THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE OF PARASTATALS IN KENYA

BY

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DECLARATION

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

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SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI

DEDICATION

To my family members, Mrs.Ndetirishwa Njoroge, my son, Melvin Baraka Njoroge and my lovely energetic daughter, Valma Mucera Njoroge for their patience and accepting the fact that dad had turned out to be a nocturnal creature.

I would also like to dedicate this work to my mother, Ruth Waithira Murage, whose tireless effort, sacrifice and devotion to her first born ensured that her son is now qualified to be a 'master' in his own right.

Last but not least, I dedicate this work to my father, mzee Japheth Msuya, who whispered to me: ***"Pleasure in the job puts perfection in the work"***

Thank you and God bless you abundantly.

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To all I say, may God Bless you in a mighty way.

Finally, I would like to end my acknowledgements with the famous Aristotle's quote:

"Excellence is an art won by training and habituation. We do not act rightly because we have virtue or excellence, but we rather have those because we have acted rightly. We are what we repeatedly do. Excellence, then, is not an act but a habit."

TABLE OF CONTENTS

THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE OF PARASTATALS IN KENYA i

DECLARATION ii

DEDICATION iii

ACKNOWLEDGEMENT iv

TABLE OF CONTENTS v

LIST OF TABLES viii

ABSTRACT ix

CHAPTER ONE 1

1.0. INTRODUCTION 1

1.1 Background 1

1.2. Statement of the Problem 4

1.3. Objective of the Study 6

1.4. SIGNIFICANCE OF THE STUDY 6

CHAPTER TWO 7

2.0. LITERATURE REVIEW 7

2.1. Introduction 7

2.1.1. Review of Theories 7

2.1.2. Agency Theory 7

2.1.3. Stakeholders' Theory 9

2.1.4. Stewardship Theory 10

2.2.0. Other Relevant Issues 11

2.2.1. Corporate Governance In Kenya 11

2.2.2. Global corporate governance 12

2.3.0 Board Attributes 13

2.3.1 Independent directors 13

2.3.2 Board size 13

2.3.3 Split chairman/CEO roles 13

2.3.4 Board meetings 14

2.4.0 Audit Committees 14

2.4.1 Independence of committees 14

2.4.2 Competence of audit committee members 15

2.4.3 Independent assurance function of external auditors 15

2.4.4 Audit committee meetings 15

2.4.5 Effective corporate governance and institutional ownership 15

2.4.6 Effective corporate governance and managerial ownership 16

2.5.0 Corporate Governance Practices 17

2.5.1. Reforming Corporate Governance 19

2.5.2. Pillars of Good Governance 20
2.6.0. Parastatals 21
2.6.1. Rationales and Motives for parastatals 21
2.6.2. Problems afflicting parastatals 23
2.6.3. Principles of governance 24
2.6.4. Principles of governance in the public-sector context 24
2.7.0 Financial Performance 26
2.7.1. Corporate Governance and Financial Performance 26
2.7.2. Empirical Studies 28
CHAPTER THREE 30
3.0. RESEARCH METHODOLOGY 30
3.1. Introduction 30
3.2. Research Design 30
3.3. Population 30
3.4. Sample Design 30
Table 3.1: Sampling table 31
3.5. Data Collection 31
3.6. Pilot test 32
3.7. Data Analysis 32
3.8. The Regression Model 33
CHAPTER FOUR 35
4.0. DATA PRESENTATION AND ANALYSIS 35
4.1. Introduction 35
4.2. Demographic information 35
4.3. Sector of the economy under which the selected corporations operated 35
Table 4.1.Sampled Sector of the economy under which the corporations operate 35
4.3.1. The Evaluation of the Questionnaire Results 36
4.3.2. Functions of the Board 36
Table 4.2 Functions of the Board 37
4. 3.3. Board Meetings and Procedures 38
Table 4.3 Board Meetings and Procedures 39
4.3.4: Appointment, Selection, Induction, Training and Removal of Directors 40
Table 4.4 Appointment, Selection, Induction, Training and Removal of Directors 41
4.3.5. Board Structure 42
Table 4.5 Board Structure 42
4.3.6. Effectiveness of Chairpersons 43
Table 4.6 Effectiveness of Chairpersons 44
4.4. Factors that lead to corporate governance 44
Table 4.7 Factors that lead to corporate governance 45

4.5.0 Regression analysis 45
4.5.1 Analysis of corporate governance and parastatal performance 45
Table 4.8: Regression and the Coefficient of Determination 47
Table 4.9: Model Summary 48
CHAPTER FIVE 50
5.1. Summary 50
5.2. Conclusion 52
5.3. Policy Recommendation 53
5.4. Limitations of the Study 55
5.5. Suggestions for further Studies 55
REFERENCES 57
APPENDICES: 66

LIST OF TABLES

Table 3.1: Sampling table 31

Table 4.1sampled Sector of the economy under which the corporations operate..35

Table 4.2 Functions of the Board..37

Table 4.3 Board Meetings and Procedures 39

Table 4.4 Appointment, Selection, Induction, Training and Removal of Directors 41

Table 4.5 Board Structure 42

Table 4.6 Effectiveness of Chairpersons 44

Table 4.7 Factors that lead to corporate governance 45

Table 4.8: Regression and the Coefficient of Determination 47

Table 4.9: Model Summary 48

ABSTRACT

Recent global events concerning high-profile corporate failures have put back on the policy agenda and intensified debate on the efficacy of corporate governance mechanisms as a means of increasing financial performance of parastatals. Since the 1990s to very recently, grand scandals in Kenya such as the Goldenberg and Anglo leasing among many others have put the quality of corporate governance into question. These scandals have, in one way or another, involved one or more parastatals and government institutions and have conspicuously featured in the public domain. The objective of this research was to determine the relationship between corporate governance and financial performance of parastatals in Kenya.

The study adopted a causal design. The population of interest in this study consisted of all the parastatals in Kenya. There are 158 Parastatals as obtained from the Inspectorate of State Corporations - Office of the President as at March 2009. The study proposed to investigate a total of 79 state corporations. The research used primary data collected through semi-structured questionnaires with open and closed ended questions.

The study concludes that there is a positive relationship between corporate governance and financial performance of parastatals in Kenya. The results are consistent with existing literature, but there is need to err on the side of caution in any attempt to generalize the findings as the sample selection was determined by the availability of data rather than by any probability criterion.

From the study, parastatals that employed effective appointment, selection, induction, training, development of board members, had operative board structures and efficient Chairpersons were linked to good financial performance. The study further concludes that efficiency and effectiveness in service delivery, prevailing corporate culture, the stipulation by the code of best practice, and the strategic direction that the corporation has are the main factors that lead to corporate governance practices in the state corporations.

CHAPTER ONE

1.0. INTRODUCTION

1.1 Background

The role of corporate governance has been gaining momentum over the past two centuries. Although initially established as a legal requirement for incorporation, corporate governance has become a critical link between firms and those who have vested interests in the firm. Corporate governance is mandated to ensure the interests of public-sector and private-sector organizations are represented. In addition, corporate governance aids in securing confidence not only for stockholders but also for other stakeholders such as customers, suppliers, employees and the government in ensuring that firms are accountable for their actions. The dominant form of corporate governance for these firms is the board of directors.

Corporate governance is the means by which an organisation is directed and controlled. In broad terms, corporate governance refers to the processes by which organisations are directed, controlled and held accountable. Corporate governance encompasses the authority, accountability, stewardship, leadership, direction and control exercised in corporations. Parastatal organisations have been established with financial resources from tax-payers. This means that the main stakeholders in parastatals are members of the public, whose taxes have been invested in these corporations.

Firms which implement sound corporate governance systems provide more useful information to investors and its other stakeholders to reduce information asymmetry as well as to help the company improve its operations. But what is corporate governance? Corporate governance is seen as concerned with ways of bringing the interests of (investors and managers) into line and ensuring that firms are run for the benefit of investors. It has two-way relationship between internal governance mechanisms of corporations and society's conception of the scope of corporate accountability. Therefore, corporate governance should be inclusive of the structures, processes, cultures and systems that engender the successful operation of organizations (McKensey et al 1997). As stated in the Cadbury Committee Report

1992, corporate governance is the system by which companies are directed and controlled.

Corporate governance has been receiving increasing attention from the academic and corporate communities, focusing on topics such as the power and responsibility of boards of directors, rules related to hostile acquisitions of shareholding control, institutional investors' participation in company management, and remuneration policies for senior managers and directors, and the structure and composition of the board of directors among others. In recent years for instance, academics, professional associations and multilateral organizations have analyzed the profiles of the boards' members with the basic objective of identifying whether the "ideal" structure and composition for the boards are to increase their supervisory activity and to make them more efficient (Saito and Dutra, 2006).

Longeneck and Pringle (1981) documented issues relating to corporate governance in the 1970s highlighting the fact that governance issues came to the fore as a reaction to rising business scandals in the United States of America during that period. During the period, failure of companies led to increased scrutiny of boards and action was taken to demand top management show accountability and prudence in allocation of company resources. Financial failures and questionable business practices in the 1970s and 1980s led to a number of initiatives.

The challenges from these recent events have necessitated the taking of various measures across the globe. These measures, such as the Sarbanes-Oxley Act of 2002, regulate the system to ensure adherence to principles of good corporate governance. For instance, the Tread way Commission was formed in 1985 and reported in 1987 (Vinten, 2001). It found out that almost 50% of fraudulent financial reporting resulted in part from breakdown in internal controls and recommended that many different internal philosophies be integrated. Cadbury's 1992 report greatly influenced thinking in corporate governance. The report's proposals and its code of best practice emphasized the importance of independent, no-executive directors, and the need for audit committees. It also called for the separation of the chair of the board from the chief executive. The argument being advanced at that time was that governance was about performance as well as conformance. This era saw a proliferation of research

and writing in this area, leading to debates on the significance or importance of various aspects of corporate governance. What was needed was a vibrant alternative way to ensure that power was exercised, over every type and form of corporate entity and strategic alliance around the world, in a way that ensured both effective performance and appropriate social accountability and responsibility.

Better corporate performance has been cited as one of the main benefits of adopting good corporate governance structures within organizations. However, in contrast to theory, a prior European study (Bauer et al., 2004) reports evidence of a negative relationship between corporate governance and corporate performance.

In recent years, the debate has focused on the activity of the board of directors: the most outstanding governance mechanism of the internal control systems. In fact, if other corporate governance mechanisms are weakened, the inefficiency of boards can be costly to organizations and to society as a whole (Lopez et al., 2005). However, much of the debate has concentrated in Europe and United States of America. The rest of the world, until recently has had lukewarm embracement of this debate.

In Africa, the Africa Capital Markets Forum has been undertaking a study on the state of corporate governance in Africa. The King's Committee Report and Code for Corporate Governance in South Africa published in 1994 continues to stimulate corporate governance debate in Africa. In the later part of 1998 and early 1999, consultative corporate sector seminars held in Kenya were the precursor to the Private Sector Initiative for Corporate Governance. This was envisioned to formulate and develop a code of best practice for corporate governance in Kenya. It was also mandated to explore ways of facilitating the establishment of a national body to promote corporate governance in this country and to coordinate developments in the area of corporate governance in Kenya and with other initiatives in East Africa, Africa, and the Commonwealth among others. It also gave mandate to the Private Sector Initiative to establish the Corporate Governance Foundation and collaborate with the Global Governance forum, the relevant Commonwealth association, and the African capital Markets Forum and Uganda and Tanzania in promoting good corporate governance (Center for Corporate Governance, 2003).

1.2. Statement of the Problem

Although there is a growing literature linking corporate governance to company performance there is, equally, a growing diversity of results. The diversity of results has been partly explained by differences in the theoretical perspectives applied, selected research methodologies, measurement of performance and conflicting views on board involvement in decision making and, in part, to the contextual nature of the individual firm. More specifically, Bauer et al. (2004) report evidence of a negative relationship between ratings on the extent of compliance with international best practices and firm operating performance, whereas Jensen (1993), predicts a positive relationships and a prior American study (Larcker et al., 2005) finds some (albeit weak) evidence of a positive relationship. Even studies based on the integrative models of board involvement; incorporating different theoretical perspectives and various board attributes, provide inconclusive results, suggesting that corporate governance has, at least, an indirect effect on company performance (Zahra and Pearce, 1989; Jonnergard and Svensson, 1995; Maassen, 1999).

Other researchers have examined the impact of board attributes on corporate governance, albeit arriving at conflicting results (Zahra and Pearce, 1989; Gopinath et al., 1994; McNulty and Pettigrew, 1996; Hung, 1998; Maassen, 1999). The conflicting results in these studies, in themselves, pose a knowledge gap, in that no conclusive evidence has been found to link corporate governance to financial performance. Further, none of the past studies have focused on parastatals. Additionally, most of these studies have been done in the developed world, hence there is need to develop an empirical study based on a developing country. Again, the allusion by Zahra and Pearce (1989) to the possibility of influence of firm specific contextual factors supports the need for a study that focuses specifically on parastatals.

Despite so many public concerns about poor corporate governance practices in the business sector, to date there has been very little empirical research that systematically examines corporate governance in Kenya, let alone in parastatals. Majority of studies carried out to examine corporate governance in Kenya were limited to the private sector (especially in banking institutions). In addition, not all of

the results of the studies were released to the public. Ayubi (1995) stated that very few countries have conducted their own empirical studies on the performance of their own public sectors. On this subject they have, on the whole, been prepared to take the word of 'experts' from the developed countries and their international organizations.

Hence, Kenya, as a developing nation, needs empirical evidence about corporate governance practices in parastatals and how those practices impact on their financial performance. As such, if poor corporate governance is the victim, then the more that is known about it, the more likely a suitable remedy can be applied to solve the problem and to prevent its recurrence. It thus follows that the more research on corporate governance, the more people will focus the attention on how to create the sound business environment needed to release the country from the economic crisis and to attain sustainable development growth.

This study seeks to fill the major gaps in knowledge by examining the relationship between corporate governance and financial performance specifically among parastatals in Kenya. It seeks to answer the question: What is the relationship between corporate governance and financial performance of state corporations in Kenya? How do we bridge the gap between corporate governance and performance in order to satisfy all the stakeholders? The conventional wisdom espoused by the Centre for Corporate Governance that poor governance and company profitability are directly related and the general understanding that good governance usually translates to companies' long-term existence and generation of profit takes center stage in this study. The criticality and dire need for good corporate practices in these corporations for their sustainable performance and growth is indispensable. It is for this reason that a study is necessary to investigate into the corporate governance practices in these corporations so that a plausible conclusion could be drawn regarding their nature and hence impact on the corporations' performance.

Whereas a number of studies (Wang'ombe, 2003: Mwangi. 2002; Mucuvi, 2002; Gakuo, 2001; Jebet, 2000 have been done on corporate governance, only a few (Wang'ombe, 2003, Mwangi, 2002; and Mucuvi, 2002 have looked at the corporate governance practices as the elements that determine the performance of organizations. Further still, while these studies looked at the corporate governance practices in

different contexts (Wang'ombe looked at co-operative societies in Nairobi, Mwangi did his study in the insurance industry, and Mucuvi in the motor industry'), no study has looked at the public sector organizations like the parastatals which form a great part of the Kenyan economy.

1.3. Objective of the Study

The objective of this study is to determine the relationship between corporate governance and financial performance of parastatals in Kenya.

1.4. Significance of the Study

For policy makers, the study will go a long way in helping them gain a deeper understanding on the role of corporate governance and performance of parastatals and hence come up with policies that will help firms improve their performance and in turn the performance of the economy at large.

To the management of the parastatals, it will give them an in depth understanding of corporate governance issues, the role of boards, audit reports and other relevant laws and institutions in the proper management of their corporations to enhance performance and to minimize waste.

To academicians and other researchers, the study is a contribution to the literature on corporate governance and the performance of the firm by filling the gap in the body of knowledge, particularly in parastatals.

CHAPTER TWO

2.0. LITERATURE REVIEW

2.1. Introduction

This chapter details literature of past studies done in the area of corporate governance. The first section introduces the concept of corporate governance and examines the global and Kenyan trends in corporate governance. It then examines critical aspects of corporate governance. The second section deals with firm performance. It illustrates how past studies have approached firm performance and concludes by giving the method to be adopted in this study.

2.1.1. Review of Theories

By using Agency theory, stakeholders' and Stewardship's theories we can explain the relationships between the agents and the principals given that parastatals have no real owner but they are loose coalition of various agents depending on the percentage of shareholding.

2.1.2. Agency Theory

Agency theory is the basic theoretical reference in corporate governance. Agency problems arise because of the separation of ownership and control (Jensen & Meckling, 1976). Agency theory posits that there is a potential conflict of interest between the shareholder (principal) and the management (agent). Managers will pursue their own interests and these may not be congruent with the shareholders' interests. Shleifer and Vishny (1997) suggest that expropriation of shareholders by managers can occur in many ways including empire building, perks, stealing and transferring money from the firms, insider trading, inappropriate investment due to management incompetence, and management entrenchment.

Agency theory and the corporate governance literature identify and propose an array of devices which can be used by investors to protect their investments from the self-interested motivations of managers. Examples include carefully designed executive compensation contracts, board of directors' control, and the market for corporate control. The key mechanisms of an effective corporate governance framework

identified by Keasey, Thompson, & Wright (1997) are ownership (including institutional and managerial ownership), directors and the board (including board structure), CEO and directors' remuneration, auditing and information, and the market for corporate control. The Cadbury Report (1992) recommends that firms should adopt model codes of governance (best practices) and stress the importance of these control mechanisms.

Corporate governance is a much discussed topic and many researchers have investigated the relationship between corporate governance and firm performance. Earlier studies focused on the direct relationship between governance and performance but the findings are mixed. Cubbin & Leech (1983) find a positive relationship between ownership concentration and profitability, while Demsetz & Lehn (1985) examine the endogenous relationships between ownership and performance and find an insignificant relationship between them. Jensen and Murphy (1990) find that the explanatory power of the CEO's pay for performance relationship is very low and this casts doubts on the descriptive validity of agency theory. They suggest that it is important to test the explanatory value of alternative paradigms to the agency based models. In a similar vein, Barkema & Gomez-Mejia (1998) suggest that in order to understand fully the CEO compensation issue it is necessary to examine the organization factors. On the effectiveness of the board of directors, agency theory argues in support of outsider representation on the board and the separation of the CEO/chairman positions. Dalton, Daily, Johnston, & Ellstrand (1998) in a meta-analysis of studies relating to board effectiveness (CEO duality and the insider/outsider proportion of the board) conclude that these two aspects of governance have no direct relationship to firm performance. Heracleous (2001b) concludes that studies have failed to find any convincing connection between the 'best practices' in corporate governance and organization performance. Although agency theory provides a theoretical basis for corporate governance mechanisms and possibly explains the one-to-one relationships between corporate governance constructs and firm performance, its descriptive validity is weak. This is due to firms operating under the influence of many governance mechanisms, and agency theory alone has little relevance in predicting the relationships among corporate governance mechanisms and performance.

Dennis, Dennis & Sarin (1999) and Amihud & Lev (1999) use agency theory to explain the relationship between ownership structure and diversification; Lane, Cannella, & Lubatkin (1999) on the other hand, use a strategic management perspective to explain the same relationship and they reach a different conclusion. In sum, agency theory, stewardship theory, strategic management, and other management theories may give contrasting predictions on the relationships among corporate governance and firms' financial performances.

2.1.3. Stakeholders' Theory

As originally detailed by R. Edward Freeman (1984), stakeholder theory identifies and models the groups which are stakeholders of a corporation, and both describes and recommends methods by which management can give due regard to the interests of those groups. In short, it attempts to address the "Principle of Who or What Really Counts." In the traditional view of the firm, the shareholder view (the only one recognized in business law in most countries), the shareholders or stockholders are the owners of the company, and the firm has a binding fiduciary duty to put their needs first, to increase value for them. In older input-output models of the corporation, the firm converts the inputs of investors, employees, and suppliers into usable (saleable) outputs which customers buy, thereby returning some capital benefit to the firm. By this model, firms only address the needs and wishes of those four parties: investors, employees, suppliers, and customers. However, stakeholder theory argues that there are other parties involved, including governmental bodies, political groups, trade associations, trade unions, communities, associated corporations, prospective employees, prospective customers, and the public at large. Sometimes even competitors are counted as stakeholders.

The stakeholder view of strategy is an instrumental theory of the corporation, integrating both the resource-based view as well as the market-based view, and adding a sociopolitical level. The political philosopher Charles Blattberg has criticized stakeholder theory for assuming that the interests of the various stakeholders can be, at best, compromised or balanced against each other. Blattberg argues that this is a product of its emphasis on negotiation as the chief mode of dialogue for dealing with conflicts between stakeholder interests. He recommends

conversation instead and this leads him to defend what he calls a 'patriotic' conception of the corporation as an alternative to that associated with stakeholders' theory.

2.1.4. Stewardship Theory

Whereas agency theory has its origins in economics, stewardship theory has emerged from the fields of psychology and sociology. It grew out of the seminal work by Donaldson and Davis (1989, 1991) and was developed as a model where senior executives act as stewards for the organization and in the best interests of the principals. The model of man in stewardship theory is based upon the assumption that the manager will make decisions in the best interest of the organization, putting collectivist options above self-servicing options. This type of person is motivated by doing what's right for the organization, because she believes that she will ultimately benefit when the organization thrives. The steward manager maximizes the performance of the organization, working under the premise that both the steward and the principal benefit from a strong organization. In contrast to the controls put in place through agency theory, the principal who espouses stewardship theory will empower the steward with the information, the tools and the authority to make good decisions for the organization. The principal will fully enable the steward to act in the best interest of the organization, trusting that the steward will make choices that maximize the long-term return for the organization. In fact, putting control structures on stewards will significantly de-motivate the steward and be counterproductive for both the steward and for the organization. Given the upside potential of stewardship theory, why have most organizations not adopted this approach? The issues come back to the risk tolerance of the principal and the typical assumptions of the principal. In the short run, it's safer and quicker for a principal to assume agency theory and to not invest the time and energy required to build the requisite trusting relationship with the manager. The principal must be able to overcome this inherent fear before he is willing to place full authority for the business in the hands of the steward.

It is important to note that Donaldson and Davis (1991) argued that agency theory places limits on the upside potential for the business; agency theory is focused on controlling costs and minimizing downside, while stewardship theory is focused on maximizing the upside of the relationship. Given the potential of stewardship theory, how does one find and develop a manager who could become a steward for the

organization, as opposed to an economic man? In the influential work done by Davis, Schoolman and Donaldson (1997), they defined a series of factors that describe the management philosophy of stewardship and they include: trust, open communication, empowerment, long-term orientation and performance enhancement. The dimensions of open communication and empowerment are consistent with Walton (1985) in his work on high-commitment organizations. The long-term orientation and empowerment facets are consistent with Lawler (1986) in his work on involvement oriented approaches. The dimension of trust is essential to building the type of relationships necessary to make stewardship work and is consistent with the work done by Mayer, et al., (1992).

2.2.0. Other Relevant Issues

2.2.1. Corporate Governance In Kenya

As is the trend with other countries, corporate governance has gained prominence in the Kenyan context. Notwithstanding the corporate governance concerns globally, the Kenyan environment is mainly shaped by corporate experiences, particularly corporate failures or poor performances of public and private corporations. For instance, affirming this fact, the former Governor of the central bank of Kenya, presenting a paper on Kenyan corporate governance experience in the banking sector commented "bad corporate governance has led to the failure of 33 banks in Kenya in 1985" (Banki Kuu News, October-December 2000).

An important player in developing corporate governance framework in Kenya is the Centre for Corporate Governance (CCG) Kenya, an affiliate of the Commonwealth Association for Corporate Governance (CACG). In November 1999, the Centre for Corporate Governance developed principles for Corporate Governance in Kenya to be adopted voluntarily by companies. This document substantially constituted the draft Corporate Governance Practices for Listed Companies in Kenya (2000) issued by the Capital Markets Authority, which subsequently in 2002 became a mandatory guideline for all listed companies in Kenya. The guideline and the sample code mainly deal with issues of the Board (for example, composition, role of audit committee, separation of the role of the board chair and CEO) and the rights of shareholders.

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In 2005, in line with the emphasis on the need to improve the quality of financial reporting and governance by Kenyan companies, the Centre for Corporate Governance issued a draft Corporate Governance Guidelines on Reporting and Disclosures in Kenya. The emphasis of the draft guidelines is on non-financial disclosures, such as ownership, board (composition, qualifications, committees, meetings) auditor independence and corporate social responsibility.

2.2.2. Global corporate governance

The World Bank Group and the Organization for economic Co-operation and Development have established the Global corporate Governance Forum to build a consensus in favor of appropriate policy, regulatory and corporate reforms, co-ordinate and disseminate corporate governance activities, provide corporate development and human capacity building in the associated fields of corporate governance and train the various professionals and other agents who are essential to bringing about a culture of compliance.

During the October 1997 commonwealth Heads of Government in Edinburgh it was solved that capacity should be established in all Commonwealth countries to create or reinforce corporations to promote good corporate governance in particular, codes of good practice establishing standards of behavior in public and Private sector should be agreed to secure greater transparency and to reduce corruption. The Commonwealth Association for Corporate Governance was subsequently established and developed that The CAGG Guidelines- Principles for Corporate Governance in the Commonwealth which were adopted at the November 1999 Commonwealth Heads of Government in Durban, South Africa, as guidelines for all Commonwealth countries to develop or enhance their own national corporate governance principles (The Pan African Consultative Forum on Corporate Governance, 2004).

Determinants of corporate performance have been grouped into three main areas, namely: board attributes, board committees and Audit Committees. The following section looks at the components of each of these sub groups in turn.

2.3.0 Board Attributes

The corporate governance literature identifies four sets of board attributes; namely, composition, characteristics, structure and process (Zahra and Pearce, 1989; Maassen, 1999).

2.3.1 Independent directors

The focus on board independence is grounded in agency theory (Fama and Jensen, 1983). In fact, it has long been argued in the finance literature that boards with a corporate governance majority of independent directors are more effective in monitoring management (Bay singer and Butler, 1985; Rosenstein and Wyatt, 1990; Byrd and Hickman, 1992; Morck and Nakamura, 1994; Kaplan and Minton, 1994; Bhagat and Black, 2002) and are more likely to replace poorly performing CEOs (Weisbach, 1988). More independent boards are also more likely to opt for a clean slate when company performance deteriorates significantly, and to hire a replacement CEO from outside the firm rather than promote an internal candidate (Borokhovich et al., 1996; Huson, 2001).

2.3.2 Board size

The size of the board has been shown to have a material impact on the quality of corporate governance. Several studies support the idea that large boards can be dysfunctional. Hermalin and Weisbach (2003) believe that board size proxies for the board's activity, explaining why smaller board sizes are better than larger ones that may be plagued with free rider and monitoring problems. For example, Yermack (1996) and Eisenberg et al. (1998) find a negative relation between board size and firm value, indicating that smaller boards are more effective since they experience fewer communication and coordination problems.

2.3.3 Split chairman/CEO roles

The question of whether the chairman and CEO positions should be separate has been controversial. The advantages and the drawbacks of separating the chairman and CEO positions have been studied extensively. Jensen (1993) argues that separating CEO and chairman roles is in the shareholders' interest. Similarly, large firms that separate the two functions trade at higher price-to-book multiples (Yermack, 1996) and have higher return on assets and cost efficiency ratios (Pi and Timme, 1993) than firms where the same person holds both titles. In addition, bestowing the CEO and

chairman duties on one individual makes it harder for a board to replace a poorly performing CEO (Shivdasani and Zenner, 2004), which can reduce the flexibility of a board to address sizable declines in performance (Goyal and Park, 2002). On the other hand, Brickley et al. (1997) find no evidence that separating these roles improve firm performance.

More precisely, combining the positions of chairman and CEO confers greater power to the CEO, who gains the title of chairman after having outperformed his/her peers (Brickley et al., 1997). So the chairman title serves as a reward to a new CEO who has demonstrated superior performance and represents an implicit vote of confidence by outside directors. Then, requiring companies to separate the positions of CEO and chairman would deprive boards of an important tool to motivate and reward new CEOs (Brickley et al., 1997).

2.3.4 Board meetings

Boards should be ready to increase meetings frequency if the situation requires a high supervision and control (Shivdasani and Zenner, 2004). Other studies suggest that boards should balance the costs and benefits of frequency. For example, if the board increases the frequency of its meetings, the recovery from poor performance is faster (Vafeas, 1999).

2.4.0 Audit Committees

2.4.1 Independence of committees

Similarly, independence is also considered important for a board committee to be an effective monitor (Klein, 1998). John and Senbet (1998) report empirical evidence showing that the presence of monitoring committees (audit, nomination, and compensation committees) is positively related to factors associated with the benefits of monitoring. However, the presence of insiders in the compensation committees increases the probability of making decisions in favor of the CEO's interests (Newman and Mozes, 1999). Moreover, when the CEO sits on the nominating committee or when no nominating committee exists, firms appoint fewer independent outside directors and more gray outsiders with conflicts of interest (Shivdasani and Yermack, 1999). In addition, the stock market's reaction to appointments of independent outside directors is more positive when the director's selection process is viewed as relatively independent of CEO involvement

(Shivdasani and Yermack, 1999). Klein (2002) shows that independent audit committees reduce the likelihood of earnings management, thus improving transparency. Finally, when the CEO serves on the nominating committee, the audit one is less likely to have a majority of independent directors (Klein, 2002).

2.4.2 Competence of audit committee members

Audit committee's members are in charge of overseeing internal control and financial reporting, so they should possess a certain level of financial competency (Be´dard et al., 2004).

2.4.3 Independent assurance function of external auditors

The financial statements of all parastatal organisations should be subject to an independent audit. This is usually undertaken by the Auditor-General or by private-sector auditors working on his or her behalf. The audit reports should be primarily addressed to Parliament rather than to the parastatal organisation itself. In addition, the Public Accounts Committee of Parliament should use the audit reports to assist with holding the governing body and the chief executive to account for their decisions and for the management of the organisation. The Auditor-General represents the wider public-sector interest in parastatal organisations and thus has a wider scope compared with an auditor in the private sector. The audit of parastatal organisations, as for other public-sector entities, should be of the whole of the financial management of the organisation, including specific consideration of probity and regularity, rather than of its accounts alone.

2.4.4 Audit committee meetings

To carry out its function of control the audit committee must maintain a certain level of activity through increased frequency of meetings (Be´dard et al., 2004).

2.4.5 Effective corporate governance and institutional ownership

The role that the institutional investors can play in the corporate governance system of a company is a controversial question. Some studies show that the institutional investors must interfere in the corporate governance system of a company. The result of these studies shows that if the corporate governance system in the companies succeeds, then the institutional investors must play an active role in the entire process. For example, Shleifer and Vishny (1986) observe that institutional investors by virtue of their large stockholdings would have greater incentives to monitor corporate

performance since they derive greater benefits from monitoring. Cremers and Nair (2005) argue that some institutional investors such as pension funds might have more incentives to monitor than others and act as more aggressive shareholder activists. Other studies find that institutional investors need not play a role in the corporate governance system of a company. For example, Wharton et al. (1991) argue that institutional investors need not take active interest in the corporate governance of a company because the institutional investors have their primary fiduciary responsibility for their own investors and beneficiaries, which can lead to a conflict of interest with their acting as owners. For instance, Monks (1995) has argued that absence of appropriate incentives and free rider problems hinder institutional activism efforts. Some recent research, however, shows that companies with good governance system have actually generated risk-adjusted excess returns for their shareholders and hence, if an institutional investor invests in companies with good corporate governance records, it will actually help its own shareholders. Ajinkya et al. (1999) found a positive relationship between financial analysts' ratings of corporate disclosure practices and institutional stock ownership. Overall, it is not clear from the current literature how the institutional ownership affects the strength of monitoring. However, the literature suggests that the nature of these institutional investors might be important in determining their willingness to monitor.

2.4.6 Effective corporate governance and managerial ownership

Jensen and Meckling (1976) argue that the agency problems can be minimized when managers have an ownership interest in the company. This convergence-of-interest model maintains that the interests of management and shareholders become more aligned and the incentive to indulge in opportunistic behavior diminishes as the proportion of equity owned by insiders increases. In this area, insiders and managers and directors who, in addition to being shareholders, also participate in the decision-making process. In this context, a large body of literature suggests that, for most companies, managerial ownership helps executives make better decisions, which enhances corporate governance quality. For example, Lewellen et al. (1985) and Loderer and Martin (1997) show that when executives have larger ownership stakes, acquisition decisions are received more positively by the market. Although increased managerial ownership could indicate the presence of managerial entrenchment, it has been argued that managers could indulge in opportunistic behavior which is contrary

to shareholders' interests. However, this opportunistic behavior can be minimized if firm adopt certain governance characteristics relating to incentive and monitoring mechanisms (i.e. strong governance).

2.5.0 Corporate Governance Practices

From the principles of corporate governance, (Wang'ombe, 2003, Mwangi, 2002; and Mucuvi, 2002) identified the following as the corporate governance practices, which this study will adopt to form the variables of study.

Leadership: the corporations should be headed by effective boards exercising leadership, enterprise, integrity, and judgment in directing the corporations so as to achieve continuing prosperity and to act in the best interest of the corporations in a manner based on accountability, transparency and responsibility.

Appointment to the board: appointment to the board ought to ensure that a balanced mix of proficient individuals is made and that each of those appointed is able to add value and bring independent judgment to bear on the decision-making process.

Strategy values: the boards of directors are expected to determine the purpose and the values in order to ensure that the corporations survive and thrive. The boards should also ensure that procedures and values that protect the assets and reputation of the corporations are in place.

Structure and organization: the boards should ensure that proper management structure is in place and make sure that the structure functions to maintain corporate integrity, reputation and responsibility.

Corporate performance, viability, and financial sustainability: the boards are expected to monitor and evaluate the implementation of strategy, policies, management performance criteria and plans of the organizations. The boards are expected to also constantly review the viability and financial sustainability of the corporations at least annually.

Corporate compliance: the boards should monitor and evaluate the corporations' compliance with the relevant laws, regulations, and governance practices, accounting and auditing standards.

Corporate communication: the boards need to ensure that the organizations communicate with all the stakeholders effectively.

Responsibility to stakeholders: the boards should identify the corporations' internal and external stakeholders; agree on policies on determining how the corporations relate to and with stakeholders in creating wealth, serving the public, creating jobs, and the sustainability of financially sound corporations. They should ensure that the rights of stakeholders are respected, recognized, and protected.

Balance of power: it is the responsibility of the boards to ensure that no person or group of persons has unvested power and that there is an appropriate balance of power on the boards to enable them exercise objective and independent judgment Internal control procedures: the boards must regularly review systems, processes and procedures to ensure effectiveness of internal controls so that their decision-making capabilities and accuracy of their reporting and financial results are maintained at the highest level at all times.

Assessment of performance of the boards of directors: for effective governance to take place, the boards need to regularly assess their performance and effectiveness as a whole and that o the individual members. An effective board will recognize its weaknesses and put in place mechanisms for self-evaluation and possible categories of evaluation may include the role, the working style and the directors themselves. The valuation may be, performed by the members of the board, management or by outside consultants. The evaluation should ideally cover topics such as attendance to board and committee meetings, participation in board discussions, preparedness for meetings and availability to management etc.

Induction, development and strengthening of skills of board member: the weighty responsibilities placed upon a director, the level of commitment called for, and the fast changing corporate environment, dictate that the corporations must prepare those expected to assume these roles, and calls on all members to develop and strengthen governance skills. The boards should accordingly recognize systematic induction and continuous development of their members.

Appointment and development of executive management: the boards will appoint the CEOs and participate in the appointment of all senior management staff and

ensure motivation and protection of intellectual capital to the corporations. They should also ensure availability of adequate training for management and other employees and put in place a succession plan for senior management.

Adoption of technology and skills: the boards must recognize that to survive and thrive, they have ensure that technology, skills and systems in the corporations are adequate to run the corporations and that the corporations regularly review the same to remain competitive.

Management of corporate risks: the boards will identify key risk areas and key performance indicators of the corporations' businesses and constantly monitor the factors.

Corporate culture: the boards should define, promote and protect corporate ethos, ethics, and beliefs on which the corporations premise their policies, actions and behaviors in their relationships with all who deal with them.

Recognition and utilization of professional skills and competencies: the boards will recognize and encourage professional development and have the right to consult with the corporations' professional advisors and consult with independent advisors at the corporations' expense.

2.5.1. Reforming Corporate Governance

Scandals witnessed in corporations have shown the importance of pursuing profits within ethical bounds, and the danger of executives and shareholders enriching themselves by exhorting the public or employees. Toothless codes of ethics like no help. Ethical concerns must grow teeth- which mean biting into reform of corporate governance. While most proposals for reform today merely tinker at the margins, some get to the heart of the matter (Estes, 2002). A number of practices have come up to strengthen corporate governance.

Stock exchanges in many countries of the world are coming up with new rules aimed at ensuring the quality of disclosure by preventing harmful conflicts that were evident in the most spectacular recent bankruptcies. The NYSE requires firms to get shareholders approval for all stock option plans. They must also have a majority of independent directors in their boards and only independent directors on the audit committees and the committees that select chief executives and determine pay. US

companies are now prohibited from providing subsidized loans to executives, and require bosses to reimburse incentive-based compensations if profits are found to have been misstated. In Kenya, the Capital Markets Authority issued guidelines for observance by companies listed in Kenya, in order to enhance corporate governance practices by such companies. These guidelines came into effect on 14th January 2002 (CMA, 2002). There are moves to ensure auditors really audit by making them fully independent. Auditors are not the tools of management. They are the eyes and ears of shareholders (who own the company) and no bonds or other deals should be put above the ownership of shareholders (without their permission). Instead of having companies as the "bosses" of their own auditors- selecting and paying the firms they want to work with - a Corporate Accountability Commission could assign auditors and pay them from fees assessed on companies. The commission would be empowered to expand reporting requirements beyond stockholder needs to encompass data needed by other stakeholders-such as pollution emissions, wages and benefits paid, and corporate welfare received (Estes, 2002).

2.5.2. Pillars of Good Governance

In all fields of human endeavor good governance is founded upon the attitudes, ethics, practices and values of the society regarding accountability of power based on the fundamental belief that power should be exercised to promote human well being, democratic values in respect of the sharing of power, representation and participation, the sense of the right and wrong, what is fair and just, work ethics, technology and continuing corporate social responsibility, efficient and effective use of resources for the production of goods and services, protection of human rights and freedoms and the maintenance of essential order and security for the person and his \her property and recognition of the government as the only entity to which the society gives authority to use the coercive power to maintain public order and national security , collect taxes , re-locate society's resources to meet the public needs and use that coercive power to confiscate assets , deprive a person of liberty or life but provided that always that such power and authority are not used to suppress, oppress and deny basic human rights and freedoms. In Corporate Governance the above can be summarized into five basic tenets namely; accountability, efficiency and effectiveness, integrity and fairness, responsibility and transparency (Ledgerwoods, 1981).

2.6.0. Parastatals

There is no universally accepted definition of the term 'parastatal'. Mazzolini (1976) defines a parastatal as a company for which the ultimate formal authority rests in the hands of the state. Aharoni (1986) describes parastatal as an enterprise with a corporate identity where capital is wholly or substantially provided by the government. According to Aharoni (1986), a parastatal has three distinguishing characteristics. Firstly, a parastatal is part of the public sector, therefore, it must be owned by the government. Secondly, a parastatal is an enterprise and therefore it must engage in production and sale of goods and services. Thirdly, the sales revenue of a parastatal should bear some relation to cost. In view of that, parastatals are the 'hybrid parts of the state'. (Birkinshaw et al., 1990). As such, they have two features of both private and public sector organizations.

As long as parastatals remain in public ownership, there will be continued pressure from interest groups for special treatment (NZ Business Roundtable, 1988). According to Hart (1995) corporate governance issues arose wherever two conditions are present. Firstly there has to be an agency problem, or conflict of interest, involving members of the organization: the owners, managers, workers or customers. Secondly, transaction costs are such that the agency problem cannot be dealt with through a contract. Transaction costs are the costs of formulations, maintenance and enforcing a relationships based on written or unwritten contracts within markets and hierarchies (Gay, 2002)

2.6.1. Rationales and Motives for parastatals

One of the arguments as to why many governments establish parastatals is because they can be used by government to fulfill their expanded roles by controlling certain key sectors, filling gaps left open by the private sector, rescue operations, or dogmatic motives (Mazzolini, 1979).

In the African context, it is particularly important to talk about corporate governance as it relates to parastatals. In Africa, as elsewhere in the world, it is primarily parastatals that work in the natural resource sector. These companies exert huge influence over their national economies, and therefore, it is essential that they adopt good corporate governance. However, because parastatals have been put in the command position in the economy, good corporate governance and growth in this

sector would lead to development in other sectors. For example, seeing the positive applications for parastatals, in April 2003, Kenya launched its guidelines on corporate governance and state owned enterprises. Shortly thereafter, the government introduced performance contracting in parastatals. Today, performance contracting has been introduced into the ministries, and into local administrations. It is mandatory for directors who sit on the boards of state-owned companies to be trained in corporate governance as part of their performance contracts. Furthermore, in public procurement, the government requires transparent disclosure by all involved parties.

Economists traditionally viewed parastatals as curing market failures (Atkinson and Stilglitz, 1980). Parastatals are controlled by governments to maximize social welfare and improve on the decisions of private sectors when monopoly power or externalities introduce divergence between private and social objectives (Shleifer and Vishny, 1994). Parastatals are also claimed to be productively efficient, and charge prices that more accurately reflect social marginal costs (Ibid). Herein, parastatals are believed to have superiority over private enterprises, particularly in their capability to boost the economy and to better serve the public interest.

Fernandes (1986) identifies five motives for the establishment of parastatals. The first is the national strategy of a country. The argument is that there are certain critical areas of the economy that are too important to be left in the hands of the private sector, particularly in the area of national defense that should be in public hands. The second is the concept of 'natural monopolies'. If certain activities can be performed on a monopoly basis, then the government should exercise the monopoly rights and plough back the surplus to national development. The third is the concept of 'commanding heights' – the belief that the state can 'mastermind' the economy and promote development by control over certain infrastructural and basic economic sectors more effectively. The fourth is the fact that there are 'unattractive' investments- areas of investment which do not attract private capital particularly in areas characterized by slow growth, high risk, low profitability and calling for massive investments for which private capital is not available. Finally, the absence of an organized domestic private sector particularly in countries where the existing private sector is foreign owned.

2.6.2. Problems afflicting parastatals

Many reasons have been given as to why the positive impacts of the parastatals have not been felt. Some of the reasons are as follows:

-**Politicization and poor corporate governance** – boards of parastatals are appointed by political powers (the president and the minister) as the chief executives. Thus many operational decisions are not necessarily non partisan;

-**Weak supervisory mechanism** – the role of the parastatals' advisory committee is just advisory yet it could play a more powerful role as a monitor and evaluator of performance;

-**The structure of financing and financial management** – many parastatals are allocated funds through line ministries thus end up being chronically underfunded. They are allowed to borrow funds but many have not repaid their loans. Expenditure controls are weak; Prosecution of chief executives for abuse of office and misappropriation of funds is usually not carried out.

More profoundly, however, the governance troubles at the parastatals have been a symptom of a more generalized policy muddle about what the Kenyan government wants parastatals to do and how to get them to do it. Are they primarily money-making enterprises, in which case, why are they state-owned? Or do they have a developmental role? If so, how can the state mandate and incentivize them to pursue that role in ways that do not end up costing taxpayers a fortune? As long as the government is not clear on just what kind of enterprises it wants, it is difficult to decide what kind of people should take leadership roles and how they should be selected.

Parastatals in Kenya have been experiencing a myriad of problems, including corruption, nepotism, and mismanagement (Daily Nation, March 12, 2003; Petiffor, 2001, free dictionary.com, 2004). For example, a World Bank (2004) article stated as follows: A key area for corruption-busting reform is the parastatals sector. When compared to similar economies, Kenya has an over-abundance of state corporations many of which are a drain on public resources; more to the point, they have been the locus of corruption that thrives in public monopolies, especially when coupled with

lax oversight, management and fiduciary control procedures. An area of parastatals dominance that cries out for reform is the financial sector.

For years the financial sector was the vehicle for illegal and corrupt transactions, not to mention mismanagement – the result is that the public sector banks are left holding loans, up to 30 percent of which are non-performing, with the result being restricted credit availability to honest individuals. In fact from the Public Investment Committee reports of 2002, out of 130 reports examined by the Auditor General –Corporations, only 23 managed a clean bill of health. The general story is one of loss, fraud, theft and gross mismanagement.

2.6.3. Principles of governance

The Report of the Committee on the Financial Aspects of Corporate Governance (the Cadbury Report) defined corporate governance as "the system by which organisations are directed and controlled". It identified the three fundamental principles of corporate governance as: Openness, Integrity and Accountability.

These principles are relevant to all parastatal organisations. Parastatal organisations usually have to satisfy a complex range of political, financial and social objectives, which subject them to external constraints and influences. They are also subject to different forms of accountability to their various stakeholders. These three principles have been developed and redefined to reflect the public-sector context.

2.6.4. Principles of governance in the public-sector context

Openness- Openness is required to ensure that stakeholders can have confidence in the decision-making processes and actions of parastatal organisations, in the management of their activities, and in the individuals within them. Being open through meaningful consultation with stakeholders and communication of full, accurate and clear information leads to effective and timely action and stands up to necessary scrutiny.

Integrity- Integrity comprises both straightforward dealing and completeness. It is based upon honesty and objectivity, and high standards of propriety and probity in the stewardship of public funds and resources, and management of an organisation's affairs. It is dependent on the effectiveness of the control framework and on the

personal standards and professionalism of the individuals within the organisation. It is reflected both in the organisation's decision-making procedures and in the quality of its financial and performance reporting.

Accountability-Accountability is the process whereby parastatal organisations, and the individuals within them, are responsible for their decisions and actions, including their stewardship of public funds and all aspects of performance, and submit themselves to appropriate external scrutiny. It is achieved by all parties having a clear understanding of those responsibilities, and having clearly defined roles through a robust structure. In effect, accountability is the obligation to answer for a responsibility conferred. Stakeholders will include the electorate, elected representatives (Parliament), providers of resources (taxpayers, lenders, bondholders and creditors), service providers and partners (employees and their trade unions, contractors and other government organisations) users of services (individuals and businesses who benefit from the services that the organisation provides), interest groups, analysts and other statistics gatherers (policy analysts, economists, financial analysts, rating agencies), the media and the wider community.

These fundamental principles are reflected in each of the dimensions of the governance of parastatal organisations:

Standards of behaviour – how the governing body, chief executive and senior management of the organisation exercise leadership in determining the values and standards of the organisation, which in turn define the culture of the organisation and the behaviour of everyone within it.

Organizational structures and processes – how the governing body, chief executive and senior management within organisations are appointed and organized, how their responsibilities are defined, and how they are held to account .

Control – the network of various controls established by the governing body, chief executive and senior management of the organisation to ensure that the achievement of the organisation's objectives, the effectiveness and efficiency of operations, the reliability of internal and external reporting are achieved.

Compliance with applicable laws and regulations and internal policies and;

External reporting – how the governing body and chief executive and senior management of the organisation demonstrate their financial accountability for the stewardship of public money and the organisation's use of resources.

2.7.0 Financial Performance

Blair (1995) puts forward five major areas in which financial performance can be examined. These include: Liquidity, Solvency, Profitability, Financial efficiency and Repayment capacity. The association between quality of corporate governance and firms' profitability is quite a major focus in corporate governance studies, but one cannot predict much on the direction as prior literatures show mixed results. Jensen and Meckling (1976) have proven that better-governed firms might have more efficient operations, resulting in a higher expected future cash-flow stream. In Brown and Caylor (2004), the result of the Pearson Correlations used in the study provides evidence that all measures of return except for one-year return; and all measures for profitability are significantly positively correlated with the CGQ scores that represent quality of corporate governance. Klapper and Love (2003) use return on assets as measure for performance found evidence that firms with better governance have higher operating performance. Contrast results are seen in Gompers et al. (2003), Beiner et al. (2004) and Bauer et al. (2004). According to Cho and Kim (2003), company would enhance their corporate governance when the company's performance is poor because changes in corporate governance structure are expected to bring out positive result on their performance. Many factors inform performance in organizations. According to Senge (1999) organization is considered as a structural process in which individuals bound together in a formal relationship and interacts with each other to accomplish certain common objectives. The success of any organization depends highly on the efficiency, role performance and job satisfaction of its employees. The study revealed that factors like affiliation, recognition, behavior of superior and self perception of job responsibility had positive and significant relationship with the job performance. The overall level of job performance was moderate.

2.7.1. Corporate Governance and Financial Performance

There are, generally speaking, two reasons why good corporate governance increases firm value. First, good governance increases investor trust. Investors might perceive well-governed firms as less risky and apply a lower expected rate of return, which

leads to a higher firm valuation. Secondly, as shown for example by Jensen and Meckling (1976), better-governed firms might have more efficient operations, resulting in a higher expected future cash-flow stream. In theory, good corporate governance should be related to high-corporate valuation. A number of empirical studies have found that investors are willing to pay a premium averaging 10-12 percent for good corporate governance. The correlation of the governance index with performance could be explained in several different ways. One explanation, suggested by the results of other studies, is that inefficient governance directly causes additional agency costs. If the market estimates these additional costs, then stock returns will drop. An alternative explanation is that good governance is a signal or symptom of lower agency costs – a signal not properly incorporated in market prices. Each of these explanations has different economic implications for the source of agency problems and different policy implications for the regulation of governance. To examine this relationship, this study adopts Gillans model with a slight modification on the dependent variables. Determinants of corporate performance have been grouped into two main areas, namely: Independence of the Board and duality of the Chief Executive.

According to the shareholder model the objective of the firm is to maximize shareholder wealth through allocative, productive and dynamic efficiency i.e. the objective of the firm is to maximize profits. The criteria by which performance is judged in this model can simply be taken as the market value (i.e. shareholder value) of the firm. Therefore, managers and directors have an implicit obligation to ensure that firms are run in the interests of shareholders. The underlying problem of corporate governance in this model stems from the principal-agent relationship arising from the separation of beneficial ownership and executive decision-making. It is this separation that causes the firm's behavior to diverge from the profit maximizing ideal. This happens because the interests and objectives of the principal (the investors) and the agent (the managers) differ when there is a separation of ownership and control. Since the managers are not the owners of the firm they do not bear the full costs, or reap the full benefits, of their actions. Therefore, although investors are interested in maximizing shareholder value, managers may have other objectives such as maximizing their salaries, growth in market share, or an attachment to particular investment projects, etc.

Parastatals in Kenya are established with the expectation that they would earn a surplus and also accomplish other social objectives not necessarily financial in nature; they would establish businesses to provide goods and services deemed necessary for development; they may engage in projects with large capital outlay, which while necessary for development are unattractive to the private sector; and that they may provide much needed direction, support to commercial enterprises and act as the consumer's watchdog (Nyamongo, 1993).

2.7.2. Empirical Studies

Empirical work on corporate governance has undergone a remarkable growth in recent times, especially in advanced countries where data are available. Various theorists of corporate governance have tried to examine the link between corporate governance and the general well being of a firm. Studies have indicated that corporate governance impacts on firm performance. For instance, McConnell and Serveas (1990) reported a significant relationship between ownership concentration and firm value. In related work from India, Sarkar and Sarkar (2000) reported a relationship between ownership concentration and firm performance. But Demsetz and Lehn (1985) found no relationship between ownership concentration and firm performance. Klapper and Love (2003) use return on assets as measure for performance found evidence that firms with better governance have higher operating performance. Contrast results are seen in Gompers et al. (2003), Beiner et al. (2004) and Bauer et al. (2004). According to Cho and Kim (2003), company would enhance their corporate governance when the company's performance is poor because changes in corporate governance structure are expected to bring out positive result on their performance.

Many factors inform performance in organizations. According to Senge (1999) organization is considered as a structural process in which individuals bound together in a formal relationship and interacts with each other to accomplish certain common objectives. The success of any organization depends highly on the efficiency, role performance and job satisfaction of its employees. Companies with better corporate governance have better operating performance than those companies with poor

corporate governance (Black, Jang, and Kan, 2002) which was concurrent with the view that better governed firms might have more efficient operations, resulting in higher expected returns (Jensen and Meckling, 1976). It is also believed that good corporate governance helps to generate investor goodwill and confidence. Another study had demonstrated that the likelihood of bankruptcy is related to poor corporate governance characteristics (Daily and Dalton, 1994).

CHAPTER THREE

3.0. RESEARCH METHODOLOGY

3.1. Introduction

In this section, the methods employed in the study in testing the research hypotheses are described. The specifics of data collection, and the methods applied to empirically assess the proposed framework are described.

3.2. Research Design

The study adopted a causal design. The method was appropriate for this study as the study sought to determine whether there was a relationship between corporate governance and financial performance of parastatals. The relationship established shows that an independent variable, and nothing else, causes a change in a dependent variable. It also establishes how much of a change is shown in the dependent variable.

3.3. Population

The population of interest in this study consisted of all the parastatals in Kenya. There were 158 Parastatals as obtained from the Inspectorate of State Corporations - Office of the President as at March 2009. Parastatals are government-owned corporation. Parastatal is a legal entity created by a government to undertake commercial or regulatory activities on behalf of an owner-Government. Every permanent secretary of a parent ministry is required to be a board member of the Ministry's parastatal. These state corporations are both directly or indirectly regulated by the various regulatory boards and also operate under various ministries and sectors of the economy. The government has substantial control in the affairs of the parastatals regardless of the percentage holdings, though by definition, parastatals must have more than 50% of the government's shareholding.

3.4. Sample Design

The study investigated a total of 79 state corporations. The sample was selected by way of Government of Kenya (GOK) shareholding in the state corporations. The corporations were stratified into three main strata for purposes of sampling. The first

stratum consisted of corporations in which the government has 100% ownership, the second stratum consisted of those in which the government is a major shareholder (51%-99%), while the last stratum consisted of those in which it is a minority shareholder (50% and below). The study then randomly drew 50% of the corporations from each stratum to add to the sample as shown below.

Table 3.1: Sampling table

GOK Shareholding	Number of State Corporations	Sample (50%)
100%	142	71
51-99.9%	12	6
50% and Below	4	2
Total	158	79

3.5. Data Collection

The study used primary data collected through semi-structured questionnaires with both open and closed ended questions. The questionnaires were constructed using information on best code of practice of corporate governance alongside which responses from a particular corporation were benchmarked. The questionnaires were administered directly to the respondents. The respondents of the study were CEOs, Board members and/or any other designated senior management officers in the state corporations.

The variables of interest were measures of firm performance, corporate governance characteristics and firm specific heterogeneity. For firm

performance variables, the study focused on profitability due to availability of data and the choice of statistical analysis. The study then employed one variable for the measurement of performance: Return On Assets (ROA).

The analysis was based on information from annual reports over the five year period from 2005 to 2009 available at the then Controller and Auditor General's office. Liquidity and solvency of the parastatals, revenue growth, profitability and financial position as reflected by Surplus funds, increase in interest and dividend income were some of the financial information collected from these reports.

3.6. Pilot test

Before going to the field, the research instruments were pre-tested to check for validity and to correct any technical anomalies.

3.7. Data Analysis

The variables that were used in the analysis were as follows:-

Dependent Variable: (i) Return On Assets (ROA) – (Profit before interest and Tax / Total Assets) x 100

Independent Variables

(i) Duality - This is a binary variable which has a value of one if one individual has the joint title of chairman and CEO or if one individual has the executive position and there is no separate CEO. If the posts are separate, it is zero.

(ii) Proportion of independent directors (NED) - This measures the number of non executive directors on the board. There were two (2) comparisons:

• NED 33 - This measure would include binary number of one if the independent directors represent at least one third of the board. Binary number zero represent if the independent directors is less than one third. We expected parastatals which had more than one third of the board to perform better.

• NED 50 - This measure would include binary number of one if the independent directors represent 50% of the board. Binary number zero represent if the independent directors is less than 50%. We expected firms which had more than 50% of independent directors to perform better than firm which do not.

(iii). For other variables (That is, external audit, committee meetings, institutional ownership, and managerial ownership) the binary measure of one meant that the variables would represent at least 50% of the attributes represented by each variable measure and if less than 50%, then the binary number zero would be used to show poor corporate governance practices.

SPSS Statistical Package was used along with a number of statistical techniques in measuring the relationship between the dependent variable and independent variables.

3.8. The Regression Model

Regression analysis is a statistical tool for the investigation of relationships between variables. Usually, the investigator seeks to ascertain the causal effect of one variable upon another. To explore such issues, the investigator assembles data on the underlying variables of interest and employs regression to estimate the quantitative effect of the causal variables upon the variable that they influence. In our study, we used the following regression model:

$$Y=\beta 0+ \beta_1X_1+\beta_2X_2+ \beta_3X_3+ \beta_4X_4+ \beta_5X_5+ \beta_6X_6+ \beta_7X_7+ \beta_8X_8+e$$

Where Y= Return on Asset

$\beta 0$= defines value of return on asset without inclusion of predictor variables

X_1-X_8= predictor variables where,

X_1= Duality

X_2=Independence of the board

X_3 =Board size

X_4=External Auditors

X_5=Committee meetings

X_6=Institutional Ownership

X_7=Managerial Ownership

X_8= Competence of Audit Committee

e = the "error" term reflecting other factors that influence performance.

β_1- β_8 regression coefficients- define the amount by which Y is changed for every unit change in predictor variables.

The test was whether the independent variables (duality role of CEO and independence of directors, Board size, Audit committee meetings, Competence of audit committee members, External auditors, Institutional ownership, and Managerial ownership) were capable of predicting financial performance and whether there existed a relationship between the corporate governance issues and financial performance of parastatals.

CHAPTER FOUR

4.0. DATA PRESENTATION AND ANALYSIS

4.1. Introduction

This chapter presents analysis and findings of the study as set out in the research methodology. The data was gathered from questionnaires as the research instrument. The questionnaires were designed in line with the objectives of the study. To enable analysis of qualitative data obtained, Likert type questions were included whereby respondents indicated the extent to which the variables were practiced in a five point Likert scale.

4.2. Demographic information

4.3. Sector of the economy under which the selected corporations operated

This section aimed at establishing the sector of the economy under which the sampled corporations operated. Results depicted in table 4.1 below revealed that a majority of the corporations operated in trade and industry comprising 30 percent, while 27 percent were in industry and allied, 20 percent were in finance and investment while 13 percent were in agriculture and related field. This means that no one sector was overwhelmingly domineering over other sectors and therefore the results of the study could be generalized to all sectors.

Table 4.1.Sampled Sector of the economy under which the corporations operate

	Freq	Percent
Agriculture	8	13
Regulatory,	6	10
Trade and industry	18	30
Finance and investment	12	20
Industrial and allied	16	27
Total	60	100

Source: Researcher, 2010

4.3.1. The Evaluation of the Questionnaire Results

The following are the overall findings of the questionnaires on corporate governance principles that were practiced in parastatals. The evaluation of the results was based on the respondents; namely, the CEOs and senior management of the evaluated parastatals.

Out of 79 parastatals selected, 60 of them responded to the questionnaires, giving a response rate of 76% which was sufficient to draw valid conclusions. 52% of the respondents replied that they were aware of corporate governance principles and standards.

4.3.2. Functions of the Board

This section aimed at establishing the various functions of the board. Results shown in table 4.2 reveal that most respondents agreed that the Board understood, agreed, defined and propagated its functions (90 percent), the Board was involved in formulating long-range strategy (85 percent), the Board ensured that the organization had sufficient and appropriate resources to achieve its strategic goals, the Board ensured that key members of management were brought into the Board meetings so that they could participate and add value and every Board member had been supplied with a letter of appointment shown by 83 percent each. In addition, the respondents further agreed that proposals from management were analyzed and debated vigorously before being approved by the Board (82 percent), a proposal that was considered inappropriate was declined (81 percent), the board had procedures in place to ensure that the organization was meeting its legal responsibilities (81 percent) and that the Board devoted significant time and serious thought to the organization's long-term objectives (80 percent). However, most respondents disagreed that the majority of the Board's time was not spent on issues of day-to-day management shown by 70 percent.

Table 4.2 Functions of the Board

	Frequency		Percent	
	Yes	No	Yes	No
The Board understands, agrees, defines and propagates its functions	54	6	90	10
The Board is involved in formulating long-range strategy	51	9	85	15
The Board ensures that the organization has sufficient and appropriate resources to achieve its strategic goals.	50	10	83	17
The Board ensures that key members of management are brought into the Board meetings so that they can participate and add value	50	10	83	17
Every Board member has been supplied with a letter of appointment.	50	10	83	17
Proposals from management are analyzed and debated vigorously before being approved by the Board. A proposal that is considered inappropriate is declined.	49	11	82	18
The Board has procedures in place to ensure that the organization is meeting its legal responsibilities.	49	11	82	18
The Board devotes significant time and serious thought to the organization's long-term objectives	48	12	80	20
Formal review of the Board's performance has become an integral part of the culture of the Board.	48	12	81	19
The letter of appointment defines the roles and functions of the Board.	48	12	81	19
The Board ensures all conflicts are a) Declared b) Resolved	46	14	77	33
The Board knows and understands the Company's beliefs, values, philosophy, mission and vision	45	15	75	25
Beliefs, values, mission and vision are consistent with the company's status.	44	16	73	27
Board activities are conducted in an atmosphere of conducive	44	16	73	27

atmosphere.				
The Board has defined and communicated to management the scope and powers, roles and responsibilities.	43	17	72	28
The Board has an operating plan that specifies its functions, activities and objectives.	42	18	70	30
When appropriate, the Board seeks counsel from professional advisors.	40	20	66	34
The Board understands and agrees that its first duty is to a) The Company b) Members and shareholders c) Others	40	20	66	34
The Board determines annually, the objectives and measurement criteria for the CEO.	38	22	63	37
Indicators are used to monitor the performance of management.	34	26	57	43
The CEO's remuneration and performance is reviewed and determined by the Board.	32	28	53	47
The Board has identified the groups to which it is: a) Accountable b) Responsible	32	28	53	47
The majority of the Board's time is not spent on issues of day-to-day management.	18	42	30	70

Source: Researcher, 2010

4. 3.3. Board Meetings and Procedures

This section aimed at establishing various Board Meetings and Procedures in the Corporation and whether they were being followed. Results from the study revealed that a majority of the respondents agreed that board meetings were facilitated, but not overtly influenced by the Chairperson where all Board members received detailed Board papers, copies of draft minutes and agenda papers in advance (87 percent), every Board member was supplied with a calendar of meetings showing dates of Board meetings, committee meetings etc. and key or critical events of the company (82 percent), Board meetings were conducted in a manner that encouraged open communication, meaningful participation, and timely resolution of issues (82 percent). All proceedings and Resolutions of the Board were recorded accurately, adequately and on a timely basis (82 percent), board members received

timely and accurate minutes, advance written agendas and meeting notices; and clear and concise background material to prepare in advance of meetings (81 percent), sufficient time was provided during Board meetings for thoughtful discussion in addition to management dialogue (80 percent) and that board time was used effectively so that the Board could add value to management as the Board had adopted formal meeting and reporting procedures (79 percent). The study further revealed that majority of the respondent disagreed that there was absenteeism from Board meetings (70 percent).

Table 4.3 Board Meetings and Procedures

	Frequency		Percent	
	Yes	No	Yes	No
Board meetings are facilitated, but not overtly influenced by the Chairperson._All Board members receive detailed Board papers, copies of draft minutes and agenda papers in advance	52	8	87	13
Every Board member was supplied with a calendar of meetings showing dates of Board meetings, committee meetings etc. and key or critical events of the company	49	11	82	18
Board meetings are conducted in a manner that encourages open communication, meaningful participation, and timely resolution of issues	49	11	82	18
All proceedings and Resolutions of the Board are recorded accurately, adequately and on a timely basis	49	11	82	18
Board members receive timely and accurate minutes, advance written agendas and meeting notices; and clear and concise background material to prepare in advance of meetings	48	12	81	19
Sufficient time is provided during Board meetings for thoughtful discussion in addition to management dialogue	48	12	80	20
Board time is used effectively so that the Board adds value to management. The Board has adopted formal meeting and	47	13	79	21

reporting procedures				
Every Board member has been supplied with a Board manual and a copy of standing orders and regulations governing conduct of Board meetings	46	14	77	33
All Board members are fully informed of relevant matters and there are never any surprises	46	14	77	33
Absenteeism from Board meetings is the exception, rather than the rule.	8	52	10	90

Source: Researcher, 2010

4.3.4: Appointment, Selection, Induction, Training and Removal of Directors

This section aimed at establishing the respondent's views on appointment, selection, induction, training, development, succession and removal of directors in the corporation. Results presented in table 4.4 reveal that most respondents agreed that directors understood the extent of their personal liability for the affairs of the company; a succession plan was in place for the Chairperson, Chief Executive Officer, Board members and senior management and was reviewed regularly. The performance of the Chief Executive Officer was reviewed formally on an annual basis and that encouragement was given for Board members to continue their study of corporate governance and improve the skills they needed shown by percentages of 87, 82 and 81 respectively. In addition, the respondents agreed that directors who had not been contributing to the governance of the organization and were uninterested in improving their performance, were asked to terminate, the composition of the Board fairly represented the diversity of stakeholders and that where the ethical or professional conduct of any director was called into question, such a director was suspended pending investigations shown by percentages of 80, and 71 respectively. The least cited issue on appointment, selection, induction, training, development, succession and removal of directors in the corporation was that board members bound themselves to uphold, honour, and respect the Code of Ethics of the organization on first appointment and to resign where their actions were called into question shown by 40 percent.

Table 4.4 Appointment, Selection, Induction, Training and Removal of Directors

	Frequency		Percent	
	Yes	No	Yes	No
Directors understand the extent of their personal liability for the affairs of the company	52	8	87	13
A succession plan is in place for the Chairperson. Chief Executive Officer, Board members and senior management and is reviewed regularly	49	11	82	18
The performance of the Chief Executive Officer is reviewed formally on an annual	48	12	81	19
Encouragement is given for Board members to continue their study of corporate governance and improve the skills they need	48	12	81	19
Directors who have not been contributing to the governance of the organization and are uninterested in improving their performance, are asked to terminate	48	12	81	19
The composition of the Board fairly represents the diversity of stakeholders._	46	14	77	33
Where the ethical or professional conduct of any director is called into question, such director is suspended pending investigations.	46	14	77	33
The Board members are introduced to their duties with an appropriate ' induction process	45	15	75	25
The Board actively encourages good candidates to stand for Board's appointments	44	16	73	27
A new Board members understand the extent of their relationship with management and the separation of stewardship and management	44	16	73	27
Board members evaluate their individual and overall Board performance, formally on an annual basis	44	16	73	27

The board is involved in the selection of appointed directors.	42	18	70	30
The selection process considers any deficiencies in the skills of current Board members.	40	20	66	34
Board members bind themselves to uphold, honor, and respect the Code of Ethics of the organization on first appointment and to resign where their actions are called into question.	40	20	66	34

Source: Researcher, 2010

4.3.5. Board Structure

The study further established the respondents' view on board structures. Results from the study revealed that most respondents agreed that committees had been established and appointed in light of the need to increase the effectiveness of the Board by utilizing the specialized skills of Board members (83 percent), the roles of Chairperson of the Board and Chief Executive Officer were separated and held by different persons (82 percent), the committees had been established and appointed in light of the need to provide support and guidance to management (82 percent) and that the Board had established and appointed an Executive Committee, An Audit Committee, a Board Appointment and Remuneration Committee (80 percent).

Table 4.5 Board Structure

	Frequency		**Percent**	
	Yes	**No**	**Yes**	**No**
The committees have been established and appointed in light of the need to increase the effectiveness of the Board by utilizing the specialized skills of Board members.	50	10	83	17
The roles of Chairperson of the Board and Chief Executive Officer are separated and held by different persons	49	11	82	18
The committees have been established and appointed in light of the need to provide support and guidance to management.	49	11	82	18
The Board has established and appointed an Executive	48	12	80	20

Committee				
The Board has established and appointed An Audit Committee	48	12	81	19
The Board has established and appointed a Board Appointment and Remuneration Committee	48	12	81	19
The Board has established and appointed committees with defined terms of reference, composition and reporting requirements. These aspects are formally recorded._	46	14	77	33
The committees have been established and appointed in light of the need to ensure effective and independent professional consideration of issues e.g. audit reports, finance issues, etc	45	15	75	25
The Board has a balanced mix of Executive, Non-Executive and Independent Non-Executive Directors	44	16	73	27

Source: Researcher, 2010

4.3.6. Effectiveness of Chairpersons

The study further inquired on the effectiveness of the Board Chairperson. This section of study used a likert scale score of 1 [Very poor], 2[Poor], 3[Fair], 4[Good], and 5[Very good]. Results were presented in mean and standard deviation. Findings from the study revealed that most respondents cited that the most effective chairperson was involved in promoting the image of the company shown by a mean of 4.6, portraying the requisite leadership in the community shown by a mean of 4.3 , managed shareholder relationships and met with shareholders shown by a mean of 4.2, effectively monitored and evaluated performance of the CEO and senior officers shown by a mean of 4.2, managed shareholder meetings effectively and promoted a sense of participation in all shareholders and instilled shareholder confidence shown by a mean of 4.1 and was an effective Board leader shown by a mean of 4.2. The respondents further cited that effective chairpersons rarely were involved in leading the company in charitable, educational, and cultural activities shown by a mean of 3.2 and ensuring succession plans were in place at senior management level shown by a mean of 3.1.

Table 4.6 Effectiveness of Chairpersons

	Mean	SD
Promotes the image of the company, portraying the requisite leadership in the community	4.656	.657
Manages shareholder relationships and meets with shareholders	4.343	.545
Effectively monitors and evaluates performance of the CEO and senior officers	4.287	.983
Manages shareholder meetings effectively and promotes a sense of participation in all shareholders and promotes shareholder confidence	4.232	.562
Is an effective Board leader	4.232	.234
Promotes effective participation of all Board members in the decision making process	4.121	.653
Actively meets with potential sources of equity and debt capital	4.009	.883
Effectively represents shareholders and the Board to the management	3.989	.434
In conjunction with the CEO effectively develops relationships and represents the company with regulators and government agencies	3.989	.232
Effectively represents management to the Board and shareholders	3.923	.564
In conjunction with the CEO effectively represents the company to public, suppliers, customers and staff	3.657	.545
Is effective in maintaining accountability	3.233	.545
Is effective in ensuring succession plans are in place at senior management level	3.165	.564
In liaison with CEO and management, effectively leads the company in charitable, educational, and cultural activities	3.129	.545

Source: Researcher, 2010

4.4. Factors that lead to corporate governance

The study further inquired on the extent into which various factors lead to corporate governance practices in the state corporations. A likert scale of 1- Not at all; 2- To a less extent; 3- To a fairly large extent; 4- To a large extent; 5- To a very large extent was used. Results presented in table 4.7 revealed that most respondents agreed to a

great extent that the efficiency and effectiveness in service delivery, the prevailing corporate culture, the stipulation by the code of best practice and the strategic direction that the corporation was pursuing were the major factors that led to corporate governance practices in the state corporations as was shown by means of 4.2, 4.1, 4.0, and 3.9 respectively.

Table 4.7 Factors that lead to corporate governance

Factors	Mean	SD
The efficiency and effectiveness in service delivery	4.232	.879
The prevailing corporate culture	4.165	.564
The stipulation by the code of best practice	4.090	.789
The strategic direction that the corporation is pursuing	3.989	.656
The prevailing board and/or organizational structure(s)	3.878	.767
The legislation (the practices are part of the provisions of the law	3.857	.988
Political considerations (more so on board selection)	3.767	.345
Particular stakeholder interests	3.654	.675
The prevailing national culture	3.435	.656
Developments in the economic arena	3.129	.545

Source: Researcher, 2010

4.5.0 Regression analysis

4.5.1 Analysis of corporate governance and parastatal performance

Theoretical studies and practical experiences have demonstrated that sound corporate governance provides the basic assurance for the long-term well-being and sustainable development of a company. Corporate governance serves as a company's internal control system. On the one hand, it drives the board of directors and management to maximise benefits for the company and its stakeholders; on the other hand, it provides an effective supervision over the optimum utilisation of company's resources. Parastatals with sound corporate governance tend to deliver better financial results against those parastatals with poor corporate governance mechanisms, thus attracting more and better publicity and both Government and Donor-funding. Analysis results

indicated that a parastatal's corporate governance had a positive correlation with its financial performance.

The study was conducted to evaluate the effect of corporate governance on parastatal performance through examining the corporate governance parameters and financial performance of parastatals from 2005-2009 by applying linear regression through SPSS. The model was of the functional form:

$$Y=\beta 0+ \beta_1X_1+\beta_2X_2+ \beta_3X_3+ \beta_4X_4+ \beta_5X_5+ \beta_6X_6+ \beta_7X_7+ \beta_8X_8+e$$

Where Y= Return on Asset

$\beta 0$= defines value of return on asset without inclusion of predictor variables

X_1-X_8= predictor variables where,

X_1= Duality

X_2=Independence of the board

X_3 =Board size

X_4=External Auditors

X_5=Committee meetings

X_6=Institutional Ownership

X_7=Managerial Ownership

X_8= Competence of Audit Committee

e = the "error" term reflecting other factors that influence performance.

Hypothesis of this research is: Ho = Corporate Governance affects the Firm Performance

The data collected comprised of a five year period (2005-2009).The data was obtained from the financial reports of the parastatals selected for this study, Board size was equal to total number of directors in the firm; Board independence indicated what percentage of non-executives was present in the board of directors. Ownership concentration showed what part or authority the last five shareholders had among all the shares a company held. Managerial Ownership reflected the number of shares top management held with regard to the total shares of the company. The table below summarises the findings of the study.

Table 4.8: Regression and the Coefficient of Determination

	Un-standardized Coefficients	Standardized Coefficients			
	B	Std. Error	Beta	t	Significance
(Constant)	6.153	0.50667	0.87688	0.01171	0.0506
Duality	2.630	0.422	.644	0.086	.002
Independence of the board	1.043	0.438	.996	0.715	.055
Board size	1.696	0.655	.153	0.405	.670
External Auditors	0.522	0.670	-4.576	0.126	.034
Committee meetings	-0.804	0.725	6.284	0.080	.065
Institutional Ownership	0.348	0.997	-2.252	0.962	.087
Managerial Ownership	0.011	0.581	-1.285	0.521	.023
Competence of Audit Committee	0.707	0.950	2.976	0.880	.028

The corporate governance factors that were considered most significant had a significance of less than 0.05 and were Duality (0.02), Managerial Ownership (.023), Competence of Audit Committee (.028) and External Auditors (0.34). Results reveal that these factors contributed most to the financial performance of the parastatal.

The established regression equation was:

$$Y=\beta 0+ \beta_1X_1+\beta_2X_2+ \beta_3X_3+ \beta_4X_4+ \beta_5X_5+ \beta_6X_6+ \beta_7X_{7+} \beta_8X_8+e$$

Y (Return on Asset) = X_1 (Duality) + X_2(Independence of the board) + X_3 (Board size) + X_4 (External Auditors) + X_5 (Committee meetings) + X_6 (Institutional Ownership) + X_7 (Managerial Ownership) + X_8 (Competence of Audit Committee) and e is the error term.

Financial performance = Return on asset= $6.153 + 2.630\ X_1 + 1.043\ X_2 + 1.696 + X_3 + 0.522\ X_4 - 0.804\ X_5 + 0.348\ X_6 + 0.011\ X_7 + 0.707\ X_8$

The regression results show that when values of corporate governance indicators/measures used in the study (Duality, Independence of the board, Board size, External Auditors, Committee meetings, Institutional Ownership, Managerial Ownership and Competence of Audit Committee) were zero, the Return on Asset was 6.153. The results also show that committee meetings negatively affected Return on Asset while Duality, Independence of the board, Board size, External Auditors, Institutional Ownership, Managerial Ownership and Competence of Audit Committee affected financial performance positively.

An increase in duality led to an increase in financial performance by a factor of 2.63, a unit increase in independence of the board size led to an increase in financial performance by a factor of 1.043 while a unit increase in board size, led to an increase in financial performance by a factor of 1.696. A unit increase in Institutional Ownership led to an increase in financial performance by a factor of 0.348. However a unit increase in committee meetings led to a 0.804 decrease in financial performance, indicating that board activity intensity affects profitability negatively.

Table 4.9: Model Summary

R	**R Square**	**Adjusted R Square**	**Std. Error of the Estimate**	**Durbin-Watson**	
.975a	0.949985	0.749923	1.578726	1.270923	
	Sum of Squares	**Df**	**Mean Square**	**F**	**Sig.**
Regression	47.340	7	11.835	4.748	.330a
Residual	2.492	1	2.492		
Total	49.832	8			

The model summary presented in table 4.9, shows that the relationship was strong as the R square value was 0.95. However the model was insignificant for prediction as the f significance was 0.33 meaning that the model might be 33% wrong in its prediction.

CHAPTER FIVE

5.0: SUMMARY, CONCLUSION, POLICY RECOMMENDATIONS, LIMITATIONS OF THE STUDY AND SUGGESTIONS FOR FURTHER STUDY

5.1. Summary

On the topic of the various functions of the board, the study revealed that the Board understood, agreed, defined and propagated its functions, was involved in formulating long-range strategy, it ensured that the organization had sufficient and appropriate resources to achieve its strategic goals, it ensured that key members of management were brought into the Board meetings so that they could participate and add value and every Board member had been supplied with a letter of appointment. In addition, the study revealed other functions of the board as having procedures in place to ensure that the organization was meeting its legal responsibilities and that the Board devoted significant time and serious thought to the organization's long-term objectives.

On the area of the various Board Meetings and Procedures in the Corporation and whether they were being followed, the study established that board meetings were facilitated, but not overtly influenced by the Chairperson where all Board members received detailed Board papers, copies of draft minutes and agenda papers in advance, every Board member was supplied with a calendar of meetings showing dates of Board meetings, committee meetings etc. and key or critical events of the company. Board meetings were conducted in a manner that encouraged open communication, meaningful participation, and timely resolution of issues. All proceedings and Resolutions of the Board were recorded accurately, adequately and on a timely basis, board members received timely and accurate minutes, advance written agendas and meeting notices; and clear and concise background material to prepare in advance of meetings and that sufficient time was provided during Board meetings for thoughtful discussion in addition to management dialogue.

On the topic of the appointment, selection, induction, training, development, succession and removal of directors in the corporation, the study revealed that directors understood the extent of their personal liability for the affairs of the company; a succession plan was in place for the Chairperson, Chief Executive

Officer, Board members and Senior Management and was reviewed regularly. The performance of the Chief Executive Officer was reviewed formally on an annual basis and that encouragement was given for Board members to continue their study of corporate governance and improve the skills they needed.

On the issue of board structures, the study established that committees had been established and appointed in light of the need to increase the effectiveness of the Board by utilizing the specialized skills of Board members. The roles of Chairperson of the Board and Chief Executive Officer were separated and held by different persons. The committees had been established and appointed in light of the need to provide support and guidance to management and that the Board had established and appointed an Executive Committee, An Audit Committee, a Board Appointment and Remuneration Committee.

On the area of the effectiveness of the Board Chairperson, the study revealed that the most effective chairperson was involved in promoting the image of the company, portraying the requisite leadership in the community , managed shareholder relationships and met with shareholders, effectively monitored and evaluated performance of the CEO and senior officers, managed shareholder meetings effectively and promoted a sense of participation in all shareholders and inspired shareholder confidence and was an effective Board leader.

On the topic of the extent into which various factors led to corporate governance practices in the state corporations, the study found that the efficiency and effectiveness in service delivery, the prevailing corporate culture, the stipulation by the code of best practice, and the strategic direction that the corporation was pursuing were the major factors that led to corporate governance practices in the state corporations.

On regression, the corporate governance factors that were considered most significant had a significance of less than 0.05 and were Duality (0.02) Managerial Ownership (.023), Competence of Audit Committee (.028) and External Auditors (0.34). Results revealed that these factors contributed most to the financial performance of a company. The frequency of board meetings as a measure of board activity intensity, though insignificant, had a negative relationship with ROA. The results confirm studies by Jensen (1993) who argues that board meetings do not necessarily enhance

firm performance and that board meeting frequency increases when there are problems.

5.2. Conclusion

The relevance of corporate governance cannot be over-emphasized since it constitutes the organizational climate for the internal activities of a company. Corporate governance brings new outlook and enhances a firm's corporate competitiveness. The study examined the effect of corporate governance on the performance of parastatals in Kenya by Return On Asset as a financial performance measure. The results show that boards were deemed to be relatively less independent with about 58% of their composition being made of executive directors in the overall sample and there was also a clear separation of the functions of the CEO and board chair. The boards of the sampled parastatals furthermore appeared very busy with a mean annual meeting frequency of 11. In addition, the firms also had relatively independent audit committees who appeared to meet on a regular basis. The regression results show further that the direction and the extent of impact of governance was dependent on the performance measure being examined. Results show that large boards enhanced corporate performance and that when such boards were dominated by non-executive directors, it enhanced firm value. While, the CEO duality did not significantly impact on financial performance measure of ROA, it had a positive relationship with financial performance in conflict with other studies. We also find that board activity intensity had a negative effect on profitability consistent with other studies.

The study concluded that there was a positive relationship between corporate governance and financial performance of parastatals in Kenya. From the study, parastatals that employed effective appointment, selection, induction, training, development of board members, had operative board structures and efficient Chairpersons were linked to good financial performance.

The study further concluded that efficiency and effectiveness in service delivery, prevailing corporate culture, the stipulation by the code of best practice, and the strategic direction that the corporation had were the main factors that led to corporate governance practices in the state corporations.

Furthermore, the findings of the analysis of the relationship between the corporate governance principles and the performance of parastatals were found to be in parallel with the other similar studies in literature. Accordingly, a linear relationship existed between the parastatals' performances that increased in the positive direction along with the implementation of corporate governance principles. However, in general, findings did not prove a strong relation among the variables.

5.3. Policy Recommendation

The study recommends that state corporations should employ good corporate governance and avoid politicisation .Boards of parastatals should not be appointed by political powers. The study further recommends that state corporations should have effective structures of financing and financial management. Many parastatals are allocated funds through line ministries thus end up being chronically underfunded. They are allowed to borrow funds but many have not repaid their loans. Expenditure controls are weak; Prosecution of chief executives for abuse of office and misappropriation of funds is usually not carried out. Further, the study recommends the following:

For good corporate governance to prevail and as part of a necessary system of checks and balances the roles of chairperson and chief executive officer (CEO) should not be exercised by the same individual, as is the practice in other jurisdictions. Boards of directors have to govern and give directions to the organisation's management team. They cannot be executives as well as giving directions. Moreover one key task of the Chairperson should be to assess the CEO's performance in running the organisation.

The board should have an appropriate balance of executive and non-executive independent directors such that no individual or small group of individuals can dominate the board's decision taking. In the same vein, the matrix of competencies should also be ensured.

On appointment, board members (including the chairperson) should be given their Terms of Reference laying down their roles and functions in writing. Reference should be made to the requirements of the Code of Corporate Governance. Clear mention should be made that all members of the board have collective responsibility for decisions and have equal status in discussions. The only exception is that the

chairperson is called upon to chair and lead board meetings. Board members should recognise their collective responsibility for the board's decisions and strive to make decisions that further the organisation's purpose, rather than the interests of any specific group or organisation with which they are associated.

Board members, including the chairperson, should have sufficient humility to accept that they are not always well-equipped with the demands that the governance process brings. Often they do not have the training. They should, once appointed, undertake to undergo an induction course and other training on corporate governance. In addition, the board's performance (including the chairperson's performance) should be appraised on an annual basis. Those who fail to discharge their duties and responsibilities should be removed. On the other hand, the Board should appraise the performance of the chief executive officer.

The board should develop a board governance policy and a code of conduct for board members to give the directors guidance on how to proceed under various circumstances that might arise and ways in which the directors may discharge their duties. The chairperson and board members should avoid giving direct instructions to staff members. They should also refrain from conducting management meeting with staff.

While regular board meetings are essential for good governance, best practices suggest that four to six board meetings per year are sufficient. Too many meetings have a tendency to shift the focus of the board from strategic and policy issues to operational and day to day matters, thus paving the path for internal conflicts.

Levels of remuneration of directors should be sufficient to attract and retain the directors needed to run the organisation successfully, but organisations should avoid paying more than is necessary for this purpose. The "per sitting" fee paid to board members may explain the large number of board meetings. Also the present quantum fee paid to board members of parastatal bodies reflects the lack of commitment from board members as well as their regular absences and replacement by junior officers, thus diminishing the board standard and status.

The reporting requirements of the Code – timely and in-depth coverage of financial and non-financial information - should be strictly adhered to add visibility, transparency and accountability to the activities of public sector organisations.

From the foregoing analysis, it is evident that corporate governance has an influence on a firm's performance. Indeed, while some of the study's findings are revealing, clear policy implications should not be lost. For enhanced performance of corporate entities, it is important to separate positions of CEO and board chair and also parastatals should be encouraged to maintain relatively independent audit committees. It should be emphasized, however, that in trying to examine the link between corporate governance and performance of parastatals, it would have been appropriate to use a broader spectrum of variables. The data which dates back to 2005 also constitute another limitation of the study. These limitations, however, do not compromise on the validity of conclusion drawn based on the results.

5.4. Limitations of the Study

Since the study used "drop and pick" questionnaire method rather than an in-depth interview method, a lot of information which could have been given by the would-be respondents was not captured and this could have given a much more detailed analysis of the relationship between corporate governance and financial performance of parastatals' parameters. One-to-one interaction between the interviewer and the interviewee and facial expressions/body language could enhance the quality and authenticity of the information. Cost of questionnaire method is also more expensive compared to face- to- face interview.

Also, the study did not use a whole population of parastatals but just a sample of them and this limited the scope of the study and limited fuller and deeper analysis of the factors involved in the study.

As in all research work, finances are never enough to conduct a thorough research and time constraint is also a major factor.

5.5. Suggestions for further Studies

It is suggested that in future studies, interviews should be used more often than questionnaire and also total populations should be used, if time and cost allow, more

than a sample of population in order to have a relatively complete picture of the study. More variables can also be used to enhance the quality of the research.

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APPENDICES

APPENDIX I

RESEARCH QUESTIONNAIRE

Dear sir/ madam,

I am a postgraduate student of the school of business, university of Nairobi, doing an MBA course.

I am seeking your cooperation in writing this research work. The work aims at conducting a research on the topic, **"THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE OF PARASTATALS IN KENYA."**

Your humble consent is strongly solicited to make this work a success.

Your responses will be treated confidentially for academic purpose.

Thanks.

Yours faithfully,

Herrie N.Murage

APPENDIX II

THE UPDATED LIST OF ALL PARASTATALS IN KENYA AS ON JUNE, 2010

1) Agricultural Development Corporation
2) Agricultural Finance Corporation
3) Agro-Chemical & Food Company Ltd
4) Athi Water Services Board
5) Bomas of Kenya Ltd
6) Capital Markets Authority
7) Catchment Area Advisory Committee
8) Catering Tourism and Training Development Levy Trustees
9) Central Water Services Board
10) Chemilil Sugar Company Limited
11) Coast Development Authority
12) Coast Water Services Board
13) Coffee Board Of Kenya
14) Coffee Research Foundation
15) Commission for Higher Education
16) Communication Commission of Kenya
17) Consolidated Bank of Kenya
18) Cooperative College of Kenya
19) Council for Legal Education
20) Deposit Protection Fund Board
21) East African Portland Cement Co.
22) Egerton University
23) Ewaso Ng'iro South Development Authority
24) Export Processing Zone Authority

25) Export Promotion Council

26) Gilgil Telecommunications industries

27) Higher Education Loans Board

28) Horticultural Crops Development Authority

29) Horticulture Crops Development Authority

30) Industrial and Commercial Development Corporation

31) Industrial Development Bank

32) Investment Promotion Centre

33) Jomo Kenyatta University of Agriculture and Technology

34) KASNEB

35) Kenya Agricultural Research Institute

36) Kenya Airports Authority

37) Kenya Anti-Corruption Commission

38) Kenya Broadcasting Corporation

39) Kenya Bureau of Standards

40) Kenya Bureau of Standards (KEBS)

41) Kenya Civil Aviation Authority

42) Kenya College of Communication & Technology

43) Kenya College of Communications Technology

44) Kenya Dairy Board

45) Kenya Electricity Generating Company

46) Kenya Ferry Services Limited

47) Kenya Forestry Research Institute

48) Kenya Industrial Estates

49) Kenya Industrial Property Institute

50) Kenya Industrial Research & Development Institute

51) Kenya Institute Of Administration

52) Kenya Institute of Public Policy Research and Analysis

53) Kenya Literature Bureau

54) Kenya Marine & Fisheries Research Institute

55) Kenya Maritime Authority

56) Kenya Meat Commission

57) Kenya National Assurance Company

58) Kenya National Examination Council

59) Kenya National Library Service

60) Kenya National Shipping Line

61) Kenya National Trading Corporation Limited

62) Kenya Ordinance Factories Corporation

63) Kenya Pipeline Company Ltd

64) Kenya Plant Health Inspectorate Services

65) Kenya Ports Authority

66) Kenya Post Office Savings Bank

67) Kenya Railways Corporation

68) Kenya Re-insurance Corporation

69) Kenya Revenue Authority

70) Kenya Roads Board

71) Kenya Safari Lodges & Hotels

72) Kenya Seed Company Ltd

73) Kenya Sisal Board

74) Kenya Sugar Board

75) Kenya Sugar Research Foundation

76) Kenya Tourist Board

77) Kenya Tourist Development Corporation

78) Kenya Utalii College

79) Kenya Water Institute

80) Kenya Wildlife Service

81) Kenya Wine Agencies Limited

82) Kenyatta International Conference Centre

83) Kenyatta University

84) Kerio Valley Development Authority

85) Lake Basin Development Authority

86) Lake Victoria South Water Service Board

87) Lake Victoria South Water Service Board

88) Local Authority Provident Fund

89) Maseno university

90) Moi University

91) National Aids Control Council

92) National Bank of Kenya

93) National Cereals and Produce Board

94) National Council for Persons with Disabilities

95) National Council for Law Reporting

96) National Environmental Management Authority

97) National Hospital Insurance Fund

98) National Housing Corporation

99) National Irrigation Board

100) National Museums of Kenya

101) National Oil Corporation of Kenya Ltd

102) National Social Security Fund(NSSF)

103) National Water Conservation and Pipeline Corporation

104) National Co-ordinating Agency for Population and Development

105) New K.C.C

106) NGO's Co-ordination Bureau

107) Numerical Machining Complex

108) Numerical Machining Complex

109) Nyayo Tea Zones Development Corporation

110) Nzoia Sugar Company

111) Pest Control Products Board

112) Postal Corporation of Kenya

113) Pyrethrum Board of Kenya

114) Public Procurement Oversight Authority

115) Retirement Benefits Authority

116) Rift Valley Water Services Board

117) School Equipment Production Unit

118) South Nyanza Sugar Company

119) Sports Stadia Management Board

120) Tana and Athi Rivers Development Authority

121) Tea Board Of Kenya

122) Tea Research Foundation Of Kenya

123) Teachers Service Commission

124) Telkom (k) Ltd

125) University of Nairobi

126) University of Nairobi Enterprises & Services Ltd

127) Water Resources Management Authority

128) Water Services Regulatory Board

129) Western University College of Science and Technology

APPENDIX III

Research Questionnaire Section A: Corporation Profile

1. **Name of the corporation**_____________

2. Year of establishment

3. Current number of employees ( ) tick the choices below:

Below 500 [ ] 5001-1000 [ ] 1001 and Over [ ]

4. Sector of the economy under which the corporation operates (e.g. Agriculture, Regulatory, Trade and Industry etc)__________________________________

5. Line Ministry under which the corporation operates _________________

6. GoK Shareholding in the Corporation (Give in Percentage)

Section B: The Board

7. The following are some of or all **Functions of the Board.** Please indicate whether or not the Board performs them by ticking Yes or No against each board function.

Answer 'Yes' if agreeing or 'No' if not agreeing	**Yes**	**No**
The Board understands, agrees, defines and propagates its functions		
The Board knows and understands the Company's beliefs, values, philosophy, mission and vision		
Beliefs, values, mission and vision are consistent with the company's status.		
The Board devotes significant time and serious thought to the organization's long-term objectives		
The Board has defined and communicated to management the scope and		

powers, roles and responsibilities.		
The majority of the Board's time is not spent on issues of day-to-day management.		
The Board is involved in formulating long-range strategy		
The Board ensures that the organization has sufficient and appropriate resources to achieve its strategic goals.		
Proposals from management are analyzed and debated vigorously before being approved by the Board. A proposal that is considered inappropriate is declined.		
The Board has an operating plan that specifies its functions, activities and objectives.		
When appropriate, the Board seeks counsel from professional advisors.		
The CEO's remuneration and performance is reviewed and determined by the Board.		
The Board determines annually, the objectives and measurement criteria for the CEO.		
Indicators are used to monitor the performance of management.		
The Board has identified the groups to which it is: a) Accountable b) Responsible		

The Board understands and agrees that its first duty is to a) The Company b) Members and shareholders c) Others		
Board activities are conducted in an atmosphere of conducive atmosphere.		
The Board has procedures in place to ensure that the organization is meeting its legal responsibilities.		
Formal review of the Board's performance has become an integral part of the culture of the Board.		
The Board ensures that key members of management are brought into the Board meetings so that they can participate and add value		
The Board ensures all conflicts are a) Declared b) Resolved		
Every Board member has been supplied with a letter of appointment.		
The letter of appointment defines the roles and functions of the Board.		

Section C: Board Meetings and Procedures

8. The following statements relate to Board Meeting Management and Procedures in the Corporation. Indicate whether or not they are being followed in the corporation by following the same procedure as in (7) above.

Every Board member has been supplied with a Board manual and a copy of standing orders and regulations governing conduct of Board meetings._ (Yes) (No) tick the appropriate choice.

Every Board member was supplied with a calendar of meetings showing dates of Board meetings, committee meetings etc. and key or critical events of the company- (Yes) (No)

Board meetings are conducted in a manner that encourages open communication, meaningful participation, and timely resolution of issues. – (Yes) (No)

Sufficient time is provided during Board meetings for thoughtful discussion in addition to management dialogue- (Yes) (No)

Board time is used effectively so that the Board adds value to management. The Board has adopted formal meeting and reporting procedures. – (Yes) (No)

Board members receive timely and accurate minutes, advance written agendas

and meeting notices; and clear and concise background material to prepare in

advance of meetings- (Yes) (No)

All Board members are fully informed of relevant matters and there are never any surprises. (Yes) (No)

Absenteeism from Board meetings is the exception, rather than the rule. – (Yes) (No)

Board meetings are facilitated, but not overtly influenced by the Chairperson. All Board members receive detailed Board papers, copies of draft minutes and agenda papers in advance. – (Yes) (No)

All proceedings and Resolutions of the Board are recorded accurately, adequately and on a timely basis- (Yes) (No)

Section D: Appointment, Selection, Induction, Training and Removal of Directors

9. The following regard to Appointment, Selection, Induction, Training Development, Succession and Removal of Directors in the corporation. Indicate whether or not they are practiced in the corporation by writing **Yes or No** against each statement in the table below.

Answer 'Yes' if ageing or 'No' if not agreeing	**Yes**	**No**
The board is involved in the selection of appointed directors.		

The selection process considers any deficiencies in the skills of current Board members.		
The composition of the Board fairly represents the diversity of stakeholders._		
The Board members are introduced to their duties with an appropriate ' induction process		
The Board actively encourages good candidates to stand for Board's appointments		
A new Board members understand the extent of their relationship with management and the separation of stewardship and management		
Board members evaluate their individual and overall Board performance, formally on an annual basis		
The performance of the Chief Executive Officer is reviewed formally on an annual		
Encouragement is given for Board members to continue their study of corporate governance and improve the skills they need.		
Directors understand the extent of their personal liability for the affairs of the company		
A succession plan is in place for the Chairperson. Chief Executive Officer, Board members and senior management and is reviewed regularly		
Directors who have not been contributing to the governance of the organization and are uninterested in improving their performance, are asked to terminate.		
Where the ethical or professional conduct of any director is called into question, such director is suspended pending investigations.		

Board members bind themselves to uphold, honor, and respect the Code of Ethics of the organization on first appointment and to resign where their j actions are called into question.		

Section E: Board Structure

10. Indicate the applicability of the following statements regarding the Board Structure in the corporation. Tick either **(Yes)** or **(No**

The Board has a balanced mix of Executive, Non-Executive and Independent Non-Executive Directors. (Yes) or (No)

The roles of Chairperson of the Board and Chief Executive Officer are separated and held by different persons. (Yes) or (No)

The Board has established and appointed committees with defined terms of reference, composition and reporting requirements. These aspects are formallv recorded. (Yes) or (No)

The committees have been established and appointed in light of:

a) The need to increase the effectiveness of the Board by utilizing the specialized skills of Board members. (Yes) or (No)

b) The need to provide support and guidance to management. (Yes) or (No)

c) The need to ensure effective and independent professional consideration of issues e.g. audit reports, finance issues, etc. (Yes) or (No)

The Board has established and appointed:

a) An Executive Committee. (Yes) or (No)

b) An Audit Committee. (Yes) or (No)

c) A Board Appointment and Remuneration Committee. (Yes) or (No)

The terms of reference of each of committee are restricted and defined. (Yes) or (No)

Section F: Effectiveness of Chairpersons

11. Use a scale score of 1 [Very poor], 2[Poor], 3[Fair], 4[Good], and 5[Very good] to evaluate the effectiveness of the Board Chairperson. Please tick as appropriate. The Chairman of the Board:

i) Manages shareholder relationships and meets with shareholders

[1] [2] [3] [4] [5]

ii) Actively meets with potential sources of equity and debt capital

[1] [2] [3] [4] [5]

iii) Manages shareholder meetings effectively and promotes a sense of participation in all shareholders and promotes shareholder confidence

[1] [2] [3] [4] [5]

iv) Is an effective Board leader

[1] [2] [3] [4] [5]

v). Promotes effective participation of all Board members in the decision' making process

[1] [2] [3] [4] [5]

vi) Promotes the image of the company, portraying the requisite leadership in the community

[1] [2] [3] [4] [5]

vii) Effectively monitors and evaluates performance of the CEO and senior officers

[1] P] [3] [4] [5]

viii) Effectively represents shareholders and the Board to the management

[I] [2] [3] [4] [5]

ix) Effectively represents management to the Board and shareholders

[1] [2] [3] [4] [5]

x) Is effective in maintaining accountability

[1] [2] [3] [4] [5]

xi) Is effective in ensuring succession plans arc in place at senior management level

HI [2] [3] [4] [5]

xii) In conjunction with the CEO effectively represents the company to public, suppliers, customers and staff [1] [2] [3] [4] [5]

xiii) In conjunction with the CEO effectively develops relationships and represents the company with regulators and government agencies [1] [2] [3] [4] [5]

xiv) In liaison with CEO and management, effectively leads the company in charitable, educational, and cultural activities HI [2] [3] [4] [5]

Section G: Factors of Corporate Governance

13. The following are the factors that lead to the corporate governance practices in the state corporations. Indicate below each factor, the extent to which it contributes to the practices. Use the 1 to 5 likert scale as follows 1- Not at all; 2- To a less extent; 3- To a fairly large extent; 4- To a large extent; 5- To a very large extent

i. The prevailing corporate culture

[1] [2] [3] [4] [5]

ii. Developments in the economic arena [1] [2] [3] [4] [5]

iii. The strategic direction that the corporation is pursuing [1] P] [3] [4] [5]

iv. The legislation (the practices are part of the provisions of the law) [1] [2] [3] [4] [5]

v. The prevailing national culture [1] [2] [3] [4] [5]

vi. Political considerations (more so on board selection) [1] [2] [3] [4] [5]

vii. Particular stakeholder interests [1] [2] [3] [4] [5]

viii. The prevailing board and/or organizational structure(s) [1] [2] [3] [4] [5]

ix. The stipulation by the code of best practice [I] [2] [3] [4] [5]

x. The efficiency and effectiveness in service delivery [1J [2] [3] [4] [5]

This questionnaire will be used solely for my research analysis.

Thank you very much for your participation and co-operation.