationship between the dependent variable i.e., agency cost measured by return on assets and the independent variable corporate governance mechanism measured by auditors fees, board remuneration and size of board, management fees and ownership by directors. To achieve this objective, three data analysis techniques were used namely graphical presentation, correlation matrix and regression analysis.

Graphical presentation of variables revealed that, first, as the cost of institutionalization of corporate governance seems to raise the firms’ returns on asset in the same period was declining; second, the costs seemed to decline while the of performance in the same period was increasing.

Correlation matrix showed that there is a strong correlation between agency costs and good corporate governance. Institutionalisation of good corporate governance costs: audits fees, management fees and director ownership were highly related with return on asset as a measure of agency costs. This indicates that cost of good corporate governance measured by audits fees, management fees and director mitigates agency costs. However, board
remuneration and size of the board were weekly related to agency cost proxied by return on asset.

Regression results revealed that R-squared was 0.535, implying that 54% variations from the expected and actual output of dependent variable i.e., agency cost (measured by return on assets) are explained by independent variable corporate governance mechanisms measured by auditors fees, board remuneration and size of board, management fees and ownership by directors. The estimated equation shows that there is no marginal effect of board remuneration and size of board on return on asset. This implies that between board remuneration and size of board on return as a measure corporate governance mechanism has no effect firms’ return on assets. However, institutionalization of good corporate governance costs: audits fees, management fees and director ownership have strong and significance marginal effects on returns on asset and hence they were found to mitigate to agency costs.

5.3 Conclusion

Institutionalization of good corporate governance costs: audits fees, management fees and director ownership have strong and significance marginal effects on returns on asset and hence they were found to mitigate to agency costs. Thus, there exists negative relationship between corporate governance mechanisms and agency cost for the firms studied. From the study, it can be concluded that the institutionalization of good corporate governance can help reduce (mitigate) the agency costs resulting to high return on asset for the companies quoted on the Nairobi Stock Exchange. The study also reveals that good corporate governance does not increase the agency costs. Therefore the study concludes that there is no financial burden in institutionalizing corporate governance.
5.4 Recommendations

The study also reveals that there is no evident that good corporate governance increases the agency costs. The study concludes that there is no financial burden in institutionalizing corporate governance. On the basis of the result of this study, it is recommended that companies listed in the Nairobi Stock Exchange should institute good corporate governance because it does not lead to financial burden to the company. It is further recommended that all companies, whether listed or not should institute good corporate governance in order to mitigate agency costs and hence increase the performance of their companies.

5.5 Suggestions of Areas for further research

This study was done only on the companies quoted on the Nairobi Stock Exchange. Therefore similar studies can be done for other stock exchanges in other countries. The study can also be extended to other companies in Kenya not listed in the Nairobi stock exchange.
References


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