

**THE EFFECT OF CORPORATE GOVERNANCE ON A FIRM'S FINANCIAL
PERFORMANCE: A CASE STUDY OF COMPANIES LISTED ON THE NAIROBI
STOCK EXCHANGE**

By: Jacob Odhiambo Ombayo •^v

A Management Research Project Submitted in Partial Fulfilment of the
Requirement of the Degree of Master of Business Administration,
School of Business, University Of Nairobi.

September, 2011.

DECLARATION

This research project is my original work and has not been presented for a degree in any University or institution. No part of this research project may be reproduced without prior permission of the author.

i

Name: Jacob Odhiambo Ombayo

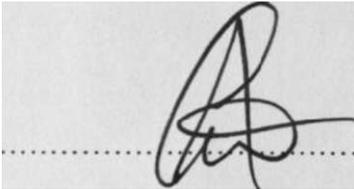
^

7*

S i g n a t u r e . ^ ^ ^ ^ ^ ; . . . Date

j

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

Signed 

igkht 11

Angela Kithinji

Lecturer

Department of Finance and Accounting,

School of Business,

University of Nairobi.

DEDICATION

This work is dedicated to my loving wife and best friend, Alice, for her understanding, willing acceptance of new demands, patience, care and support; our sons and daughters, Ernest, Margaret, Jane and Caesar for their love, support and courage; in memory of my dad John, and my mum Margaret, for their prayers. All praise is reserved for the Creator and Author of Truth, Jesus Christ, who has been gracious in my quest for cultivating intellectual virtues.

ACKNOWLEDGEMENT

I wish to express my sincere gratitude to the School of Business, University of Nairobi, and in particular my supervisor, Mrs Angela Kithinji, for her immense support and guidance during the entire research period. I would like to offer my sincere gratitude to my lecturers Dr.Ogutu, Mr.Odipo, Mr.Kamasara, and Mr.Mwangi Mirie, for being extremely supportive. I really appreciate their guidance and readiness to help. Their comments and suggestions have gone a long way in improving this research. My sincere thanks to the department head of finance and accounting, Dr.Aduda, for providing helpful comments and guidance. To my classmates, I benefited immensely from our discussions. I am grateful to those who agreed to participate in this research by completing the questionnaire, conducting the survey, data capturing, analysis and editing. I wish to express a word of gratitude to my employer for providing me the opportunity and financial support to undertake my MBA studies.

Last, but certainly not least, a special word of gratitude to my- wife ,Alice ,who exhibited such patience while she shared her husband with Master of Business Administration in Finance. I benefited immensely from her interactive academic engagement in research, being a post graduate student herself. Our children Ernest, Margaret, Jayne and Caesar were a source of inspiration, strength and courage, given their tender age-the later took time to comprehend why his dad was attending classes at a mature age.

I glorify the Almighty God for the strength, courage, wisdom and inspiration throughout the period of my studies.

TABLE OF CONTENTS

v

DECLARATION ii

v

DEDICATION iii

ACKNOWLEDGEMENT iv

TABLE OF CONTENTS..... v

LIST OF ABBREVIATIONS.....xi

ABSTRACT.....xii

CHAPTER ONE: INTRODUCTION 1

 1.1 Background of the Study.....1

 1.2 Statement of the Problem 6

 1.3 Objectives of the Study.....8

 1.3.1 General Objective.....8

 1.3.2 Specific Objectives 8

 1.4 Importance of the Study.....8

CHAPTER TWO: LITERATURE REVIEW.....10

 2.1 The Concept of Corporate Governahce10

 2.2 Corporate Governance Practices 15

2.3 Theoretical Review.....	16
2.3.1 Agency Theory.....	16
2.3.2 Shareholder Theory.....	17
2.4 Corporate Governance and Stock Market Performance.....	20
2.4.1 Board Size.....	20
2.4.2 Composition.....	24
2.4.3 Independence of Committees.....	25
2.5 Empirical review.....	27
2.6 Chapter Summary.....	29
CHAPTER THREE: RESEARCH METHODOLOGY.....	31
3.1 Research Design.....	31
3.2 Target Population and Sampling.....	32
3.3 Research Instruments.....	33
3.4 Data Collection Methods.....	33
3.4.1 Data on company's financial performance.....	34
3.5 Piloting.....	34
3.6 Data Processing and Analysis.....	35
CHAPTER FOUR: ANALYSIS, PRESENTATION AND INTERPRETATION.....	36

4.1 Introduction.....	36
4.2 General Information on the Respondent's Firm.....	36
4.2.1 Business Sector.....	36
4.2.2 Ownership and control structure of firms.....	37
4.2.3 Legal Status Of The Firms.....	38
4.2.4 Firms controlled by the government.....	39
4.2.5 Firms controlled by Foreign Investors.....	40
4.3 Shareholders' Rights.....	41
4.4 Disclosure and Transparency.....	42
4.5 Effectiveness of the Board of Directors.....	44
4.5.1 Composition of the Board of Directors.....	44
4.5.2 Independence of the Board.....	45
4.5.3 Committees of the Board.....	46
4.5.4 Effectiveness and independence of audit committees.....	46
4.5.5 Evaluation and Compensation of the CEO.....	48
4.6 Corporate governance and Firm performance.....	48
4.6.1 Financial performance of the listed firms.....	49

CHAPTER FIVE: SUMMARY OF FINDINGS, CONCLUSIONS AND

RECOMMENDATIONS.....51

5.1 Introduction.....51

5.2 Summary of the Findings. 51

5.2.1 Corporate governance practices of listed companies.....51

5.2.2 Linkage between the quality of corporate governance and firm performance.....56

5.3 Conclusion and Policy Recommendations.....57

5.4 Limitations of the study.....57

5.5 Areas for further research.....58

REFERENCES.....59

APPENDICES.75

List of Tables

Table 4.1 Business Sectors of respondent companies.....	36
Table 4.2 Ownership and control structure of firms.....	37
Table 4.3 Legal status of the firms.....	38
Table 4.4 Firms controlled by Government.....	39
Table 4.5 Firms controlled by Foreign Investors.....	40
Table 4.6 Number of shareholders.....	41
Table 4.7 Disclosure and Transparency.....	42
Table 4.8 Composition of the Board of Directors.....	44
Table 4.9 Independence of the Board.....	45
Table 5.0 Effectiveness and Independence of Audit committees.....	47
Table 5.1 Evaluation and compensation of the CEO.....	48

List of Figures

Fig 4.1 Business Sectors of respondent companies.....	37
Fig 4.3 legal status of respondent firms.....	38
Fig 4.4 :Firms controlled by the government.....	39
Fig 4.5 Firms controlled by Foreign Investors.....	40
Fig 4.6 Number of shareholders.....	41
Figure 4.7 Return on Equity Trend for Survey Firms (Year 2005 to Year 2008).....	49

LIST OF ABBREVIATIONS

ISS	International Shareholder Services
GNP	Gross National Product
PPP	Purchasing Power Parity
CEO	Chief executive Officer
CMA	Capital Market Authority
SPSS	Statistical Program of Social Science
NSE	Nairobi Stock Exchange
ROE	Return on Equity

ABSTRACT

Good corporate governance contributes to a company's competitiveness and reputation, facilitates access to capital markets and thus helps develop financial markets and spur economic growth. Today, both domestic and foreign investors place an ever greater emphasis on the way that corporations are operated and how they respond to their needs and demands. Investors are increasingly willing to pay a premium for well-governed companies that adhere to good board practices, provide for information disclosure and financial transparency, and respect shareholder rights. Well-governed companies are also better positioned to fulfill their economic, environmental, and social responsibilities, and contribute to sustainable growth. Improvement in corporate governance practices can improve the decision making process within and between a company's governing bodies, and should thus enhance the efficiency of the financial and business operations. Better corporate governance also leads to an improvement in the accountability system, minimizing the risk of fraud or self-dealing by company officers. An effective system of governance should help ensure compliance with applicable laws and regulations, and further, allow companies to avoid costly litigation.

The purpose of this study is to examine corporate governance practices of companies listed at the Nairobi Stock Exchange and identifying how the corporate governance practices impact on a firm's financial performance. The study uses a sample of the twenty companies comprising the NSE-20 share index. The respondents in this study were company secretaries and other officers who deal with governance and shareholder relations in the respondent companies. Data on financial performance for a period of four years (from 2005 to 2008) was compiled from the company returns filed with the NSE.

The study found that the firms surveyed had all companies had boards composed of eight to twelve directors. Independent directors comprised 25% to 50%' of the total directors. All boards have audit committees comprising independent directors. On disclosure and transparency, most respondents indicated that there is a room for improvement. The results further indicated that most of the surveyed firms conduct a formal appraisal of the CEO's performance and periodically review his performance. Regarding performance, most of the surveyed firms posted strong performance with majority of the firms' profitability increasing by over 100% for a period of four years. The study recommends that regulatory mechanisms be strengthened so as to promote good corporate governance practices among listed firms

CHAPTER ONE: INTRODUCTION

•*

1.1 Background or the Study

Corporate governance is the set of processes, customs, policies, Laws and institutions affecting the way a corporation is directed, administered or controlled. Corporate governance also includes the relationships among the many players involved (the stakeholders) and the goals for which the corporation is governed. The principal 'players are the shareholders, management and the board of directors. Other stakeholders;include employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at large (Knell 2006).

Corporate governance is a multi-faceted subject. An important theme of corporate governance deals with issues of accountability and fiduciary duty, essentially advocating the implementation of guidelines and mechanisms to ensure good behaviour and protect shareholders. Another key focus is the economic efficiency view, through which the corporate governance system should aim to optimize economic results, with a strong emphasis on shareholders welfare. There are yet other sides to the corporate governance subject, such as the stakeholder's view, which calls for more attention and accountability to players other than the shareholders (e.g: the employees or the environment) (Singh 2005). Recently there has been considerable interest in the corporate "governance practices of modern corporations, particularly since the high-profile collapses of Igrge U.S. firms such as Enron Corporation and Worldcom (Knell 2006).

The argument has been advanced time and time again that the governance structure of any corporate entity affects the firm's ability to respond to external factors that have some bearing

on its performance. In this regard, it has been noted that well governed firms largely perform better and that good corporate governance is of essence "to" firms. The subject matter of corporate governance has dominated the policy agenda in developed market economies for sometime especially among very large firms. Subsequently, the concept is gradually warming itself to the top of policy agenda in the Africa continent. Indeed, it is believed that the Asian crisis and the seemingly poor performance of the corporate sector in Africa have made the concept of corporate governance a catchphrase in the development debate (Berglof and von Thadden, 1999).

◊

It is believed that good governance generates investor goodwill and confidence. Again, poorly governed firms are expected to be less profitable. Claessens et al. (2003) also posits that better corporate framework benefits firms through greater access to financing, lower cost of capital, better performance and more favourable treatment of all stakeholders. They argue that weak corporate governance does not only lead to poor, firm performance and risky financing patterns, but are also conducive for macroeconomic crises like the 1997 East Asia crisis. Other researchers contend that good corporate governance is important for increasing investor confidence and market liquidity (Donaldson, 2003). ••

Becht et al. (2002) identifies a number of reasons for the growing relevance of corporate governance, which includes the world -wide wave of privatization of the past two decades, the pension fund reform and the growth of private savings, the takeover wave of the 1980s, the deregulation and integration of capital markets, the 1997 East Asia Crisis, and the series of recent corporate scandals involving firms such as Enron and WorldCom in the USA and elsewhere. Developing countries are now increasingly embracing the concept knowing it leads to sustainable growth. Indeed, corporate governance in Kenya is now gaining some

level of recognition with very little work in the area even in the well-regulated institutions and sectors.

Several studies have been done to establish relationship between governance structure and firm's performance. One argument is that a strong corporate governance structure, could lead to a high performance (Sanda et al, 2005). It will help to promote a firm's performance and protect stake holder's interests. Nam et al (2002) found that corporate governance should lead to better performance since managers are better supervised and agency costs are decreased. Poor corporate governance on the other hand is a fertile ground for corruption and poor financial performance. Brown et al (2003) found that firms with weaker corporate governance perform poorly compared to those with stronger corporate governance in terms of stock returns, profitability, riskiness and dividend payments.

The Anglo-Saxon economies being predominantly market-based and market-driven operates through dispersed shareholdings and influential sophisticated institutional shareholders where minorities may expect some degree of protection; and where the board is increasingly made up of majority non-executive independent directors who may not align with the interests of dominant shareholders but rather all shareholders (Coombs and Watson, 2001; La Porta et al., 1999). Here, financial information disclosure is crucial not only to ensure transparency and accountability, but more importantly the sustenance of market liquidity to provide a workable environment for corporate divestment, takeover and merger activities. Corollary to this, the corporate and capital market frameworks are geared towards greater focus on transparency, accountability and enforcement issues.

Corporate governance is not just about board structure and interests alignments for its own end. It is very much about perceived benefits in terms of attraction of capital and its retention.

For corporations it could well mean enhanced market Capitalization. An international corporate governance survey showed that investors are prepared to pay more for corporations with more effective governance structures and practices:- This resulted in lower share premiums for Asian, Latin American and other emerging economies; a comparatively higher premium for those in continental Europe where there are still pressures for better disclosure of information to shareholders; and an even higher premium for those in the UK and US capital markets where information disclosure to shareholders is enhanced either through strict securities laws or codes of best practices (McKinsey & Co., 2005).

A well defined and functioning corporate governance system helps a firm to attract investment, raise funds and strengthen the foundation for firm's financial performance. Good corporate governance shields a firm from vulnerability to future financial distress (Demsetz and Villalonga, 2002; Bhagat and Jefferis, 2002). The argument has been advanced time and time again that the governance structure of any corporate entity affects the firm's ability to respond to external factors that have some bearing on its financial performance (Donaldson, 2003). In this regard, it has been noted that well governed firms largely perform better and that good corporate governance is of essence to firm's financial performance.

The subject matter of corporate governance has dominated the policy agenda in developed market economies for sometime especially among very large firms. Subsequently, the concept is gradually warming itself to the top of policy agenda in the African continent. Indeed, it is believed that the Asian crisis in 1997 and the seemingly poor performance of the corporate sector in Africa have made the concept of corporate governance a catchphrase in the development debate (Berglof and von Thadden, 1999). It is believed that good governance generates investor goodwill and confidence. Again, poorly governed firms are expected to be less profitable. Claessens *et al.* (2002) also posits that better corporate

framework benefits firms through greater access to financing, lower cost of capital, better financial performance and more favourable treatment of all stakeholders. They argue that weak corporate governance does not only lead to poor firm financial performance and risky financing patterns, but are also conducive for macroeconomic crises like the 1997 East Asia crisis. Other researchers contend that good corporate governance is important for increasing investor confidence and market liquidity (Donaldson, 2003).

Among the many claimants on firm's cash flows, equity shareholders have always claimed a special attention may be because of the residual nature of their claims. Parker (2007a) paradigm of the separation of share holder ownership and management's control explained that agency problem occurs when the principal (Shareholders) lacks the necessary power/information to monitor and control the agent (manager)-and when the compensation of the principal and the agent is not aligned.

Given the existing problem inherent in the corporate firm, financial performance will be function of the quality of the corporate governance structures of the company (McKinsey and Co. 2005). In an efficient capital market, investors will discount the price they are willing to pay for a company's shares by the expected level of managerial agency costs. It is therefore assumed that for a company to prosper it will choose a corporate governance that is efficient in minimizing agency costs. It has also been argued that in the end it is a country's political framework which determines the quality of its corporate governance practices (Roe, 2003).

Corporate governance is defined as a field in economics that investigates how to secure or motivates efficient management of corporations by the use of incentives mechanism, such as contracts, organization design and legislation (Mathiesen./2002).. Abor, (2007) defines corporate governance as the system by which companies are, directed and controlled. It also refers to as the way in which corporations are handled by corporate boards and officers.

Hampel (1998) observes that good governance ensures that stakeholders with the relevant interest in the company business are fully taken into account, thus enhancing the financial performance of the firm. Brown and Caylor (2004) also shares the foregoing views seeing corporate governance as the relationship among various participants in determining the direction and performance of the companies consistent with the public good.

•v.

Corporate governance can be defined as the set of institutional arrangements affecting corporate decision making (Carter and Lorsch, 2004). Evans and Loh (2002 p.1) describe corporate governance as " rules governing board structures; managers and board's incentive compensation, decisions rights by the board and the Chief Executive Officer (CEO), session of the board and Chief Executive Officer, shareholding voting, debt/equity finance decisions as well as disclosure during take-over.

1.2 Statement of the Problem

Corporate governance has received much attention in the accounting literature, with studies focusing on the impact of corporate governance and the financial performance of the firm. Brown and Caylor (2004) provide insights to relationships between good corporate governance and corporate performance. Research indicates that companies with better corporate governance guarantee the payback to the shareholder and limit the risk of the investment. The association between quality of corporate governance and firms' profitability is quite major focus in corporate governance studies, but one cannot predict much on the direction as prior literatures show mixed results. Jensen and Meckling (1993) have proven that better-governed firms might have more efficient operations, resulting in a higher expected future cash-flow stream. Klapper and Love (2003) that 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) who found no significant relationship between firms governance and operating performance. Eisenberg *et*

al. (1998) also find negative correlation between board size and profitability when using sample of small and midsize Finnish firms. Mak and Yuanto (2003) re-echo the above findings in firms listed in Singapore and Malaysia when they found that firm valuation is highest when a board has five directors, a number considered relatively small in those markets. 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.

Even though corporate governance principles have always been important for getting good rating scores for large and publicly-held companies, they are also becoming much more important for investors, potential investors, creditors and governments (Gompers *et al.*, 2001). Because of all of these factors, corporate governance receives high priority on the agenda of policymakers, financial institutions, investors, companies and academics (Heracleous, 2001). In the literature a number of studies have sought to investigate the relation between corporate governance mechanisms and financial performance (e.g. Berglof, von Thadden, 1999). Most of the studies have shown mixed results without "a clear-cut relationship. E.g. a study by Becht *et al.*, (2002) show that corporate governance practices positively influences the profitability of the organization while MacAvoy and Millstein (2003) found that board composition does not have any effect on financial performance. This study thus seeks to investigate the relationship that exists between corporate governance and financial performance of firms at NSE. Further, the limited studies in the area have focused mainly on developed economies (E.g. Becht *et al.*, 2002). It is crucial to examine the relationship in the context of a developing economy.

Locally, Jebet (2001) conducted a study of corporate governance the case of quoted companies in Kenya, Muriithi (2005) did a study on the relationship between corporate

governance mechanisms & performance of firms quoted on the NSE. Manyuru (2005) researched on corporate governance and organizational performance the case of companies quoted at the NSE while Matengo (2008) did a study on the relationship between corporate governance practices and performance: the case of banking industries in Kenya. None of these studies have focused on the relationship between corporate governance and financial performance in Kenya at the NSE. This study aims to explore the relationship between corporate governance and the financial performance at the NSE. The study findings will be invaluable to all the firms in Kenya as it will provide a benchmark on the effect of good corporate governance on the financial performance.

1.3 Objectives of the Study

1.3.1 General Objective

The main objective of the study is to establish the relationship between corporate governance and firm financial performance at the NSE.

1.3.2 Specific Objectives

The specific objectives of this study are;

- i. To determine the corporate governance practiced by quoted firms in Kenya.
- ii. To establish the relationship between corporate governance and the financial performance of quoted firms at NSE.

1.4 Importance of the Study

This study is important to the different firms at NSE as they will be able to know for certain how corporate governance plays a bigger role in shaping their operations and how they affect their financial performance.

The aim of the study will be to investigate the effects of corporate governance on the firm financial performance at the NSE. This study therefore attempts to find out the effect of corporate governance on the firm financial performance at the NSE.

»

The results of this study will also be invaluable to researchers and scholars, as it will form a basis for further research. The students and academics will use this study as a basis for " discussions on the corporate governance practices adopted "by various firm^and how these affect their financial performance at NSE.

CHAPTER TWO: LITERATURE REVIEW

2.1 The Concept of Corporate Governance

Corporate governance has attracted various definitions. Metrick and Ishii (2002) define corporate governance from the perspective of the investor as "both the promise to repay a fair return on capital invested and the commitment to operate a firm efficiently given investment". Metrick and Ishii argue that firm level governance may be more important in developing markets with weaker institutions as it helps to distinguish among firms.

The theory on corporate governance stems from the thesis' "The Modern Corporation and Private Property" by Berle and Means (1932). The thesis highlights a fundamental agency problem in modern firms where there is a separation between management and ownership. It has long been recognized that modern firms are run by professional managers (agents), who are accountable to dispersed shareholders (principals). The scenario fits into the well-discussed principal-agent paradigm. The question is how to ensure that managers follow the interests of shareholders in order to reduce cost associated with principal-agent theory. To do that, the principals have to deal with two problems. First, they face an adverse selection problem: that is, they must select the most capable managers. Second, they are also confronted with a moral hazard problem: that is how to adequately motivate the managers to put forth the appropriate effort and make decisions aligned with shareholders interests. Cadbury Committee (1992) defines corporate governance as "the system by which companies are directed and controlled". On the other hand, Rajan and Zingales (1998) define a governance system as "the complex set of constraints that shape the ex- post bargaining over the quasi rent registered by the firm".

In Mayer (1997), 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. Again, corporate governance is concerned with the relationship between the internal governance mechanisms of corporations and society's conception of the scope of corporate accountability (Deakin and Hughes, 1997). It has also been defined by Keasy et al. (1997) to include "the structure, processes, cultures and system's that engender the successful operation of organizations".

From these definitions, it may be stated more generally that different systems of corporate governance will embody what are considered to be legitimate lines of accountability by defining the nature of the relationship between the company and key corporate stakeholders. Thus, corporate governance describes how companies ought to be run, directed and controlled (Cadbury Committee, 1992). It is about supervising and holding to account those who direct and control management. Shleifer and Vishny (1997), describe corporate governance as "the way in which suppliers of finance to corporations assure themselves of getting a return to their investment".

Separation between ownership and control of corporations characterizes the existence of a firm. The design of mechanisms for effective corporate control to make managers act in the best interest of shareholders has been a major concern in the area of corporate governance and finance (Allen and Gale, 2001) and continuing research in agency theory attempts to design an appropriate framework for such control. In a corporation, the shareholders are the principals and the managers are the agents working on behalf of, and for the interests of, the principals. In agency theory, a well-developed market for corporate controls is assumed to be non-existent, thus leading to market failures, non-existence of markets, moral hazards,

asymmetric information, incomplete contracts and adverse selection among others. Various governance mechanisms have been advocated which include monitoring by financial institutions, prudent market competition, executive compensation, debt, developing an effective board of directors, markets for corporate control, and concentrated holdings. Developing an effective board of directors remains an important and feasible option for an optimal corporate governance mechanism.

Agents or managers may not always act in the best interest of shareholders when the control of a company is separate from its ownership. In June 1959, Simon Herbert (Baysinger and Hoskisson, 1990) proclaimed that managers might be "satisfiers" rather than "maximisers," that is. they tend to play it safe and seek an acceptable level of growth because they are more concerned with perpetuating their own existence than with maximizing the value of the firm to its shareholders. But shareholders delegate decision-making authority to the agent (CEO) with the expectation that the agent will act in their best interest.

In contrast, Demesetz (1983) and Fama and Jensen (1983) suggest that the primary monitoring of managers comes not from the owners but from the managerial labour market. It is argued that management control of a large corporation is completely separate from its security ownership. Efficient capital markets provide signals about the value of a company's securities and thus about the performance of its managers. If the managerial labour market is competitive both within and outside the firm, it will tend to discipline the manager. Therefore, the signals given by changes in the total market value of the firm's securities become very, important.

Kaplan and Reishus (1990), Find evidence consistent with this argument: directors of poorly performing Firms, who therefore may be perceived to have done a poor job overseeing management, are less likely to become directors at other Firms/ On the other hand, reputation concerns do not correct all agency problems and can, in fact, create new ones.

A comprehensive theory of the Firm under agency arrangements was developed by Jensen and Meckling (1976), who show that the principals (the shareholders) can assure themselves that the agent will make the optimal decisions only if appropriate incentives are given and only if the agent is monitored. Incentives include such things as bonuses and prerequisites which are directly related to how well the results of management's decisions serve the interests of shareholders. Monitoring consists of bonding the agent, systematic reviews of management prerequisites, financial audits, and placing specific limits on management decisions. These involve costs, which are an inevitable result of the separation of corporate ownership and control. Such costs are not necessarily bid for shareholders, but the monitoring activity they cover needs to be efficient.

Jensen and Meckling (1976) further define agency relationship and identify agency costs. Agency relationship, according to them, is a contract under which "one or more persons (principal) engage other person (agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent". The scenario normally generates a conflict of interests. This conflict of interest between managers or controlling shareholder, and outside or minority shareholders refers to the tendency that the former may extract perks out of a firm's resources and be less interested to pursue new profitable ventures. Agency costs in this case include monitoring expenditures by the principal such as auditing, budgeting, control and compensation systems, bonding expenditures by the agent

and residual loss due to divergence of interests between the principal and the agent. Usually,

" v -*

the share price paid by shareholders (principal) reflects such.'agency costs. This is one way to view the linkage between corporate governance and corporate performance. Fama (1980) aptly comments that separation of ownership and control can be explained as a result of "efficient form of economic organization"

Previous empirical studies have provided the nexus between Corporate governance and firm performance (Yermack (1996); Claessens et al. Klapper and Love, 2002; Gompers et al. 2003; Black et al. 2003 and Sanda et al. (2003) with inconclusive results). Others, Bebchuk and Cohen (2004), Bebchuk et al. (2004) have shown that well-governed firms have higher firm performance. The main characteristic of corporate governance identified in these studies include board size, board composition, and whether the CEO is also the board chairman.

There is a view that larger boards are better for corporate performance because they have a range of expertise to help make better decisions, and are harder for a powerful CEO to dominate. In recent times on the contrary, emphasis has geared toward smaller boards. Jensen (1993) and Lipton and Lorsch (1992) contend that large boards are less effective and are easier for a CEO to control. The reason is that when a board gets too big, it becomes difficult to co-ordinate and process problems. Klapper and Love (2002) examine corporate governance and performance in a sample of firms in 14 countries, most of which are developing economies. They find that better corporate governance is associated with better performance in the form ofTobin's q and ROA.

John and Senbet (1998) provide a comprehensive review of the Stakeholder theory of corporate governance. The main issue raised in the theory is'the presence of many parties

with competing interests in the operations of a firm. They also emphasized the role of non-market mechanisms such as the size of the board, committee structure as important to firm performance; Jensen (2001) critiques the Stakeholder theory for assuming a single-valued objective. They thus, propose an extension of the theory called an enlightened stakeholder theory. However, problems relating to empirical testing of the extension have limited its relevance and applicability in a modern day corporate entity (Jensen et al., 2003).

In Kenya, corporate governance is still at its infancy stage and therefore an examination of its relationship with firm financial performance is not only desirable but long overdue.

2.2 Corporate Governance Practices

The emphasis placed on various aspects of corporate governance depends on how corporate governance is defined to bring out the key salient features. According to Hendrikse et al (2004) corporate governance is the system that maintains the balance of rights, relationships, roles and responsibilities of shareholders, directors and management in the direction, conduct, performance and control of sustainable performance of the company's business with honesty and integrity in the best long-term interests of the company, shareholders and business community stakeholders. The elements of corporate governance vary from one country to the other and from company to company. Klappart and Love (2002) found that corporate governance provisions at the Firm level matter more in countries with strong legal environment.

The Capital Market Authority (CMA) provides a comprehensive list of recommended governance practices (CMA 1998). The recommended governance practices have three objectives which include; economical and financial well being of shareholders, directors and management, and employees; social well being of employees, community and society and

environmental well being for every one (Manyurn 2005).The four board attributes namely; composition, characteristics, structure, and process , form -the basis for categorizing the corporate governance practices in this study.

2.3 Theoretical Review

2.3.1 Agency Theory

*..

Historically, definitions of corporate governance also took into consideration the relationship between the shareholder and the company, as per "agency theory", i.e. director-agents acting on behalf of shareholder-principles in overseeing self-serving behaviors of management. However, broader definitions of corporate governance are now attracting greater attention (Solomon and Solomon,2004). Indeed, effective corporate governance is currently understood as involving a wide number of participants. The primary participants are management, shareholders and the boards of directors, but other key players whose interests are affected by the corporation are employees, suppliers, customers, partners and the general community. Therefore, corporate governance, understood in these broadening social contexts, ensures that the board of directors is accountable not only to shareholders but also to non-shareholder stakeholders, including those who have a vested interest in seeing that the corporation is well governed. Some corporate governance scholars (Carter and Lorsch, 2004; Leblanc and Gillies, 2005) also argue that at the heart of good corporate governance is not board structure (which receives a lot of attention in the current regulations), but instead board process (especially consideration of how board members work together as a group and the competencies and behaviours both at the board level and the level of individual directors). As a result, the current scholarly discourse about the nature of corporate governance has come to reflect this body of research.

This separation is however, linked and governed through proper "agency relationship" at various levels, among others "between shareholders and boards of directors, between boards

and senior management, between senior and subordinate levels of management" (ISDA, 2002). In such a principal-agent relationship, there is always an inherent potential for conflicts within a firm because the economic incentives faced by the agents are often different from those faced by the principals" (ISDA, 2002). According to ISDA (2002), all companies are exposed to agency problems, and to some extent develop action plans to deal with them. These include establishing such measures as: "controls on the actions of agents, monitoring the actions of agents, financial incentives to encourage agents to act in the interest of the principals, and separation of risk taking functions from control functions" (ISDA, 2002).

2.3.2 Shareholder Theory

There are two main theories of shareholder-oriented governance: the principal-agent or finance model and the myopic market model. The principal-agent model starts from an assumption that the social purpose of corporations is to "maximise shareholders' wealth" (Coelho et al., 2003; Friedman, 1970). The principal-agent model regards the central problem of corporate governance as self-interested managerial behaviour in a universal principal-agent relationship. Agency problems arise when the agent does not share the principal's objectives. Furthermore, the separation of ownership and control increases the power of professional managers and leaves them free to pursue their own aims and serve their own interests at the expense of shareholders (Berle and Means, 1932). There are two problems occurring in the agency relationship with which agency theory is concerned. The first is that because it is difficult or expensive for the principal to verify what the agent is actually doing, the principal cannot verify that the agent has behaved appropriately. The second problem is that the principal and the agent may prefer different actions because of the different attitudes toward risk (Eisenhardt, 1989, p. 58). Those two problems bring about a particular type of management cost incurred as principals attempt to ensure that agents act in principals' interests: "agency cost" (Jensen and Meckling, 1976). To solve those problems, agency

theory must determine the most efficient contract governing the principal-agent relationship and an optimal incentive scheme to align the behaviour of the managers with the interest of owners. While the principal-agent model agrees upon the failure of corporate internal control, it denies the inherent failure of market mechanisms, insisting that markets are the most effective regulators of managerial discretion, the so-called "efficient market model" (Blair, 1995).

The myopic market model shares a common view with the principal-agent model that the corporation should serve the shareholders' interests only, but criticises the Anglo-American model of corporate governance because of "competitive myopia" (Hayes and Abernathy, 1980) and its consequent pre-occupation with short-term gains in return, profit and other performance measures induced by market pressures. The myopic market model holds that what is wrong with corporate governance is that the system encourages managers to focus on short-term performance by sacrificing long-term value and competitiveness of the corporation. The financial markets often force managers to behave in a way divergent from the maximisation of long-term wealth for shareholders (Blair, 1995). The myopic market view contends that corporate governance reform should provide an environment in which shareholders and managers are encouraged to share long-term performance horizons. Shareholders' loyalty and voice should increase, whereas the ease of shareholders' exit should reduce. Policy proposals for the reform include the encouragement of "relationship investing" to lock financial institutions into long-term positions, restrictions on the takeover process and on voting rights for short-term shareholders, and the empowerment of other groups such as employees and suppliers that have long-term relationships with the firm (Keasey et al., 1997).

Current Anglo-American corporate governance arrangements vest excessive power in the hands of management who may abuse it to serve their own interest at the expense of shareholders and society as a whole (Hunon, 1995). Supporters of such a view argue that the

current institutional restraints on managerial behaviour, such as non-executive directors, the audit process, the threat of takeover, are simply inadequate; to prevent managers abusing corporate power. Shareholders protected by liquid asset markets are uninterested in all but the most substantial of abuses. Incentive mechanisms, such as share options, are means through which managers can legitimise their abnormal overpayment (viewed by some as a symptom of the breakdown of governance (Keasey et al., 1997). The abuse of executive power is particularly embedded in the problem of executive overpay since executive remuneration has risen far faster than average earnings and there is at best a very weak link between compensation and management performance (Conyon et al., 1995; Gregg et al., 1993). The only restraint on executive pay seems to be the modesty of Executives themselves, and the creation of so-called independent remuneration committees by large companies is not effective. What is worse is that it legitimises self-serving managerial behaviours. The independence is generally a sham, not for restraining excess of pay, but for justifying it (Kay and Silberston, 1995). The supporters of this model do not believe that the main lines of corporate governance reform, such as non-executive directors, shareholder involvement in major decisions and fuller information about corporate affairs, are suitable monitoring mechanisms (Kay and Silberston, 1995). Instead, they propose statutory changes in corporate governance, under which hostile takeovers are not possible to effect, since ownership of shares no longer brings the right to appoint executive management. The basic objective of corporate governance in this guise is "managerial freedom with accountability", to allow executive management the power to develop the longer term business, while holding them rigorously responsible to all stakeholders involved in the business.

Perhaps the most fundamental challenge to the orthodoxy is the stakeholder model, with its central proposition that a wider objective function of the firm is more equitable and more socially efficient than one confined to shareholder wealth (Keasey et al., 1997). The well-

being of other groups such as employees, suppliers, customers and managers, who have a long-term association with the firm and therefore a "stake" in its long-term success, is recognised. The goal of corporate governance is to maximise the wealth creation of the corporation as a whole. These definitions were formulated from the base that modern corporation is affected by a large set of interest groups, including at a minimum shareholders, lenders, customers, employees, suppliers and management, which are often referred to as the primary stakeholders, who are vital to the survival and success of the corporation. To these the corporation adds secondary stakeholders, such as the local community, the media, the courts, the government, special interest groups and the general public, that is society in general. From this perspective, corporate governance debates often proceed with a fixation on the relationship between corporate managers and shareholders, which presupposes that there is only one right answer. In fact, shareholders are difficult and reluctant to exercise all the responsibilities of ownership in publicly held corporations, whereas other stakeholders, especially employees, may often too easily exercise their rights and responsibilities associated as owners. This is a compelling case for granting employees some form of ownership.

2.4 Corporate Governance and Firm Financial Performance

2.4.1 Board Size

Fama (1980) argued that for the board to play its oversight" role of effective monitoring, it should be composed of majority of outside directors. He argued that outside directors will exhibit considerable independence from top management.

Mace (1971) reported that poor proposals or performance will be opposed by outside directors. Weishach (1998) found out that outside dominated boards are significantly likely to respond to poor firm financial performance by dismissing the chief executive officer.

Brickley et al (1991) also find evidence that outside directors' act in the shareholders interest

in their decision in the adoption of the poison pill provision.. Brickley and James (1987),
»
further, found that the proportion of outside directors is significantly lower on boards of
companies in state that restricts acquisitions. •

Weisbach and Hermalin (1998) found that outsiders are more likely to join the board after the
firm performs poorly or leaves an industry, reflecting the need to inject new blood to procure
, f
expertise in the new industry. Both Coughlan and Schmidt.(1995) and Warner , Watts, and
Wruck (1998)while examining the extent to which board discipline managers, found out that
poor firm financial performance increases the likelihood of change in top management team.
However, the relationship between firm performance and CEO-turn over has been found to be
fairly weak (Jensen and Murphy, (1990); Hermalin and Weisbach, (1998).

In the Jebet (2001), carried out a research on how the corporate governance structures affect
the firm performance (listed). Board composition was noted to be a quality/fixation of firm
performance. She sampled the various listed companies in the Nairobi Stock Exchange and
• :
found that the firms with high number of outside directors performed well as compared to
those with less representation from outside directors. 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

in their decision in the adoption of the poison pill provision. Brickley and James (1987), further, found that the proportion of outside directors is significantly lower on boards of companies in state that restricts acquisitions.

Weisbach and Hermalin (1998) found that outsiders are more likely to join the board after the firm performs poorly or leaves an industry, reflecting the need to inject new blood to procure expertise in the new industry. Both Coughlan and Schmidt (1985) and Warner, Watts, and Wruck (1998) while examining the extent to which board discipline managers, found out that poor firm financial performance increases the likelihood of change in top management team. However, the relationship between firm performance and CEO-turn over has been found to be fairly weak (Jensen and Murphy, (1990); Hermalin and Weisbach. (1998).

In the Jebet (2001), carried out a research on how the corporate governance structures affect the firm performance (listed). Board composition was noted to be a quality/fixation of firm performance. She sampled the various listed companies in the Nairobi Stock Exchange and found that the firms with high number of outside directors performed well as compared to those with less representation from outside directors. 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 (Brown and Caylor. 2004). In Corporate Governance the above can be summarized into five basic tenets namely; accountability, efficiency and effectiveness, integrity and fairness, responsibility and transparency.

'v

The corporate governance literature identifies four sets of board attributes; namely, composition, characteristics, structure and process (Schilling, 2003). Board composition refers to the size of the board and the mix of different director's demographics (insiders/outside, male/female, foreign/local) and the degree of affiliation directors have with the corporations (Claessens et al, 2002). Board characteristics encompass director's background, such as director's experience; tenure; functional background; independence; and other variables that influence director's interest and their performance (McCord, 2002). Board structure covers board organization; the role of subsidiary boards in holding companies; board committees; the formal independence of one-tier and two-tier boards; the leadership of boards and the flow of information between board structures (Cadbury Report, 1992). Board process refers to decision-making activities; styles of board; the frequency and the length of board meetings; the formality of board process and board culture on evaluation of director's performance (Jensen, 1993).

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, Karpo et al. (1996) 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.

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. 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 and have higher return on assets and cost efficiency ratios than firms where the same person holds both titles.

Studies of the impact of boards/board effectiveness on corporate profitability and shareholder value have dominated corporate governance research in finance. These researchers focused on the influence of non-executive directors, splitting of the roles of chairman and chief executive, or the introduction of board sub-committees, have enhanced board effectiveness which in turn has added to shareholder value. For example, Deakin and Hughes (1997) investigated the relationship between top management turnover (a measure of board effectiveness) and financial performance (a measure of management effectiveness). Others have studied the appointment of non-executive directors and their role in monitoring company management, on behalf of shareholders (Bhagat and Black, 2002). Research has considered whether there is a positive relationship between the number of non-executive directors and corporate financial performance, generally showing that there is. Researchers have also investigated the relationship between executive remuneration and financial performance (Jensen, 1993). A host of corporate governance research has focused on takeovers and mergers and their relationship with performance, stemming from a seminal study which identified takeover as a disciplining mechanism over company management, again within the finance paradigm of agency theory (Jensen, 1993).

2.4.2 Composition

The composition of the board may be used to ameliorate the principal-agent problem. The participation of outside directors is designed to enhance the ability of the firm to protect itself against threats from the environment and align the firm's resources for greater advantage. However, research on the impact of outside directors has grown significantly, but with mixed results. While the study by Wen et al.(2002) found a negative relationship between the number of outside directors on the board and performance, Bhagat and Black (2002) found no relationship between outside directors and Tobin's Q. In another related work, the proportion of outside directors was found to have a significant positive relationship to firm performance (Hermalin and Weisbach, 2003). Firms with higher number of outside directors are expected to pursue activities that would bring about low financial leverage with a high market value of equity (Sanda et al, 2003).

The number of board of directors is assumed to have an influence on financial performance. The board is vested with responsibility for managing the firm and its activities. There is no agreement over whether a large or small board does this better. Yermack (1996) suggests that the smaller the board of directors the better the firm's performance. Yermack (1996) further argued that larger boards are found to be slow in decision making. The monitoring expenses and poor communication in a larger board has also been seen as a reason for the support of small board size (Jensen. 1993). However, there is another school of thought that believes

- \

that firms with larger board size have the ability to push the managers to pursue lower costs of debt and increase performance. Studies by Wen et al.(2002) and Abor (2007) both reported evidence in support of a positive relationship between board size and leverage. They argued that large boards with superior monitoring ability pursue higher leverage to raise the value of the firm.

Bhagat and Black (2002) also find negative correlation between board size and profitability when using sample of small and midsize Finnish firms. Mak and Yuanto (2003) re-echo the above findings in firms listed in Singapore and Malaysia when they found that firm valuation is highest when a board has five directors, a number considered relatively small in those markets. In a Nigerian study, Sanda et al. (2003) found that firm performance is positively related with small, as opposed to large boards.

2.4.3 Independence of Committees

Independence is considered important for a board committee to be an effective monitor. Klapper and Love (2003) 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.

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). Abor (2007) shows that independent audit committees reduce the likelihood of manipulation of earnings by 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.

Audited financial statements frequently fail to include enough information to allow an analysis of the financial sustainability of an organization, including the condition of its portfolio. To help remedy this problem, CGAP strongly recommends that audited organization financial statements contain all the elements laid out in this annex. The Audit Committee should annually assess its own performance, considering responsiveness to the

Audit Committee Charter, effectiveness of relationships and communications with management, internal and external auditors, and the Board of Directors (Rutherford, 2000).

In addition to cash donations, organizations often receive in-kind donations that may not appear on their income statement. For instance, a donor may pay the salary of the organization's executive director, the organization may be occupying rent-free offices, or fixed assets may bypass the income-statement and be recorded directly on the balance sheet. A note should identify any such in-kind subsidies, and where practical, estimate the cost or market value of such subsidy.

The rationale for including such information is that the goods or services in question may be important for the viability of the organization's business, and the organization may have to pay for them in the future, especially as it expands. Thus information about in-kind subsidies may be important in forming an overall picture of the organization's business prospects (Monks and Minnow, 2004).

Best Practices for evaluating performance include soliciting informal feedback from Board, CEO, CFO, Compliance Officer and internal and external auditors on specific opportunities to improve Audit Committee effectiveness, completing a self-assessment survey and reviewing the results with the Board, management and internal and external auditors and assessing the contributions and performance of individual Audit Committee members by the Audit Committee chairperson for review with the Board Chairperson and CEO (Littlefield et al, 2003).

Internal Audit is available to facilitate the survey process and accumulate results for future Committee discussion and action. These processes are generally sufficiently sophisticated to address the organization's business model risks. While we consider these systems to be adequate, we expect them to continue to evolve to meet new challenges facing the industry.

The review of the audit systems was limited to understanding and evaluating the inherent industry operational risks as they pertain to each organization's particular business model in addition to looking at the systems' capabilities and shortcomings in allowing management and the board to take timely actions. In our view, the varied levels of transparency in the publicly quoted companies and increased competition for limited capital underscores the need for a coherent, articulate, and effective method of measuring, managing, and controlling risks.

Accounting standards are guidelines that specify the accounting treatment for financial transactions. Such standards are used to ensure the comparability, consistency, and completeness of financial records. Accounting standards may be national, such as the standards developed by a country's recognized national accountant's organization, or international, such as the International Accounting Standards (IAS) developed by the International Accounting Standards Committee. It is important to recognize differences between accounting standards and methods when comparing financial information from different institutions or countries.

According to Brownbride (1997) to maintain the credibility of its financial statements, an organization must adhere to a recognized, comprehensive set of accounting standards. A company may want to consider retaining the services of a reputable certified public accountant or accounting firm to design an accounting system that complies with national and international standards, and to train staff in the system's use.

2.5 Empirical review

Review of research articles particularly on the determinants of corporate governance and firm financial performance has been made as follows:

The number of studies has examined the relationship between corporate governance and firm's performance that show how good governance practices have increased the economic value to firms, higher productivity and lower risk systematic risk (see, Shleifer and Vishny, 1997; John and Senbet, 1998 and Hermalin and Weisbach, 2003).

i

The empirical study of Mitton (2001) which had taken samples of 398 firms from Korea, Malaysia, Indonesia, Philippines and Thailand found that- the firm-level differences in variables related to corporate governance had strong impact on firm performance during East Asian Crisis in 1997 and 1998. The results suggest that better price performance is associated with firms that have indicators of higher disclosure quality, higher outside ownership concentration and they are focused rather than diversified.

Brown and Caylor (2004) analyze the US firms with 51 factors, 8 sub-categories for 2327 firms based on dataset of Institutional Shareholder Service (ISS). Their findings indicate that better governed firms are relatively more profitable, more valuable and pay more cash to their shareholders. Jensen (1993) opines that limiting board size improves firm performance because the benefits by larger boards of increased monitoring are outweighed by the poorer communication and decision-making of larger groups. The study by Yermack (1996) shows an inverse relationship between board size and profitability, asset utilizations, and Tobin's Q. Anderson et al. (2004) document that the cost of debt is lower for larger boards, because creditors view these firms as having more effective monitors of their financial accounting processes.

Fich and Shivdasani (2004) find that firms with director stock option plans have higher market to book ratios, higher profitability and they document a positive firm financial performance reaction when firms announce stock option plans for their directors. The study by Ashraf and Ghani (2005) examines the origins, growth, and the development of

accounting practices and disclosures in Pakistan and the factors that influenced them. They document that lack of investor protection, judicial inefficiencies, and weak enforcement mechanisms are more critical factors than are cultural factors in explaining the state of accounting in Pakistan. They conclude that it is the enforcement mechanisms that are paramount in improving the quality of accounting in developing economies. La Porta, et al (1999) argues that an investor's protection tends to be greater when the legal environment is stronger, and therefore his willingness to invest tends to increase. They find strong positive association between corporate governance and firm's performance.

Drobetz et al. (2004) found a positive relationship between governance practices and firm valuation. Aggarwal et al. (2008) determines the number of-governance attributes with data available for each firm-year observation, and then define the governance index as the percentage of attributes a particular company has in place. Adjaoud et al (2007) used the 2002 rankings to examine the relationship between firm performance and the governance scores. They found that the relationship generally was not significant between the scores and accounting-based measures of performance (such as ROI, ROE, EPS, and market-to-book) while the relationship between the scores and measures Of value created (such as market value added and economic value added) was generally significant.

2.6 Chapter Summary

The chapter has discussed the area of the study: effect of corporate governance on firm financial performance. The chapter commenced with introduction of the topic under study whereby it introduced the studies done on the topic, corporate governance and financial performance; board size; and composition. The chapter reviewed the effects of corporate governance on financial firm performance at the NSE. The chapter further reviewed the corporate governance theories: Poor proposals or performance will be opposed by outside

directors. Outsiders are more likely to join the board after the firm performs poorly or leaves an industry, reflecting the need to inject new blood to procure expertise in the new industry. Board composition was noted to be a quality/fixation of firm performance, Jebet (2001). She sampled the various listed companies in the Nairobi Stock Exchange and found that the firms with high number of outside directors performed well compared to those with less representation of outside directors. The corporate governance literature identifies four sets of board attributes namely; composition, characteristics, structure and process. The participation of outside directors is designed to enhance the ability of the firm to protect itself against threats from the environment and align the firm's resources for greater advantage. The number of board of directors is assumed to have an influence on financial performance. The board is vested with responsibility of managing the firm and its activities. Audited financial statements frequently fail to include enough information to allow an analysis of the financial sustainability of an organization, including the condition of its portfolio. The rationale for including such information is that the goods or services in question may be important for the viability of the organization's business, and the organization may have to pay for them in the future, especially as it expands.

CHAPTER THREE: RESEARCH METHODOLOGY

A.

3.1 Research design

^

Orodho (2003) defines a research design as the scheme, outline or plan that is used to generate answers to research problems. The researcher prepares a research design after formulating research problem in clear cut terms. This involves stating the conceptual structure -within which research will be conducted. The preparation of such a design facilitates research to be as efficient as possible yielding maximal information. In other words, the function of research design is to provide for the collection of relevant evidence with minimal expenditure of effort, time and money.

1

The research adopted a survey design and utilized a case study approach to achieve the objectives as outlined in chapter one. The purpose of survey research design is for researchers to describe the attitudes, opinions, behaviors, or characteristics of the population based on data collected from a sample or a population (Ngechu 2004).

The study also adopted descriptive research design, which according to Kothari (2004), is used when the problem has been defined specifically and where the researcher has certain issue to be described by the respondents about the problem. The major purpose of descriptive research is description of the state of affairs as it exists at present. It also includes attempts by researchers to discover causes even when they cannot control the variables. The methods of research utilized in descriptive research are survey methods of-all kinds. This type of research design enabled the researcher to meet the objective of the study which is examining the relationship between corporate governance and financial performance of listed companies in the Nairobi Stock Exchange.

The main advantages of descriptive design are: it provides opportunity to acquire a lot of information through of area under study, descriptions can be used as an indirect test of a

theory or model and some behaviors or situations cannot be studied in any other way. However, a major disadvantage of descriptive design is that since the setting for the subject under study is completely natural, with all variables present, the design cannot identify causes of phenomenon. In other words, the researcher has no control over the variables; he can only report what has happened or what is happening (Kothari, 2004).

The main focus of this study was qualitative. According to Mugenda (2003), qualitative research is concerned with qualitative phenomenon, i.e. phenomena relating to or involving quality or kind. It is especially important in the behavioral sciences where the aim is to discover the underlying motives of human behavior. Through such research we can analyze the various factors which motivate people to behave in a particular manner or which make people like or dislike a particular thing.

V

3.2 Target Population and Sampling

• •

In order to gather the information required, the study targeted listed companies at Nairobi stock Exchange (NSE). There are 58 companies listed in the NSE (appendix 2). According to (Kothari, 2004) a representative sample is one which is at least 10% of the population as far as it is able to give 30 or more representatives of the population. In order to identify a sample of firms to be used in the study, purposive/deliberate sampling method was employed. In this type of sampling, according to (Kothari, 2004), researcher's judgment is used for selecting items which he considers as representative of the population and which is considered will provide the information that is needed for the study. However, at times this method of sampling may give very biased results particularly when the population is not homogeneous. The researcher selected as sample all the companies that make up the NSE 20 share index, (Appendix 3). The twenty companies represent listed firms operating in various sectors of the economy. The index consists mainly of blue chip firms that have already established a history of strong financial performance and are regarded as blue chip companies. The researcher

considered these companies as ideal study units as they have strong corporate governance systems that have helped them to deliver strong over time.

3.3 Research Instruments

The researcher used quantitative methods to solicit information from the respondents. The study employed the use of a questionnaire that elicited information on background information on respondent firms, disclosure practices and board structure and efficiency. The study chose questionnaire since they have advantages over other research instruments because they are cheap, do not require as much effort from the questioner as verbal or telephone surveys, also, they often have standardized answers that make it simple to compile data. The questionnaire consists of structured questions. The structured questions were used in order to save time and to ease data analysis. Secondary data on company performance was compiled from the data gathered from Nairobi Stock Exchange website.

3.4 Data Collection Methods

According to Ngechu (2004) there are many methods of data collection. The choice of a tool and instrument depends mainly on the attributes of the subjects, research topic, problem question, objectives, design, expected data and results. This is because each tool and instrument collects specific data. Mugenda and Mugenda (2003), note that there are two major sources of data used by respondents' namely: primary and secondary data. Primary data is information gathered directly from respondents. In this study, primary data was collected through emailing questionnaires (appendix 1) to company secretaries of the respondent firms. Follow up by way of personal calls and emails were done to ensure that the company secretaries filled and return the questionnaires.

3.4.1 Data on company's financial performance :

Data on firms' financial performance was compiled from their annual returns filed with the NSE by listed companies. In evaluating performance of respondent companies, growth in profitability trend for four years (year 2005 to year 2008) was computed and results displayed in appendix 4. In order to analyze the results further, Return on Equity (RoE) ratio was computed and the average RoE shown in appendix 5. According to Wachowicz & Home, (2003) Return on Equity (RoE) of a company measures the "ability of the management of the company to generate adequate returns for the capital invested by the owners of a company. Generally a return of 10% would be desirable to provide dividends to owners and have funds for future growth of the company. The return on assets (RoA)-is the net income for the year divided by total assets, usually the average value over the year.

Return on assets = net income / average total assets

Brown and Reilly, (2008) observe that RoE is a performance measure of shareholder value, and it is by far the most popular measure of performance, since it proposes a direct assessment of the financial return of a shareholder's investment; it is easily available for analysts, only relying upon public information; and it allows for comparison between different companies or different sectors.

3.5 Piloting

The researchers carried out a pilot study to pretest and validate the questionnaire and the interview guide. The main aim of this pilot test was to enhance validity and reliability of the research. According to Mugenda and Mugenda (2003), validity is the degree by which the sample of test items represents the content the test is designed to measure. According to Kothari (2004), reliability refers to the consistency of measurement and is frequently assessed using the test-retest reliability method. Reliability is increased by including many similar items on a measure, by testing a diverse sample of individuals and by using uniform testing

procedures. The researcher selected a pilot group of individuals from the target population to test the reliability of the research instrument. This was achieved[<]_v by selecting 3 listed that were not included in the sample. The researcher administered the pretest questionnaires to company secretaries of the three firms and noted their comments on the instrument.

The pilot data was not included in the actual study. The pilot study only allowed for pre-testing^{t*} of the research instrument. The clarity of the instrument items to the respondents was established so as to enhance the instrument's validity and reliability. The pilot study enabled the researcher to be familiar with research and its administration procedure as well as identifying items that require modification. The result helped the researcher to correct inconsistencies arising from the instruments, which ensured that they measure what is intended.

3.6 Data Processing and Analysis

Further, the researcher perused completed questionnaires and document analysis recording sheets. Quantitative data collected was analyzed by the use of descriptive statistics using spreadsheets and presented through percentages, means, standard deviations and coefficient of variation.

The information is displayed by use of tables and charts. This was done by tallying up responses, computing percentages of variations in response as well as describing and interpreting the data in line with the study objectives and assumptions through use of spreadsheets.

CHAPTER FOUR: ANALYSIS, PRESENTATION AND INTERPRETATION

f .
j. '

4.1 Introduction

In this chapter, the study seeks to examine the data collected in detail, categorizing it according to its relationship with the study objectives. The main objectives of the study were to determine corporate governance practices among the listed companies. The data collected from the respondents was analyzed by use of descriptive tools (SPSS and Microsoft Excel 2007 package) and is presented using graphs and tables. / '

The study targeted 20 listed companies that form NSE 20-Share Index (appendix 3). The 20 companies represent listed firms operating in various sectors of the economy. From the study, 17 out of 20 targeted respondents filled-in and returned the questionnaires making a response rate of 85%. The researcher considers this response rate as significant enough to provide reliable conclusions from the data collected towards satisfaction of the study objectives. Secondary data on the performance of the 20 listed companies for the period 2005 to 2008 was obtained from company returns as filled with Nairobi Stock Exchange.

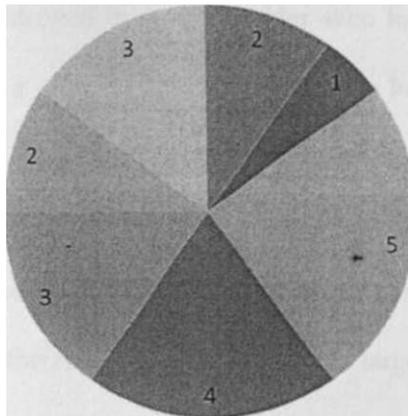
4.2 General Information on the Respondent's Firm

4.2.1 Business Sector

Table 4.1 Business Sectors of respondent companies • • j.

Sector	Number of companies
Agricultural	2
Automobiles and Accessories	1 •
Banking	5 .
Commercial and services	4
Construction and Allied	3 .
Energy and Petroleum	2.
Manufacturing and Allied	3
Total	20

Source: NSE / Survey data, 2011



- Agricultural
- Automobilesand Accessories
- * Banking
- »C£>mmerialand services
- Construction and Allied
- Energy and Petroleum
- "Manufacturingand Allied

Figure 4.1: Business Sectors of respondent companies

Source: NSE / Survey data,2011

Regarding the distribution of respondent firms as shown in .Table 4.2 and Figure 4.2, the respondent companies are distributed across the various sectors of the economy. Banking sector has the highest number of respondents firm (five), .followed by commercial and services sector with four firms. Commercial and allied sector as well as manufacturing and allied sectors have three firms each while energy and petroleum and agriculture have two firms each. Automobiles and accessories sector has one respondent firm in the sample.

4.2.2 Ownership and control structure of firms

Table 4.2 Ownership and control structure of firms

	Number of firms	Percentage	Ranking
The largest shareholder has substantial voting right and control	6	35%	1
30-40% ownership but effectively controls the firm	4	24%	3
Two or More shareholders collectively control the firm	5	29%	2
Diffused ownership, no controlling shareholder	2	12%	4
Total	.17	100%	

Source: Research data, 2011

Regarding the ownership and control structure of the respondent firms, the highest number (35%) is controlled by a shareholder who has substantial voting right and control. Second ranked with a score of 29% are firms who have two or more shareholders who collectively control the firm. 24% of the respondent firms have a shareholder with significant ownership (30-40%) but still effectively control the firm. Only 12% of the respondent firms have diffused ownership with no controlling shareholder. It can therefore be concluded that majority of the respondent firms have a large shareholder or a small group of shareholders who control the firm.

4.2.3 The legal status of the firms

Table 4.3 the legal status of the firms

Status of the Firm	Number of firms	Percentage	Ranking
Is standalone company	4	24%	2
Subsidiary of a business group	3	18%	3
A holding company	10	59%	1
Total	17		

Source: Research data, 2011

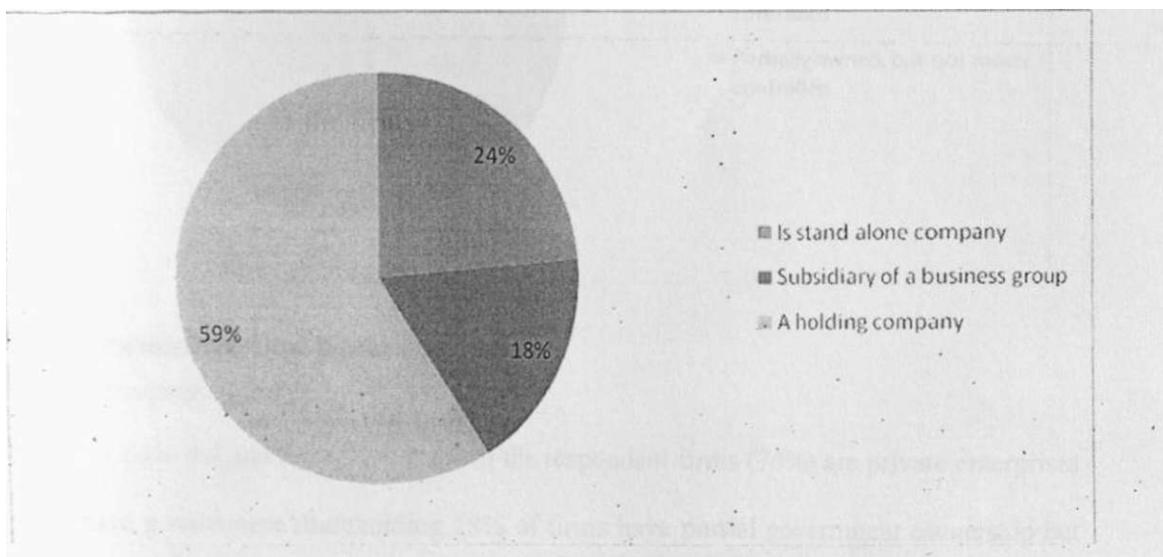


Fig 4.3 legal status of respondent firms

Source: research data, 2011

Concerning the legal status of the respondent firms, majority are holding companies (59%) are holding companies while 24% of companies are stand alone companies. Only 18% of the respondent firms are subsidiaries of a business group.

4.2.4 Firms controlled by the government

Table 4.4 Firms controlled by the government

Extent of Government control	Number of firms	Percentage	Ranking
No Government control	13	76%	1
Yes, substantially owned and controlled	1	6%	3
Partially owned, but not much controlled	3	18%	2
Total	17		

Source: Research data, 2011

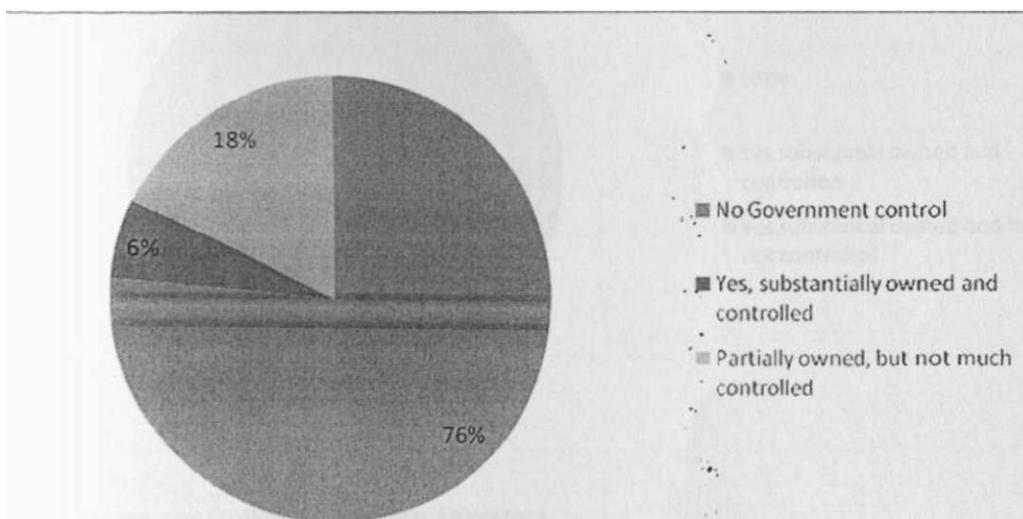


Fig 4.4 :Firms controlled by the government

(Source: Researcher, 2011)

As per the table 4.4 and figure 4.4, most of the respondent firms (76%) are private enterprises do not have government shareholding. 18% of firms have partial government ownership but have are not controlled by the government. Most of these firms are former government

controlled companies from which the government later divested by selling shares to other investors through the Nairobi Stock Exchange. A small number of respondent firms (6%) are substantially owned and controlled by the government.

4.2.5 Firms controlled by Foreign Investors

Table 4.5 Firms controlled by Foreign Investors

Extent of control by Foreign Investors	Number of firms	Percentage	Ranking
Little	7	41%	1
Yes, substantial owned and controlled	6	35%	2
Yes, substantial owned and but not controlled	4	24%	3
Total	17		

Source: Researcher, 2011

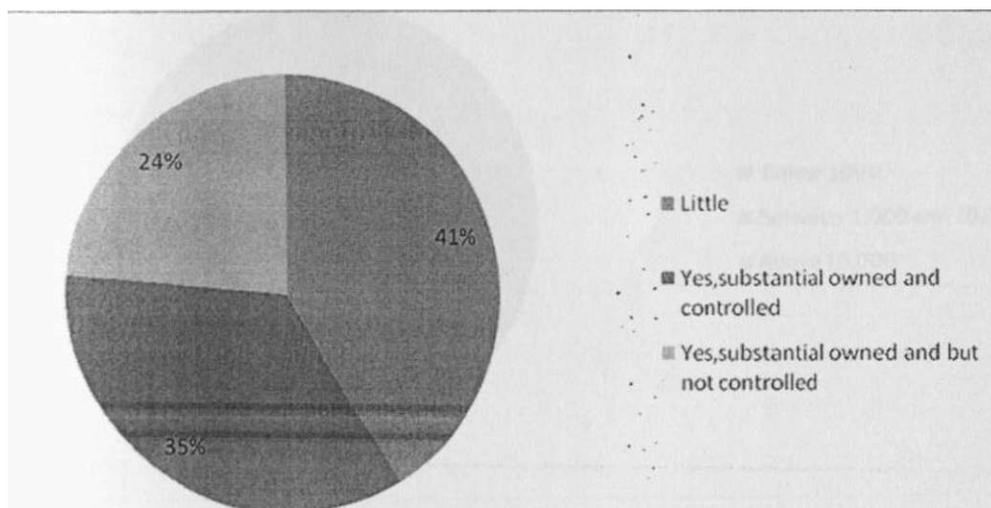


Fig 4.5 Firms controlled by Foreign Investors

(Source: Researcher, 2011)

Table 4.5 and Figure 4.5 shows that while 41% of the respondent firms have little level of by foreign investors, 59% of the firms (24% and 35%) have substantially owned by foreign investors. 35% of the firms are substantially owned by foreign investors while 24% of the

firms, though owned by significantly by foreign investors, they are not controlled by foreign investors

4.3 Shareholders' Rights

Table 4.6 Number of shareholders

Number of shareholders	Number of firms	Percentage	Ranking
Below 1000	1	6%	3
Between 1,000 and 10,000	6	35%	2
Above 10,000	10	59%	1
Total	17		

Source: Researcher,2011

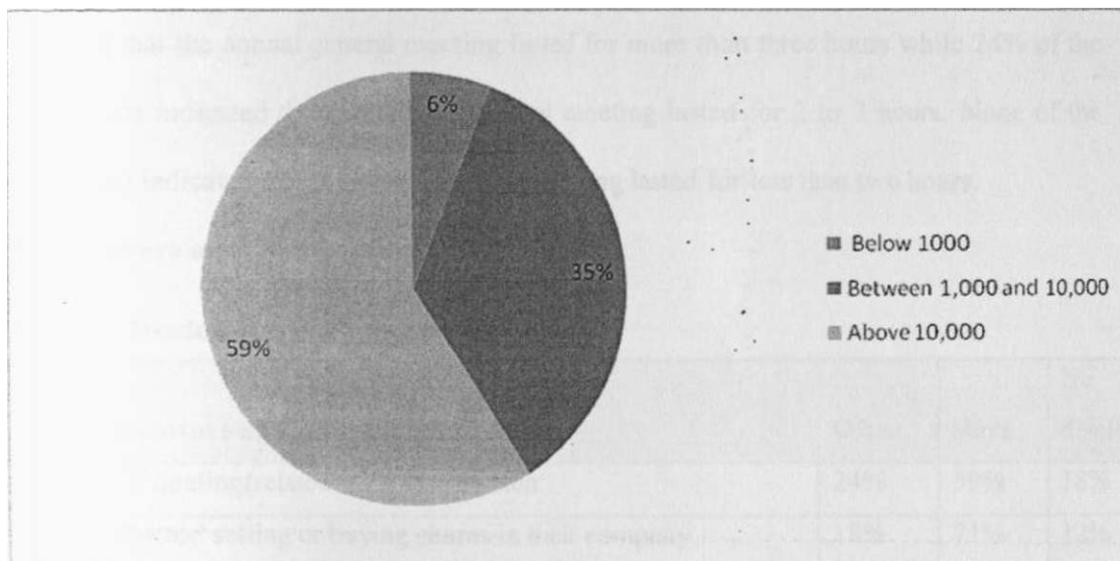


Table 4.6 Number of shareholders

Source:Research data.2012

As per table 4.6 and figure 4.6. most of the respondent firms (59%) have more than 10,000 shareholders.35% of the firms have between 1,000 and 10,000 shareholders while only 6% of the firms have less than 1,000 shareholders.

On the issue of whether director candidates are disclosed before the shareholders' meeting, 76% of the respondents indicated that there is disclosure of director candidates before the

shareholders meeting while 24% of the respondents indicated that director candidates are not disclosed prior to the shareholders meeting.

Concerning whether it would be possible for the director candidates proposed by the management of the respondent's firm to fail to be elected at the shareholders' meeting, majority of the respondents (82%) indicated that it is "rare",-6% of the respondents indicated that it is "unthinkable" that director candidates proposed by management would fail to be elected at the shareholders' meeting. However, 12% of the respondents indicated that "sometimes" director candidates fail to be elected at the shareholders' meeting.

Regarding the length of the previous annual general meeting, majority of the respondents indicated that the annual general meeting lasted for more than three hours while 24% of the respondents indicated that the annual general meeting lasted -for 2 to 3 hours. None of the respondent indicated that the annual general meeting lasted for less than two hours.

4.4 Disclosure and Transparency

Table 4.7 Disclosure and Transparency

	Disclosure and Transparency	Often	Rare	No disclosure
1	Self dealing(related-party)transaction	24%	59%	18%
2	Director' selling or buying shares in their company	18%	71%	12%
3	Background of Directors	82%	18%	0%
4	Remuneration of directors	12%	71%	18%
5	Fees paid to external auditors, advisors, and other related parties	18%	59%	24%
6	Policies on Risk Management	76%	24%	0
7	Significant changes in ownership	82%.	12%	6%

Source: Research data (2011)

On the subject of disclosure and transparency as per table 4.6, majority of the respondents (59%) indicated that disclosure on self dealing (related -party) is rare, while 18% of

respondents indicated that there is no disclosure. On the other hand 24% indicated that disclosure on self dealing is done often. It can therefore be concluded that majority of respondents consider the disclosure on self dealing inadequate since 76% of the respondents observed that disclosure on self dealing is either rare (59%) or no disclosure (18%).

• • •

In regard to disclosure on directors' buying or selling shares in their company, most of the respondents indicated that it happens rarely (71%), and 12% noted that there is no disclosure. On the other hand, 18% indicated that often, there is disclosure on directors' selling and buying of shares in their company. It is noteworthy that majority of the respondents indicated that the disclosure on directors' shares trading in their company is either rare (71%) or there is no disclosure (12%), implying that most respondents (83%) are not satisfied with the level of disclosure on directors shares trading transactions in their companies.

On the subject of disclosure on the background of directors, majority of the respondents (82%) noted that it is often done and 18% indicating that it is rarely done. Therefore, it can be observed that there is adequate disclosure on the background of directors.

Regarding disclosure on remuneration of directors, 12% of the respondents indicated that disclosure is often, 71% indicated that it is rare and 18% noted that there is no disclosure of such information. It can therefore be observed that majority of the respondents feel that there is inadequate disclosure of information relating to remuneration of directors.

* i

Concerning disclosure on fees paid to external auditors, advisors, and other related parties, 18% the respondents noted that it is often done, 59% of the respondents indicated that it is rare while 24% indicated that there is no disclosure. As such, it can be observed that majority of the respondents are not satisfied with the level, of disclosure on the area of fees paid to external auditors, advisors, and other related parties.

Regarding disclosure of policies on risk management, 76% of the respondents indicated that the disclosure is often while on 24% noted that it is rare. All respondents indicated that there is some form of disclosure on policies on risk management.

Concerning disclosure on significant changes in ownership- majority of the respondents (82%) noted that disclosure is often done, 12% of the respondents indicated that it was rare while only 6% of the respondents indicated that there is no disclosure on significant changes in ownership.

4.5 Effectiveness of the Board of Directors

4.5.1 Composition of the Board of Directors

Regarding the size of the board of directors, majority of the respondents (88%) indicated that the size of their boards is between 8 and 12 directors. Only 12% of respondents indicated that their boards have between 13 and 17 directors. Further, most of the respondents indicated that boards of directors have independent directors, ranging from 7 to 8 independent directors in the board.

Concerning whether foreign nationals sit in the board, majority of the respondent (88%) indicated that foreign nationals do sit in their boards, while only 12 of the respondents indicated that they do not have foreign nationals in their boards. Further, all the respondents said that the CEO does not serve as the board chairman.

Table 4.8 Composition of the Board of Director

	Whether the following persons sit in the board	Yes	No
1	Current or former officer of a major creditor financial institution	82%	18%
2	Officer of an affiliated company	65%	35%
3	Senior manager from a supplier or customer company"	76%	24%
4	Someone from a law/accounting/consulting firm that provides professional service to the firm	24%	76%

Source: Research data, 2011

Most of the respondents (82%) said that Current or former officer of a major creditor financial institution while 18% indicated that such former Officers do not serve in their boards. Regarding whether an officer of an affiliated company sit in the board, 65% of the respondents indicated they do sit in the board while 35% said that such officers do not sit in the board. Concerning whether senior manager(s) from a supplier or customer company sit in the board, majority of the respondent said that senior officers from supplier or customer company sit in the board while 24% said that they do not sit in the board. Further, 76% of the respondent indicated that they do not have someone from a law/accounting/consulting firm that provides professional service to the firm in their boards while 24% of the respondents indicated that they have such officers in their boards.

4.5.2 Independence of the Board

Table 4.9 Independence of the Board

How prevalent are the following practices?	often	Sometimes	Rare	Never
Independent directors meeting formally or informally without management to discuss corporate matters	6%	18%	65%	12%
Independent directors altering or adding the board meeting agenda set by the CEO	0%	18%	71%	12%
Independent directors participating actively in board discussions	65%	35%	0%	0%
Individual directors' positions on board meeting agendas recorded in minutes	65%	24%	6%	6%

Source: Researcher, 2011

Regarding whether independent directors meeting formally or informally without management to discuss corporate matters. 6% of the respondents indicated that often, 18% indicated sometimes while 65% indicated that it is rare while 12% of the respondents never meet. It can therefore be observed that Independent directors do not generally meet to discuss corporate matters without management.

Concerning whether independent directors altering or adding the board meeting agenda set by the CEO, 18% of the respondents noted that sometimes it is done, but majority of the respondents (71%) indicated that it is a rare practice and 12% of the respondents indicated that it never happens. It can therefore be concluded that generally, independent directors do not interfere with the agenda set by the CEO.

Regarding independent directors participating actively in board discussions, majority of the respondents (65%) said that independent directors often do and 35% indicated that sometimes they do participate. As such, it can be observed that, majority of the respondents noted that there is active participation by independent directors in board deliberations.

Finally, on individual directors' positions on board meetings agendas recorded in minutes, most of the respondents (65%) noted that it is done often, 24% noted that it is done sometimes, 6% of the respondents said it is rarely done and 6% of the respondents noted that it never done. It can therefore be observed that individual directors' position on board meeting agendas is usually recorded in minutes.

4.5.3 Committees of the Board

Regarding whether there is audit committee in the board; all respondents indicated that there is such a committee, which is composed of three independent directors who have some expertise in accountancy and finance. Further all respondents indicated that there is a committee of the board that handle compensation and nomination and are generally composed of two independent directors and one executive director, usually the CEO.

4.5.4 Effectiveness and independence of audit committees . . .

Concerning whether audit committee is headed by a director with accounting/finance expertise. 76% of the respondents indicated that the board is headed by a director with accounting/finance expertise and 24% of respondents indicated that audit committee is

headed by a director without accounting/finance expertise." Further, all the respondents indicated that minutes are written for each audit committee meeting.

Table 5.0 Effectiveness and independence of audit committees

	Very much so	To some extent	Hardly
Does it autonomously select/recommend the external auditor and conduct a proper review of his work?	6%	35%	59%
Does it approve the appointment of the internal auditor and supervise him to routinely review risk exposure and accounting procedures?	12%	41%	47%

Source: Researcher, 2011.

Regarding whether the audit committee autonomously select/recommend the external auditor and conduct a proper review of his work, 6% of the respondents indicated "very much so" while 35% of the respondents said that it is "to some extent" while majority of the respondents (59%) indicated that it is hardly done. It can therefore be observed that audit committee generally do not autonomously select or recommend the external auditor and conduct a proper review of his work.

Concerning whether audit committee approve the appointment of the internal auditor and supervise him to routinely review risk exposure and accounting procedures, as per table 4.9, only 12% of the respondents indicated "very much so" while 41% of the respondents said that it is "to some extent" while majority of the respondents (47%) indicated that it is hardly done. It can therefore be observed that audit committee do not generally approve the appointment of the internal auditor and supervise him to routinely review risk exposure and accounting procedures.

4.5.5 Evaluation and Compensation of the CEO

Table 5.1 Evaluation and Compensation of the CEO

		Yes,, as a routine	Sometimes	Rarely	Never
1	Does your board or compensation committee formally evaluate the CEO's performance	76% ¹	24%	0%	0%
2	Is there a formal review of the CEO compensation	65%	24%	12%	0%

Source: Researcher, 2011

Regarding whether the board or compensation committee formally evaluates the CEO's performance, 76% of the respondents indicated "Yes, as a routine" while 24% of the respondents indicated "sometimes". It can therefore be observed that there is generally a formal evaluation of the CEO's performance by the board.

Concerning whether there a formal review of the CEO compensation, most of the respondents (65%) indicated "Yes, as a routine" while 24% of the respondents indicated "sometimes". 12% of the respondents indicated that it is rarely done. Thus it can be observed that there is generally a formal review of the CEO's compensation.

4.6 Corporate governance and Firm performance

The study targeted 20 listed companies that form NSE 20-Share Index (appendix 3). The 20 companies represent listed firms operating in various sectors of the economy. The index consists mainly of blue chip firms that have already established a strong hold on their market shares in the sectors they operate in and a policy on dividend pay-out. Investors use stock market indices to track overall performance of a stock market,, with most preferring to hold portfolios comprising index constituent counters.

This study tracks financial performance of listed firms for a period of four year from year 2005 to the year 2008. the two years included. The study seeks to establish the financial performance of respondent companies over a period of four years.

4.6.1 Financial performance of the listed firms

According to published financial statement, 11 out of the 20 firms in the survey had a profitability of over one billion shillings (appendix 4).Over k period of four years, 16 of 20 firms had attained one billion shillings profitability mark (appendix 4).

Average Return on Equity Trend for Survey Firms (Year 2005 to Year 2008)

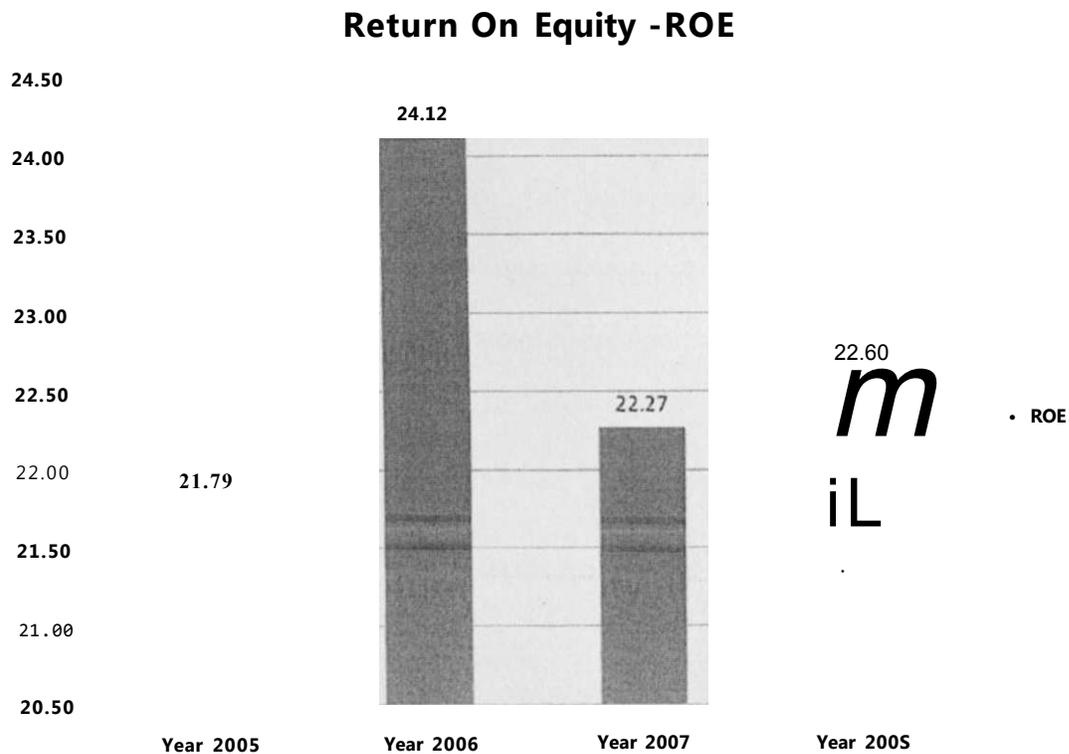


Figure 4.9 Return on Equity Trend for Survey Firms (Year 2005 to Year 2008)

Regarding return on investment by the respondent firms over a period of four years, (year 2005 to year 2008) the average return on equity (capital invested) in the year 2005 was 21.79%.In the year 2006. the surveyed firms posted the highest average return on equity of

24.12 % while in the year 2007. it was 22.27%.In the year 2008, return on equity was 22.6%. According to Brown and Reilly, (2008) a return of 10%* would be desirable to provide dividends to owners and have funds for future growth of the company. It can therefore be concluded that, the companies surveyed posted strong results during the period under review (year 2005 to year 2008).

CHAPTER FIVE: SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter provides the summary of the study, conclusion, and recommendations of the study based on the objectives of the study. It also highlights areas of further research.

5.2 Summary of the Findings

5.2.1 Corporate governance practices of listed companies

The surveyed firms are doing relatively well in allowing shareholders to participate in choosing directors. The right to vote for directors is one of the most important shareholders' rights, as directors actually make most key business decisions on behalf of shareholders. Majority of the respondents indicated that there is disclosure of director candidates before the shareholders meeting. However, it seems that the management still exercises immense powers on who becomes the director. Concerning whether it would be possible for the director candidates proposed by the management of the respondent's firm to fail to be elected at the shareholders' meeting, majority of the respondents indicated that it is "rare", and "unthinkable" that director candidates proposed by management would fail to be elected at the shareholders' meeting. Further, there seems to be adequate time allowed for the shareholders meeting with majority of the firms indicating that the previous shareholders meeting lasted for over three hours.

Disclosure of corporate information seems to be relatively good for such information as significant changes in ownership, resumes of directors, and policies on risk management. However, most respondents indicated that disclosure for such information as self-dealing or related-party transactions, directors' trading of their company shares and directors' remuneration is inadequate.

Timely disclosure of accurate information on important firm-related matters is crucial for the protection of shareholders' rights for two main reasons. First, shareholders need to have access to information about important matters to make decisions that are in their interests. Second, information disclosure is crucial in preventing managers and dominant shareholders from engaging in activities that are illegal or are detrimental to minority shareholders. Managers and dominant shareholders will be more reluctant to undertake such activities when they expect that shareholders will find out about them and may take action against them. Managers and dominant shareholders will also run the risk of violating laws when they fail to disclose information about such activities

The board of directors is the central corporate governance mechanism that the shareholders entrust to monitor and to provide strategic guidance to the management of a corporation. In the Anglo-American model, the board's major objective is supposed to be maximizing the value of the firm or the interests of all shareholders. The survey is concerned mainly with board structure and independence, functions of the board and its committees, support for directors, and director compensation.

Board size and composition are important determinants of board effectiveness. The size should be large enough to secure sufficient expertise on the board, but not so large that productive discussion is impossible and free-riding among directors is prevalent. According to Minja and Barine (2011), it is preferable to have not less than and not more than 10 persons on the board of directors. Regarding the size of the board of directors, majority of the respondents indicated that the size of their boards is between 8 and 12 directors.

A board should have a mix of inside/executive and outside/independent directors with a variety of experience and core competence if it is to be effective in judging the management's performance objectively. For the purpose of board independence, a substantial share of a

board should consist of independent directors. Most of the respondents in the surveyed firms indicated that boards of directors have independent directors: ranging from 3 to 8 and is typically constitute between 25% and 50% of the board.

Having the board chairperson be someone other than the CEO is also believed to enhance the

* * 4

board's independence on the ground that the roles of supervisor and supervised should not be combined, though the separation might result in side-effects that could have a detrimental effect on firm performance. All the respondents in the survey "indicated that said that the CEO does not serve as the board chairman. Finally, for firms with many foreign shareholders, having foreigners represented on the board may be another indication of board independence. Majority of the respondent surveyed indicated that foreign nationals do sit in their boards.

The boards in the firms surveyed often directors from affiliated companies, senior manager from a supplier or customer company and current or former officer of a major creditor financial institution. While this may help to safeguard business interests, there may be cause conflicts of interest.

With regard to independence of the directors, most of the firms surveyed may fail the strict criteria of determining independence of the board. According to Barine and Minja, (2011) the behavior of independent directors may be directly observed to determine their independence. For example, do they often meet without inside directors, to discuss corporate matters, actively participate in board discussions, sometimes alter or add to board meeting agendas, or ask for the minutes of board meetings? According to the survey results, majority of the respondents indicated that independent directors rarely meet, formally or informally without management to discuss corporate matters. Further, independent directors rarely alter or add

the board meeting agenda set by the CEO. However, the majority of the board members actively participate in board discussions.

To improve the board's vigilance and to ensure continued independence, restricting the dismissals of directors and introducing fixed term limits, particularly for outside directors, may be necessary (Warther 1998). However, the extent of board independence, which often defies direct observation, may be better assessed by gathering subjective opinions about why independent directors might not be behaving independently.

The board's overall role and specific functions may have to be assessed on the basis of the subjective opinions of directors. Specific functions include "formulating long-term corporate strategies; selecting, monitoring, and replacing the CEO; reviewing the remuneration of executives and directors; overseeing potential conflicts of interest; and ensuring the integrity of financial reporting, the proper disclosure of information, and the effectiveness of various governance practices (OECD 1999). As a practical matter," how much time and effort directors devote to board meetings may also be an indicator of board effectiveness, for

instance, the frequency and length of board meetings, the directors' attendance rate, and the number of boards on which directors serve.

Certain important board functions are often better performed by board committees, especially if the board is so large that decision making is inefficient. Committees also allow for a division of labor based on the expertise of individual directors and help the board have more clearly defined mandates, particularly in relation to monitoring management. The independence and effectiveness of the audit committee is particularly important and may be assessed by its composition (share of independent directors, presence of accounting or finance experts, and whether or not the committee chair, is an independent director) and practices (meeting minutes, members' remuneration, written rules for the audit process, role

in the selection of internal and external auditors, and quality Of the working relationship with the auditors).

The survey results indicate that all the surveyed firms have audit committee which is composed of three independent directors who have some expertise in, accountancy and finance. Regarding whether the audit committee autonomously select/recommend the external auditor and conduct a proper review of his work, majority of the respondents indicated •"to some extent" and "hardly" Concerning whether audit committee approve the appointment of the internal auditor and supervise him to routinely review risk exposure and accounting procedures, majority of the respondents said that it is "to some extent" and "hardly".

Board compensation and nomination committees should, without undue influence by the CEO or controlling owners, formally review the performance and compensation packages of senior executives and other directors and play a major role" in the selection and dismissal of the CEO and independent directors. Stock options for executives that align their interests with those of shareholders are believed to be one of the most powerful corporate governance mechanisms, although they may also be abused and inefficient. The survey results indicate that all the firms surveyed have compensation and nomination committees. Regarding whether the board or compensation committee formally evaluates the CEO's performance, 76% of the respondents indicated "Yes, as a routine" Further, concerning whether there a formal review of the CEO compensation, most of the respondents indicated "Yes, as a routine".

in the selection of internal and external auditors, and quality Of the working relationship with the auditors).

s
t

The survey results indicate that all the surveyed firms have audit committee which is composed of three independent directors who have some expertise in, accountancy and finance. Regarding whether the audit committee autonomously select/recommend the external auditor and conduct a proper review of his work, majority of the respondents indicated "to some extent" and "hardly" Concerning whether audit committee approve the appointment of the internal auditor and supervise him to routinely review risk exposure and accounting procedures, majority of the respondents said that it is "to some extent" and "hardly".

Board compensation and nomination committees should, without undue influence by the CEO or controlling owners, formally review the performance and compensation packages of senior executives and other directors and play a major role" in the selection and dismissal of the CEO and independent directors. Stock options for executives that align their interests with those of shareholders are believed to be one of the most powerful corporate governance mechanisms, although they may also be abused and inefficient. The survey results indicate that all the firms surveyed have compensation and nomination committees. Regarding whether the board or compensation committee formally evaluates the CEO's performance, 76% of the respondents indicated "Yes, as a routine" Further, concerning whether there a formal review of the CEO compensation, most of the respondents indicated "Yes, as a routine".

.

5.2.2 Linkage between the quality of corporate governance and firm performance

C:

Better corporate governance is supposed to lead to better corporate performance by preventing the expropriation of controlling shareholders and ensuring better decision making. In expectation of such an improvement, the stock price may respond instantaneously to news indicating better corporate governance. Good governance means little expropriation of corporate resources by managers or controlling shareholders, which contributes to better allocation of resources and better performance. As investors and lenders will be more willing to put their money in firms with good governance, they will face lower costs of capital, another source of better firm performance. Other stakeholders, including employees and suppliers, will also want to be associated with and enter into business relationships with such firms, as the relationships are likely to be more prosperous, fairer, and longer lasting than those with firms with less effective governance.

Implications for the economy as a whole are also obvious. Economic growth will be more sustainable, because the economy is less vulnerable to a systemic risk. With better protection of investors at the firm level, the capital market will also be boosted and become more developed, which is essential for sustained economic growth. At the same time, good corporate governance is critical for building a just and corruption-free society. Poor corporate governance in big businesses is fertile soil for corruption and corruptive symbiosis between business and political circles. Less expropriation of minority shareholders and fewer corruptive links between big businesses and political power may result in a more favorable business environment for smaller enterprises and more equitable income distribution. According to a survey by McKinsey & Company (2002), in 2002, 78% of professional investors in Asia said that they were willing to pay a premium for a well-governed company. The average premium these investors were willing to pay generally ranged from 20% to 25%.

According to survey results, majority of the respondent firms had a profitability of over one billion shillings. Over a period of four years, 16 of 20 firms had attained one billion shillings profitability mark. Regarding growth in profitability, majority of the surveyed firms delivered growth in profitability by over 100% and only three firms recorded a decline over the same period.

5.3 Conclusion and Policy Recommendations

To a great extent, it can be concluded that the study achieved its objectives as outlined in Chapter one. The study has identified corporate governance practices of listed companies surveyed and also tracked financial performance of the respondent firms for a period of four years (year 2005-2008). The study found that majority of the* firms surveyed were able to deliver over 100% growth in profitability over the review"period. This is attributable to fairly good corporate governance practices adopted by these firms. .

The presence of an effective system of corporate governance within and individual firm and across an economy helps provide a degree of confidence necessary for the proper functioning of a market economy. Therefore, this study recommends that regulatory mechanisms be strengthened so as to promote good corporate governance practices among listed firms

5.4 Limitations of the study

This study investigated the corporate governance practises of firms listed in the NSE and the relationship between corporate governance practises- and financial performance of the respondent firms. Due to sensitivity of some information collected, the researcher holds a moral obligation to treat the information with utmost propriety. The results of the survey are presented only in aggregate without revealing the individual'firms. Since information on performance of companies listed in the NSE is public, data- on company performance is

displayed in the study without linking individual companies to the information on corporate governance obtained from the respondents.

5.5 Areas **for further research**

The study focused on the companies listed in the Nairobi Stock Exchange, with an inclination towards companies that make up the NSE 20-share index. Another study could be undertaken on other sectors of the economy. A study on corporate governance practices among the Small and Medium enterprises (SMEs) would especially offer interesting insights when compared with the findings of this study since most SMEs aspire to list at Nairobi Stock Exchange.

Further, another study can be undertaken that empirically determines the relationship between corporate governance and stock prices in the local setting. •' ~

Finally, apart from capital structure, there are other factors that influence a firm's performance. These include corporate ownership structure and capital structure. Another study could be conducted to determine the influence of corporate ownership structure and capital structure on a firm's performance in the local setting.

REFERENCES

- Levine, R. (1997) Financial development and economic growth: views and agenda. *Journal of Economic Literature*, v.35, n.2, p.688-726.
- Levine, R.; Zervos, S. (1996a) *Stock market, banks e economic growth*. The World Bank, Policy Research Departament, Washington.
- Brown, L. D., Caylor, M. L. 2004. '*Corporate Governance and Firm Performance*'. Washington
- Fich, E., and A. Shivdasani 2004. 'The Impact of Stotk-option.Compensation for Outside Directors on Firm Value, *Journal ofBusiness*, Vol. 78, Issue 6, pp. 2229-2254.
- John, K. and L. W. Senbet (1998). 'Corporate Governance and Board Effectiveness', *Journal of Banking and Finance* 22: 371-403.
- Mitton, T. 2001,'*A Cross-section Analysis ofthe impact ofCorporate Governance on the East Asian Crisis*, USA.
- Yermack, D. 1996. 'Higher Market Valuation for Firms With a Small Board of Directors', *Journal of Financial Economics* 40,185-211.
- Jensen, M. 1993. "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems, *Journal ofFinance* 48: 831-880.
- Anderson, R., S. Mansi, and D. Reeb 2004. 'Board Characteristics, Accounting Report Integrity, and The Cost of Debt, *Journal ofAccounting, and Economics* 37, 315-342
- Ashraf, J., and W. I. Ghani 2005. Accounting in a Country: *A Case ofPakistan*. (CMER Working Paper NO. 05-40.
- Drobetz, W., Schillhofer, A. and H. Zimmermann, 2004. 'Corporate governance and expected stock returns: *evidence from Germany*', *European Financial Management* 10,267-93. ;:
- La Porta, R., F. Lopez-de-Silanes, A. Shleifer, and R. Vishny". T999. Legal Determinants of External Finance, *Journal ofFinpnce* 54: 1131-1150..
- Aggarwal, R., Erel, I., Stulz, R., and R. Williamson, 2008. 'Differences in governance practice between U.S. and foreign firms: measurement; causes, and consequences, *Review ofFinancial Studies*, Volume22, Issue8, pp. 3131-3169

- Adjaoud, F., Zeghal, D., and Andaleeb, S. 2007. "The effect of Board's Quality on Performance: *An International Review*, Vol. 15 No. 4, pp. 623-635.
- Abdullah, N.S. (2006). "Directors remuneration, firm's performance and corporate governance in Malaysia among distressed companies". *Journal of corporate Volume 6 Number 2*, 162-174.
- Abdullah, S.N. (2004). "Board Composition, CEO duality and performance among Malaysia Listed Companies" *Journal of Corporate governance*, volume 4 Number 4, 47-61.
- Abor, J. (2007), "Corporate governance and financing decisions of Ghanaian listed firms", *Corporate Governance: International Journal of Business in Society*, Vol. 22 No.1, pp.83-92.
- Aluchna, M (2004), Corporate governance mechanisms used by Polish public listed companies: *doctoral dissertation, Warsaw School of Economics*.
- Aluchna, M (2005), Shareholders fight for corporate control, *Journal for Social Responsibility*, Vol. 2 No.1, pp.50-61.
- Anthony Coleman, (2006). The link between corporate governance and performance of the non- traditional export sector: evidence from Ghana, *Journal of corporate governance*. Volume 6, Number 5, 609-623
- Anthony Coleman, (2007). "The impact of Capital structure on the performance of micro-finance institutions", *Journal of Risk Finance* Volume 8, Number 1, 56-71.
- Bauer, R. Guenster, N (2003), "Good corporate governance pays off! Well-governed companies perform better on the stock market".
- Becht, M., Bolton, P., Roell, A. (2002), "*Corporate governance and control*, working paper, ECGI. Brussels,.

- Beiner, S, Drobetz, W, Schmid, M, Zimmermann, H (2004), ..'Corporate governance, Unternehmensbewertung und Wettbewerb - eine Untersuchung für die Schweiz".
- Berglof, E, Claessens, S (2006), "Enforcement and good corporate governance in developing countries and transition economies", World Bank Research Observer, Vol. 21 No.1, pp. 123-50.
- Berglof, E", von Thadden, E.-L. (1999), "The changing corporate governance paradigm: .. implications for transition and developing countries",-paper presented at the Annual World Bank Conference on Development Economics, Washington, DC, ..
- Bhasa, P. M. (2004), "Understanding the corporate governance quadrilateral". Journal of corporate governance, Volume 4. Number 4, pp. 7-15.J. .;
- Black, B, Jang, H, Woochan, K (2003), "Does corporate governance affect firm value? Evidence from Korea", available at: ssrn.com.
- Blair, M. (1999), "Firm-specific human capital and theories of the firm", in Blair, M. and Roe, M.J. (Eds)", Employees and Corporate Governance, Brookings Institution Press, Washington.
- Bonazzi L. and Sardar, M.N. (2007). Agency theory and corporate governance. Journal of Modeling in Management, Volume 2 Number 1, ~~7-2X-~~
- Brickley, J. Lease, R, Smith, C (1988), "Ownership structure and voting on antitakeover amendments". Journal of Financial Economics. Vol. 20 pp.267-91.

Brown, L.D. and Marches L.C., (2003) Correlation between Corporate Governance and Corporate Performance. Research Study Commissioned by Institutional Shareholders Services.

Bryman, A and Bell, E (2003) *Business Research Methods* Oxford University Press

Bhagat, S., Black, B. (2002), "The non-correlation between board independence and long-term firm performance", *Journal of Corporation Law*, Vol. 27 pp.231-73.

Cadbury Committee Report (1992), Voting Rights Can be Regarded as an Asset, December.

Campbell, K. Jerzemowska, M, Najman, K (2006), "The initial analysis of compliance with the corporate governance guidelines by the companies listed on Warsaw Stock Exchange in 2005", in.

Carter, C.B., Lorsch, J.W. (2004), *Back to the Drawing Board: Designing Corporate Boards for a Complex World*, Harvard Business School Press, Boston, MA,.

Conyon, M. (1997), "Corporate governance and executive compensation", *International Journal of Industrial Organization*, Vol. 15 pp.493-509..

Conyon, M. Peck, S. (1998), "Board control, remuneration committees and top management compensation", *Academy of Management Journal*, Vol. 41 No.2, pp.146-57.

Conyon. M. Schwalbach, J. (2000), "Executive compensation: evidence from the UK and Germany", *Long Range Planning*, Vol. 33 pp.504-26.

Coombs, P., Watson, M. (2001), "Corporate reform in the developing world", *McKinsey*

- Brown, L.D. and Marches L.C., (2003) Correlation between Corporate Governance and Corporate Performance. Research Study Commissioned by Institutional Shareholders Services.
- Bryman, A and Bell, E (2003) *Business Research Methods* Oxford University Press
- Bhagat, S., Black, B. (2002), "The non-correlation between board independence and long-term firm performance", *Journal of Corporation Law*, Vol. 27 pp.231-73.
- Cadbury Committee Report (1992), Voting Rights Can be Regarded as an Asset, December.
- Campbell, K, Jerzemowska, M, Najman, K (2006), "The initial analysis of compliance with the corporate governance guidelines by the companies listed on Warsaw Stock Exchange in 2005"), in.
- Carter, C.B., Lorsch. J.W. (2004), *Back to the Drawing Board: Designing Corporate Boards for a Complex World*, Harvard Business School Press, Boston, MA,.
- Conyon, M. (1997), "Corporate governance and executive compensation", *International Journal of Industrial Organization*, Vol. 15 pp.493-509..
- Conyon, M, Peck, S. (1998), "Board control, remuneration committees and top management compensation". *Academy of Management Journal*, Vol. 41 No.2, pp. 146-57.
- Conyon, M, Schwalbach, J. (2000), "Executive compensation: evidence from the UK and Germany", *Long Range Planning*, Vol. 33 pp.504-26.
- Coombs. P., Watson. M. (2001), "Corporate reform in the developing world", *McKinsey*

Quarterly. No.4. pp.90.

Cooper, D.R and Schindler, P.S. (2003) *Business Research Methods* (8thedn) McGraw-Hill:

New York

Claessens, J.P. Fan, P.H., Wong, T.J. (2003), A study of the relationship between the independent director system and the operating performance of the business in Taiwan", *working paper*.

Cho, D.S., Kim, J. (2003), "Determinants in introduction of outside directors in Korean companies", *Journal of International and Area Studies*; Vol. 10 No.1, pp. 1-20.

Daily, C, Johnson, J, Ellstrand, A, Dalton, D. (1996), "Compensation committee composition as a determinant of CEO compensation", *Academy of Management Journal*, Vol. 41 No.2, pp.209-20.

Demsetz, H, Villalongab, B (2002), "Ownership structure and corporate performance", *Journal of Corporate Finance*, Vol. 7 pp.209-33.

Dolphin. R.R., (2004). "Corporate reputation - a value creating-strategy Corporate governance, Volume 4, Number 3, 77-92.

Donald Cooper, H. (2006) *Synthesizing Research*, A guide for Literature Reviews (3rd edn)

Sage: Thousand Oaks

Dolton. M.C., Jacobs, H.D, and Dalton R.D (2006). "Corporate governance best practices:

The proof is in the process" *Journal of business strategy*. Volume 27, Number 4, 5-7.

Dondo Aleke (2005), *An Overview of the Microfinance Industry in Kenya*.

:/

Donaldson. W. (2003), "Congressional testimony concerning the implementation of the

Sarbanes-Oxley Act of 2002"; available at:
www.sec.gov/newytestimony/090903tswhd, . . .

Dzier zzanowski, P. Tamowicz, M. (2001), *Wlasnosc i kontrola polskich korporacji*,

[Owneship and control of Polish corporations], Market Economy Institute, Gdansk,
available at: 'www.pfcg.org.pl/pfcg/download/dopdf.pdf'.

Eisenberg, T., Sundgren, S., Wells, M.T. (1998), "Larger board size and decreasing firm

value in small firms", *Journal of Financial Economics*, Vol. 48 No.1, pp.35-54

Eldomiaty, T.T., Ain, A. and Chong Ju Choi, (2006). "Corporate governance and strategic

transparency: East Asia in the international business systems". *Corporate governance*,
Volume 6, Number 3, 281-295.

Elloumi. F. Guelie, J. (2001), "CEO compensation, IOS and the role of corporate

governance". *Corporate Governance*, Vol. 1 No.2, pp.-23-33.

Faccio, M, Lasfer, A (2000), "Do occupational pension funds monitors companies in which

they hold large stakes?", *Journal of Corporate Finance*, Vol. 6 pp.71-110.

Faccio, M. Lasfer, M.A. (2002), "Managerial ownership and firm value: the UK evidence",

working paper. City University Business School, London.

Francis. A. (2001). "Business Mathematics and statistics, London continuum.

Gerald Vinten, (2002). "The corporate governance lessons of Enron". Journal of Corporate governance Volume 2, Number 4, 4-9.

GoySI, V.K., Park, C.W. (2002, "Board Leadership structure and CEO turnover", Journal of Corporate Finance, Vol. 8 No. 1, pp. 49-66. •

Grant. G.H. (2003) "The evolution of corporate governance and its impact on Modern corporat America". Management decision, Volume 41, Number 9, pp. 923-34.

Grosfeld, I, Tressel, Th (2001), "Competition and corporate governance: Substitutes or complements? Evidence from the Warsaw Stock Exchange", working paper no. 369, William Davidson Institute.

Guthrie, J.P., Datta, D.K. (1998), 'Corporate strategy, executive selection and firm performance', Human Resource Management.. Vol 37 No. 2, pp. 101-6.

Gompers, A., Ishii, J.L., Metrick, A. (2003), "Corporate governance and equity prices", *Quarterly Journal of Economics*, Vol. 118 No.1, pp. 1.07-55.

Hambrick, D. Jackson, E. (2000), "Outside directors with a stake: the linchpin in improving governance", California Management Review, Vol. 42-No.4; pp. 108-27.

Hampel (1998) "Ownership structure and corporate performance", *Journal of Corporate Finance*, Vol. 7 pp.209-33.

Heracleous, C.W. (2001), "Board leadership structure and Cfeo turnover", *Journal of Corporate Finance*, Vol. 8 No. 1, pp.49-66.

i

Holdemess, C, Sheehan, D (1988), "The role of majority shareloders in publicly held corporations", *Journal of Financial Economics*, Vol. 20 pp.317-46.

Ikaheimo. S. Puttonnen, V, Ratilainen, T (2007), "External corporate governance and performance - evidence from the Nordic countries", available at: [ssrn.com/abstract = 960431](http://ssrn.com/abstract=960431).

Jebet Caroline, (2001). A study of corporate governances. The case of quoted companies in Kenya, Unpublished MBA project. University of Nairobi.

Jenkinson, T., Mayer, C. (1992), 'The assessment: corporate governance and corporate control'. *Oxford Review of Economi Policy*, Vol. 8 No.3.

John W. (2004). "Corporate governance and measuring performance" *Measuring Business Excellence*, Volume 8 Number 4, 13-16.

Kakabadse, N.K, Kakabadse. A.K and Kouzmin A. (2001). "Board governance and Company performance: any correlations?" *journal of corporate governance*, volume 1 Number 1,24-30.

Kamau. K., (19972) *Juhudi Credit Officer Training Manual*, Juhudi Credit Ltd.

ii

Khiari, W. Karaa, A. and Abdelwahed, O. (2007) "Corporate governance efficiency: An

indexing approach using the stochastic frontier analysis". *Corporate governance*, Volume 7 Number 2, 148-161.

Kitonga T.M. (2001). A survey of the opinions of management and external auditors of publicly quoted companies and the need for a corporate governance audit in Kenya. Unpublished MBA project. University of Nairobi.

Klapper, L. Love, I. (2002), "Corporate governance, investor protection and performance in emerging markets", World Bank Policy Research, Working Paper 2818.

i

Knell Alex (2006), *Corporate Governance: A practical implementation guide*.

Kozarzewski, P. (2002), "Changes in corporate governance structures in Polish privatized companies", Working Paper No. 8, Centre for the Study of Economic and Social Change in Europe, School of Slavonic and East European Studies.

Krupa, K. (2006), "Lad korporacyjny ("Corporate governance")", *Forbes (Polska)*, June, pp. 70-2.

Kula, V. and Tatoglu, E. (2006). "Board process attributes and company performance of family-owned business in Turkey". *Journal of corporate governance*, volume 6 Number 5-6 24-634.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A. (2000), "Investor-protection and corporate governance", *Journal of Financial Economics*, Vol. 58. pp. 3-27.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A. (1999), "Corporate ownership around the world", *Journal of Finance*, Vol. 54 No. 2. pp. 471.

Labie. M.(2001). "Corporate governance in micro-finance organizations: Along and winding road". Management Decision, Volume 39 Number 4,296-302.

Laing. D., and Weir, M. (1999). "Governance structures, size and corporate performance in UK firms", Management decision Volume 37, Number '5, 457-464.

Larcker. D.F., Richardson, S.A., Tuna, I. (2004), 'How important is Corporate governance?', working paper, The Wharton School, University of Pennsylvania, Philadelphia, PA.

Ledgerwood Joana, White Victoria (2006), Transforming Microfinance Institutions

MacAvoy, P, Millstein, I (2003). The Recurrent Crisis of Corporate Governance, Palgrave Macmillan.

MacAvoy and Millstein, (2003), "Meta-analytic reviews of board composition, leadership structure, and financial performance", *Strategic Management Journal*, Vol. 19 pp.269-90.

Manual on Corporate Governance in Ghana (The) (2000), prepared by the International Finance Corporation (IFC), Carl Bro Intelligent Solutions and African Management Services Company (AMSCO).

Matengo Meshack (2008) the relationship between corporate governance practices and performance: the case of banking industries in Kenya. Unpublished MBA Project. University of Nairobi.

Manyuru J. Pascal (2005), corporate governance & organizational performance. The case of companies quoted at the NSE Unpublished MBA Project. University of Nairobi

- Vak Y.T., Yuanto, K. (2003), "Board size really matters: further evidence on the negative relationship between board size and firm value". *Pulses; Singapore*.
- Manyuru Paschal Juma (2005), corporate governance and organization performance, The case of companies quoted at the Nairobi Stock Exchange.
- Maug. E. (1998), "Boards of directors and capital structure: Alternative forms of corporate restructuring", *Journal of Corporate Finance*, Vol. 3 pp.113-39.
- Mathiesen, (2002) "Ownership structure and corporate performance", *Journal of Corporate Finance*, Vol. 7 pp.209-33.
- Mc Adam. R. (2003). "Corporate Social responsibility in a total quality management context: opportunities for sustainable growth" *Journal of corporate governance* volume 3, Number 4, 36-45.
- McConnell, J. Servaes, H (1990), "Additional evidence on equity ownership and corporate value", *Journal of Financial Economics*, Vol. 27 pp.595-612.
- Mensah, S., Aboagye, K., Addo, E., Buatsi, S. (2003), *Corporate Governance and Corruption in Ghana*, a report prepared for IDRC CRDI ACMF CIPE. October.
- McKinsey & Co. (2005), "Investor opinion in corporate governance", available at", www.worldbank.org (accessed 28 March,
- Monks. R. (2001), "Corporate governance and value: appearance and reality", *European*

Monks. R. Minow, N (2004), Corporate Governance, Blackwell Business, Cambridge, MA.

Vtucui E.M.,(2001) a survey of corporate governance practices in the motor vehicle industry in Kenya,. Unpublished MBA project. University of Nairobi.

Mullei. A and Bokea, C.,(1999) Micro and small Enterprises in Kenya: agenda for Improving the Policy Environment. The International Center for Economic Growth.

Mutua, A.K and Mitero, S., (1985) What Kenya Micro enterprise Credit Schemes can Learn from Grameen Bank's Credit Model, A case Study.

Muriithi A.M. (2005) The Relationship Between Corporate Governance Mechanisms & Performance Of Firms Quoted On The NSE. Unpublished MBA Project. University of Nairobi.

Mwangi A.K.G., (2001). A survey of corporate governance practices among insurance companies in Kenya. Unpublished MBA project. University of Nairobi.

Mwenda, K.K. and Muuka. N.G. (2004). Towards best practices for micro-finance institutional engagement in Africa rural areas. International journal of social Economics, Volume 31, Number 1 or 2, 143-158.

Nam Sang-woet al (2005) Linkage between Corporate Governance and Firm Performance, ADB Institute. •

Neun, S. Santerre. R (1986), "Dominant stockownership and profitability", Managerial and

Decision Economics, Vol. 7 pp.207-10.

Nogalski, B, Dadej. R (2006), The code of best practice as an instrument for process of building confidence on the capital market.

Pajuste, A (2002), Corporate governance and stock market performance in Central and Eastern Europe.

Pajuste, A (2004), "What do firms disclose and why? Enforcing corporate governance and transparency in Central and Eastern Europe", Beyond Transition. The Newsletter About Reforming Economies, The World Bank, December:

Parker, S., Peter, G., and Turetsky, H.F. (2002). "Corporate governance and corporate failure: a survival analysis". Journal of corporate governance, volume 2 Number 2, 4-12.

Parker. L.D. (2007a), "Financial and external reporting research: the broadening corporate governance challenge", *Accounting & Business Research*, Vol. 37 No.1, pp.39-54.

Polish Institute of Directors (2005), "Corporate governance XXII - wrócenie nagrod Spółka Godna Zaufania 2005 (Awarding ceremony for company worth trust)", pp.9-13.

Polish Institute of Directors (2006), "Brakuje nam jeszcze jednego kroku". Przegląd Corporate Governance., ("We need one more step"), interview with Mr. Igor Chalupiec, CEO of PKN Orlen.

Preobragenskaya, G, McGee, R (2003), "Corporate governance in a transition economy: a case study of Russia, academy of international business - Southeast.

Reily. F.K and Brown. K.C., (1997) Investment Analysis and Portfolio Management, Dryden Press, USA.

Rudolf, S (2006a), "Funkcjonowanie rad nadzorczych w Polsce". ("Functioning of supervisory boards in Poland"), in, in Lis, K, Sterniczuk, H (Eds), Nadzorkorporacyjny, Oficyna, (Corporate governance), pp.356-84.

Rudolf, S (2006b), "Analiza zmian w wybranych obszarach nadzoru korporacyjnego", in Rudolf, S (Eds), Tendencje zmian w nadzorze korporacyjnym, The analysis of changes in selected areas of corporate governance.

Roe, M.J. (2003), "Oxford University Press, Oxford, pp. 201-4* *Political Determinants of Corporate Governance.*

Sanda, A.M; Milkailu, A.S and Garba, T., (2005) Corporate Governance Mechanisms and Firm Performance in Nigeria.

Shleifer, A, Vishny, R (1997), "A survey of corporate governance", Journal of Finance, Vol. 52 pp.737-83.

Singh S. (2005), Corporate governance: Global concepts and Practices.

Siwale. J. Ritchie, J. and Dixon, R. (2006). "Micro-Finance: accountability from the grassroots", accounting, Auditing and Accountability journal Volume 19, Number 3; 405-427.

Sroka, I (2006), "Investor relations - teoria i praktyka w Polsce i w Unii Europejskiej"

("Investor relations - theory and practice in Poland and the European Union"), in", in Ostaszewski. J. Zalewska. M (Eds), W stron? teorii i praktyki finansow. (Theory and practice of finance), Szkoła Główna Handlowa. pp.241-50.

Steen Thomsen, (2005). "Corporate governance as a determinant of corporate values".

Volume 5, Number 4, 10-27.

*

..

Steinweller. H (2006), "The influence of corporate governance on the value of a company",

written assignment, course on comparative analysis of corporate governance, Warsaw School of Economics.

..

Szczygiel (2005), "II edycja ratingu spółek giełdowych według oceny inwestorów

instytucjonalnych" ("Second edition of public listed companies rating according to the institutional investors assessment"), Przegląd (Review) Corporate Governance, Vol. 1 No.4, pp.11-3.

Thomsen, S. (2004). "Corporate values and corporate governance". Journal of corporate governance, Volume 4, Number 4, 29-46.

Tian, G.G., Zeitun, R. (2007). "Does ownership affect a firm's performance and default risk in Jordan?" Journal of corporate governance Volume 7, Number 1, 66-82.

t

Useem. M (1996), "Shareholders as strategic assets", California Management Review, Vol.

39 No.1, pp.8-27.

'•;

Van de Ven, A.H. (1986), 'Central problems in the management of innovation'. Management Science, Vol. 32 pp. 590-607.

...

Wainaina, J.N., (2003) Corporate Governance Practices of MFIs in Kenya, Unpublished

Wairimu Gakuo (2002), Governance practices among NGOs in Nairobi.

Wangombe J.G.(2003) a survey of corporate governance practices in cooperative societies in Nairobi. Unpublished MBA project. University of Nairobi.

Warsaw, Dobre praktyki (2005), "Good corporate governance practice in public listed companies 2005 - Committee of Good Practice Forum Corporate Governance", w spółkach publicznych.

Woidtke, T (2002), "Agents watching agents?: evidence from pension fund ownership and firm value", Journal of Financial Economics, Vol. 63 pp.99-131.

Writer, N. (2001). "Twinbull 2000: Corporate governance and financial sector". Balance Sheet, Volume 9, number 2, p. 20-23.

Zajac, E, Westphal, J (1996), "Director reputation CEO-board power, and the dynamics of board interlocks", Administrative Science Quarterly, Vol. 41 No.3, pp.507-33.

Zheka, V (2008), "Corporate governance determinants: the firm-level evidence from transitional country", Ukraine, available at: papers.ssrn.com/sol3/papers.cfm?abstract_id=979523 (forthcoming in Journal of International Economic Policy).

APPENDICES

Appendix I: Questionnaire

Questionnaire Survey on Corporate Governance Practices

My name is JACOB OMBAYO, a Kenyan student pursuing a Masters in Business Administration (MBA) Degree at University of Nairobi. My study requires that I undertake a field study in the aforementioned subject. I kindly request your assistance in filling in this questionnaire to help me achieve my study objective. The survey is asking questions on the practices in your firm. Your accurate and frank response is key to attaining the objectives of this study. The results will be used only for research purposes and be presented only in aggregate without being revealed by individual firms.

In advance, I thank you for sparing your time and your cooperation

To be answered by the company secretary or any officer in charge of governance matters shareholder relations, public disclosure, assisting outside directors, etc.)

Section 1: General Information on the Firm and Respondent

1. Which business segment is your firm listed at Nairobi Stock Exchange
 - o Agricultural Sector U
 - o Commercial and Services Sector { }
 - o Finance and Investment Sector i }
 - o Industrial and Allied Sector v { }
 - o Alternative Investment Market Segment { }
2. How do you describe the ownership and control structure of the firm?
 - o The largest shareholder has a substantial voting right (over 30-40%, including that of companies he controls) and effectively controls the firm { }
 - o The largest shareholder effectively controls the firm even though his voting right is less than 30-40% U
 - o Two or more large shareholders collectively control the firm { }
 - o Ownership is fairly diffuse with no controlling shareholder, and the

- Management is not directly controlled by shareholders { }
3. Is the firm a stand-alone company or a subsidiary of a business group or a holding company ;
- o Stand-alone company { }
 - o Subsidiary of a business group { }
 - o A holding company { }
4. Is the firm wholly or partially owned and controlled by the government?
- o No { }
 - o Yes, substantially owned and controlled by the government { }
 - o Partially owned, but not much controlled by the government { }
5. Is the firm wholly or partially owned and controlled by foreigners (foreign firms)?
- o Little owned by foreign investors { }
 - o Yes, substantially owned and controlled by foreigners (foreign firms) { }
 - o Substantially owned, but not controlled, by foreign investors { }

Shareholder Rights

6. Approximately how many shareholders does your firm has
- o Below 1000
 - o Between 1,000 and 10,000
 - o Above 10,000
7. Are director candidates disclosed before the shareholders' meeting?
- {Yes} {No}
8. Would it be possible for the director candidates proposed by the management of your firm fail to be elected at the shareholders' meeting?
- Sometimes {A} Rarely {B} Unthinkable { }
9. How long did last previous annual general meeting last
- o Less than 1 hour { }
 - o 1-2 hours { }
 - o 2-3 hours { }
 - o Over 3 hours { }

Disclosure and Transparency

10. What is the extent of disclosure of the following information in your firm?

- o Self-dealing (related-party) transactions {Often} {Rarely} {No disclosure}
- o Directors' selling or buying shares in their company {Often} {Rarely} {No disclosure}
- o Background of directors {Often} {Rarely} {Nodisclosure}
- o Remuneration of directors {Often} {Rarely} {No disclosure}
- o Fees paid to external auditors, advisors, and other related parties {Often} {Rarely} {No disclosure}
- o Policies on risk management {Often} {Rarely} {Nodisclosure}
- o Significant changes in ownership {Often} {Rarely} {Nodisclosure}

Effectiveness of the Board of Directors

11. How is your board composed?

- o How many directors does your board have in total?
- o How many independent directors does your board have?
- o Are there any foreign nationals on your board? {Ye} {No}
- o Does the CEO of your firm also serve as board Chainnan? {Ye} {No}

12. Do you have the following person on your board now (as a director)?

- o Current or former officer of a major creditor financial institution { Yes} { No}
- o Officer of an affiliated company { Yes} { No}
- o Senior manager from a supplier or customer company { Yes} { No}
- o Someone from a law/accounting/consulting firm that provides professional service to the firm {Yes} { No}

13. How prevalent are the following practices?

- o Independent directors meeting formally or informally without management to discuss corporate matters {Often} {Sometimes} {Rarely} {Never}
- o Independent directors altering or adding the board meeting agenda set by the CEO

{Often} {Sometimes} {Rarely} {Never}

- o Independent directors participating actively in board discussions

{Often} {Sometimes} {Rarely} {Never}

- o Individual directors' positions on board meeting agendas recorded in minutes

{Often} {Sometimes} {Rarely} {Never}

14. Does your board have the following committees? What proportion of the committee members are independent directors (e.g. yes, 2 out of 3 etc)?

o Audit Committee {Yes} { } {No}

o Compensation Committee {Yes} { } {No}

o Nomination Committee " {Yes} { } {No}

15. (If you have an audit committee) How effective and independent is your audit committee?

- o Does it have someone with accounting/finance expertise?

{Yes} {No}

- o Are minutes written for each audit committee meeting?

{Yes} {No}

- o Does it autonomously select/recommend the external auditor and conduct a proper review of his work?

{Very much so} {To some extent} {Hardly} " !"

- o Does it approve the appointment of the internal auditor and supervise him to i.

routinely review risk exposure and accounting procedures?

{Very much so} {To some extent} {Hardly}

16. How is the CEO evaluated and compensated?

- o Does your board or compensation committee formally evaluate the CEO's performance?

{Yes, as a routine} {Sometimes} {Rarely} {NeVer}

- o Is there a formal review of the CEO compensation?

o {Yes, as a routine} {Sometimes} {Rarely} {Never}

Appendix 2: Companies Quoted in Nairobi Stock Exchange

AGRICULTURAL

Eaagads Ltd Ord 1.25 \

Kakuzi Ltd Ord.5.00

Kapchorua Tea Co. Ltd Ord Ord 5.00

The Limuru Tea Co. Ltd Ord 20.00 ^

Rea Vipingo Plantations Ltd Ord 5.00

Sasini Ltd Ord 1.00 .. ^

Williamson Tea Kenya Ltd Ord 5.00

AUTOMOBILES & ACCESSORIES ^

Car & General (K) Ltd Ord 5.00

CMC Holdings Ltd Ord 0.50

Marshalls (E.A.) Ltd Ord 5.00

Sameer Africa Ltd Ord 5.00

BANKING ;

Barclays Bank of Kenya Ltd Ord 0.50 .

CFC Stanbic of Kenya Holdings Ltd ord.5.00 •

Diamond Trust Bank Kenya Ltd Ord 4.00

Equity Bank Ltd Ord 0.50

Housing Finance Co.Kenya Ltd Ord 5.00

Kenya Commercial Bank Ltd Ord 1.00 _

National Bank of Kenya Ltd Ord 5.00

NIC Bank Ltd Ord 5.00 5.

Standard Chartered Bank Kenya Ltd Ord 5.00

The Co-operative Bank of Kenya Ltd Ord 1.00 ' .

COMMERCIAL AND SERVICES

Express Kenya Ltd Ord 5.00 AIMS

Hutchings Biemer Ltd Ord 5.00

Kenya Airways Ltd Ord 5.00 •

Nation Media Group Ltd Ord. 2.50

Scangroup Ltd Ord 1.00

Standard Group Ltd Ord 5.00

TPS Eastern Africa Ltd Ord 1.00 :

Uchumi Supermarket Ltd Ord 5.00

CONSTRUCTION & ALLIED

Athi River Mining Ord 5.00 _____ ;
Bamburi Cement Ltd Ord 5.00 _____
Crown Berger Kenya Ltd Ord 5.00 _____ •
E.A.Cables Ltd Ord 0.50 _____
E.A.Portland Cement Co. Ltd Ord 5.00 _____ '•>

ENERGY & PETROLEUM

KenGen Co. Ltd Ord. 2.50 _____
KenolKobil Ltd Ord 0.05 _____
Kenya Power & Lighting Co Ltd Ord 2.50 _____
Total Kenya Ltd Ord 5.00 _____

INSURANCE _____ -

British-American Investments Company (Kenya) Ltd Ord 0.10 _____
CFC Insurance Holdings Ltd ord. 1.00 _____
Jubilee Holdings Ltd Ord 5.00 _____ ••
Kenya Re Insurance Corporation Ltd Ord 2.50 _____ :
Pan Africa Insurance Holdings Ltd Ord 5.00 _____ :

INVESTMENT

Centum Investment Co Ltd Ord 0.50 _____
City Trust Ltd Ord 5.00 AIMS _____ ;'•
Olympia Capital Holdings Ltd Ord 5.00 _____
Trans-Century Ltd Ord 0.50 AIMS _____

MANUFACTURING & ALLIED

A.Baumann & Co Ltd Ord 5.00 AIMS _____
B.O.C Kenya Ltd Ord 5.00 _____
British American Tobacco Kenya Ltd Ord 10.00 _____ '
Carbacid Investments Ltd Ord 5.00 _____ '└
East African Breweries Ltd Ord 2.00 _____
Eveready East Africa Ltd Ord. 1.00 _____
Kenya Orchards Ltd Ord 5.00 AIMS _____
Mumias Sugar Co. Ltd Ord 2.00 _____ • •
Unga Group Ltd Ord 5.00 _____

TELECOMMUNICATION & TECHNOLOGY

AccessKenya Group Ltd Ord. 1.00	..
Safaricom Ltd Ord 0.05	>

Source: Nairobi Stock Exchange

%
v

Appendix 3: The Sample: NSE 20 Share Index companies

	Company	Sector
1	REA Vipingo	Agricultural
2	sasini	Agricultural
3	CMC	Automobiles and Accessories
4	BBK	Banking
5	Equity	Banking
6	KCB	Banking
7	Stanchart	Banking
8	Coopbank	Banking
9	KQ	Commercial and services
10	Safaricom	Commercial and services
11	Nationmedia	Commercial and services
12	Express	Commercial and services
13	Bamburi	Construction and Allied
14	Athi River mining	Construction and Allied
15	Kengen	Energy and Petroleum
16	KenolKobil	Energy and Petroleum
17	KPLC	Energy and Petroleum
18	BAT	Manufacturing and Allied
19	EABL	Manufacturing and Allied
20	Mumias sugar	Manufacturing and Allied

Appendix 4: The Sample: NSE 20 Share Index companies

	Company	2005	2006	2007	2008	Growth in Profitability
		<i>Figures in "000"</i>				
1	Equity	344.60	753.37	1,890.28	3,910.00	1035%
2	Coopbank	446.10	866.50	1,549.60	2,373.90	432%
3	Kenya Commercial Bank	1,326.03	2,431.88	2,974.57	4,190.69	216%
4	Kengen	1,753.20	3,768.93	2,445.67	4,809.45	174%
5	CMC motors	339.99	434.25	618.32	927.16	173%
6	Athi River mining	199.50	264.56	421.66-1	503.45	152%
7	Safaricom	5,855.00	8,425.00	12,010.00	13,853.00	137%
8	East African Breweries	4,769.91	5,392.49	6,133.22	9,184.39	93%
9	Nationmedia	716.20	783.20	1,076.40	1,298.00	81%
10	REA Vipingo	124.46	112.58	115.30	202.36	63%
11	Bamburi	2,155.00	2,614.00	3,596.00	3,412.00	58%
12	Barclays Bank of Kenya	3,729.00	4,492.00	4,910.00	5,525.00	48%
13	Kenya Power	1,270.27	1,644.23	1,718.48	1,764.87	39%
14	Stanch art	2,452.17	2,634.30	3,469.88	3,250.81	33%
15	Kenya Airways	3,020.00	4,829.00	4,098.00	3,869.00	28%
16	KenolKobil	915.88	842.95	593.43	1,155.32	26%
17	British American Tobacco	1,382.04	1,201.42	1,385.65	1,700.40	23%
18	Mumias sugar	1,289.93	1,526.62	1,393.61	1,213.84	-6%
19	Express	53.93	66.33	73.62	(43.24)	-180%
20	Sasini	(386.59)	236.74	(33.57)	875.66	-327%

Source: Compiled from NSE data on company performance . •

Appendix 5: Return on Equity Statistics for the Respondent firms

Return on Equity (ROE)						
Company	2005	2006	2007	2008		
<i>Figures in %.</i>						
1	Equity	31.04	50.11	15.85	25.53	
2	Cooperative bank	17.56	24.06	30.54	24.00	
3	Kenya Commercial Bank	19.32	27.25	32.00	28.51	
4	Kengen	10.33	3.84	7.06	9.80	
5	CMC motors	11.20	12.26	15.22	19.18	
6	Athi River mining	17.17	19.97	24.3f	23.66	
7	Safaricom	38.16	40.55	36.63	32.49	
8	East African Breweries	31.08	31.92	32.62	45.97	
9	Nationmedia Group	21.77	21.83	28.15*	31.08	
10	REA Vipingo	20.10	17.26	16.26	23.12	
U	Bamburi	20.18	20.08	25.27"	22.02	
12	Barclays Bank of Kenya	39.17	40.30	43.57	40.99	
13	Kenya Power	6.72	8.00	7.79	7.46	
14	Stanchart	41.05	44.98	37.62	36.63	
15	Kenya Airways	24.50	27.98	18.94	14.95	
16	KenolKobil	22.81	18.04	11.91'	10.58	
17	British American Tobacco	35.50	28.64	29.52	34.75	
18	Mumias sugar	21.22	19.80	16.71	13.43	
19	Express	21.32	17.56	16.57	(11.29)	
20	Sasini	(14.33)	8.06	(1.17)	19.06	
	Average	21.79	24.12	22.27	22.60	

Source: Compiled from NSE-company annual returns