FINANCIAL PERFOMANCE AND THE EXTENT OF ADOPTION OF CORPORATE GOVERNANCE PRACTICES BY SMALL AND MEDIUM ENTERPRISES IN KENYA

BY

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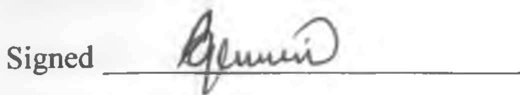
DECLARATION

I declare that this research project report is my original work and has never been submitted anywhere for any academic award.



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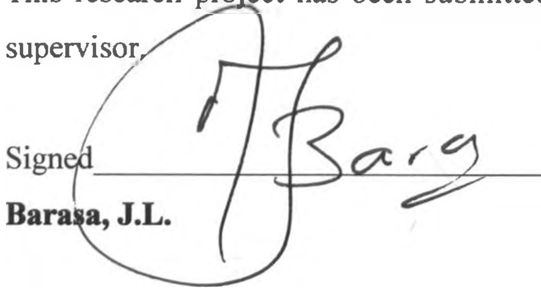

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Barasa, J.L.

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To my beloved husband Stephen Wanyonyi Luketero (PhD)

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ABBREVIATIONS

BOD	Board of Directors
CBS	Central Bureau of Statistics
CEOs	Chief Executive Officers
GDP	Gross Domestic Product
ILO	International Labor Organization
IT	Information Technology
NGOs	Non-Governmental Organizations
NSE	Nairobi Stock Exchange (NSE);
OECD	Organization for Economic Co-operation and Development
SACCOs	Savings and Credit Cooperative societies (SACCOs)
SMEs	Small and Small and Medium-sized Enterprises
SPSS	Statistical Package for Social Sciences
UK	United Kingdom
USA	United States of America

ABSTRACT

The study sought to examine the financial performance and extent of adoption of corporate governance practices of SMEs in Kenya. The review was undertaken in order to eliminate duplication of what has been done and provide a clear understanding of existing knowledge base in the problem area. The literature review is based on authoritative, recent, and original sources such as journals, books, thesis and dissertations. Descriptive survey design was used to structure the research. The population of study was the registered SMEs in the manufacturing sector in Kariobangi Light Industries that have adopted corporate governance practices. The study utilized a combination of both quantitative and qualitative techniques in the collection of data. The study targeted 30 SMEs in Kariobangi Light Industries. The owners or managers of the SMEs were the respondents in the study. Out of the 30 questionnaires sent out, 27 questionnaires were returned completed, a 90.0% response rate.

The primary data was collected by administering semi-structured structured questionnaires to the sampled respondents. A self-administered questionnaire was used since the level of understanding of the questions by the respondents is expected to be relatively high. The questionnaire was considered effective since it is not time consuming, considering that all respondents are based at the market centers in the study area. The questionnaire was pilot tested on ten randomly selected respondents before they are administered to ensure that it is understood in its correct perspective, in order to meet the research objectives. Data pertaining to the extent of adoption of corporate governance by SMEs in Kenya was conducted using descriptive statistics, which includes measures of central tendency, measures of variability and measures of frequency among others. Descriptive statistics help to simplify large amounts of data in a sensible way. Each descriptive statistic reduces lots of data into a simpler summary.

The data was analyzed by employing descriptive statistics such as percentages, frequencies and tables. Statistical Package for Social Sciences (SPSS) was used to aid in analysis. The researcher preferred SPSS because of its ability to cover a wide range of the most common statistical and graphical data analysis and is very systematic. Computation of frequencies in tables was used in

data presentation. The information is presented and discussed as per the objectives and research questions of the study. Findings of the study indicate that some SMEs that participated in the study had adopted the following corporate governance practices: formation of board of directors; development and institutionalization of a system for evaluating board and individual directors; development of Bylaws to govern board meetings; holding four or more regular board meetings per year; use of cumulative voting for election of directors; choosing shareholder meeting dates and locations to encourage attendance; and ensuring board approval for related party transactions.

The findings further show a positive relationship between the following corporate governance practices and profitability of the SMEs that participated in the study: availability of board of directors; existence of a system of evaluating board and individual directors; existence of Bylaws to govern board meetings; and use of cumulative voting for elections of directors. The findings also show that adoption of the following corporate governance practices did have a direct influence on profitability of the SMEs that participated in the study: holding four or more regular board meetings per year; the choice of shareholder date or location to encourage attendance; and board approval requirement for related party transactions.

The relevance of corporate governance cannot be over emphasized since it constitutes the organizational climate for the internal activities of a company. In Kenya corporate governance can greatly assist the SME sector by infusing better management practices, stronger internal auditing and greater opportunities for growth. Corporate governance brings new strategic outlook through external independent directors; it enhances firms' corporate entrepreneurship and competitiveness. It is not a threat to value creation in entrepreneurial firms if the guidelines on corporate governance are properly applied.

CHAPTER ONE

INTRODUCTION

1.1 Background of the study

Corporate governance is the process and structure used to direct and manage the business affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long-term shareholder value, whilst taking into account the interest of other stakeholders (Keasey *et al.*, 1997). The issue of corporate governance has been a growing area of management research especially among large, publicly listed firms. For Small and Small and Medium-sized Enterprises (SMEs), corporate governance is about the respective roles of the shareholders as owners and the managers (the directors and other officers). In SMEs, the resources, stewardship and control offered by directors for instance may be very different from and more direct than in large corporations. The limited studies in the area with respect to SMEs have focused mainly on developed economies (Eisenberg *et al.*, 1998; Bennett and Robson, 2004).

The issue is of critical significance given the important role SMEs play in the Kenyan economy. SMEs have been noted to make major contributions to employment generation. According to the Economic survey 2004, employment within the SME sector increased from 4.2 million persons in 2000 to 5.5 million persons in 2003 accounting to 75.3 percent of the total persons engaged in 2003. The sector contributes up to 18.4 per cent of the country's Gross Domestic Production (CBS, 1999). The SME sector should therefore not only be seen as a provider of goods and services, but also as a driver of competition and innovation, enhancing the enterprise culture which is necessary for private sector development and industrialization (Republic of Kenya, 2005).

According to the 1999 SME Baseline Survey, the sector employed 2.4 million persons. This increased to 5.1 million persons in 2002 as per the 2003 Economic survey and translates to 675,000 jobs per year. The level of employment within SMEs in 2002 accounted for over 74.2% of the total number of persons engaged in the country. This is evidence that, with proper development strategies, the sector is capable of providing and surpassing the Government's

target of creating 500,000 jobs per year. As compared to other sectors of the economy, the contribution of the SME sector to the country's Gross Domestic Product (GDP) has been impressive increasing from 13.8% in 1993 to over 18% in 1999 (Republic of Kenya, 2005).

SME development is however hindered by a number of factors, notable amongst which is the lack of adequate financing (Steel and Webster, 1991; Aryeetey *et al.,* 1994). The problem of financing has been argued to be the main reason for many SMEs failing to start or progress. This stems from the fact that SMEs have limited access to capital markets, locally and internationally, in part because of the perception of higher risk, informational barriers, and the higher costs of intermediation for smaller firms. As a result, they often cannot obtain long-term finance in the form of debt and equity (Kayanula and Quartey, 2000). Also, banks and other formal finance providers are often reluctant to extend credit to SMEs. Lack of managerial competencies and proper governance systems in the SME sector have been identified to swamp efforts at attracting such finance and thus are said to be the main barriers to SME development (Gockel and Akoena, 2002). It is necessary then for SMEs to adopt good corporate governance practices to ensure enhanced performance, given that this would have major implications for financing opportunities for the sector.

1.1.1 Corporate Governance

Corporate governance is concerned with the processes and structures through which members interested in the overall well being of the firm take measures to protect the interests of the stakeholders. Good corporate governance is centered on the principles of accountability, transparency, fairness and responsibility in the management of the firm. The institution of corporate governance in a firm is an attempt to ensure the separation of ownership and control, and this often results in principal-agent problems (Jensen and Meckling, 1976; Byrnes *et al.,* 2003).

According to Keasey *et al.* (1997), corporate governance includes the structures, processes, cultures and systems that engender the successful operation of the organizations. Corporate governance is seen as the whole set of measures taken within the social entity (enterprise) to favor the economic agents to take part in the productive process, in order to generate some

organizational surplus, and to set up a fair distribution between the partners, taking into consideration what they have brought to the organization. The Cadbury Committee defines a governance system as "the system by which companies are directed and controlled" (Cadbury, 1992).

Corporate governance systems may be thought of as mechanisms for establishing the nature of ownership and control of organizations within an economy. In this context, corporate governance mechanisms are economic and legal institutions that can be altered through the political process - sometimes for the better (Shleifer and Vishny, 1997). The impact of regulation on corporate governance occurs through its effect on the way in which companies are owned, the form in which they are controlled and the process by which changes in ownership and control take place (Jenkinson and Mayer, 1992). Ownership is established by company law, which defines property rights and income streams of those with interests in or against the business enterprise (Deakin and Slinger, 1997). Metrick and Ishii (2002) view 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". This suggests that corporate governance has an impact on a firm's ability to access the capital market.

1.1.2 Small and Medium Enterprises

Various definitions of the concept of Small and Medium-sized Enterprises (SMEs) appear especially in business, commerce, economics and development literature. For example, the common definition adopted by the Organization for Economic Co-operation and Development (OECD) countries is based on employment figures; correspondingly an SME has less than 500 employees (Organization for Economic Co-operation and Development (OECD) (2000). The South African SME Act, on the other hand, defines SMEs as having up to 100-200 employees or a turnover of five million Rand (US$833,000), while micro enterprises have up to five employees. In Egypt, the Ministry of Trade has unified definitions based on three criteria: (i) the number of workers; (ii) fixed assets; and (iii) annual turnover (Rizk, 2004).

In countries such as the USA, Britain, and Canada, small-scale business is defined in terms of annual turnover and the number of paid employees. In Britain, small-scale business is defined as

that industry with an annual turnover of 2 million pounds or less with fewer than 200 paid employees. In Japan, small-scale industry is defined according to the type of industry, paid-up capital and number of paid employees. Consequently, small and medium-scale enterprises are defined as: those in manufacturing with 100 million yen paid-up capital and 300 employees, and those in the retail and services trades with 10 million yen paid-up capital and 50 employees.

In Kenya, SMEs are defined as businesses in both formal and informal sectors, classified into farm and non-farm categories employing 1-50 workers (Republic of Kenya, 2005). The sector is considered as one of the major contributors to the economy by providing income and employment to a significant proportion of the population (Moyi *et al,* 2006). Since Independence, the Government has recognized the potential of the SME sector in employment creation and poverty reduction in its numerous policy documents. The *Sessional Paper No. 1 of 1986 on Economic Management for renewed growth* was the first to give explicit recognition of the sector's role in economic growth and development. Its recommendations led to the publication of *Sessional Paper No. 2 of 1992, Small Enterprises and Jua Kali Development in Kenya,* that identified the small-scale and Jua Kali enterprise sector for support to assist it to "graduate into the formal sector" and to become a major player in the creation of new jobs and economic growth. This was followed by Sessional Paper No. 2 of 2005 on *Development of Micro and Small Enterprises for Wealth and Employment Creation for Poverty Reduction.*

1.1.3 Corporate Governance and SMEs

Traditionally, corporate governance has been associated with larger companies and the existence of the agency problem. Agency problem arises as a result of the relationships between shareholders and managers. It comes about when members of an organization have conflicts of interest within the firm. This is mainly due to the separation between ownership and control of the firm. It is tempting to believe that corporate governance would not apply to SMEs since the agency problems are less likely to exist. In many instances, SMEs are made up of only the owner who is the sole proprietor and manager (Hart, 1995). Basically, SMEs tend to have a less pronounced separation of ownership and management than larger firms. Some argue that because SMEs have few employees who are mostly relatives of the owner and thus no separation of ownership and control, there is no need for corporate governance in their operations. Also, the

question of accountability by SMEs to the public is non-existent since they do not depend on public funds. Most, especially the sole proprietorship businesses do not necessarily need to comply with any disclosure. Because there is no agency problem, profit maximization, increasing net market value and minimizing cost are the common aims of the members. Members also disregard outcomes of organizational activities that will cause disagreement. They are rewarded directly and as such need no incentives to motivate them. Thus disagreement does not exist and hence no need for corporate governance to resolve them.

In spite of these arguments, there is a global concern for the application of corporate governance to SMEs. It is often argued that similar guidelines that apply to listed companies should also be applicable to SMEs. Jensen (1993) gives an example of what should be looked at when trying to improve a governance structure. Efficient systems have six key elements. Effective governance systems are characterized by: (i) limited partnership agreements at the top level that prohibit headquarters from cross-subsidizing one division with the cash from another; (ii) high-equity ownership on the part of managers and board members; (iii) board members who in their funds directly represent a large fraction of the equity owners of each subsidiary company; (iv) small boards of directors (of the operating companies), typically consisting of no more than eight people; (v) CEOs who are typically the only insiders on the board; and (vi) CEOs who are seldom the chairman of the board.

1.1.4 Corporate Governance and Financial Performance

According to James Wolfensohn former World Bank Group President, Corporate governance is about promoting corporate fairness, transparency and accountability (Financial Times, 1999). Governance is a requisite for survival and a gauge of how predictable the system for doing business in any country is. In developing countries, the importance of governance is to strengthen the foundation of society and chip into the global economy. International standards and guidelines on corporate governance have been established by many multilateral organizations including the OECD and the Basel Committee in the effort to ensure improved legal; institutional and regulatory framework for enhancing corporate governance in institutions (Kibirango, 2002). It is worth highlighting that, insufficient financial disclosure evidenced by high level of off-balance sheet items, lack of transparency resulting from gross mismanagement

and dubious accounting actions as observed in cases of ICB, GBL (Yunusu, 2001) and TransAfrica Bank Ltd (B.O.U., 2002) are detrimental to interests of firms stakeholders. The firm's capital, asset and earnings values are affected and as a result the financial performance is questionable. This may be due to poor corporate governance.

Transparency, disclosure and trust, which constitute the integral part of corporate governance, can provide pressure for improved financial performance. Financial performance, present and prospective is a benchmark for investment. The Mckinsey Quarterly surveys suggest that institutional investors will pay as much as 28% more for the shares of well governed companies in emerging markets (Mark, 2000). According to the corporate governance survey 2002, carried out by the Kuala Lumpur stock exchange and accounting firm Price Water House Coopers (PWC), the majority of investors in Malaysia are prepared to pay 20% premium for companies with superior corporate governance practices.

1.2 Statement of the Problem

Understanding and appreciating the nature and power of effective governance structures is vital for a country's stability as well as economic and social growth. Good governance results in transparency and accountability thus promoting ethical managerial practices, high positive impact and sustainable development. Corporate governance has been identified in previous studies to influence firms' financing or capital structure decisions which also affect performance (Friend and Lang, 1988; Berger *et al.,* 1997). Weak corporate governance does not only lead to poor firm performance and risky financing patterns, but is also conducive to macroeconomic crises (Claessens *et al.,* 2002), like the 1997 East Asia crisis. Becht *et al.* (2002) identify a number of reasons for the growing importance of corporate governance; including, 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 in the USA and elsewhere. Developing countries, of which Kenya is no exception, are now increasingly embracing the concept of good corporate governance, because of its ability to impact positively on sustainable growth.

Despite the increasing awareness of corporate governance issues, little empirical studies exist on the corporate governance practices of SMEs in the emerging economies. These empirical studies have tended to focus mainly on developed economies with inconclusive results. Very little, however, has been done on corporate governance in Sub-Saharan Africa, especially with respect to SMEs. In addition, there seems to be very little enthusiasm on the business scene about the impact of corporate governance in SMEs in Kenya. Tsamenyi *et al* (2007) observes that corporate governance studies in developing countries are limited and available only on an individual country basis.

Studies related to small and micro enterprises in Kenya include the following: Kessio (1981) studied the problems facing small businesses and the effect of management training on the performance of the proprietors. The problems established included limited access to capital for expansion, inadequate managerial skills, limited access to profitable markets and relatively low quality of products and services. The study also established that management training within the SMEs was positively related to performance. Mwangi (2001) focused on the factors affecting provision of non-financial services by NGOs to small and micro-sized enterprises in Nairobi. The findings indicate that the factors affecting provision of non-financial services by NGOs to SMEs include limited knowledge by SMEs on the non-financial services offered by the NGOs, limited uptake of the knowledge and skills acquired and reluctance by the SME owners to access the services for a fee. Wanyungu (2001) focused on the financial management practices of micro and small enterprises in Kibera, Kenya. The study findings indicate that whereas basic book keeping was undertaken, the financial management practices undertaken by MSEs in Kibera did not conform to the generally accepted international standards. The type of financial management practices adopted differed and was dependent on the level of education of the business owner (s).

Mwindi (2002) focused on the relationship between interest rates charged by MFIs and performance of micro and small enterprises in Nairobi. The study established that the interest rates charged by MFIs had a direct effect on performance of SMEs. The SMEs that had accessed credit indicated that the higher the interest rates, the lower were their returns. Kilonzo (2003) focused on the relationship between financial structure and performance of micro and small

enterprises in Nairobi. The study established that SMEs that financed the businesses through both owner equity and debt had access to financial advisory services and hence their performance was relatively better than the SMEs that were financed by capital contributions from the owner (s). Mwaura (2003) focused on the environment as a moderator of the relationship between business strategy and performance, a case of SMEs in Kenya. The study established that whereas business strategy adopted by the SMEs in Kenya had a direct effect on performance, the environment, which is made up of such factors as political-legal, economic, socio-cultural and technological acted as a moderating factor.

None of the above studies focused on financial performance and extent of adoption of corporate governance in SMEs in Kenya. This study has attempted to bridge the existing gap by seeking answers to the following research questions: (i) to what extent have SMEs in Kenya adopted corporate governance practices?; and what is the relationship between adoption of corporate governance practices by SMEs and financial performance ?

1.3 Objective of the Study

The objective of the study was to examine the financial performance and extent of adoption of corporate governance practices of SMEs in Kenya

1.4 Significance of the Study

This study, therefore, sought to raise ideas and issues in the hope that the various stakeholders and persons directly addressing issues related to corporate governance in SMEs in Kenya will continue the discussion. It does not presume to offer a prescription for the ideal measures to be employed by the stakeholders so as to reverse the trends. The findings of this study, it is hoped, will be beneficial to various key stakeholders as discussed in the subsequent sections.

1.4.1 The SMEs in Kenya

The SMEs in Kenya will gain a better understanding of the key components of corporate governance framework that would facilitate successful SMEs; the benefits derived from adoption on corporate governance by the SMEs; the challenges faced by SMEs in Kenya that hinder adoption of corporate governance practices; and the possible interventions that could be employed to address the challenges faced by SMEs in Kenya in adoption of corporate governance. On the basis of the findings of the study, the SMEs in Kenya will implement corporate governance practices from an informed position.

1.4.2 Policy makers in the SMEs sector in Kenya

The SMEs policy makers will acquire insight into the critical areas of support amongst SMEs that would facilitate adoption of effective corporate governance practices for enhanced performance.

1.4.3 Academicians and Researchers

The symbiotic relationship between corporate governance in SMEs and their performance is a relatively new and unexplored concept. The academic world should definitely consider the enormous potential of this strategic intersection. The study will make a significant contribution to the growing body of research on support of adoption of corporate governance by SMEs. The findings may also be used as a source of reference for other researchers. In addition, academic researchers may need the study findings to stimulate further research in this area and as such form a basis of good background for further researches.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter presents a review of the literature related to the purpose of the study. The chapter is organized according to the specific objectives in order to ensure relevance to the research problem. The review was undertaken in order to eliminate duplication of what has been done and provide a clear understanding of existing knowledge base in the problem area. The literature review is based on authoritative, recent, and original sources such as journals, books, thesis and dissertations.

2.2 Theoretical Framework

Theoretical underpinnings for the extant research in corporate governance come from the classic thesis, ''The Modern Corporation and Private Property'' by Berle and Means (1932). The thesis describes a fundamental agency problem in modern firms where there is a separation of ownership and control. Since the seminal work by Berle and Means (1932), different theories have been propounded in explaining the corporate governance issue. These include the agency theory, the stewardship theory, the resources dependence theory, and the stakeholder theory.

Jensen and Meckling (1976) define agency relationship and identify agency costs. Agency relationship is a contract under which ''one or more persons (principal) engage another person (agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent''. Conflict of interests between managers or controlling shareholder, and outside or minority shareholders refer to the tendency that the former may extract ''perquisites'' (or perks) out of a firm's resources and less interested to pursue new profitable ventures. Agency costs 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. The share price that shareholders pay reflects such agency costs. To increase firm value, one must therefore reduce 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''.

The stewardship theory, on the other hand suggests that managerial opportunism is not relevant (Donaldson and Davis, 1991; Muth and Donaldson, 1998). The aim of management is to maximize the firm's performance since that speaks of the success and achievements of management. Donaldson and Davis (1991) argue that managerial opportunism does not exist because the manager's main aspiration is ''to do a good job, to be a good steward of corporate assets''. This clearly replaces the lack of trust to which the agency theory refers with the respect for authority and inclination to ethical behavior.

The resource dependence approach, developed by Pfeffer (1973) and Pfeffer and Salancik (1978), emphasizes that non-executive directors enhance the ability of a firm to protect itself against the external environment, reduce uncertainty, or co-opt resources that increase the firm's ability to raise funds or increase its status and recognition. Firms attempt to reduce the uncertainty of outside influences to ensure the availability of resources necessary to their survival and development. The board is hence seen as one of a number of instruments that may facilitate access to resources critical to company success. There are four primary types of broadly defined resources provided by boards of directors. These are: (i) advice, counsel, and know-how; (ii) legitimacy and reputation; (iii) channels for communicating information between external organizations and the firm; and (iv) preferential access to commitments or support from important actors outside the firm (Pfeffer and Salancik, 1978). This resource role is played by board of directors mainly through their social and professional networks (Johannisson and Huse, 2000), and through interlocking directorates (Lang and Lockhart, 1990).

Similarly, the stakeholder approach also considers the provision of resources as a central role of board members. The main resource stakeholder proponents refer to is consensus. According to this view, the board should comprise representatives of all parties that are critical to a company's success. This will result in the firm's ability to build consensus among all critical stakeholders. The board of directors is hence seen as the place where conflicting interests are mediated, and where the necessary cohesion is created (Donaldson and Preston, 1995; Luoma and Goodstein,

1999). The stakeholder theory argues about the importance of a firm paying special attention to the various stakeholder groups in addition to the traditional attention given to investors (Freeman, 1984; Gibson, 2000). These various groups of stakeholders which include customers, suppliers, employees, the local community and shareholders are deemed to also have a stake in the business of a firm. The representation of all stakeholder groups on boards is therefore necessary for effective corporate governance.

Corporate governance has traditionally been associated with larger companies. This is mainly due to the separation between ownership and control of the firm. It is tempting to believe that corporate governance would not apply to SMEs since the agency problems are less likely to exist. In many instances, SMEs are made up of only the owner who is the sole proprietor and manager (Hart, 1995). Basically, SMEs tend to have a less pronounced separation of ownership and management than larger firms. It is sometimes argued that because SMEs have few employees who are mostly relatives of the owner and thus no separation of ownership and control, there is no need for corporate governance in their operations. Also, the question of accountability by SMEs to the public is non-existent since they do not depend on public funds. Most especially the sole proprietorship businesses do not necessarily need to comply with any disclosure.

In spite of these arguments, there is a global concern for the application of corporate governance to SMEs. It is often argued that similar guidelines that apply to listed companies should also be applicable to SMEs. The ongoing tendency toward improving board functions within publicly listed firms will extend to SMEs by mimicry and institutional pressures (Corbetta and Salvato, 2004). The extant empirical literature on corporate governance of SMEs focuses on a number of factors including board size, board skill level, board composition and control, CEO duality, percentage of shares closely held, family ownership, and foreign ownership. These are discussed in turn.

2.2.1 Board Size

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. However, recent thinking has leaned towards smaller boards. Jensen (1993), and Lipton and Lorsch (1992) argue that large boards are less effective and are easier for the CEO to control. When a board gets too big, it becomes difficult to co-ordinate and often creates problems. Smaller boards also reduce the possibility of free riding by, and increase the accountability of individual directors. Large board size which influences firm performance negatively is predominantly in businesses of larger sizes (Baysinger and Butler, 1985; Kosnik, 1990). For SMEs, one of the most important transitions is that from a single/owner-manager to a wider board. Instituting a team approach permits clearer development and definition of the choices facing the business. It also permits a stronger development of a more open and less oppressive internal human relations structure (Drucker, 1992; Sparrow, 1993). The benefit of encouraging team development through a widen board has been argued to be an important step in improved corporate governance in SMEs (Cadbury, 2000). Such widened board development for very small firms has been noted as directly improving firm performance (Goodstein *et al.,* 1994) especially where these are non-executive directors (Cowen and Osborne, 1993). Eisenberg *et al.,* (1998) however found a negative correlation between board size and profitability when using a sample of small and midsize Finnish firms.

2.2.2 Board Composition and Control

Though the issue of whether directors should be employees of or affiliated with the firm (inside directors) or outsiders has been well researched, no clear conclusion is reached. On the one hand, inside directors are more familiar with the firm's activities and they can act as monitors to top management if they perceive the opportunity to advance into positions held by incompetent executives. On the other hand, non-executive directors may act as ''professional referees'' to ensure that competition among insiders stimulates actions consistent with shareholder value maximization (Fama, 1980). John and Senbet (1998) argue that boards of directors are seen to be more independent as the proportion of their non-executive directors increases. A number of empirical studies on non-executive directors support the beneficial monitoring and advisory functions to firm shareholders (Byrd and Hickman, 1992; Brickley *et al.,* 1994). Baysinger and

Butler (1985) and Rosenstein and Wyatt (1990) showed that the market rewards firms for appointing non-executive directors.

Brickley *et al.* (1994) found a positive relation between proportion of non-executive directors and stock-market reactions to poison pill adoptions. However, Fosberg (1989) found no relation between the proportion of non-executive directors and various performance measures. Hermalin and Weisbach (1991) and Bhagat and Black (2002) found no significant relationship between board composition and performance. Yermack (1996) also showed that, the percentage of non-executive directors does not significantly affect firm performance.

2.2.3 Board and Staff Skill Levels

The level of training among board members and mangers could have a strong influence on the performance of the firm. Lybaert (1998) argues that better performance is due to the proven positive relation of higher levels of education among entrepreneurs and their willingness to use external information, develop networks, make use of consultants or develop more detailed accounting and monitoring. However, there is contrary evidence about the level of training among SMEs owners and managers. Lawrie (1998) demonstrates that gaps in management expertise are less of a recognized barrier to SME development than the availability of specialist staff skills, chiefly IT and languages. Therefore, although higher-level management qualifications may be useful to SMEs, there is still some doubt as to their relevance. Powell (1991) maintains that there may even be a negative effect on firm performance as a result of the occupational and professional affiliations of highly qualified managers which may encourage increased agency behavior.

2.2.4 CEO Duality

Fama and Jensen (1983) suggest that concentration of decision management and decision control in one individual reduces board's effectiveness in monitoring top management. The literature reveals a board structure typology, the system where the CEO also acts as chairman of the board and the system where the positions of CEO and chairman are occupied by two individuals. It has been noted that the system where the CEO also acts as board chairman leads to leadership facing conflict of interest and agency problems (Brickley *et al.,* 1997) thus giving preference for the

system where the CEO's role is separated from that of the board chairman. Yermack (1996) argues that firms are more valuable when the CEO and board chair positions are separate. Relating CEO duality more specifically to firm performance, researchers however found mixed evidence. Daily and Dalton (1992) found no relationship between CEO duality and performance in entrepreneurial firms. Brickley *et al.* (1997) showed that CEO duality is not associated with inferior performance. Sanda *et al.* (2003) found a positive relationship between firm performance and separating the functions of the CEO and Chairman. Rechner and Dalton (1991) however, reported that companies with CEO duality have stronger financial performance relative to other companies.

2.2.5 Inside Ownership

A high level of inside ownership is said to create conditions conducive for managerial entrenchment and self-aggrandizing behavior. Consequently, it reduces outside owner's ability to monitor and control the behavior of the firm's leadership, which reduces the value of the firm. The firm actually incurs high agency cost for the lack of transparency (Randøy and Goel, 2003). In the case of SMEs which receive less scrutiny from other stakeholders that can provide corporate governance monitoring compared to large publicly listed firms, a high level of insider ownership is not efficient, given that managers will pursue policies to their own advantage instead of aiming at innovative entrepreneurial opportunities and shareholder value maximization. Randøy and Goel (2003) found that a high level of board and insider ownership has a positive impact on firm performance in founder-led firms, but a negative performance effect in non-founder firms.

2.2.6 Family Ownership

It is often argued that the benefit of founding family leadership of firms is that family traits, such as trust, altruism and paternalism can create an atmosphere of love and commitment towards the business (James, 1999) and therefore curtail agency costs. Previous studies by Kang (1998), James (1999) and Mishra *et al.* (2001) showed that founding family businesses provide special kind of corporate governance that offers lower agency costs and better performance. Other studies however indicated that entrepreneurs and managers of founding family firms are more likely to engage in managerial entrenchment to the detriment of the firm, resulting in weaker

performance (Thomsen and Pedersen, 2000; Gomez-Mejia *et al.*, 2001). Some studies also revealed inconclusive results (Dalton and Daily, 1992; Begley, 1995).

2.2.7 Foreign Ownership

Foreign ownership is said to facilitate stronger monitoring of managers (Randøy and Goel, 2003). In addition, the firms cost of capital can be reduced by having large foreign institutional investors who actively monitor the actions of management (Randøy *et al.*, 2001). Prior empirical evidence suggests that the existence of foreign institutional investors leads to lower agency cost (Stulz, 1999) and this is especially relevant in small countries with smaller investor community and in small businesses (Oxelheim *et al.*, 1998). Firms with high foreign ownership may tend to institute certain control measures such as auditing and frequent reporting systems. These actions are likely to reduce agency cost and thus result in higher firm performance.

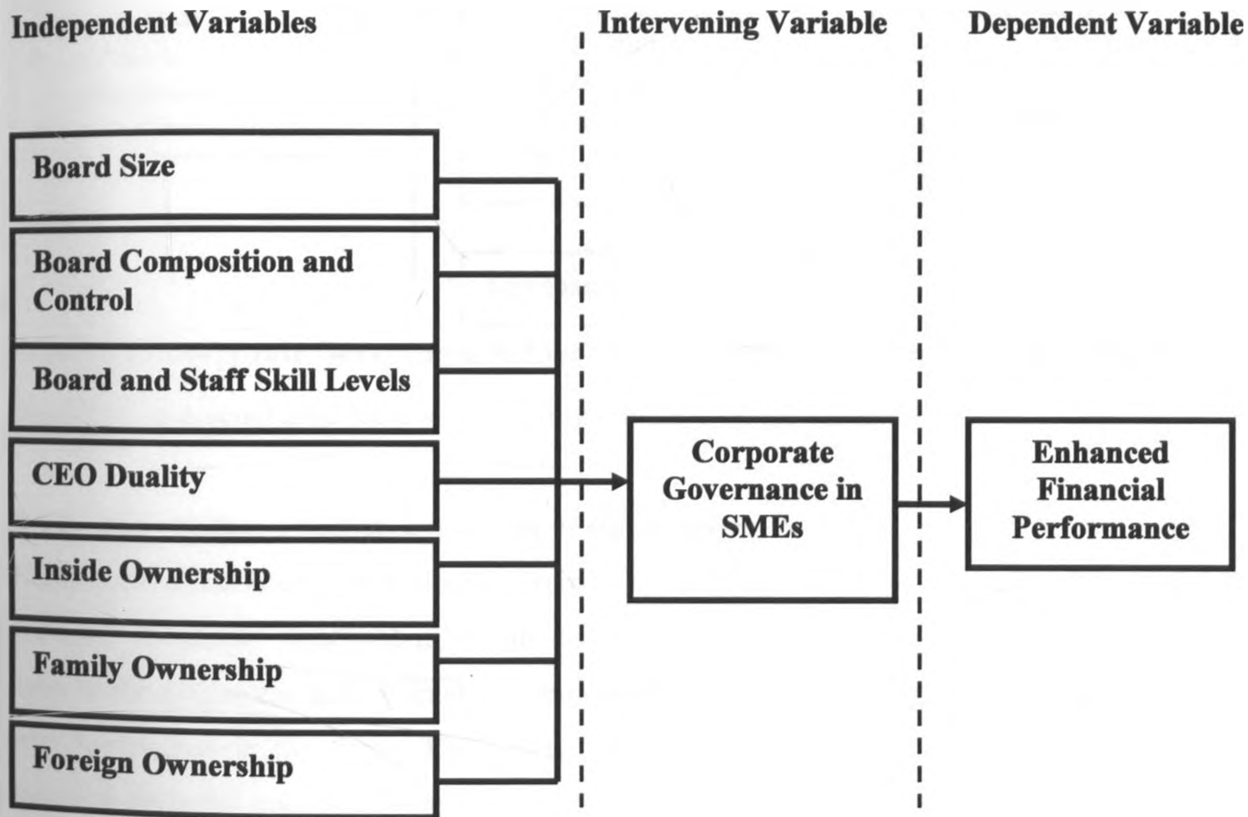

Figure 2.1.: Theoretical Framework of Corporate governance in SMEs

Source: Author (2011)

2.3 Corporate governance and Financial Performance

2.3.1 Overview of the key variables

To understand corporate governance and financial performance variables in relation to SMEs, the major corporate governance pillars i.e. financial transparency, disclosure and trust are dissected. Financial performance is also reviewed based on the performance dimensions comprising: capital adequacy, asset quality, earnings and liquidity. The significance of stakeholders in SMEs is also highlighted. These are compressed in a conceptual framework as shown in Figure 2.2 below.

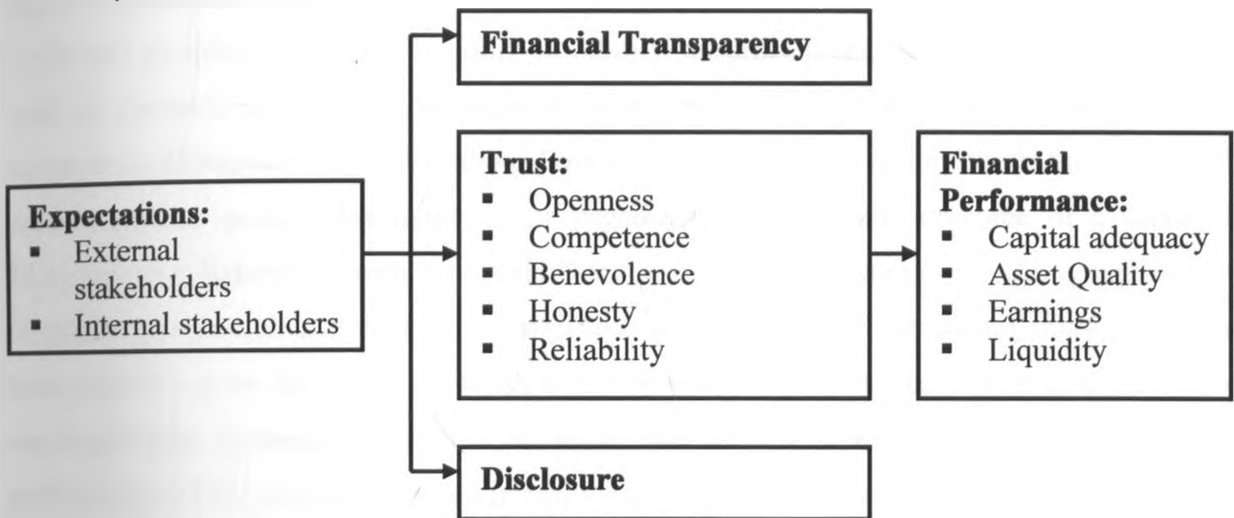

Figure 2.2: Corporate Governance & Financial Performance Conceptual Framework

Source: Constructed after reviewing existing literature on the variables

2.3.2 Expectations, Rights, and duties of stakeholders

Numerous stakeholders (internal and external) exist in any business enterprise. Some of these include; customers, shareholders, financiers, government among others. Internal stakeholders such as the employees and external stakeholders like Shareholders, Customers, Tax Authorities, and Supervisors in the firms. These expect firms to be financially transparent and disclose adequate financial information voluntarily. Shareholders, particularly have a variety of rights in terms of receiving a dividend and appointing managing director. It is not clear whether their duties might lie. Since it is understood that buying shares is an investment there is no reason why a shareholder remains loyal to a company, or a management team in any circumstances. It is thus entirely unreasonable for industrialists to accuse shareholders of short termism when selling

shares that have not performed to expectations James and Arthur (2003). One of the key stakeholders includes the government. Government formulates rules and regulations that enterprises should follow as they transact their business, organizations are also expected to file returns to the tax authorities for instance Kenya Revenue Authority and the Central Bank of Kenya, the expectation of government is that, information from these enterprises should not be biased and misleading. Management has to take into account the stakeholders expectations when they set a strategic direction but this can only be attained through sound corporate governance.

2.3.3 Corporate Governance

Corporate governance is about building credibility, ensuring transparency and accountability as well as maintaining an effective channel of information disclosure that would foster good corporate performance. It is also about how to build trust and sustain confidence among the various interest groups that make up an organization. Indeed the outcome of a survey by Mckinsey in collaboration with the World Bank in June 2000 attested to the strong link between corporate governance and stakeholder confidence (Mark, 2000). Given that a study has already been carried out on the extent to which board composition affects team processes (orientation communication feedbacks, coordination, leadership and monitoring), board effectiveness and performance of the selected financial institutions in Kenya (Rosette, 2002), the researcher picked three basic tenets of Corporate Governance; Transparency, Disclosure and Trust in relation to performance of firms in Kenya, these tenets fall under the accounting field. The constructs/tenets are reviewed in the following sections.

Transparency: Transparency is integral to corporate governance, higher transparency reduces the information asymmetry between a firm's management and financial stake holder's (equity and bondholders), mitigating the agency problem in corporate governance (Sandeep *et al,* 2002).

Disclosure: The concept of transparency is broad in scope it refers to the quality and quantity of public information on a firm's risk profile and to the timing of its disclosure, including the firm's past and current decisions and actions as well as its plans for the future. The transparency as a whole also includes public information on industry regulations and on safety net operations (Enoch *et al,* 1997 and Rosengren, 1998).

Weak transparency makes firms' asset risks opaque. Stock market participants including professional analysts such as Moody's encounter difficulties in measuring firms credit worthiness and risk exposures (Poon, Firth, and Fung, 1999, Morgan 1999, and Jordan, Peek, Rosengren, (2000)). Ball (2001) argues that timely incorporation of economic losses in the published financial statements (that is, conservatism) increases the effectiveness of corporate governance, compensation systems, and debt agreements in motivating and monitoring managers. For instance, improved governance can manifest in a reduction of the private benefits that managers can extract from the company or in a reduction of the legal and auditing costs that shareholders must bear to prevent managerial opportunism.

Governance research in accounting exploits the role of accounting information as a source of credible information variables that support the existence of enforceable contracts, such as compensation contracts with payoffs to managers contingent on realized measures of performance, the monitoring of managers by boards of directors and outside investors and regulators, and the exercise of investor rights granted by existing securities laws. There are a number of issues to consider in this regard. First, the existence of a strong financial accounting regime is likely a precondition for the existence of a vibrant stock market and in its absence the notions of equity-based pay and diffuse ownership of firms become moot (Ball (2001) and Black (2000)). Institutional Variables Used to Measure Corporate transparency comprises Financial accounting disclosures of major stakeholders, Timeliness of disclosures, Information dissemination and completeness of information. Robert and Abbie (2001) concur with BPS especially on institutional transparency, they outline the transparency dimensions as; Completeness of financial information, Release of information, Timeliness, and Means of dissemination.

Disclosure: Given the recent corporate scandals (US Based; Enron, WorldCom... (Heidi and Marleen (2003) restoring public trust is at the top of the agenda of today's business leaders. Greater information provision (disclosure) on the company's capital and control structures – can be an important means to achieve this goal. High quality and relevant information is crucial for exercise of governance powers. Full Disclosure seeks to avoid financial statements fraud (Beasley, 1996; Beasley *et al,* 2000). Prior studies have concentrated on disclosure of items such

as management earnings forecasts (Johnson *et al*, 2001; Lev and Penman 1990) or interim earnings (Leftwich and Zimmerman 1981), or have examined a very general disclosure index of financial and/or non - financial items (Chow and Wong – Borren, 1987). The CIFAR Index (i.e. a disclosure index created by the Center for Intentional Financial Analysis and Research (CIFAR) rates annual reports on the inclusion or omission of about 90 (rather traditional and mandatory financial) items from the following categories; general information, income statements, balance sheet, funds flow statement, accounting standards, stock data and special items (Laporta *et al,* 1998).

Dangers of Voluntary Disclosure: The most common arguments against voluntary disclosure from a managerial perspective are fear of giving away sensitive information to competitors and procurement of extra costs for collecting and disclosing the information (Eccles and Mavrinac (1995), Healy and Palepu (1993), Reich and Cylinder (1997).However, it is worth noting that as competition continues to bite, the "basket of secret" information tends to reduce.

Financial Disclosure: Financial disclosure, which is a key component of the newly proposed Basel Capital Accord, is reviewed in the following paragraphs. In April 2003, the Basel Committee on Banking Supervision (BCBS, 2003a), headquartered at the Bank for International Settlements in Switzerland, released the new Basel Capital Accord, which replaced the 1988 Capital Accord with an attempt to set regulatory capital requirements that are comparable across countries. The purpose of pillar three is to complement the other pillars by presenting an enhanced set of public disclosure requirements focusing on capital adequacy. This pillar is examined in more detail than the first 2 pillars given that disclosure represents one of the key variables in the scope of this study.

Details of Pillar Three: Pillar Three addresses the issue of improving market discipline through effective public disclosure. Specifically, it presents a set of disclosure requirements that should improve market participants' ability to firms' capital structures, exposures, management processes, and, hence, their overall capital adequacy. The proposed disclosure requirements consist of qualitative and quantitative information in three general areas: corporate structure, capital structure and adequacy, and management. Corporate structure refers to how an

organization is organized; for example, what is the top corporate entity of the group and how are its subsidiaries consolidated for accounting and regulatory purposes. Capital structure corresponds to how much capital is held and in what forms, such as common stock. The disclosure requirements for capital adequacy focus on a summary discussion of the firm's approach to assessing its current and future capital adequacy.

The Concept of Trust: Trust means many things. Everyone knows intuitively what it is to trust; yet articulating a precise definition is not a simple matter (Wayne and Megan 2002). Trust is difficult to define because it is so complex, in fact, Hosmer (1995) has observed. "There appears to be widespread agreement on the importance of trust in human conduct, but unfortunately there also appears to be an equally widespread lack of agreement on a suitable definition of the construct". Trust is a multifaceted construct, which may have different bases and phases depending on the context; it is also a dynamic construct that can change over the course of a relationship (Wayne and Megan, 2002).

Facets of trust: There are at least five facets of trust that can be gleaned from the literature on trust (Hoy and Tschannen-Moran, 1998; Tschannen-Moran and Hoy 2001). Benevolence, reliability competence, honesty and openness are all elements of trust (Wayne and Megan 2002). Benevolence perhaps the most common facet of trust is a sense of benevolence - confidence that one's well being or something one cares about will be protected and not harmed by the trusted party (Baier, 1986; Butter and Cantecell, 1984; Cummings and Bramily, 1996; Deutch, 1958 Frost, Stimpson and Maughan, 1978; Ganbetta, 1988; Hosner, 1995; Hoy and Kupersmith 1985; Mishra 1996).

Reliability at its most basic level trust has to do with predictability that is, consistency of behavior and knowing what to expect from others (Butter and Cantrell, 1984; Hosmer 1995). In and of itself, however, predictability is insufficient for trust. We can expect a person to be invariably late, consistently malicious, inauthentic, or dishonest when our well-being is diminished or damaged in a predictable way, expectations may be met, but the sense in which we trust the other person or group is weak.

Competence: Good intentions are not always enough when a person is dependent on another but some level of skill is involved in fulfilling an expectation an individual who means well may nonetheless not be trusted (Baier 1986; Butter and Cantrell, 1984; Mishra, 1996). Competence is the ability to perform as expected and according to standards appropriate to task at hand, many organizational tasks rely on competence. Honesty: Honesty is the person's character, integrity and authenticity Rotter (1967) defined trust as "the expectancy that the word, promise, verbal or written statement of another individual or group can be relied upon". Statements are truthful when they confirm to "what really happened "from that perspective and when commitments made about future actions are kept. A correspondence between a person's statements and deeds demonstrates integrity.

Openness: Openness is the extent to which relevant information is shared; it is process by which individuals make themselves vulnerable to others. The information shared may be strictly about organizational matters or it may be personal information, but it is a giving of oneself (Butter and Cantrell, 1984, Mishra, 1996) such openness signals reciprocal trust a confidence that neither the information nor the individual will be exploited and recipients can feel the same confidence in return. Individuals who are unwilling to extend trust through openness end up isolated (Kramer, Brewer and Hanna, 1996).

Macro-Economic Variable: Macro-economic variables through factors such as inflation and changes in interest rates may either enhance or distress firm's financial performance. Cordella and levy Yeyati (1998a) point out that if the shocks of the economy are wide and banks cannot control their asset portfolio risks, then full transparency of banks risk positions may destabilize the banking system. A country's macro economic environment may also affect transparency levels therefore it becomes difficult to relate to financial performance of commercial Banks.

2.4 Empirical Review

In this section, we consider various empirical studies conducted as well as related literature to establish the extent of implementation of corporate governance. Such studies have pursued a broad range of topics but this report will focus on three main areas: Firstly, the implementation of corporate governance in Africa with emphasis on Kenya; and secondly, the models upon

which corporate governance frameworks across the world and specifically in the SMEs sector are based on.

2.4.1 Principles of Good Governance and their Implementation

Good governance imposes processes and procedures that act as the boundaries of accepted behavior for both organizations and societies and if well implemented can also provide an opportunity-creating environment (Kakabadse and Korac-Kakabadse, 2002). Consequently, corporate governance has become a major policy objective around the world and many countries have adopted codes of corporate governance that specify common standards of behavior to be followed by organizations. Most of these codes of corporate governance have been modeled around the Organization for Economic Co-operation and Development (OECD) principles of good corporate governance which imply that good governance should be pluralistic in nature, inclusive in decision making, empowering the weaker sections of society and be geared towards achieving the generally accepted common good (Frederikson, 1992).

Several studies have been conducted on the adoption and implementation of codes of corporate governance in Africa. Findings from a broad range of these studies identify continued serious shortcomings in the implementation of good governance. Goldsmith (2003) conducted a comparative study of Ghana, Kenya, Madagascar, Malawi, Senegal, Tanzania, Uganda and Zambia and found that despite a decade of reforms in corporate governance, there is still a general lack of will and capacity by governments to provide a legal, regulatory and political environment to enhance the implementation of good governance practices. Mensah (2003) in a multi country study covering Egypt, Ghana, Mauritius and Kenya, found that poor governance is not as a result of lack of reasonable rules for supporting corporate governance, but arises from the problem of enforcement and inappropriate mechanisms to reinforce the effectiveness of governance promoting rules.

Okeahalam (2004) who investigated the issues and challenges of corporate governance and disclosure in Africa discovered that corruption and the absence of informed and responsive shareholders and appropriate monitors are some of the hindrances to the implementation of good governance practices. Tsamenyi *et al.* (2007) in their study on disclosure and corporate

governance in Ghana found that disclosure and transparency levels in that country are generally low, while Okike (2007) found that although the government had taken steps to initiate an effective system in Nigeria, the effectiveness of the enforcement mechanisms put in place is still in doubt. Commendably though, research conducted by Vaughn and Ryan (2006) indicated that although a lot still remains to be done, South Africa rates among the best performers in corporate governance in emerging markets. In a study specific to Kenya, Trade and Development Board (2003) found that the main obstacles to the implementation of good governance were non-separation of the roles of managers and the board, inappropriate board composition and characteristics, lack of training on corporate governance as well as weak legal and regulatory systems.

Nonetheless, a study by Barako *et al.* (2006) that covered the period 1992 – 2001 found that listed companies do voluntarily disclose information on their annual reports. Results of a trend analysis carried out in this research suggested that there had been an increase in the level of information voluntarily disclosed by the listed companies over time. A key argument running across the studies highlighted above is that the implementation of good corporate governance practices by organizations is largely dependent on their country and business contexts and therefore, generic corporate governance frameworks are unrealistic and inappropriate. In spite of this, however, there seems to be a consensus with respect to the basic principles that transcend borders and which are viewed as representing global standards of good governance.

Studies conducted by corporate organizations (OECD, 1999; OECD, 2004; Centre for African Family Studies, 2001; Private Sector Corporate Governance Trust, 2002) indicate that effective governance in organizations including SMEs should be founded on the following basic principles: i) Accountability to funding agencies, stakeholders, legal authorities, employees and beneficiaries; ii) Transparency and open leadership with accurate and timely disclosure of information relating to activities of an organization; iii) Effectiveness and efficiency in the use of resources and in getting results; iv) Integrity and fairness in all dealings and operations, hence implying honesty, faithfulness and diligence; and v) Responsibility, that is, the leadership should be capable, responsible, representative and conscious of its obligations.

Whereas some codes of good corporate governance, for example, the South African King II Report (2002) have further expanded these principles to include discipline, independence and social responsibility, there is a general consensus among authors that corporate governance hinges on the four cardinal values of fairness, accountability, responsibility and transparency (Spira, 2001; Walker and Fox, 2002; Grant, 2003 and Rezaee *et al.,* 2003). These values are the pillars of good governance, and although maintaining them, especially over a long period of time may be challenging, any framework for governance must provide for these basic principles which are interdependent and cannot be isolated. The achievement of these characteristics is generally determined by factors such as: a) The ethical tones and existence of a culture of upholding ethical standards by the top structure of an organization; b) The dominance and personality of the Chief Executive of the organization; and c) Willingness of the board to adopt a questioning and independent approach to issues at hand.

Implicit in the above mentioned factors is the reality that the board of directors (BOD) must comprise of individuals of integrity, high ethical standards and unquestionable character who will not only comply with the requirements of the codes of corporate governance but who will actually believe in and uphold the values entrenched in those codes. This is the particularly important because apart from a selected few, many codes are voluntary and not legislative. A study by Kakabadse and Korac-Kakabadse (2002) concludes that good governance imposes processes and procedures that act as the boundaries of accepted behavior for both organizations and societies and if well implemented can also provide an opportunity-creating environment. Consequently, corporate governance has become a major policy objective around the world and many countries have adopted codes of corporate governance that specify common standards of behavior to be followed by organizations.

2.4.2 Corporate Governance Models

Corporate governance has been implemented in different ways throughout the world and its practice varies across nations and organizations along dimensions like control structures, financial systems, legal regimes, business circumstances and competitive conditions thus reflecting divergent societal values. A comparison of existing literature indicates that corporate governance reforms and the phenomenon of corporate governance in general have been captured

in simple dichotomous distinctions (Heugens and Otten, 2007; Abdesselam *et al.*, 2008) and that national systems of corporate governance can therefore be classified into two distinct models: the shareholder (Anglo-American) model and the stakeholder (Continental European) model (Goergen *et al.*, 2008; Ooghe and Langhe, 2002). Whereas in the shareholder model of corporate governance - widely practiced in the UK and USA - the ownership structure of the firms tend to be dispersed among a myriad of small shareholders and capital markets are highly developed; in the stakeholder model which is dominant in Germany and Japan, the role of the stock market in the provision of financing is less pronounced (Goergen *et al.*, 2008). These differences are summarized in table 2.1

Table 2.1: Shareholder versus Stakeholder Corporate Governance Models

No.	Shareholder Model	Stakeholder Model
1	Great management power	Great shareholder power
2	Free-riding problem	Conflicts of interest
3	Over-investments	Limited financial resources
4	Problem of control	Movement of cash flows
5	Short-term problem	

Source: Van Hulle (1997)

2.4.3 The convergence debate

Because of the aforesaid merits and demerits and their potential consequences, questions have arisen as to which model of corporate governance is optimal: the shareholder model or the stakeholder model. Which of the two is less flawed than the other? This has resulted in the ongoing convergence debate – some arguing that there is a convergence towards the shareholder model. Studies in this area have returned varied findings. Sam (2007) in his study of Asia concluded that it is neither appropriate nor necessary to apply the Western ideas of corporate governance in a wholesome manner. Rather than doing this, each model should be recognized and respected in terms of its merits and demerits. Rossouw (2009) in his study of the four regions: Africa, Asia, Continental Europe and North America found that there is divergence rather that convergence and argued that the divergence should be appreciated as an indication of context specific factors, while Khanna *et al.* (2006) concluded that globalization may have induced the adoption of some common corporate governance standards, but there is little evidence that these standards have been implemented.

A study by Lane (2003) on convergence toward the shareholder model in German corporations, found that transformation is already taking place in the German system with support from powerful actors within the German economy particularly large organizations, internationally oriented and listed German Companies and some government ministries. A similar study conducted by Goergen *et al.* (2008) on the other hand showed that most of the features of the German system are still intact. However, the study noted that the German system had experienced some cultural changes such as the principles of shareholder value and stock-based remuneration packages which make it more similar to the shareholder system than one would expect.

Sarra and Nakahigashi (winter 2005-2006) in their study on Japan found that a majority of Japanese companies do not list on overseas markets. Hence, while there has been increasing competition for capital there has been less pressure for Japanese corporations to conform to Anglo-American securities and governance standards imposed by listings on international exchanges. This is likely to result in hybrid forms of corporate governance as opposed to adoption of the shareholder model. A study by Wang (winter 2005- 2006) also revealed that China has opted to fuse the American and German Corporate practices with their Chinese characteristics. The divergent views exposed by the studies referred to above, provide grounds to infer that the convergence debate may be misplaced and even misguided. Critics of this debate have stressed the need to customize governance frameworks to national and business contexts while taking into consideration the cultural and other social factors that may come into play even at the industry level.

2.4.4 Interpreting the Models in the SMEs Context

The Shareholder Model: From the SMEs perspective, the shareholder model reflects the traditional approach to accountability and is interpreted according to the principal-agent model where principals delegate authority to agents to act in their interests. Accountability is ensured through economic and legal incentives and sanctions. However, this understanding is narrow and restrictive, as it affords only those with formal authority over an SME the right to hold it accountable. Within the SMEs context, therefore, the interpretation of this model permits

organizations to focus on their accountability relationships with financiers, governments and their board of directors, to the exclusion of other stakeholders such as the communities they purport. Moreover, this approach tends to propagate the minimalist view that SMEs accountability is mainly about how money is spent and how the sources of finances can be maintained (Slim, 2002).

The Stakeholder Model: SMEs accountability is better understood through the stakeholder approach, which transfers the right to accountability from exclusively those that have authority over an organization to multiple stakeholders including those that may be affected by the organization's policies, procedures, processes and even businesses, thus making accountability a more inclusive and open concept. The open and participatory approach creates positive feedback that enables organizations to learn and ensures that decisions are made in a fair and equitable manner. Viewed from this broader perspective, accountability shifts from being a simple mechanism for either rewarding responsible managers or disciplining errant managers and becomes a force for social change (Lloyd, 2005). According to this approach SMEs are accountable to stakeholders in four different ways: upwards to the financiers and governments that provide them with the legal and financial support for their operations; downwards to their beneficiaries, that is, those expected to gain from the businesses or on whose behalf they purport to speak in policy forums; inwards to themselves in terms of respecting and honoring their organizational mission, values and staff effort; and horizontally to their peers with regard to upholding the standards of professionalism and reputation of the sector (Edwards and Hulme, 1996).

Lloyd (2005) argues that the strength of the aforementioned accountability relationships varies depending on the relative power wielded by each group of stakeholder over the SME. Financiers and government, for example, enjoy solid accountability relationships because they can reinforce SMEs accountability through their financial leverage and by creating the legal and regulatory framework within which SMEs must function. On the other hand, the accountability relationships between SMEs and their beneficiaries and peers tend to be fragile attributable to the fact that these groups of stakeholders lack adequate power to demand accountability.

2.5 Conclusion

The relevance of corporate governance cannot be over emphasized since it constitutes the organizational climate for the internal activities of a company. In Kenya corporate governance can greatly assist the SME sector by infusing better management practices, stronger internal auditing and greater opportunities for growth. Corporate governance brings new strategic outlook through external independent directors; it enhances firms' corporate entrepreneurship and competitiveness. It is not a threat to value creation in entrepreneurial firms if the guidelines on corporate governance are properly applied. Good governance mechanisms among SMEs are likely to result in boards exerting much needed pressure for improved performance by ensuring that the interests of the firms are served. In the case of an SME, board members bring into the firm expertise and knowledge on financing options available and strategies to source such finances thus dealing with the credit constraint problem of SMEs as well. We argue that for SMEs in particular the role of other stakeholders must be well articulated through a bottom-up approach where, for example, unions' (in the case of workers) views are explicitly laid out in board meetings. It must be noted that good governance does not guarantee business success. However, poor governance could be symptomatic of a business failure. More importantly, lifting the confidence of existing owners and potential new ones is a valuable goal.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter covers a description of the research design, population of the study, sampling procedures and sample size, instrumentation, data collection and data analysis techniques.

3.2 Research Design

According to Brown *et al.* (2003), research design provides the glue that holds the research project together. Descriptive survey design was used to structure the research, to show how all of the major parts of the project, which include the samples or groups, measures, treatments or programs, and methods of assignment that work together to try to address the central research questions. A descriptive survey will be undertaken. Descriptive survey designs result in a description of the data, whether in words, pictures, charts, or tables, and whether the data analysis shows statistical relationships or is merely descriptive. It is preferred to draw findings from the analysis of numerical data, in which case a survey becomes handy. Survey was preferred as a result of financial constraints. In this case, it was possible to administer the data collection tools to the respondents in their workstations, which was relatively easy, and played a great role in increasing the response rate.

3.3 Population of the Study

The population of study was the registered SMEs in the manufacturing sector in Kariobangi Light Industries that have adopted corporate governance practices. There are 1192 SMEs that have single business permit and are licensed to operate within Kariobangi light industries (Nairobi City Council). Some of the SMEs in study area have accessed credit facilities from financial institutions and compliance with good corporate practices was one of the requirements.

3.4 Sample

Cooper and Schindler (2000) assert that the researcher must clearly define the characteristics of the population, determine the required sample size and choose the best method for selecting members of the sample from the larger population in order to ensure that the sample accurately represents the population. A sample size of 30 SMEs was then selected using systematic random sampling. According to Mugenda and Mugenda (1999), a sample size of 30 is adequate.

3.5 Data collection

The primary data was collected by administering semi-structured structured questionnaires to the sampled respondents. The questionnaire was divided into two sections, section I covered the extent of adoption of corporate governance practices and section II covered the financial performance specifically the net profit. A self-administered questionnaire was used since the level of understanding of the questions by the respondents is expected to be relatively high. The questionnaire was considered effective since it is not time consuming, considering that all respondents are based at the market centers in the study area.

The questionnaire was pilot tested on ten randomly selected respondents before they were administered to ensure that it was understood in its correct perspective, in order to meet the research objective. The procedure that was used in collecting data was through distribution of the questionnaires that was, dropping and picking questionnaires from respondents at their most convenient time that was agreeable to both parties. A letter of introduction, stating the purpose of the study, was attached to each questionnaire. In addition, the researcher made telephone calls to the respective respondents to make follow up on the questionnaires that were delivered to the respondents. Once completed, the researcher and her assistants collected the questionnaires. This gave the researcher and her assistants the opportunity to clarify certain issues arising from the various responses.

3.6 Data Analysis and Presentation

Statistical Package for Social Sciences (SPSS) was used as an aid in the analysis. The researcher preferred SPSS because of its ability to cover a wide range of the most common statistical and

graphical data analysis and is very systematic. Data pertaining to the extent of adoption of corporate governance by SMEs in Kenya was conducted using descriptive statistics, which includes measures of central tendency, measures of variability and measures of frequency among others. According to Mugenda and Mugenda (1999) descriptive statistics enable meaningful description of a distribution of scores or measurements using a few indices or statistics. Descriptive statistics help to simplify large amounts of data in a sensible way. Each descriptive statistic reduces lots of data into a simpler summary.

Measures of central tendency gave us the expected score or measure from a group of scores in a study. Measures of variability, such as standard deviation, inform the analyst about the distribution of scores around the mean of the distribution. Frequency distribution shows a record of the number of times a score or record appears. In order to determine the relationship between extent of adoption of corporate governance practices of SMEs in Kenya and financial performance, regression analysis was used. A typical simple regression model in form of:

Given the fact that we are looking for the association between financial performance measure with a number of corporate governance measures, linear regression will be best suited to quantify the strength of the relationship. The equation to establish the relationship between corporate and performance of the firm therefore will be:

$$Y=\alpha + \beta 1X1+ \beta 2X2+ \beta 3X3+ \beta 4X4 + e$$

Y – Financial performance measured by Net profit.
X1 - measure of board of directors (measured by whether organization have board of directors),
X2 - measure of outside directors (measured by the proportion of outside directors),
X3 - measure of shareholder rights (measured by whether firms use cumulative voting for election of directors),
X4 - measure of disclosure and audit process (measured by the laws governing audit committee/ internal audit),
α - constant term explained by other factors other than corporate governance structure,
$\beta 1$, $\beta 2$, $\beta 3$ and $\beta 4$– Co-efficient of corporate governance, & e - error term.

Regression analysis is preferred as it enables the researcher to measure the relationship in consideration and a regression model employing only one independent variable will be used. The model is set up because it is believed that there is a linear relationship between one dependent variable and one independent variable. For the relationship between financial performance and adoption of corporate governance practices by SMEs in Kenya, a regression model can be constructed using financial performance as the dependent variable and the adoption of corporate governance practices as the independent variables. The analytical results will be presented by reports and conclusion drawn from the outcome.

CHAPTER FOUR

DATA PRESENTATION, ANALYSIS AND INTERPRETATION

4.1 Introduction

The study utilized a combination of both quantitative and qualitative techniques in the collection of data. The study targeted 30 SMEs in Kariobangi Light Industries. The owners or managers of the SMEs were the respondents in the study. Out of the 30 questionnaires sent out, 27 questionnaires were returned completed, a 90.0% response rate.

The data was analyzed by employing descriptive statistics such as percentages, frequencies and tables. Statistical Package for Social Sciences (SPSS) was used to aid in analysis. The researcher preferred SPSS because of its ability to cover a wide range of the most common statistical and graphical data analysis and is very systematic. Computation of frequencies in tables was used in data presentation. The information is presented and discussed as per the objectives and research questions of the study.

4.2 Extent of adoption of corporate governance practices of SMEs in Kenya

In order to determine the extent of adoption of corporate governance practices by SMEs in Kenya, the respondents were asked to indicate whether their organizations had undertaken various corporate governance practices in relation to board of directors, outside directors, shareholder rights, and disclosure and audit process. The responses are summarized and presented in the table below.

Table 4.1: Board of Directors

Board of Directors	Yes		No	
	N	%	N	%
Does your organization have board of directors?	16	59.3	11	40.7
Is the CEO and board chairman different people?	10	37.0	17	63.0
Does the firm have two third or more of board members as independent non- executive directors?	14	51.9	13	48.1
Does a system for evaluating board and individual directors exist?	18	66.7	9	33.3
Does a bylaw exist to govern board meetings?	19	70.4	8	29.6
Does the firm hold four or more regular board meetings per year?	20	74.1	7	25.9

The study findings shows that most of the SMEs, 59.3% had board of directors. Meanwhile, 40.7% of the SMEs did not have board of directors. With respect to CEO and board of directors, 37% of the organizations indicated that CEO and board chairman are different people and 63% of the organizations indicated that CEO and board chairman is the same person. On board members, 51.9% of the organizations have two third or more of board members as independent non-executive directors and 48.1% of the organizations do not have two third or more of board members as independent non-executive directors. With respect to system for evaluating board and individual systems, 66.7% of the organizations had a system for evaluating board and individual directors. Approximately 70% of the organizations had by-laws to govern board meetings. Moreover, regular board meetings were held as indicated by 74.1%.

Outside Directors

Table 4.2: Outside Directors

Outside Directors	**Yes**		**No**	
	N	**%**	**N**	**%**
Does the firm have more than 50% outside directors?	13	48.1	14	51.9
Does the firm have one or more foreign outside directors?	9	33.3	18	66.7
Does the firm have a system of evaluating outside directors?	12	44.4	15	55.6
Is there a nominating committee for the outside directors?	8	29.6	19	70.4
Does the shareholders approve outside directors' pay at shareholder meeting?	10	37.0	17	63.0
Is there code of conduct for outside directors?	11	40.7	16	59.3

Most SMEs, 51.9% were found to have less than fifty percent outside directors, 66.7% of the organizations did not have foreign outside directors and 55.6% of the organizations did not have a system of evaluating outside directors. Further, most organizations, 70.4% had a nominating committee for the outside directors, 63% of the organizations' shareholders do not approve outside directors' pay at shareholder meetings and 59.3% do not have code of conduct for outside directors.

Shareholder Rights

Table 4.3: Shareholder Rights

Shareholder Rights	Yes		No	
	N	%	N	%
Does the firm use cumulative voting for election of directors?	15	55.6	12	44.4
Does the firm allow shareholders to call a poll on all resolutions at the meeting?	13	48.1	14	51.9
Does the firm choose shareholder meeting date or location to encourage attendance?	17	63.0	10	37.0
Does the firm disclose director candidates to shareholders' in advance of shareholder meeting?	9	33.3	18	66.7
Is board approval required for related party transactions?	16	59.3	11	40.7

The study findings indicated that the organizations used Cumulative voting for election of directors, (55.6%), whereas 51.9% of the organizations did not allow shareholders to call a poll on all resolutions at the meeting. With respect to shareholder meeting date or location, 63.0% of the organizations chose shareholder meeting date or location to encourage attendance. On disclosure of director candidates, it was revealed that 66.7% of the organizations do not disclose director candidates to shareholders. Meanwhile, 59.3% of the organizations required board approval for related party transactions.

Disclosure and Audit Process

Table 4.4: Disclosure and Audit Process

Questions related to Outside directors	Yes		No	
	N	%	N	%
Does audit committee of the board of directors exist?	7	25.9	20	74.1
Are there by laws governing audit committee/ internal audit?	6	22.2	21	77.8
Do the members of audit committee have the expertise?	7	25.9	20	74.1
Is the report on audit committee's activities disclosed at the annual shareholder meeting?	7	25.9	20	74.1
Does audit committee recommend the external auditor at the annual shareholder meeting?	6	22.2	21	77.8
Does the audit committee meet with external auditor to review financial statements?	6	25.9	21	74.1

It was found that most SMEs, 74.1% did not have an audit committee of the board of directors, 77.8% did not have by-laws governing audit committee, whereas 74.1% indicated that the members of audit committee did not have the expertise. Further, 74.1% of the organizations did not disclose the report on audit committee's activities at the annual shareholder meeting, 77.8% of the audit committee did not recommend the external auditor at the annual shareholder meeting, and 74.1% of the audit committee did not meet with external auditor to review financial statements.

4.3 Regression Statistics

4.3.1 Regression analysis I

In this part of the study, regression analysis was done using net profit against specific factors from the corporate governance sub-indices. These factors are taken to be the critical factors for the corporate governance index. They include; for board of directors-are there by laws governing audit committee/ internal audit?; for outside directors-does your organization have board of directors?; for shareholder rights-does the firm has more than 50% outside directors?, and for disclosure and audit process-does the firm use cumulative voting for election of directors?

Regression of Net profit against Specific Aspects Corporate Governance Measures

Table 4.5 Model Summary (a) Regression analysis I

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.408(a)	.167	.015	2.00627

a Predictors: (Constant), Are there by laws governing audit committee/ internal audit, Does your organization have board of directors, Does the firm has more than 50% outside directors, Does the firm use cumulative voting for election of directors.

The coefficient of determination (R square) measures the proportion of variability in a data set that is accounted for by a statistical model. In this case it is evident that there is fairly strong

relationship between corporate governance and net profit. For all the 27 SME respondents involved in the study 16.7% of net profit is explained by the key corporate governance factors. Adjusted R squared attempts to correct R squared to more closely reflect the goodness of fit of the model in the population but since we used only one model, we can only rely on R square. Standard error is a measure of variability and as such measures the variability that a constant would be expected to show during sampling.

Table 4.6 ANOVA (a) Regression analysis I

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	17.707	4	4.427	1.100	.381(a)
	Residual	88.552	22	4.025		
	Total	106.260	26			

a Predictors: (Constant), Are there by laws governing audit committee/ internal audit, Does your organization have board of directors, Does the firm has more than 50% outside directors, Does the firm use cumulative voting for election of directors

b Dependent Variable: Net profit of SMEs

Analysis of variance (ANOVA) is a method of testing the null hypothesis that several group means are equal in the population, by comparing the sample variance estimated from the group means to that estimated within the groups. Sum of squares measures the variability of a data set. For all the SME companies, the regression model on the sum of squares is less than residual. Thus the conclusion is that this model does not account for most of the variation on the dependent model, which is net profit. The significance level being above our threshold of 0.05 confirms that the significance of corporate governance factors to return on asset is low and confirmed by the F test.

Table 4.7 Coefficients (a) Regression analysis I

Model		Unstandardized Coefficients		Standardized Coefficients	t
		B	Std. Error	Beta	
1	(Constant)	7.855	1.746		4.498
	Does your organization have board of directors	1.415	2.095	.351	.675
	Does the firm has more than 50% outside directors	3.146	1.609	.792	1.956
	Does the firm use cumulative voting for election of directors	-3.745	2.457	-.938	-1.524
	Are there by laws governing audit committee/ internal audit	-.381	1.116	-.080	-.342

a Dependent Variable: Net Profit of SMEs

The unstandardized coefficients are the coefficients of the estimated regression model. With this information, we can be able to write the following equations:

$Y=\alpha + \beta 1X1+ \beta 2X2+ \beta 3X3+ \beta 4X4+e$

Net profit = 7.855 + 1.415X1 + 3.146X2 + -3.745X3 + -.381X4 + 1.746

The study reveals that board of directors, outside directors, shareholder rights and disclosure and audit process had a significant impact on net profit. Shareholders' rights and disclosure and audit process had a negative relationship with net profit indicating that an increase in the cumulative voting for election of directors and laws governing audit committee/ internal audit leads to a decrease in net profit

Board of directors and outside directors had a significant positive relationship with net profit, this perhaps could be attributed to the fact that the existence of a board of directors would lead to better control and review of operations resulting to correction of any inconsistencies in good time leading to better performance of the firm. Having more than 50% of outside directors leads to increase in net profit.

4.4.2 Regression Analysis II

In this part of the study, regression analysis was done using net profit against the corporate governance sub-indices: board of directors, outside directors, shareholder rights, and disclosure and audit process, as well as the combined corporate governance index.

Table 4.8 Model Summary (b) 4.4.2 Regression Analysis II

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.594(a)	.352	.235	1.76849

a Predictors: (Constant), Disclosure and Audit Process , Shareholder Rights , Outside Directors , Board of Directors

The coefficient of determination (R square) measures the proportion of variability in a data set that is accounted for by a statistical model. In this case it is evident that there is strong relationship between corporate governance and net profit. For all the 27 SME companies involved in the study 35.2% of net profit is explained by the key corporate governance factors. Adjusted R squared attempts to correct R squared to more closely reflect the goodness of fit of the model in the population but since we used only one model, we can only rely on R square. Standard error is a measure of variability and as such measures the variability that a constant would be expected to show during sampling.

Table 4.9 ANOVA (b) 4.4.2 Regression Analysis II

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	37.454	4	9.363	2.994	.041(a)
	Residual	68.806	22	3.128		
	Total	106.260	26			

a Predictors: (Constant), Disclosure and Audit Process , Shareholder Rights , Outside Directors , Board of Directors

b Dependent Variable: Net profit of SMEs

Analysis of variance (ANOVA) is a method of testing the null hypothesis that several group means are equal in the population, by comparing the sample variance estimated from the group

means to that estimated within the groups. Sum of squares measures the variability of a data set. For all the SME companies, the regression model on the sum of squares is less than residual. However, we can conclude that this model does partially account for most of the variation on the dependent model, which is net profit. The significance level being below our threshold of 0.05 confirms that the significance of corporate governance factors to return on asset is fairly high and confirmed by the F test.

Table 4.10 Coefficients (b) 4.4.2 Regression Analysis II

Model		Unstandardized Coefficients		Standardized Coefficients	t
		B	Std. Error	Beta	
1	(Constant)	8.128	1.079		7.533
	Board of Directors	-1.652	1.741	-.186	-.949
	Outside Directors	-1.408	1.253	-.200	-1.123
	Shareholder Rights	2.949	.891	.585	3.310
	Disclosure and Audit Process	1.835	1.674	.217	1.096

a **Dependent Variable:** Net profit of SMEs

$Y=\alpha + \beta 1X1+ \beta 2X2+ \beta 3X3+ \beta 4X4+e$

Net profit = 7.855 + 1.415X1 + 3.146X2 + -3.745X3 + -.381X4 + 1.746

The study reveals that board of directors, outside directors, shareholder rights and disclosure and audit process had a significant impact on net profit. Board of directors and outside directors had a negative relationship with net profit, whereas shareholders' rights and disclosure and audit process had a positive relationship with net profit.

Table 4.11 Model Summary (c) Combined corporate governance index

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.275(a)	.076	.039	1.98214

a Predictors: (Constant), Combined corporate governance index

In terms of financial performance with a consideration on net profit, for the combined corporate governance index it is evident that for all the SME companies involved in the study, only 7.6% of the net profit is explained by the corporate governance factors.

Table 4.12 ANOVA (c) Combined corporate governance index

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	8.038	1	8.038	2.046	.165(a)
	Residual	98.222	25	3.929		
	Total	106.260	26			

a Predictors: (Constant), Combined corporate governance index

b Dependent Variable: Net profit of SMEs

The study reveals that the regression model is lower than the residual model which means that the corporate governance index does not account to much of the variability on Net profit. The significance level being above our threshold of 0.05 confirms that the significance of corporate governance index to Net profit is low and confirmed by the F test.

Table 4.13 Coefficients (c) Combined corporate governance index

Model		Unstandardized Coefficients		Standardized Coefficients	t
		B	Std. Error	Beta	
1	(Constant)	7.016	1.129		6.212
	Combined corporate governance index	3.851	2.693	.275	1.430

a Dependent Variable: Net profit of SMEs

The unstandardized coefficients are the coefficients of the estimated regression model. X5 represents the combined corporate governance index. With this information, we can be able to write the following equations:

$Y = \alpha + \beta X5 + e$

$ROA = 7.016 + 3.851X5 + 1.129$

This analysis indicates that there is a positive relationship between corporate governance indices and Net profit of SMEs.

4.4.3 Conclusion

From the regression analysis 1 it is evident that there is a significant influence of the specific factors measuring corporate governance on Net profit. The analysis indicates that Shareholders' rights and disclosure and audit process had a negative relationship with net profit while Board of directors and outside directors had a significant positive relationship with net profit.

From the regression analysis 2, where corporate governance sub-indices and combined index are used, it is evident that the results are different from the results in regression analysis 1. In regression analysis 2, Board of directors and outside directors had a negative relationship with net profit, whereas shareholders' rights and disclosure and audit process had a positive relationship with net profit. The two analyses reveal conflicting results although past studies in the same area also have had inconsistencies in results.

CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents conclusions drawn from the research findings and the recommendations for practice and for further studies.

5.2 Summary of Findings and Interpretations

The study found out that most of the SMEs, 59.3% had board of directors. With respect to CEO and board of directors, most of the SMEs 63% of the organizations indicated that CEO and board chairman are one and the same people. Majority of the board members, 51.9% had two third or more of board members as independent non-executive directors. With respect to system for evaluating board and individual systems, 66.7% of the organizations had a system for evaluating board and individual directors. Approximately 70% of the organizations had by-laws to govern board meetings. Moreover, regular board meetings were held as indicated by 74.1%

Most SMEs, 51.9% were found to have less than 50% outside directors, 66.7% of the organizations did not have foreign outside directors and 55.6% of the organizations did not have a system of evaluating outside directors. Further, most organizations, 70.4% had a nominating committee for the outside directors, 63% of the organizations' shareholders do not approve outside directors' pay at shareholder meetings and 59.3% do not have code of conduct for outside directors.

The study also indicated that the organizations used Cumulative voting for election of directors, (55.6%), whereas 51.9% of the organizations did not allow shareholders to call a poll on all resolutions at the meeting. With respect to shareholder meeting date or location, 63.0% of the organizations chose shareholder meeting date or location to encourage attendance. On disclosure of director candidates, it was revealed that 66.7% of the organizations do not disclose director candidates to shareholders. Meanwhile, 59.3% of the organizations required board approval for related party transactions.

It was found that most SMEs, 74.1% did not have an audit committee of the board of directors, 77.8% did not have by-laws governing audit committee, whereas 74.1% indicated that the members of audit committee did not have the expertise. Further, 74.1% of the organizations did not disclose the report on audit committee's activities at the annual shareholder meeting, 77.8% of the audit committee did not recommend the external auditor at the annual shareholder meeting, and 74.1% of the audit committee did not meet with external auditor to review financial statements.

The study indicates that there is a significant influence of the specific factors measuring corporate governance on Net profit. Shareholders' rights and disclosure and audit process had a negative relationship with net profit, indicating that an increase in the cumulative voting for election of directors and laws governing audit committee/ internal audit leads to a decrease in net profit.

Board of directors and outside directors had a significant positive relationship with net profit, this perhaps could be attributed to the fact that the existence of a board of directors would lead to better control and review of operations resulting to correction of any inconsistencies in good time leading to better performance of the firm. Having more than 50% of outside directors leads to independence and injection of various expertise hence increase in net profit.

For the case where corporate governance sub-indices and combined index, it was evident that the results are different from the results in regression analysis of critical factors measuring corporate governance. Board of directors and outside directors had a negative relationship with net profit, whereas shareholders' rights and disclosure and audit process had a positive relationship with net profit. The two analyses reveal conflicting results although past studies in the same area also have had inconsistencies in results.

The board of directors is seen as the place where conflicting interests are mediated, and where the necessary cohesion is created (Donaldson and Preston, 1995; Luoma and Goodstein, 1999). Lorsch (1992) argue that large boards are less effective and are easier for the CEO to control. Smaller boards also reduce the possibility of free riding by, and increase the accountability of

individual directors. According to John and Senbet (1998), boards of directors are seen to be more independent as the proportion of their non-executive directors increases. Brickley *et al.* (1994) found a positive relation between proportion of non-executive directors and stock-market reactions to poison pill adoptions. However, Fosberg (1989) found no relation between the proportion of non-executive directors and various performance measures.

Fama and Jensen (1983) suggested that concentration of decision management and decision control in one individual reduces board's effectiveness in monitoring top management. However, Yermack (1996) argues that firms are more valuable when the CEO and board chair positions are separate. Prior studies have concentrated on disclosure of items such as management earnings forecasts (Johnson *et al*, 2001; Lev and Penman 1990).

5.3 Conclusions and policy recommendations

The findings of the study indicate that there is a significant relationship between board of directors, outside directors, shareholders' rights and disclosure and audit process with both net profits. Shareholders' rights and disclosure and audit process had a negative relationship with net profit, indicating that an increase in the cumulative voting for election of directors and laws governing audit committee/ internal audit leads to a decrease in net profit. On the other hand, Board of directors and outside directors had a significant positive relationship with net profit, this perhaps could be attributed to the fact that the existence of a board of directors would lead to better control and review of operations resulting to correction of any inconsistencies in good time leading to better performance of the firm. Having more than 50% of outside directors leads to independence and injection of various expertises hence increase in net profit.

Where corporate governance sub-indices and combined index are used, it is evident that the results are different from the results in specific factors from the corporate governance sub-indices are used. In regression analysis 2, board of directors and outside directors had a negative relationship with net profit, whereas shareholders' rights and disclosure and audit process had a positive relationship with net profit. The two analyses reveal conflicting results although past studies in the same area also have had inconsistencies in results.

In terms of policy recommendations, this study not only contributes to the literature around corporate governance and performance of SMEs. SMEs need to review their corporate governance structures with a view of improving on their financial performance in future. The board of directors, outside directors, shareholders' rights and disclosure and audit process should be monitored and be addressed to ensure effectiveness in operations and hence value addition.
The SME regulators and stakeholders should draw minimal requirements for corporate governance in the industry to serve as guideline for the SME firms; this will improve the financial performance of these firms.

Corporate governance is about building credibility, ensuring transparency and accountability as well as maintaining an effective channel of information disclosure that would foster good corporate performance. The relevance of corporate governance cannot be over emphasized since it constitutes the organizational climate for the internal activities of a company. In Kenya corporate governance can greatly assist the SME sector by infusing better management practices, stronger internal auditing and greater opportunities for growth. Corporate governance brings new strategic outlook through external independent directors; it enhances firms' corporate entrepreneurship and competitiveness. It is not a threat to value creation in entrepreneurial firms if the guidelines on corporate governance are properly applied.

Based on findings of the study, it is expected that the stakeholders, who include the Government, the SME owners and the agencies offering various support mechanisms to the SMEs will gain a better understanding of the impact of corporate governance on their performance. The following measures are recommended in order to enhance adoption of corporate governance practices among SMEs in Kenya:

Good governance mechanisms among SMEs are likely to result in boards exerting much needed pressure for improved performance by ensuring that the interests of the firms are served. In the case of an SME, board members bring into the firm expertise and knowledge on financing options available and strategies to source such finances thus dealing with the credit constraint problem of SMEs as well.

This study identifies that the research, management, and policy development of training in the SME sector needs to be more open and flexible in order to address corporate governance issues. Research, management and policy instruments of training support will need to interact with, and be responsive to, the subtle distinctions of context that will moderate what is more appropriate, and more likely to be welcomed, in the small business sector.

5.4 Limitations of the study

Limitations include the study's restricted focus on SME businesses within one geographical area. The study focused on SMEs in Kariobangi Light Industries only, and considering the diversity of the country, the findings may not be representative of the whole population of SMEs in Kenya. However, the sampling technique used ensured that each respondent had a non-zero chance of being selected to participate in the study. Though the researcher was determined to undertake the study to completion within the given time frame, various constraints were encountered as earlier envisaged. The time allocated for data collection may not have been sufficient to enable the respondents complete the questionnaires as accurately as possible, considering that they were at the same time carrying out their daily duties and priority is of essence. The researcher preferred to administer the data collection tools to only the sampled respondents, however, this was practically not possible as some of them delegated this request since they were either too busy or were away on official duties.

5.5 Recommendations for further studies

The findings of this study, it is hoped, will contribute to the existing body of knowledge and form basis for future researchers. The following areas of further researcher are thus suggested:

i. Whereas the current study focused on responses from the management of the SMEs with respect to corporate governance practices and the impact on their performance, future studies should focus on the various organizations that support SMEs, with a view to establishing any variances;

ii. The present study did not allow for the exploration of employees perspectives of corporate governance activities, considered to be crucial in the development of effective

corporate governance intervention strategies. Neither did it allow for strategists nor do training institutions' perspectives of the difficulties they face in engaging with SME managers nor in encouraging them to undertake corporate governance practices. Given the importance of the views of employees, strategists and practitioners, an exploration of their experiences should be undertaken through further research studies, using the same conceptual framework, so that a more holistic understanding of corporate governance can be established and a fully coordinated approach can be taken to policy, practice, education and training;

iii. There is need to adjust the survey instruments to capture the much more basic and limited range of training present in SMEs; extending the survey to SMEs outside of urban centers, and conducting longitudinal and qualitative studies to explore how and why investment in corporate governance practices increases with SMEs growth over time and how it contributes to enterprise development.

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APPENDICES

APPENDIX I: LETTER OF INTRODUCTION TO RESPONDENTS

OLIPHA B. ONGERI
UNIVERSITY OF NAIROBI
P.O. BOX 30197 – 00200
NAIROBI
10TH SEPTEMBER 2011

RE: REQUEST FOR RESEARCH DATA

Dear Sir/Madam,

I am currently undertaking a research study entitled "**FINANCIAL PERFORMANCE AND THE EXTENT OF ADOPTION OF CORPORATE GOVERNANCE PRACTICES BY SMALL AND MEDIUM ENTERPRISES IN KENYA**". The research is towards the partial fulfillment of the requirements for the award of Masters of Business Administration.

I would be grateful if you could spend a few minutes filling out the questionnaire below. No personal information will be disclosed or made public, and your answers will be kept strictly confidential. If you are interested in the results of this research, I would be more than happy to send you a summary upon completion of this study.

The questionnaire is divided into two sections. Please complete each section as instructed. Do not write your name or any other form of identification on the questionnaire.

Thank you for your cooperation.
Sincerely,

OLIPHA B. ONGERI
MBA STUDENT

MR. BARASA
SUPERVISOR

APPENDIX II: QUESTIONNAIRE

This questionnaire has been designed to collect information from the Small and Medium Enterprises in Kariobangi Light Industries in Nairobi. The information is meant for academic purposes only. Please complete the questionnaire as instructed. Do not write your name or any other form of identification on the questionnaire. All the information in this questionnaire will be treated in confidence.

SECTION I: THE EXTENT OF ADOPTION OF CORPORATE GOVERNANCE PRACTICES BY SMES IN KENYA

A.BOARD OF DIRECTORS

1. Does your organization have board of directors? Yes ☐ No ☐

2. Is the CEO and board chairman different people? Yes ☐ No ☐

3. Does the firm have two third or more of board members as independent non- executive directors? Yes ☐ No ☐

4. Does a system for evaluating board and individual directors exist? Yes ☐ No ☐

5. Does a bylaw exist to govern board meetings? Yes ☐ No ☐

6. Does the firm hold four or more regular board meetings per year? Yes ☐ No ☐

B.OUTSIDE DIRECTORS

1. Does the firm has more than 50% outside directors? Yes ☐ No ☐

2. Does the firm has one or more foreign outside directors? Yes ☐ No ☐

3. Does the firm has a system of evaluating outside directors? Yes ☐ No ☐

4. Is there a nominating committee for the outside directors? Yes ☐ No ☐

5. Does the shareholders approve outside directors' pay at shareholder meeting? Yes ☐ No ☐

6. Is there code of conduct for outside directors? Yes ☐ No ☐

C. SHAREHOLDER RIGHTS

1. Does the firm use cumulative voting for election of directors? Yes ☐ No ☐

2. Does the firm allow shareholders to call a poll on all resolutions at the meeting? Yes ☐No ☐

3. Does the firm choose shareholder meeting date or location to encourage attendance?
Yes ☐ No ☐

4. Does the firm disclose director candidates to shareholders' in advance of shareholder meeting?
Yes ☐ No ☐

5. Is board approval required for related party transactions? Yes ☐ No ☐

D. DISCLOSURE AND AUDIT PROCESS.

1. Does audit committee of the board of directors exist? Yes ☐ No ☐

2. Are there by laws governing audit committee/ internal audit? Yes ☐ No ☐

3. Do the members of audit committee have the expertise? Yes ☐ No ☐

4. Is the report on audit committee's activities disclosed at the annual shareholder meeting?
Yes ☐ No ☐

5. Does audit committee recommend the external auditor at the annual shareholder meeting?

Yes ☐ No ☐

6. Does the audit committee meet with external auditor to review financial statements?

Yes ☐ No ☐

SECTION II: FINANCIAL PERFORMANCE OF SME

Net profit of SMEs over the last Five (5) Years

Year	**2006**	**2007**	**2008**	**2009**	**2010**
Net profit					

THANK YOU.

APPENDIX III: FINANCIAL PERFORMANCE OF SME

Years	2,006	2,007	2,008	2,009	2,010	Average
1	450,000	468,000	510,120	561,132	568,294	511,509
2	580,000	626,400	1,190,160	1,309,176	1,453,185	1,031,784
3	879,000	949,320	1,034,758	1,138,234	1,263,440	1,052,950
4	915,000	988,209	1,077,138	1,184,852	1,315,185	1,096,077
5	550,000	594,000	647,460	712,206	790,549	658,843
6	520,000	561,000	611,490	672,639	746,629	622,352
7	600,000	648,000	706,320	776,952	862,416	718,738
8	585,000	631,800	688,662	757,528	840,856	700,769
9	750,000	810,000	882,900	971,190	1,078,020	898,422
10	650,000	702,000	765,000	841,500	934,065	778,513
11	480,000	518,400	565,056	621,562	689,934	574,990
12	856,000	924,000	1,007,160	1,107,876	1,229,742	1,024,956
13	700,000	756,000	824,000	906,444	1,006,152	838,519
14	920,000	993,600	1,083,024	1,191,326	1,322,371	1,102,064
15	870,000	939,600	1,124,264	1,236,580	1,372,603	1,108,609
16	610,000	658,800	718,092	789,901	879,790	731,317
17	790,000	853,200	929,988	1,022,987	1,135,516	946,338
18	705,000	761,400	829,926	912,919	1,013,340	844,517
19	890,000	961,200	1,047,708	1,152,479	1,279,251	1,066,128
20	495,000	544,600	593,614	652,975	724,802	602,198

21	898,000	969,840	1,057,126	1,162,839	1,290,751	1,075,711
22	950,000	1,026,000	1,118,340	1,230,174	1,307,998	1,126,502
23	910,000	982,800	1,071,252	1,178,377	1,307,998	1,090,085
24	470,000	507,600	553,284	608,612	675,559	563,011
25	710,000	766,800	835,812	919,393	1,020,526	850,506
26	645,000	696,600	759,294	835,223	927,097	772,643
27	550,000	594,000	647,460	712,206	790,549	658,843

APPENDIX IV: CORPORATE GOVERNANCE SUB-INDICES SCORES

	ROA	Board of Directors	Outside Directors	Shareholder Rights	Disclosure and Audit Process	Combined Variables
1	5.12	0.83	0.83	1.00	0.50	0.54
2	10.32	0.67	0.17	1.00	0.50	0.54
3	10.53	0.17	0.00	0.60	0.00	0.17
4	10.96	0.50	0.83	1.00	0.00	0.54
5	6.59	0.67	0.17	0.00	0.33	0.29
6	6.22	0.50	0.83	0.00	0.50	0.46
7	7.19	0.67	0.17	1.00	0.00	0.42
8	7.01	0.50	0.83	0.00	0.00	0.33
9	8.98	0.83	0.83	0.40	0.50	0.63
10	7.79	1.00	0.17	0.00	0.50	0.42
11	5.75	0.50	0.33	0.80	0.00	0.38
12	10.25	0.50	0.83	1.00	0.00	0.54
13	8.39	0.67	0.50	1.00	0.00	0.50
14	11.02	0.83	0.50	1.00	0.33	0.54
15	11.09	0.67	0.17	0.80	0.00	0.38
16	7.31	0.83	0.17	0.00	0.50	0.38
17	9.46	0.83	0.67	0.60	0.50	0.63
18	8.45	0.67	0.33	0.40	0.33	0.42
19	10.66	0.33	0.00	0.80	0.00	0.25
20	6.02	0.33	0.50	0.00	0.00	0.21
21	10.76	0.50	0.33	0.80	0.00	0.38
22	11.27	0.50	0.33	0.60	0.33	0.42
23	10.90	0.50	0.33	0.60	0.67	0.50
24	5.63	0.33	0.33	0.20	0.00	0.21
25	8.51	0.17	0.00	0.20	0.00	0.08
26	7.73	0.33	0.17	0.20	0.33	0.25
27	6.59	1.00	0.17	0.00	0.00	0.25