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School of Business

The Effect of Corporate Governance on the Value of the Firm: An Empirical Study of Firms Listed in the Nairobi Stock Exchange

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DECLARATION

This research project is my original work and has not been presented for a degree in any other university. Information from other sources has been acknowledged accordingly. No part of this research paper may be reproduced without prior written permission of the author and/ or University of Nairobi.

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

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DEDICATION

First, I most humbly thank the Almighty God for the very good health without which I couldn't have managed to come this far in my academic life.

To my dear parents Christopher and Serah Nthama, who encouraged me and showed me the benefit of acquiring knowledge early in life, and sacrificed much during my formative years to ensure I attain the best.

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ABSTRACT

Corporate governance is the process and structure used to direct and manage business affairs of the company towards enhancing prosperity and corporate accounting with the ultimate objective of realizing shareholders' long-term value while taking into account the interest of other stakeholders. It is thus incumbent of firm to strive to maximise the return to shareholders, as measured by the sum of capital gains and dividends, for a given level of risk. Embedding corporate governance in organisations enables them to be operated and run in a harmonious way so that all the stakeholder interests are met in a balanced manner. The absence of a mechanism to balance the varied stakeholder interests would precipitate havoc and ultimately, disintegration of the firm, reducing its value. The study sought to determine the effect of implementation of corporate governance on the value of firms listed on the NSE.

The study targeted all the 46 companies listed at the Nairobi Stock Exchange as at 31 December 2008 and made use of secondary data sources from the audited financial statements of individual companies sampled, which financial statements are available at the Capital Markets Authority library to collect the data. The study then employed the use of multiple regression analysis to examine the effect of the various aspects of corporate governance on the value of the firm.

The study found out that board size, proportion of shares held by insiders, number of meetings per year, chairmans' and CEOs' qualification positively influence the firms' value while the percentage of inside directors negatively correlates with the value of firms. The study recommends that companies should essentially adopt corporate governance to enhance their value.

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CHAPTER ONE

1.0 INTRODUCTION

This chapter provides a broad overview of corporate governance and value of the firm, articulates the research problem and provides the objectives as well as the importance of this study.

1.1 Background to the Study

The Capital Markets Authority (CMA) in 2002 defined corporate governance… 'as the process and structure used to direct and manage business affairs of the company towards enhancing prosperity and corporate accounting with the ultimate objective of realizing shareholders' long-term value while taking into account the interest of other stakeholders'.

The above definition underpins the core objectives of corporate governance, which in my view, is, ultimately, the maximisation of the value of the firm. For the purposes of this paper, value of the firm is the absolute return shareholders derive from their investment in the firm. The return, in this context, is dividend received as well as market price appreciation of the firm's shares. Eiteman et al (1999, p. 7) aver that …''the firm should strive to maximise the return to shareholders, as measured by the sum of capital gains and dividends, for a given level of risk''. They also give the above as a shareholder wealth maximisation model whilst giving the alternative as the 'corporate wealth maximisation model, most prevalent in continental Europe and Japan, whereby ...''the firm should treat shareholders on a par with other corporate interest groups, such as management, labour, local community, suppliers, creditors and even the government…the definition of wealth is much broader than just financial wealth, such as cash, marketable securities, and unused credit lines. It includes the firm's technical, market, and human resources''.

Embedding corporate governance in organisations (or firms, as these terms are used interchangeably in this paper) enables the organisation to be operated and run in a harmonious way so that all the stakeholder interests are met in a balanced manner. The absence of a mechanism to balance the varied stakeholder interests would precipitate havoc and ultimately, disintegration of the firm. Jensen & Meckling (1976) defined a firm as ... 'simply legal fictions which serve as a nexus

for a set of contracting relationships among individuals'. Jensen & Meckling (1976) also observed in their paper that these interrelationships exist in …'non-profit institutions such as universities, hospitals, and foundations, mutual organizations such as mutual savings banks and insurance companies and co-operatives, some private clubs, and even governmental bodies such as cities, states, and the federal government, government enterprises … and so forth'. This implies that corporate governance should prevail in all types of organisations, including the churches and is therefore not a preserve of the profit making organisations. In this paper, the word firm is used in to a corporate organisation.

Coyle (2002) defined governance as 'The act of governing or the functions of governing…. It is not the same thing as managing a business or running a business' operations. It is concerned with exercising overall control, to ensure that the objectives of the company are achieved'. In expounding on the company objectives, Coyle (2002) observes that shareholder wealth maximisation is key, although the other stakeholders are also to be considered as well.

The above definition therefore also emphasises that in addition to delivering the shareholder wealth maximisation, interests of other parties (stakeholders) need to be considered.

The aforementioned contractual relationships are entered into to try and resolve the various conflicting interests that are abound in a firm, given that the various stakeholders will invariably have interests that are not necessarily congruent. In a typical corporate firm, as observed by Mukoba (2005), the principal stakeholders in a firm are…the shareholders, management, and the board of directors. Other stakeholders include the work force, customers, creditors (e.g. suppliers, banks, bond holders), regulators, and the community at large.

The above stakeholders have, in their engagements with the firm individual objectives, which they rigorously pursue with a view to utility maximisation. The shareholder, for instance, looks into maximisation of their returns while management look into maximisation of remuneration (pecuniary and non-pecuniary), which objective may be opposed to that of maximisation of returns by the shareholder. This gives rise to the agency problem, whereby the shareholder, as the principal, having appointed the senior management, in this case the agent, may be pursuing interests that are incongruent. In their article, Shleifer and Vishny (1997), they observed thus: 'Our perspective on corporate governance is a straightfor-ward agency perspective, sometimes referred to as separation

of ownership and control. We want to know how investors get the managers to give them back their money." This concept is covered in sufficient detail in the literature review section and shows how corporate governance attempts to resolve this conflicting interests.

The CMA, in introducing corporate governance guidelines in Kenya in 2002, sought to bring Kenya at par with other emerging economies, that had also seen the unfoldoing events in the developed world, particularly the high-profile collapses of a number of large U.S. firms such as Enron Corporation and WorldCom. In 2002, the U.S. federal government passed the Sarbanes-Oxley Act, intending to restore public confidence in corporate governance.

The unfolding events sorrounding the global economic crises will no doubt lead to further renewed interest in corporate governance, considering some of the factors being given as the plausible causes of the meltdown. In The US, for instance, ‘unfair practices’ have been blamed for the economic crises. One of the unfair practice is predatory lending, which refers to the practice of unscrupulous lenders, to enter into "unsound" secured loans for inappropriate purposes. A classic bait-and-switch method was used by some of the lenders, advertising low interest rates for home refinancing. Such loans were written into extensively detailed contracts, and swapped for more expensive loan products on the day of closing.

When housing prices decreased, homeowners in had little incentive to pay their monthly payments, since their home equity had disappeared. This caused the lenders’ financial condition to deteriorate, leading to a recall of the loans and ultimately, foreclosures. The foreclosures in effect decimated the value of shareholder wealth. These unfair practices, and hence the resultant decimation of shareholder wealth, would have been prevented had the lenders’ had effective corporate governance in place.

Yermack (2002) investigated the impact of the introduction of the SOA in the United states. In his study of ‘Corporate Governance and Firm Value: The Impact of the 2002 Governance Rules’ concluded thus…we see two avenues for future research. First, our analysis captures investors’ perceptions in relation to the rules, but does not look at actual improvements in shareholder wealth in the long run. It is important to see whether the rules actually enhance firm performance. Second, our analysis suggests that, compared to their size, small firms suffer larger costs from implementing

the rules than large firms. Analyzing these costs and studying their effect on a firm's financial and non-financial strategies is an important topic for future research'.

This study was therefore partly motivated by that of Yermack (2002) and sought to uncover whether corporate governance developments indeed positively or otherwise impact on the shareholder's wealth in the long run.

1.2 Statement of the Problem

A myriad of hurdles are faced by the Kenyan firms in the attainment of their corporate objectives. Even though Jensen & Meckling (1976) were against the personalisation of the firm on the grounds that it is a …"nexus of a set of contracting relationships among individuals", it can be argued that the firm takes an individual personality, being the underlying entity beneath all the relationships between the various firms' stakeholders. It is not, as observed by Jensen & Meckling (1976) … seriously misleading …by asking questions such as "what should be the objective function of the firm?" or "does the firm have a social responsibility?"

This research sought to ascertain the role of corporate governance in the attainment of corporate objectives, namely shareholder wealth maximisation.

The global economic crises, for which a snapshot is given on page 4 is arousing previous debate on whether firms should be regulated even the more, or whether self regulation should be advocated. Although the impact of the crises has not been significantly replicated in Kenya, it could be just a number of months before the effects of this crisis could become evident.

Since the introduction of the corporate governance reforms in 2002, studies undertaken e.g. Mukoba (2005) have suggested that a number of firms have already embedded the corporate governance reforms in their on going activities to check against the myriad hurdles faced by modern corporations in their pursuit of shareholder wealth maximisation.

Mutisya (2006), studied whether the adoption of corporate governance guidelines as pronounced by the CMA affected their profitability. Mutisya (2006) concluded that profitability increased with the adoption of the guidelines. Increased profitability, combined with effective cashflow management practices would inevitably enable firms pay relatively higher dividends and even if the ernings were

to be retained, shareholder value would be created as the market price is bound to increase. Increased profitability would therefore imply a higher value of the firm. One area recommended for further studies by Mutisya (2006) is the impact of the age of the directors on the performance of the firms. This study sought to address this question.

This research sought to answer the following questions:

i. Does the adoption of corporate governance guidelines increase the value of the firm in the longer term and therefore shareholder wealth maximisation?
ii. How, and to what extent do the various aspects of corporate governance as spelt out in the CMA guidelines (2002) affect the value of the firm in the loger term?

1.3 Objectives of the study

To determine the effect of implementation of corporate governance on the value of firms listed on the NSE.

1.4 Importance of the study

This study was of benefit to the following groups:

Regulators

In Kenya, for instance, the Capital Markets Authority, would obtain new insights on whether or not the guidelines they introduced way back in 2002 have benefited the shareholders. This research would therefore provide a compelling rationale for companies being asked to comply with the the corporate governance guidelines.

Company's Board of Directors

The firm's management needs to know which key corporate governance levers deliver relatively greater value to the shareholder. This study should therefore help a firm's board of directors in embedding in their firms those aspects of corporate governance that drive shareholder value most.

Students and Researchers in Finance

This study provides a new body of knowledge in the area of corporate governance. Since the introduction of the CMA guidelines on corporate governance in Kenya, most studies have concentrated on how corporate governance has impacted the firm's profitability. This study introduces new insights to students of finance regarding, if and to what extent corporate governance drives shareholder value in the longer term.

Investing Community

In their article, Shleifer and Vishny (1997), in studying the agency problem stated: 'We want to know how investors get the managers to give them back their money." Most investors are risk averse and as such would have to seek enhanced returns from their investments. This study should help investors, retail or institutional with insights on what they can look out for in satisfying themselves that the company they would like to invest in is appropriately managed, which would in turn drive up their value.

Other publics

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

CHAPTER TWO

2.0 LITERATURE REVIEW

2.0 Introduction

This chapter includes details on corporate governance and its relationship with the value of the firm. This chapter also provides a global perspective of corporate governance, discuss recent trends in corporate governance as well as provide a detailed account of growth of corporate governance practices in Kenya.

2.1 Development of Corporate Governance

Carletti (2007) concluded that 'In many countries, firms are not only concerned with shareholders but also other stakeholders such as employees and suppliers'. This gives rise to whom, of the varied stakeholders matters most while companies makes decisions, either strategic or operational. At British American Tobacco Group for instance, the stakeholder is held very high in key decisions. Finance driven training programmes developed for use in training future Finance Directors at British American Tobacco lay a lot of emphasis on shareholder value, and hence give the shareholder the first priority.

The study by Carletti (2007) showed that in Japan, majority of senior managers (97%) thought all stakeholders were important and only a small number of those polled (3%) thought shareholder interests should be put first, results that were close to findings of the same study in Germany and France. Findings of this study in USA and UK indicated that shareholders should be given first priority.

Although Mutisya (2006) discovered a strong correlation between adoption of corporate governance practices and firms' financial performance, no study has been done in Kenya to reveal how the Kenyan senior management would rather we prioritise the the Kenyan stakeholders. This would be an interesting study for the future.

The definition by CMA Act (2002) of corporate governance seems to emphasise on the shareholder as the first priority, with other stakeholders playing second fiddle. The CMA has not, however,

expounded on the other stakeholders. Would this imply that the CMA's view on prioritisation of the stakeholders in Kenya would mirror the views of the Japanese senior management and prioritise the shareholders high up with little prioritisation, if any, going to the other stakeholders?

The Basel Committee on Banking Supervision (2006) in their paper titled 'Enhancing corporate governance for banking organisations' were relatively more explicit in their definition of corporate governance …involving a set of relationships between a company's management, its board, its shareholders and the other stakeholders.

What are the implications of prioritising the stakes of the various stakeholders? With each stakeholder seeking to maximise the value they extract from the firm, there are bound to be conflicts. Further, the stakeholders engage the other stakeholders of the firm to perform some service on their behalf and with each party seeking to maximise their own value, the contracting parties' interests would in most cases, if not all be incongruent. This gives rise to the agency problem, defined by Jensen & Meckling (1976) as … a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.

In summary, the corporate governance guidelines in each and every jurisdiction thus far reviewed seems to attempt to moderate the relationships between the various stakeholders, all of whom are invariably utility maximisers. This study sought to validate whether the interests of the prime stakeholders (shareholders), the providers of capital, are maximised by implementation of the corporate governance guidelines in the Kenyan economic landscape.

Mbugua (2006) studied the extent of compliance with CMA guidelines among companies listed at the NSE. He found that the guidelines had been effectively implemented, an indication that self regulation in the market and that no additional legislation was in deed required.

2.2 Corporate Governance – a Global Perspective

Since the late 1970's, corporate governance has been the subject of significant debate in the U.S. and around the globe. Bold, broad efforts to reform corporate governance have been driven, in part, by the needs and desires of shareholders to exercise their rights of corporate ownership and to increase the value of their shares and, therefore, wealth. Over the past three decades, corporate

directors' duties have expanded greatly beyond their traditional legal responsibility of duty of loyalty to the corporation and its shareowners.

In the early 2000s, the massive bankruptcies (and criminal malfeasance) of Enron and Worldcom led to increased shareholder and governmental interest in corporate governance. This was reflected in the swift passage of the Sarbanes-Oxley Act of 2002. The timing of the aforementioned Kenyan guidelines on corporate governance soon after the Sarbanes-Oxley one seems to suggest that the Kenyan authorities wanted to stem similar moral hazards in the Kenyan economic landscape, in the protection of the various stakeholder interests.

2.3 Corporate governance guidelines in Kenya

2.3.1 Capital Markets Authority corporate governance guidelines

The aim of introducing the Capital Markets Authority Act in 2002 was to promote growth in domestic and regional capital markets. Even though the guidelines were meant to apply to firms listed in the NSE, the privately owned firms were also encouraged to adopt the same so they may also experience growth in shareholder value.

The Act also required disclosures in the annual financial statements as to the extent of compliance, so that the regulatory authorities as well as the shareholders can obtain the information on how well their organisation is being run with respect to the corporate governance practices. Below, is a summary of the key aspects of good corporate governance as recommended by the Capital Markets Authority and relate these to the Basel's principles of corporate governance.

Board of Directors:

The CMA listed wide ranging guidelines in the matter of appointment of directors. Some of these guidelines include the appointment of an effective board to offer strategic guidance, lead and control the company and be accountable to its shareholders. This guideline does not seem to address the qualifications of persons being appointed as directors. Would boards of directors possessing higher academic and / or professional qualifications lead to better financial performance of the firm and hence higher value of the firm? This study sought to uncover any causal relationship between the qualifications of directors and the value of the firm.

The Basel's guidelines on the other hand, with regard to appointment of directors states that: 'Board members should be qualified for their positions…. In the guidelines, however, it is not clear what the qualifications of directors should be, in terms of education and training, professional or otherwise.

It would be interesting to study the effect of the education and training levels of the directors and ascertain impact of the same on the firms' value.

Board Composition:

In terms of board composition, CMA advocated for a balanced board composed of executive directors and non-executive directors (including at least one third independent and non-executive directors) of diverse skills or expertise in order to ensure that no individual or small group of individuals can dominate the boards' decision-making processes. The extent of diversity is not clarified in the guidelines and this is often times left to the discretion of the appointing authority.

The Basel's guidelines require board of directors to …structure themselves in a way, including size, which promotes efficiency and real strategic discussion'. The CMA guidelines regarding size of the board are that it should not be too large to undermine interactive discussion or too small to prevent inclusion of a wider expertise and skill base necessary for the improvement of effectiveness of the board. Nevertheless, it would be safe to posit that there is no universal optimal size of the board. The optimal size of the board would ordinarily depend on the size and complexity of the firm in question. In general, however, the smaller the board size, the more likely that the board should have a more effective debate.

Yermack (1996) suggested that small boards of directors are more effective. This was based on an inverse association between board size and firm value in his sample of 452 U.S. companies. He found that companies with small boards exhibited better values for financial ratios.

Board Committees:

As for the appointing authority, CMA recommends the establishment by the board, of both a board nominations committee and a formal and transparent procedure in the appointment of directors to the board. Whilst retaining the overall responsibility, the board delegates specific mandates to such committees as may be necessary. CMA specifically requires the establishment of the audit and board

nominates committee for the management of the firms' processes of control environment and board nominations, respectively.

Directors' Remuneration:

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

Board Members' Participation:

To ensure that the board members participate fully in their roles as directors of the company, CMA requires that every person, save for a corporate director who is a director of a listed company shall not hold such position in more than five public listed companies at any one time to ensure effective participation in the board and in the case where the corporate director has appointed an alternate director, the appointment of such alternate shall be restricted to three public listed companies, at any one time, subject to the requirements under the Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002. All directors except the managing director should be required to submit themselves for re-election at regular intervals or at least every three years. Executive directors should have a fixed service contract not exceeding five years with a provision to renew subject to regular performance appraisal and shareholders approval.

Disclosure should be made to the shareholders at the annual general meeting and in the annual reports of all directors approaching their seventieth (70th) birthday that respective year. Resignation by a serving director should be disclosed in the annual report together with the details of the circumstances necessitating the resignation. It is not clear why this is required. Could it suggest that in CMA's view the elder directors are more effective in managing the firm? In reality, is there a relationship between the age of the directors and the firms' performance?

Role of Chairman and Chief Executive

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

Approval of Major Decisions by Shareholders

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

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

Accountability and Audit

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

Public Disclosure

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

2.3.2 Private Sector Corporate Governance Trust Kenya (PSCGT)

PSCGT, a not-for-profit organisation established in year 2000 was meant to spearhead the adoption of corporate governance amongst the private sector in Kenya. The Initiative was conceived as an all-inclusive coordinating council bringing together regulatory authorities, the private sector and representatives of various stakeholder groups acting jointly to promote good corporate governance to achieve sustainable wealth creation, increased employment opportunities and overall improvement in the quality of life for the people of Kenya.

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

2.4 Global Trends in Corporate Governance

The Sarbanes-Oxley Act of 2002 was the most sweeping legislation affecting corporate governance, disclosure and financial accounting. It requires that CEO's, CFO's and independent auditors and committees:

i. Certify the accuracy of financial statements and disclosures
ii. Indicate in each periodic report whether or not there were significant changes in internal controls or related factors since their most recent evaluation and disclose all deficiencies in the design or operation of internal controls

iii. Provide auditor's attestation to, and report on, management’s assessment of the internal controls and procedures for financial reporting.

iv. Report that controls and procedures for financial reporting and disclosure have been evaluated for effectiveness.

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

Control Activities

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

Information and Communication

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

Monitoring

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

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

2.5 Corporate Governance and Value of the Firm

Previous studies in Kenya have tried to uncover the relationship between the embedment of corporate governance and the financial performance of those firms. Below, plausible relationships between embedment of corporate governance and the firms longer term value are demonstrated.

2.5.1 Corporate Ownership and Control and Value of the Firm

Jensen & Meckling (1976) analysed the effect of outside equity and therefore control on agency costs. They concluded thus: 'As the owner-manager's fraction of the equity falls, his fractional claim on the outcomes falls and this tends to encourage him to appropriate larger amounts of the corporate resources in the form of perquisites. This makes the shareholders expend more resources in monitoring the behaviour of the owner manager. Secondly, they also observed that … that as the manager's ownership claim falls, his incentive to devote significant effort to creative activities such as searching out new profitable ventures falls.

The above findings are consistent with the premise that the relatively small shareholders do not violently object the majority or controlling shareholders. In the case of British American Tobacco Kenya, for instance, where the majority shareholder owns 40% of the issued shares, there has been little resistance, if any, by the firms' minority shareholders over the years, largely because of the small shareholders' knowledge that the majority shareholder, due to the sheer size of their stake in

the firm are actively interested in the financial performance of the firm and therefore the firms' longer term value.

Accordingly, it is reasonable to conclude that corporate governance and ownership control both impact on the financial performance and therefore the value of the firm since they impact to a great extent of strategic decision-making.

The above conclusions point to the fact that firms with concentrated shareholding would:

i. Have potential shareholders not factoring the monitoring costs in the price at which they purchase a firms' share, and therefore the firms' share would be highly valued, and
ii. The search for profitable ventures would be high on the firms' strategic agenda and this would lead to higher profitability. Higher profitability would, as a result of dividending and / or retained earnings lead to market share appreciation.

Effectively, Jensen & Meckling (1976) study seems to suggest therefore, that closely held shareholding drives up the shareholder value. The requirement to disclose the top 10 shareholding, as spelt out by the CMA Act (2002) would therefore have provided insights to the investors on the extent of diffusion of shareholding of companies listed at the Nairobi Stock Exchange (NSE).

Demsetz and Lehn (1985) and Morck, Shleifer and Vishny (1988) documented that for many firms, a large shareholder owns a significant percentage of the outstanding shares. Were these shareholders to sell some of the shareholding, they would be seen to be communicating unfavourable information to the investing public. Holding a large number of shares tells investors that the entrepreneur is confident about the fir4ms prospects and that the firm is implementing strategies that maximise the value of the company's shares. Empirical studies by Ritter (1984) provide evidence that when entrepreneurs retain a higher stake in their firms when their firms go public, they get higher prices for the shares they sell. Morck, Shleifer and Vishny (1988) examined the relation between market values and management shareholdings in a sample of Fortune 500 firms. They found that, for relatively small shareholdings, firms with higher concentrations of management ownership have higher market values relative to their book values. However, as management's shareholdings rise above 5 percent, the firms become less valuable. This suggests that as the manager's holdings become too large, managers become

entrenched, allowing them more freedom to pursue their own agendas in lieu of value maximising policies.

2.5.2 Board Composition, Size, Independence and Company's Value

Fama & Jensen (1983) contend that boards of directors reduce agency costs by separating the management and control aspects of decision making. Control involves ratification and oversight of decisions made by management. Whereas management retains authority to initiate and implement decisions, the firms' board of directors retains control, for ratifying and monitoring the firms' key decisions.

The above finding would be consistent with CMA's articulation of the chief role of the board of directors in Kenyan firms, primarily to offer strategic guidance, lead and control the company and be accountable to its shareholders. This guideline seems to reflect CMA's realisation the firms' management may pursue interests that are incongruent with those of the shareholders and hence the requirement to appoint an independent board that would ensure that the shareholders' interests are safeguarded. Without such a mechanism, the firms' management may pursue own interests that may lower the firms' financial performance with a corresponding lowering of the firms' value.

In practice, the board of directors of most Kenyan firms review and approve the firms' annual and strategic plans, setting out how the firms' resources are allocated, setting annual performance targets, approving the managements' reward schemes, most of which if unchecked may be manipulated by the firms' management at the expense of the shareholders.

In addition, Fama & Jensen (1983) also observed that the board of directors, as the …apex of decision control system of organisations … have the power to hire, fire, and compensate the top level decision managers and to ratify and monitor important decisions. The ability of the board to limit managerial actions that reduce shareholder wealth such as perquisite consumption is conditional upon the extent that the board members are beholden to management. In this regard, board composition becomes important as the primary responsibility in maintaining objectivity depends largely on outside members of the board.

Bacon (1989), in a study of corporate boards reported that the number of board members at large companies declined from a median of 14 in 1972 to a median of 12 in 1989, which may had an effect of making the individual board members take their responsibilities more seriously.

Schellenger (1989) observed that … that outsider dominated boards take a more active role in promoting the financial performance of the firm. Would this conclusion be applicable with regard to the overall value of the firm, and hence shareholder wealth?

Further insights on the effectiveness of outside directors on the board became available on the publication of The Report of the Committee on the Financial Aspects of the Corporate Governance, Chaired by Sir Adrian Cadbury on 1 December 1992. The Cadbury report consisted of a formal code ('The Code of Best Practice') and extensive comments and recommendations for publicly held UK firms. The primary aim of the Cadbury report was to recognize the paramount importance of effective board monitoring, and to suggest ways of achieving that goal by codifying a regulatory framework by corporate governance.

The Cadbury Report contains a variety of specific recommendations concerning board structure and responsibilities. Among these are two key guidelines to ensure board independence, namely that boards include at least three non-executive directors and that the position of the chief executive officer and chairman of the board is separate. Compliance with the Cadbury recommendations were made voluntary. Companies were required to state whether they complied with the report and give reasons for not doing so.

2.5.3 Executive Compensation

Jensen & Meckling (1976) observed: 'The principal can limit divergences from his interest by establishing appropriate incentives for the agent …'. The principal's (the shareholder's) goal is the maximization of wealth. Accordingly, incentive schemes being put in place ought to consider the levers that drive shareholder value.

A significant source of conflict of interest between the management and shareholders, as observed by Coyle (2002) is where the management remunerate themselves generously, even when the company is underperforming. The remuneration schemes put in place should be in such a way that

the management are remunerated generously when the company is performing well and the vice versa should also be true.

In ensuring that the compensation schemes are designed to motivate the company executives, the principals are able to ensure that the agents make choices that are congruent with the objectives of the shareholders. This in a way plays a role in resolving the agency problem.

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.0 Introduction

This study investigated the correlation between the extent of corporate governance embedment and value of the firm for the companies listed at the Nairobi Stock Exchange.

3.1 Population and Sampling

The population covered all the 46 companies listed at the Nairobi Stock Exchange as at 31 December 2008 (see appendix 2) representing the different sectors namely the Agricultural, Commercial and Services, Finance and Investments and Industrial and Allied sectors. The period of study covered the years 2004 to 2008. The firms that have been listed in the NSE after 2004 were included in this study from their first year of publication of the audited financial statements.

The choice of this period of five years was considered reasonable since it allowed for a year's grace period since the publication of the Gazette Notice No. 3362 that effectively introduced corporate governance in Kenya.

Mutisya (2006) indicated in her study that data for the period prior to 2004 was largely unavailable, so the choice of the period has also taken the availability of data into account.

3.2 Data Collection

The study made use of secondary data only. Due to time and cost constraints, primary data was not be collected. Secondary data, which covered the characteristics of companies with regard to corporate governance and the value of the firm was obtained from the audited financial statements of individual companies sampled, which financials statements were available at the Capital Markets Authority library.

Data ascertained from the audited financial statements included size of boards, inside and outside directors, shareholders funds, age of directors, number of meetings held in a year, shareholding by

directors, proportion of shares owned by the top shareholder and proportion of shares held by the top 10 shareholders.

Value of the firms listed at the Nairobi Stock Exchange for the period under study was obtained from the Nairobi Stock Exchange.

3.3 Data Analysis

Multiple regression analysis was performed on the data to examine the effect of the various aspects of corporate governance on the value of the firm. The independent variables were size of boards, inside and outside directors, shareholders funds, age of directors, number of meetings held in a year, shareholding by directors, proportion of shares owned by the top shareholder and proportion of shares held by the top 10 shareholders.

The dependent variables were the value of the firm as derived from both the market price of the share on the day before the end of the year multiplied by the number of issued shared.

Below, please see the summary of the independent variables, showing the expected relationship with the dependent variables as well as the reason for the hypothesised relationship. This was the basis of the multiple regression analysis performed on the data to examine the effect of the various aspects of corporate governance on the value of the firm.

On the premise that the value of the firm is driven by all the factors listed in the appendix, the following multiple regression equations were used:

VF = BO + B1(BOS) +B2(INS)+ B3(OUT) + B4(DQF) + B5(MPA) + B6(DIR) + B7(TSH) + B8(TOT) + B9(WMN) + B10(AGE)

Where:

VF = Value of the Firm, BO = CO = Constant, with all the other variables explained in table 1, overleaf

Table 1: Summary of the Hypothesized Relationships between the Dependant Variables

Independent Variable	Measure	Relationship with Dependent Variable	Reason for Hypothesised Relationship
BOS	Board Size: Number of directors	negative	Large boards are likely to be less effective
INS	% of inside directors	negative	Inside directors are easier to manipulate by CEO
OUT	% of outside directors	positive	outside directors are able to act on behalf of the company without personal interest and hence more objective
DQF	Qualifications of directors (academic or professional)	positive	The higher the qualifications of the directors, the effective they individually and collectively are and hence higher corporate firms' value
MPA	Number of meetings per year	positive	More meetings translate to more value added by board
DIR	Proportion of shares held by insiders	negative	Insiders holding shares want to serve longer since they are serving own interest
TSH	% shareholding by top shareholder	positive	Shareholders owning a higher chunk have an increased incentive to monitor managerial behaviour, therefore affect the affairs of the company in a positive manner
TOT	% of shares owned by top 10 shareholders	Positive	The higher the % the more the incentive to monitor managerial behaviour and thus affect affairs of the company in a positive manner
WMN	Number of women serving on board	Positive	Gender diversity improves outlook of the public hence higher value
AGE	Age of directors	Positive	Elder directors are associated with greater wisdom, and hence a higher value of the firm.

CHAPTER FOUR

4.0 DATA ANALYSIS AND FINDINGS

4.1 Introduction

This chapter presents secondary data findings of the study on the effect of implementation of corporate governance on the value of firms listed on the NSE. The study was done using secondary data. Out of the population of forty seven companies, thirty five representing 74.47% had filed the annual financial reports at the Capital Markets Authority. The data analysis focused on all these thirty five companies. The number of companies analysed, at 74.47% is deemed sufficient for the purposes of making conclusions on the population.

The objective of the study was to determine the effect of implementation of corporate governance on the value of firms listed on the NSE. The presentation of this chapter starts with the analysis of the implementation of corporate governance in the firms. Secondly, the effect of implementation of corporate governance on the value of firms sampled has been analysed.

Data analysis was carried out through quantitative methods. Data was entered into Statistical Package for Social Science (SPSS) and was analysed using cross tabulation. Data frequency and percentages were used. The information was first coded by assigning numbers to the categories and analysed with the aim of searching for trends.

4.2 Data Findings

Table 2: Summary of Descriptive Statistics

	Mean	**Median**	**STD DEV**	**Minimum**	**Maximum**
Board Size	9.2	9.0	2.6	4.0	15.0
Percentage of inside directors	22.4%	19.1%	14.6%	8.3%	75.0%
Percentage of Outside directors	77.6%	80.9%	14.7%	25.0%	92.0%
Qualifications of Chief Executive				Professional Qualification	Doctorate degree
Qualifications of directors				Professional Qualification	Doctorate degree
Number of meetings per year	5	4	3	2	16
Percentage shareholding by top shareholder	50.0%	48.6%	24.8%	0.0%	92.1%
Percentage of shares owned by top 10 shareholders	66.8%	73.1%	28.7%	0.0%	94.0%
Number of women serving on board	1	1	1	0	3
Value of firm '000,000'	20,628.9	8,406	31,290.4	569.0	133,641

Table 2 above provides a summary of the descriptive statistics of the dependent and independent variables for the sample of firms. This shows the average indicators of variables computed from the financial statements, company reports and the notes accompanying the financial statement. The value of firm measured by market capitalization reveals an average of Ksh 20,628.9 million with median Ksh 8,406 million. The maximum value was Ksh 133,641 million and a minimum value of Ksh 569 million.

On the board size of the firms the data findings shows a mean of 9 with the minimum board size being 3 while the maximum number was established at 15. Whilst the number of board members varies from one company to another, a board with too few board members is unlikely to have a

good variety of knowledge and experiences. Nevertheless, boards that are too huge are likely to be ineffective.

Most companies met on average five times a year, a picture shown by a mean of 5, with some boards meeting as frequently as 15 times in a year. The more the meetings, the more the boards of directors are likely to put in quality debate into the affairs of the company and accordingly, the higher the performance of the company, leading to a higher company's value.

Table 2 also presents the data finding on the academic qualifications of the CEO and that of the directors. The table shows that the CEO and the directors who had the highest qualification had doctorate degree while the others had professional qualifications as the highest attained academic qualification.

The average value of the percentage shareholding by top shareholder was 50%, the minimum value 0% while the maximum value was 92.1%. Data findings on the percentage of shares owned by top 10 shareholders established the mean at 66.8%, minimum value was 0% while the maximum value was 94%. This reveals that while some companies did not have top shareholders, in some companies, top shareholders owned up to 94% of the total shares issued. The same also depicts that on average 50% of the total shares issued are controlled by a majority shareholder.

This shows that shareholding in most Kenyan firms is heavily concentrated. The extent of diffusion of shareholding is yet to be significantly spread so as to prevent one or a few shareholders unilaterally controlling the decision making processes in firms listed at the stock exchange.

The table above further shows that in board meetings the number of women participants was too small given a mean and a median value of 1. The table also shows that the maximum number of women participants in board meetings was 3. With the inclusion of more women into companies boards of directors, it is expected that the boards would be strengthened given the strengths expected to be brought about by at gender diversity. New lines of thought as well as perspectives are expected to be brought on board and this should yields more value for the respective firms.

4.2.1 Data Findings on the 2004 Regression Model

Using the Statistical Package for Social Scientists, data was analysed. With the use of the multiple regression analysis, the following coefficients were determined and used in building the regression model.

Table 3: Coefficients

Independent variables	**Coefficients**
(Constant)	4011.33
Percentage of inside directors	-0.703
Qualifications of Chief Executive	0.303
Number of meetings per year	0.665
Proportion of shares held by insiders	0.738
Percentage of shares owned by top 10 shareholders	-0.268
Board Size	0.703
Percentage of Outside directors	0.700
Qualifications of directors	0.514
Percentage shareholding by top shareholder	0.124
Number of women serving on board	0.665

Dependent Variable: Value of firm

From the finding of the study in the above table , the following regression equation was established by the study,

VF = 4011.333 + 0.703(BOS) - 0.700(INS)+ 0.7(OUT) + 0.514(MQF) + 0.303(CQF) + 0.665(MPA) + 0.738(DIR) + 0.124(TSH) - 0.268 (TOT) + 0.665(WMN)

Whereby:

BOS = Board Size

ISH = Percentage of inside directors

OUT = Percentage of Outside directors

MQF = Qualifications of directors

CQF = Qualifications of Chief Executive

MPA = Number of meetings per year

DIR = Proportion of shares held by insiders

TSH = Percentage shareholding by top shareholder

TOT = Percentage of shares owned by top 10 shareholders

WMN = Number of women serving on board

From the finding in the above table the study found that holding board size, percentage of inside directors, percentage of outside directors, qualifications of directors, qualifications of chief executive, number of meetings per year, proportion of shares held by insiders, percentage shareholding by top shareholder, percentage of shares owned by top 10 shareholders and number of women serving on board constant, the firm value will be 4011.333.

The study also found that a unit increase in board size will lead to a 0.703 increase in a firm's value and a unit increase in the proportion of shares held by insiders will lead to a 0.738 increase in the firm's value. A unit increase in the percentage of outside directors will lead to a 0.7 increase in a firm's value, a unit increase in the number of meetings per year or women participants in the board meeting will lead to a 0.615 in the firm's value and a unit increase in the directors qualification will lead to a 0.514 increase in the firm's value. This shows that board size, proportion of shares held by insiders, percentage of outside directors, number of meetings per year, women participants in the board meeting, directors qualification and percentage shareholding by top shareholder positively influence the firms value.

Table 4 above also shows that a unit increase in the percentage of inside directors will lead to a 0.7 decrease in the value of a firm, a unit increase in the qualifications of Chief Executives will lead to a 0.303 increase in the value of the firm and a unit increase in the percentage of shares owned by top 10 shareholders will lead to a 0.268 decrease in the value of the firms. This shows that

percentage of inside directors and percentage of shares owned by top 10 shareholders all have a negative correlation with the value of the firm.

CHAPTER FIVE

5.0 SUMMARY, DISCUSSIONS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter summarizes the results of the research work. First, it gives a summary, discussion and conclusion of each objective. Limitations of the study and suggestions for further research are also discussed. Finally, recommendations for policy and practice are provided.

5.2 Summary, Discussions and Conclusions

According to the study findings analyzed in chapter four the study found that that a unit increase in board size will lead to a 0.703 increase in a firm's value. This means that a board size of a company has a positive relationship with its value which is consisted with Kajola (2008) who found a positive and significant relationship between company value/performance and board size. A positive relationship (0.738) was also established between proportion of shares held by insiders and firm value. This is because when the insiders (employees and management) have ownership of the same company they work for, they will be motivated to work harder and this also reduces the agency cost. The study also established a positive relationship between outside directors (0.7) and the firm's value. This contradicts Kajola (2008) findings that there exists no significant relationship between firm value and board composition. This is further contradicted by the study's findings of a positive (0.615) relationship women participants in the board meeting and firm's value.

The study further found a positive relationship between the number of board meetings per year and firm value (0.615). This owes to the fact that it is from board meeting that strategic plans are made and evaluation of the same done. Hence the more flexible a board meeting can be done enhances efficiency of strategic plan control more than a once-a-year rigid board meetings whereby emergent issue are not tackled in time hence affecting a company's performance.

The study hence concludes that board size, proportion of shares held by insiders, number of meetings per year positively influence the firms' value while the percentage of inside directors negatively correlates with the value of firms.

Since the corporate governance mechanisms adopted by a company determines its performance and hence its ultimate value, companies should essentially adopt corporate governance to increase the shareholders' value. For example, companies should consider revising the number of board meetings since the number of the board meetings augment the effectiveness of strategic plans and help solve the emerging industry and firm specific issues. This will increase the company's performance and hence its value. Companies should also optimise the size of their boards, given that a company's board makes important decisions that influence their performance and value.

5.3 Limitations of the Study

With the introduction of corporate governance guidelines in 2002, not many firms commenced full disclosure of the key aspects of corporate governance. Gradually, firms started embracing corporate governance and hence disclosure of the same in the financial statements. The number of years covered by the study was therefore limited to five, whereas an ideal period would be at least ten years.

The study may also have had some inherent weaknesses due to use of secondary data. First comes the risk that firms may have reported what was ideal corporate governance and not necessarily what had been implemented. This risk is substantially mitigated by the fact that the source of data included in the financial statements had been subjected to an external audit.

5.4 Suggestions for Future Research

This study focussed on corporate governance as disclosed in the financial statements, which is restricted to the extent of compliance with what the capital markets authority had promulgated in their 2002 guidelines. Rather than rely on secondary data, future researchers could consider collection of primary data, whereby the firm captains and chief financial officers are asked to gauge the impact of the various corporate governance practices – whether voluntary or legislated, on the value of the firms they steward.

Carletti (2007) concluded that 'In many countries, firms are not only concerned with shareholders but also other stakeholders such as employees and suppliers'. This gives rise to whom, of the varied stakeholders matters most while companies makes decisions, either strategic or operational. Future

research could include ascertainment of what the industry captains as well as the regulators think about prioritisation of stakeholder interests in Kenya.

5.5 Recommendations for Policy and Practice

It is imperative that corporate governance benefits all the constituents of the firms. So as to encourage voluntary compliance by all the firms, including those not listed at the stock exchange, the regulators, financial practitioners and key policy makers should consider cascading public education on corporate governance. This would ensure that that the investing public and other firm's constituents understand the importance of corporate governance and hence their enthusiasm in following up of sustainable corporate governance implementation.

Appendix : List of firms listed at Nairobi Stock Exchange as at 31 December 2008:

1. Agriculture

a. Rea Vipingo Ltd.
b. Sasini Tea & Coffee Ltd.
c. Kakuzi Ltd.

2. Commercial and Services

a. Access Kenya Group
b. Marshalls E.A. Ltd.
c. Car & General Ltd.
d. Hutchings Biemer Ltd.
e. Kenya Airways Ltd.
f. CMC Holdings Ltd.
g. Uchumi Supermarkets Ltd.
h. Nation Media Group Ltd.
i. TPS (Serena) Ltd.
j. ScanGroup Ltd.
k. Standard Group Ltd.
l. Safaricom Ltd.

3. Finance and Investment

a. Barclays Bank of Kenya Ltd.
b. CFC Stanbic Bank Ltd.
c. Housing Finance Company of Kenya Ltd.
d. Centum Investment Ltd.
e. Kenya Commercial Bank Ltd.
f. National Bank of Kenya Ltd.
g. Pan Africa Insurance Holdings Co. Ltd
h. Diamond Trust Bank of Kenya Ltd.
i. Jubilee Insurance Co. Ltd

j. Standard Chartered Bank Ltd.
k. NIC Bank Ltd.
l. Equity Bank Ltd.
m. The Co-operative Bank of Kenya Ltd.

4. Industrial and Allied

a. Athi River Mining Ltd.
b. BOC Kenya Ltd.
c. British American Tobacco Kenya Ltd.
d. Carbacid Investments Ltd.
e. Olympia Capital Holdings Ltd.
f. E.A. Cables Ltd.
g. E.A. Breweries Ltd.
h. Sameer Africa Ltd.
i. Kenya Oil Ltd.
j. Mumias Sugar Company Ltd.
k. Unga Group Ltd.
l. Bamburi Cement Ltd.
m. Crown Berger (K) Ltd.
n. E.A Portland Cement Co. Ltd.
o. Kenya Power & Lighting Co. Ltd.
p. Total Kenya Ltd.
q. Eveready East Africa Ltd.
r. Kengen Ltd.

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