

**THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND
FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN
NAIROBI**

BY

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Declaration

I declare that this is my original work and has never been submitted in any other college or examination body.

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APPROVAL

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CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

According to Graham *et al.* (2002), the cost of poor corporate governance is borne heavily by minority shareholders, which is the case in emerging markets like Malaysia where many public companies are family owned. One of the ways to improve investor confidence is to have good governance practices that may contribute to better financial disclosures and more transparent business reporting. According to Frost *et al.* (2002), improvements in corporate governance practices that contribute to better disclosures in business reporting in-turn can facilitate greater market liquidity and capital formation in emerging markets. As such, corporate governance is of critical importance to investors, insurers, regulators, creditors, customers, employees and other stakeholders.

Nonetheless, conformity to the auditing and accounting standards does not guarantee an outright success of an organization. The manner in which leadership of a corporation is executed in the stewardship of corporate assets and resources to increase and sustain the shareholders value and to satisfy the needs and interests of all shareholders is a major determinant. Moreover, financial crisis standards as a heightened hurdle to jump for organization, making conformity to the said standard a challenge for the organizations.

Both directors and management can further strengthen the ethical environment within the organization by developing and enforcing a robust code of ethical conduct (Barrier, 2003; Brown *et al.*, 2003; Adamec *et al.*, 2005). Research evidence suggests that corporate codes of ethics, accompanied by training and monitoring programs, have an impact on employee behaviour (Pickard, 1995).

Whatever governance practices an organization chooses, it is without question, the committees' responsibility to develop the organizations approach to governance to ensure that appropriate systems are in place to enable cooperative –organization exceed members' expectations and are accountable emphasized governance or adequate

governance are therefore important on achieving a single set of high quality improved global accounting and auditing standards. We urged the International. This paper therefore intends to establish the effects of financial crisis and poor governance on accounting and auditing standards for small and medium enterprises.

A firm's size may not be the ideal criterion for differential reporting because it is relative and also depends on other factors, such as industry sector. Size is a weak indicator of the costs and benefits of financial reporting, and may not be the best way to determine what an SME is. SMEs could be defined by reference to ownership and the management of the entity, as SMEs are not necessarily just smaller versions of public companies. However, the main characteristic which distinguishes SMEs from other entities is the degree of public accountability, and so the definition of what constitutes an SME has to revolve around those entities that do not have public accountability. While the IASB should determine such criteria, it would not be practical to determine globally-applicable values, because the definition of what constitutes an SME will vary from country to country. Therefore, it should be left to individual countries to adopt measures that reflect their local economic and social environment.

It is often thought that small business managers perceive the cost of compliance with accounting standards to be greater than the benefit. Small companies with limited staff and resources may incur significant costs in attempting to comply with IFRS. This would imply that a unique financial burden is placed on SMEs because they must pay a proportionately higher cost than multinational companies for the same benefit. SMEs also have the perception that there are a limited number of users requiring such data, and that compliance with accounting standards may disclose strategic information to competitors.

The main argument for separate SME accounting standards is the undue cost burden of reporting, which is proportionately heavier for smaller firms. The cost burden of applying the full set of IFRS may not be justified on the basis of user needs. This is because the main users of SME reports are easily identified and are few in number. Further, much of the current reporting framework is based on the needs of large business, so SMEs perceive that the full statutory financial statements are less relevant to the users of SME

accounts. SMEs also use financial statements for a narrower range of decisions, as they have less complex transactions and therefore less need for the sophisticated analysis of financial statements.

The main argument against different reporting requirements for SMEs (differential reporting) is that if accounting rules are not held to apply universally, then users of accounts may lose confidence in the rules and it may lead to a two-tier system of reporting.

There are a number of accounting standards and disclosures that probably do not provide useful information for the users of SME financial statements, such as the requirement to produce consolidated accounts, to provide for deferred taxation, and to recognize profits on long-term contracts.

There is no universally-agreed definition of an SME. No single definition can capture all the dimensions of a small or medium-sized business, or cannot be expected to reflect the differences between firms, sectors, or countries at different levels of development. Most definitions based on size use measures such as number of employees, balance sheet total, or annual turnover. However, none of these measures apply well across national borders.

The most important difference between an SME and a listed public company lies in the nature of ownership. The former is characterized by the entrepreneur or family investing their own capital and running the business. The latter is always run by directors acting on behalf of institutional investors who own the majority of shares. It is this divorce of ownership and control that creates the need for directors to be held accountable to shareholders, and to adhere to the disclosure requirements laid down by law and standard setters. Nonetheless, the development of SMEs has long been restrained by a low adoption of corporate governance, which is far from commensurate to their critical socioeconomic importance in most developing countries. Such an outcome reflects, in part, the various biases against the SME sector which are inherent or still remain in the domestic policy and institutional framework.

1.1.1 Small and Medium Enterprises (Smes)

Small and medium enterprises, also called small and medium-sized enterprises and small and medium-sized businesses or small and medium businesses or SMEs are companies whose headcount or turnover falls below certain limits. But now the EU has started to standardize the concept. Its current definition categorizes companies with fewer than 50 employees as "small", and those with fewer than 250 as "medium". By contrast, in the United States, when small business is defined by the number of employees, it often refers to those with less than 100 employees, while medium-sized business often refers to those with less than 500 employees. However, the most widely used American definition of micro-business by the number of employees is the same of that of European Union: less than 10 employees (IFC, 2006).

Small and medium sized enterprises (SMEs) are the backbone of virtually all economies in the world. They play a key role in transition and developing countries. These firms typically account for more than 90% of all firms outside the agricultural sector, constitute a major source of employment and generate significant domestic and export earnings. As such, SME development emerges as a key instrument in poverty reduction efforts and promotion of SME growth and competitiveness in any economy can be expected not only to yield increasing social and economic returns domestically but also to empower the private sector in its on-going integration into the global economy (Audu 2004). However, the process has long been constrained by the limited availability and accessibility of financial resources to meet a variety of operational and investment needs within the SME sector. Both demand and supply-side factors have contributed their share to this financing problem in the developing countries (Matlay et'al 2005).

Enterprises operating within unique business environment like this are affected either positively or negatively such that the enterprise must carefully analyze the interactions between corporate policies and its environment in order to maximize efficiencies and take advantage of opportunities (Kibera 1996). Countries usually have both market and none market environments. Market environments include interactions with households and other organizations free from government interferences. None market environment

include interactions with public and none public institutions. Both environments require different strategies for positive interactions and responses to the available opportunities (Daniels 2001). A firm must understand what opportunities are in the business environment that is most crucial in determining its ability to create and sustain competitive advantage.

1.1.2 Overview of SMEs in Kenya

Micro and Small Enterprise sector has been in the focus of Kenya Government and the private sector since Kenya's independence in 1960s. The 1980's and early 1990's was a period of structural adjustment program (ASP) which created a lot of changes in the operating environment of many businesses including the micro and small enterprises. As the changes gained momentum the sector seemed to experience mainly horizontal growth with very minimal vertical growth. During the SAP period in Kenya Many people left formal employment due to retrenchment and joined this sector as the only alternative source of employment. The government also realized the potential of the SMEs sector in providing employment to its population and since then has been providing enabling environment to allow micro and small enterprises transform into medium size companies. Private sector and NGOs have also been supporting this sector in various ways (Kibera 1996).

The general business environment has been influenced by various other factors such as globalization, changing consumer demands, changing suppliers, changes in political-economic conditions and international competition. The result of these environmental conditions has been the emergence of both opportunities and constrains to business development in Kenya. Enterprises operating within unique business environment like this are affected either positively or negatively such that the enterprise must carefully analyze the interactions between corporate policies and its environment in order to maximize efficiencies and take advantage of opportunities (Kibera 1996). Countries usually have both market and none market environments. Market environments include interactions with households and other organizations free from government interferences. None market environment include interactions with public and none public institutions.

Both environments require different strategies for positive interactions and responses to the available opportunities (Daniels 2001). A firm must understand what opportunities are in the business environment that is most crucial in determining its ability to create and sustain competitive advantage.

Business sectors in Kenya respond differently to the opportunities with varied results depending on the nature of the responses and particularly the type of industry. Some Firms have closed down or relocated to other countries because they perceive threats to outweigh opportunities, while at the same time other firms still find and tap opportunities and grow. Multinationals find it easier to respond to business opportunities due to their size and economies of scale while micro-and-small enterprises may find it very hard to do so.

1.1.3 Financial Performance

Organizational performance comprises the actual output or results of an organization as measured against its intended outputs (or goals and objectives). According to Richard *et al.* (2009) organizational performance encompasses three specific areas of firm outcomes: (a) financial performance (profits, return on assets, return on investment, etc.); (b) product market performance (sales, market share, etc.); and (c) shareholder return (total shareholder return, economic value added, etc.).

There are many different ways to measure financial performance, but all measures should be taken in aggregation. Line items such as revenue from operations, operating income or cash flow from operations can be used, as well as total unit sales. Furthermore, the analyst or investor may wish to look deeper into financial statements and seek out margin growth rates or any declining debt. According to Richard *et al* (2009), getting on top of financial measures of your performance is an important part of running a growing business, especially in the current economic climate. Specific performance benchmarks are set based on the forecast, and the actual performance is measured against these values. Based on the results, changes are made to the portfolio to increase the rate of

return to meet these requirements. There is a constant process of adjustment, which is a necessary response to changing market conditions and circumstances.

The general SMEs financial performance has been influenced by various other factors such as globalization, changing consumer demands, changing suppliers, changes in political-economic conditions and international competition and depicted by the size of the firm and the level of their profitability (Matlay et'al 2005). The result of these environmental conditions has been the emergence of both opportunities and constrains to business development in Kenya.

In a traditional business setting, financial performance management relates to company profitability. A regular review of revenue and expenses provides valuable insight into business operations, risks and issues. Typical financial statements are not ideal for this purpose, because these reports are a summary of overall activity. Instead, many companies create customized reports of sales, costs, cash flow and fixed expenses.

These values are compared to budgets or forecasts, which are created as part of a long-term management strategy. The positive or negative variances are then analyzed to assist in making decisions. Business decisions about how to increase sales, reduce costs and otherwise manage the financial performance are made and then implemented. This entire process of review, comparison, analysis and making decisions is repeated on a continuous basis. It is a necessary aspect of business management. Companies that fail to perform these tasks and actually implement business changes tend to experience ongoing financial difficulties. In many situations, businesses that fail could have been rescued if the appropriate changes were made.

1.2 Research Problem

A base line survey on Small and Medium Enterprise (ICEG and K- Rep 1999) found out that vertical growth is negligible among small and medium enterprises yet many of them have sprung up due to increased horizontal growth. The same sentiments were shared by Waweru (2002). Who says that SMEs pursue horizontal growth pattern in order to reduce perceived business risks. Despite substantial funds that have been poured into the sector

and a number of business opportunities available to the SMEs sector to enable them graduate into medium size organizations, not much has been achieved. Very few SMEs are able to graduate into the formal large businesses. Kenya still lacks enterprises employing between 10 and 50 persons representing the missing middle in Kenya's economy, Yet SMEs sector was looked at as the very source of growth into medium and large organizations.

Local studies on corporate governance have not researched the effects of corporate governance and performance in SMEs. Jebet (2001) did a study of corporate governances on quoted companies in Kenya. Juliana (2004) looked at the relationship between corporate governance & financial performance of companies listed on the NSE while Mutiga the perceived role of the external auditor in corporate governance. A study on SMEs, nonetheless, is expected to yield different results by the virtue of difference in size of operation.

Despite the relevance of subjective factors, corporate governance research focuses predominantly on objective variables, presupposing managers, directors, shareholders, accountants and other gatekeepers as purposive, rational and utility maximizing individuals, and variables such as independent boards as easily measurable within taking care of the effects on Accounting and Auditing Standards. There is need to study whether SMEs adopting good governance practices will help them in their expansion and growth. The study thus seeks to find out the effects of corporate governance practices on SMEs. This study therefore filled the existing void by investigating the effects of governance on performance of SMEs in Nairobi

1.3 Objectives of the Study

1.3.1 General objectives

The main objective of this study was to establish the relationship between corporate governance and financial performance of the SMEs in Nairobi.

1.3.2 Specific Objectives

- (i) To identify the extent, to which the extent to which the number of employees affect the corporate governance framework in SMEs in Nairobi
- (ii) To find the relationship between the form of company ownership and corporate governance practices in SMEs in Nairobi
- (iii) To investigate the extent to which level of profitability affects corporate governance practices in SMEs in Nairobi

1.4 Value of the Study

The study is valuable to the following:

To the SMEs

The study promotes strategic thinking among the managers of the small and medium enterprises when addressing issues concerning good corporate governance. Through this study, The SMEs will also be able to know how corporate governance can assist in their growth and better performance. This acts as a basis upon which improvement can be made in business operations. The SMEs are therefore be in a position to put in place appropriate corporate governance mechanisms to ensure that they improve their performance.

To the Policy Makers

Policy makers will be in a position to identify and formulate the best policies in order to regulate the SME sector and allow good corporate governance

To the Academicians

Academicians will use this study for identifying areas for further studies

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter discusses past studies on corporate governance in the small and medium enterprises in Kenya. In particular, the chapter reviews theories and empiricism on governance, corporate governance mechanisms, determinants of good governance, relationship between governance and performance of an organization as well as the conclusion.

2.2 Theoretical Review

The theory on corporate governance stems from the thesis “The Modern Corporation and Private Property” by Berle and Means 1932). The thesis highlights a fundamental agency problem in modern firms where there is a separation between management and ownership. It has long been recognized that modern firms are run by professional managers (agents), who are accountable to dispersed shareholders (principals). The scenario fits into the well-discussed principal-agent paradigm. The question is how to ensure that managers follow the interests of shareholders in order to reduce cost associated with principal-agent theory. To do that, the principals have to deal with two problems. First, they face an adverse selection problem: that is, they must select the most capable managers. Second, they are also confronted with a moral hazard problem: that is how to adequately motivate the managers to put forth the appropriate effort and make decisions aligned with shareholders interests.

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

Cadbury Committee (1992) defines corporate governance as “the system by which companies are directed and controlled”. On the other hand, Rajan and Zingales (1998) define a governance system as the complex set of constraints that shape the ex post bargaining over the quasi rent registered by the firm.

In Mayer (1997), corporate governance is seen as concerned with ways of bringing the interests of (investors and managers) into line and ensuring that firms are run for the benefit of investors. Again, corporate governance is concerned with the relationship between the internal governance mechanisms of corporations and society’s conception of the scope of corporate accountability (Deakin and Hughes, 1997). It has also been defined by Keasy et al. (1997) to include the structure, processes, cultures and systems that engender the successful operation of organizations.

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

In short, the good governance structures in emerging economies often resemble those of developed economies in form but not in substance (Peng, 2004). As a result, concentrated ownership and other informal mechanisms emerge to fill the good governance vacuum. While these ad hoc mechanisms may solve some problems, they create other, novel problems in the process. Each emerging economy has a good governance system that reflects its institutional conditions. However, there are a number of similarities among emerging economies as a group; conflicts between two categories of principals are a major issue.

Neu *et al.* (2009) have written a groundbreaking study of the lending practices of international development agencies in El Salvador. They draw into accounting research

for the first time the intensely organic and dynamic socioeconomic theories of Deleuze and Guattari (1987). In contrast to traditional economic approaches to accounting grounded in assumptions of scarcity and the imperative of efficiency, this paper emphasizes the role of desire in fueling social and economic transformation. This perspective helps the authors explain the differing trajectories of two international organizations seeking to claim physical and discursive space in El Salvador. Their examination of dynamic assemblages of people, communications, and accounting practices offers accounting researchers new tools and vocabularies for research.

Jayasinghe and Thomas (2009) provide a nuanced exploration of the oral accounting systems used in indigenous fishing practices, based on Kelum's ethnographic research in a fishing village on the south coast of Sri Lanka. Their paper examines how oral accounting systems are linked to the resilience of traditional social practices in the face of economic development efforts by government and NGOs.

Alawattage and Wickramasinghe (2009) have also contributed a study of resistance by poor populations in Sri Lanka, examining the governance structures and accounting practices of a tea plantation. Their study of “hidden transcripts” attempts to describe the emancipatory aspects of accounting among subaltern Tamils on the plantation and residents of surrounding villages. They explore the opportunities for resistance to “everyday domination” provided by subaltern accounting methods and accountability networks.

Darlene Himick (2009) has contributed a study of the system of private and public pensions in Chile, a country frequently held up by some as a model for privatization of public pensions. Her paper details the role of accounting in the pension system reformation, and links accounting to the resistance of these reforms by organized labour, dissenting members of the Pinochet regime, and some in the pension industry itself.

2.3 Governance Mechanisms in SMEs

Corporate governance comprises many dimensions. Based on the U.K. Code, it can be divided broadly into the role of directors, directors' remuneration, the role of

shareholders, and accountability and audit. Some of the structures are complements while others are substitutes to certain extent. The previous research has found different governance patterns. For example, Peasnell et al. (2001) find evidence of a convex association between the proportion of outside board members and the level of insider ownership in the U.K. corporate control process. Shivdasani and Yermack (1999) observe, using U.S. data, that when the CEO serves on the nominating committee or no nominating committee exists, firms usually appoint fewer independent outside directors and more grey outsiders. Similarly, Vafeas (1999) discover that the likelihood of engaging a nominating committee is related to board characteristics such as inside ownership, number and quality of outsider directors for U.S. firms.

Board structure is an important governance mechanism. Kenneth et al. (1995) note the substitution effects between outside directors, blockholders, and incentives to insiders using eighty one U.S. bank-holding companies in his study. Both Dedman and Elisabeth (2002) and Young (2000) investigate the board structure determinants before and after Cadbury Report. They either find managerial entrenchment is reduced or non executive directors are increased following the imposition of new standards of “best practice” regarding board structure.

2.4 Determinants of Good Governance

2.4.1 Independent directors

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

2.4.2 Independence of committees

Similarly, independence is also considered important for a board committee to be an effective monitor (Klein, 1998). John and Senbet (1998) report empirical evidence showing that the presence of monitoring committees (audit, nomination, and compensation committees) is positively related to factors associated with the benefits of monitoring. However, the presence of insiders in the compensation committees increases the probability of making decisions in favor of the CEO's interests (Newman and Mozes, 1999). Moreover, when the CEO sits on the nominating committee or when no nominating committee exists, firms appoint fewer independent outside directors and more gray outsiders with conflicts of interest (Shivdasani and Yermack, 1999). In addition, the stock market's reaction to appointments of independent outside directors is more positive when the director's selection process is viewed as relatively independent of CEO involvement (Shivdasani and Yermack, 1999). Klein (2002) shows that independent audit committees reduce the likelihood of earnings management, thus improving transparency. Finally, when the CEO serves on the nominating committee, the audit one is less likely to have a majority of independent directors (Klein, 2002).

2.4.2 Board size

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

2.4.3 Split chairman/CEO roles

The question of whether the chairman and CEO positions should be separate has been controversial. The advantages and the drawbacks of separating the chairman and CEO

positions have been studied extensively. Jensen (1993) argues that separating CEO and chairman roles is in the shareholders' interest. Similarly, large firms that separate the two functions trade at higher price-to-book multiples (Yermack, 1996) and have higher return on assets and cost efficiency ratios (Pi and Timme, 1993) than firms where the same person holds both titles. In addition, bestowing the CEO and chairman duties on one individual makes it harder for a board to replace a poorly performing CEO (Shivdasani and Zenner, 2004), which can reduce the flexibility of a board to address sizable declines in performance (Goyal and Park, 2002). On the other hand, Brickley *et al.* (1997) find no evidence that separating these roles improve firm performance. More precisely, combining the positions of chairman and CEO confers greater power to the CEO, who gains the title of chairman after having outperformed his/her peers (Brickley *et al.*, 1997). So the chairman title serves as a reward to a new CEO who has demonstrated superior performance and represents an implicit vote of confidence by outside directors. Then, requiring companies to separate the positions of CEO and chairman would deprive boards of an important tool to motivate and reward new CEOs (Brickley *et al.*, 1997).

2.4.4 Board meetings

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

2.4.5 Reputation of auditors

The selection of an auditor with a global reputation (a Big 4 auditor) may convey better disclosure practices. For instance, Michaely and Shaw (1995) find that more prestigious auditors are associated with US IPOs that are less risky and that perform better in the long run.

2.4.6 Audit committee meetings

To carry out its function of control the audit committee must maintain a certain level of activity through increased frequency of meetings (Bédard *et al.*, 2004), especially in the case of firms that wish to avoid Securities and Exchange Commission enforcement actions (McMullen and Raghunandan, 1996; Abbott *et al.*, 2004).

The determinants of strong governance dealt with in this section are quite similar to strong governance indicators identified by Larcker *et al.* (2004) with a few exceptions. We do not include debt and anti-takeover provisions as governance mechanisms since they largely depend on other firm-specific factors.

2.5 Corporate Governance and the SMEs Performance

Although there is a growing focus on governance issues, such as specific board composition configuration or board leadership structure, the results are unclear with respect to firm performance (Dalton *et al.*, 1998). Many studies that demonstrate positive relationships between variables of interest from the four sets of board attributes and SMEs' performance, when meta-analytically reviewed, show negative relationships and no statistically significant relationship at all (Dalton *et al.*, 1998). For example, Hunter and Schmidh (1990, p. 29) have suggested that "conflicting rustles in the literature may be entirely artificial". There is no actual population of relationships at all. For example, a meta-analysis of 54 empirical studies of board composition and 31 empirical studies of board leadership structure and their relationship to financial performance, by Dalton *et al.* (1998, p. 269), concluded that these and other analyses "relying on firm size, the nature of financial preference indicators and various operationalizations of board composition, provide little evidence of a systemic governance structure and financial performance relationships".

Similarly, the analysis of 40 years of data from 159 studies, carried out by Dalton and Daily (1999), concluded that there is no clear evidence of a substantive relationship between board composition and financial performance, irrespective of the type of performance indicators, the size of the firm or the manner in which board composition is

measured. For example, a board could be completely independent and, at the same time, fail in its expertise, counsel and resource-dependency roles (Dalton and Daily; 1999). On the other hand, a board dominated by inside and affiliated directors could fall short in its ability to monitor and control (Daily and Dalton, 1994; 1999). Hence, reliance on the independence of board members or any one dimension of board roles and attributes will not ensure high levels of corporate financial performance, especially if it is at the expense of other director roles (Johnson et al., 1993; Dalton and Daily, 1999).

However, the key thing to note is that corporate governance compliance shows real confidence in the future and in the high growth prospects of your business. Corporate governance compliance in SMEs makes organization more attractive because it is visibly managed and directed (Knell, 2006). The recent developments provide ample evidence that inadequate corporate governance standards in certain organizations could contribute to their failure. The inadequate governance standards in the corporate sector, raises the risk profile of companies and exposes the organization and especially lending institutions to greater potential default. The adherence to formal (or mandated) corporate governance practices are particularly crucial for banks and financial institutions as weak or inadequate corporate governance standards invariably result in ineffective risk management and ultimately to financial instability (Singh 2005). In the case of banks and financial institutions, the developments in one of them may trigger systematic consequences. The essence of formal corporate governance in financial institutions, are therefore, the responsibilities of the board and its independent committees for providing adequate checks and balances, transparency and disclosures, robust risk management systems, risk containment procedures, early warning systems and prompt corrective actions to avoid default (Singh 2005).

According to agency theory, good corporate governance should lead to higher stock prices or better long-term performance, because managers are better supervised and agency costs are decreased. Poor corporate governance on the other hand is fertile soil for corruption and corruptive symbiosis between business and political circles (Manyuru, 2005).

A comprehensive and integrative review of the corporate governance contribution to company performance research suggests a tendency, amongst scholars, to search for universal associations between board attributes, board roles and company performance (Zahra and Pearce, 1989; Maassen, 1999). Zahra and Pearce (1989), reviewing 22 empirical studies in their construction of an integrative model of a literature review identifying variables of board attributes and board roles in relation to firm's performance, identify a number of shortcomings in previous research and urge cautious interpretation of results on board roles and attributes. Using the same constructs of board roles and attributes for measuring impact on firm's performance, Maassen's (1999) empirical study of the USA, UK and the Netherlands listed companies came to similar conclusions. Moreover, both studies concluded that there is an over-focus on the financial dimensions of company performance, with some attention being given to systemic performance and very little attention being paid to social dimensions of company performance (Zahra and Pearce, 1989; Maassen 1999).

2.6 Empirical Review

Chris Poullaos (2009), in contrast to the above four papers, takes a very different tack. Instead of looking at accounting practices on the margins of empire, he looks at the roots of subalternity in the imperial centre. He traces the construction of notions of race and the politics of exclusion in the British accounting profession, with a focus on the 1920s when explicit terms like "race" suddenly appeared in the minutes of chartered accountancy bodies in Britain. The result is a rich historical analysis of how notions of race were developed as barriers to the accounting profession, positing colonial accountants as the racialized and subaltern Other to prevent them from attaining full professional status.

Many studies are based on the governance index developed by these organizations. Klapper and Love (2004) construct corporate governance indices using information produced by the Credit Lyonnais Securities Asia for a list of 25 emerging economies. The survey used by Klapper and Love (2004) has a total of 57 yes or no questions. They are classified into the following seven categories: discipline, transparency, independence, accountability, responsibility, fairness, and social awareness. Each category has a weight

of 0.15 except for the last one, which has a weight of 0.10. Durnev and Kim (2005) and Patel *et al.* (2002) report on a T&D index computed by S&P. Durnev and Kim (2005) consider the Credit Lyonnais Securities Asia index partially subjective, while they define the S&P index as largely objective. Brown and Caylor (2006) build a governance score for US firms from the Institutional Shareholder Services database. Bauer *et al.* (2004) use the Deminor ratings. Black *et al.* (2006) use a subset of 38 objective questions from a survey conducted by the Korean Stock Exchange, leaving out all subjective questions. Then they classify the items into four categories, each of which has an equal weight of 0.25: shareholders' rights, board of directors in general, outside directors, and disclosure and transparency.

Campos *et al.* (2002) develop a corporate governance rating as a proxy of firm-specific governance quality, by taking into account the OECD's (1999) principles of corporate governance. This governance score is a composite of 15 factors encompassing three corporate governance factors: ownership and shareholder protection (dispersed and transparent ownerships, one share/one vote, anti-takeover defences, and meeting notification), board of directors (board size, outside and independent directors, written board guidelines, and board committees), and disclosure and transparency (disclosure, accounting standards, independent audits, broad and timely disclosure).

Gompers *et al.* (2003) compute a corporate governance index for 1,500 US companies consisting of 24 anti-takeover provisions and shareholders' rights compiled by the Investor Responsibility Research Centre that can be objectively assessed. The Governance Index (GI) is constructed as follows: for every firm, Gompers *et al.* (2003) add one point for every provision that restricts shareholder rights (increases managerial power). In summary, the GI is simply the sum of one point for the presence (or absence) of each provision. Gompers *et al.* (2003) also compute a sub index for each provision category. While this index does not accurately reflect the relative impacts of the various provisions, it has the advantage of being transparent and easily reproducible. The index does not require any judgments about the efficiency or wealth effects of any of these provisions; Gompers *et al.* (2003) compute only the impact on the balance of power.

Hopper *et al.* (2009) provide our final paper, a detailed review evaluating several decades of research on management accounting in less developed countries. They use a cultural political economy framework to make sense of the findings of 75 research papers written since 1980. The result is a clear and empirically useful description of the relationship between forms of management accounting systems and various ideal and actual stages of transition in developing countries, from colonial despotism to politicized market capitalism.

2.7 Conclusion

Performance refers to the extent to which organization's goals and objectives are achieved efficiently and effectively. Performance can take many forms depending on who and what the measurement is intended for. Different stakeholders require different performance indicators to enable them make informed decisions. Environmental and social groups are keen in following actions that the company undertakes with regards to corporate social responsibility; shareholders will be interested in viability, growth in profitability market share and turnover (Brown et al., 1997). Governments and multilateral agencies are interested by expected social and economic benefits to micro entrepreneurs, such as increases in employment and income levels.

There are various measures of performance including financial and non financial measures. Most of these measures make use of the financial statements. Financial statement analysis seeks to evaluate management performance in several areas including profitability, efficiency and risk (Reily and Brown, 1997). Microfinance performance can take many forms depending on what the stakeholders are interested in. Different stakeholders require different performance indicators to enable them make informed decisions.

The content, format and frequency of reports depend on who needs the information and for what purpose. For example shareholders will be more interested in profitability, growth, return on investment and continued financial stability of the institution (Manyuru 2005). Governments and multilateral agencies are interested by expected social and economic benefits to micro entrepreneurs, such as increases in employment and income

levels. Recent years have seen growing push for transparency in microfinance; this has seen an increasing use of financial and institution indicators to measure risk and performance of SMEs. For the purpose of this research project four indicators namely market share, turnover or disbursement, portfolio quality, and profitability were proposed as measures of microfinance performance. These were considered to be the most important indicators as they provide reasonable overview of the business volume, performance, risk and the financial condition of microfinance institution. Nonetheless, no known study had addressed the relationship between corporate governance and SMEs in Kenya (Nairobi).

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents the research design utilized by the study as well as the target population, sample size and sampling techniques, data collection and data analysis.

3.2 Research Design

This study adopted a descriptive survey research design and involved collecting data in order to answer questions concerning this study. It was an empirical investigation of corporate governance for small and medium-sized enterprises in Kenya.

This design was justifiable because it compared the quantitative reasoning of a sample. In addition the design, by the virtual of being cross-sectional, gave a representation of the whole population with minimum bias. Moreover descriptive survey made standardized measurement more precise by enforcing uniform definitions upon the respondents. This standardization ensured that similar data can be collected from groups/strata then interpreted comparatively.

3.3 Target Population

In Kenya, there are about 2.2 million SMEs (Strategic Business Advisors (Africa) Ltd., 2009). According to the City Council of Nairobi (CCN, 2010), SMEs businesses in Nairobi Central Business District are estimated at 103,000. These fit the definition of SMEs and hence constituted the population for purposes of the study. The population of this research consisted of the 396 small and medium businesses along the Biashara Street, Nairobi licensed with Single Business Permit (SBP) by the CCN, (2010). This study used annual reports and accounts of the sample companies. The Council stratifies SMEs by the number of employees as follows:

Table 3.1: Number of small and medium business in Nairobi Biashara Street

Category of firm	Number of employees	Number of Salons	Percentage of firms
Small -sized businesses	1 – 20	309	78.0
Medium- sized Salons	20 – 50	87	22.0
Total		396	10.00

Source: Estimates by ICT department, City Council of Nairobi (2011)

3.4 Sample and Sampling Techniques

Sampling is a systematic process of selecting a number of individuals for a study to represent the larger group from which they were selected. From the population, the study concentrated on SMEs in Nairobi, Biashara Street. Mugenda and Mugenda (2003) suggested that for descriptive studies, 10% of the accessible population is enough as a sample. The research sampled forty (40) small and medium-sized enterprises which constitute 10% of the population as presented in Table 3.2. Stratified random sampling was used to select the firms.

Table 3.2: Sample size of small and medium business in Nairobi Biashara Street

Category of firm	Percentage of firms	Sample size
Small -sized Salons	78	31
Medium- sized Salons	22	9
Total	100	40

Source: Source: Estimates by ICT department, City Council of Nairobi (2011)

The technique was preferred because proportionate allocation in this technique used a sampling fraction in each of the strata that was proportional to that of the total population. In addition, random sampling technique considered the whole population for sampling. Moreover, it permitted greater balancing of statistical power of tests of differences between strata by sampling equal numbers from strata varying widely in size.

3.5 Data Collection

For the purpose of collecting primary data the researcher used a semi-structured questionnaire. The questions were structured in such a manner as to elicit from the respondents the issues on corporate governance adopted by the SMEs in the recent past and how it affects performance.

Secondary data was also used. Specifically, secondary data was collected on company's return on assets, return on sales, and return on equity as financial performance indicators. This was obtained from financial statements of companies. This involved perusal of the balance sheet, the profit and lost statement as well as the cash flow statement.

3.6 Analytical Model and Data Analysis

Corporate governance in SMEs is dependent on the number of employees, the number of employees and the idiosyncratic risks as given by the following model:

$$G \propto E_n, O, I_r$$

$$\text{Therefore, } G = f(L_f, I_f, P)$$

Where

G = Practice of corporate governance

E_n = Number of employees

O = Form of Ownership (whether sole proprietorship, partnership or corporation)

P = Profitability

Given the independent variables, the dependent variable and the dependent variable, the model was formulated as follows:

$$G = \beta_0 + \beta_1 G + \beta_2 O + \beta_3 E_n + \varepsilon$$

Where:

G = Practice of corporate governance by SMEs. It is the dependent variable in the variable relation and measured in Index. This index was derived by getting the average score from the Likert answers which was then run on SPSS to generate the model coefficients

β_0 = Represents the fixed portion of the model and measured in units

β_i = It represents the slopes for the regression curve and called the regression coefficients. In this model, it indicates the change in G when each independent variable changes by 1 unit. It is measured in percent/ratio

E_n = Gives the size of the firm by the number of employees. It is a measure of finance performance of the organization since the higher the number of employees, the better the financial position of the company which directly translates to financial performance. This variable is relevant since the size of the firm will indicate its capability in supporting corporate board as well as coming up with firm management.

O = Gives the form of ownership and calculated through awarding codes to determine the relationship with the corporate governance. It is a measure of financial performance

P = Gives the overall financial performance of the organization through the level of profit

ε = A random/error term and a disturbance to the deterministic relationship.

For diagnostic test, T- Test will be used

Data collected from respondents was both quantitative and qualitative in nature. Quantitative data was analyzed using the Statistical Package for Social Scientists (SPSS) tools. Data was analyzed using descriptive statistics such as frequencies, mean scores and

the standard deviations. The basis of using descriptive approach was to give a basis for determining the weights of the variables under the study. The findings were presented using tables, pie charts, and bar graphs for easier interpretation.

On the other hand, qualitative data was analyzed using content analysis. This analysis enabled the researcher to analyze the data that was not quantitative in nature. At the same time the method allowed respondents to express their feelings on certain issues to a larger extent as compared to the quantitative analysis.

CHAPTER FOUR

DATA ANALYSIS AND INTERPRETATION OF RESULTS

4.1 Introduction

This chapter discusses data findings, analysis, interpretation and presentation. The data collected was analyzed using SPSS and the output presented in form of tables and graphs. Forty (40) SMEs were selected where the respondents were the owners/managers in those firms. These were SMEs located along the Biashara Street. The response rate was found to be 100% indicating that all firms responded to the findings. The research made the use of frequencies, percentages and comparison tables to interpret the information

4.2 Findings from the Demographic Information

This section concentrates on the demographic information of the SMEs Companies. The research was interested in knowing the extent to which the respondents are aware of corporate governance and when the companies adopted corporate governance Information on this section will enable the researcher judge whether they chose the appropriate companies for the study.

From the research it was found that 32 of the 40 SMEs were aware of corporate governance. The table below represents this information;

Table 4.1: Knowledge of Corporate Governance

	Frequency	Percent
Yes	32	80.0
No	8	20.0
Total	40	100.0

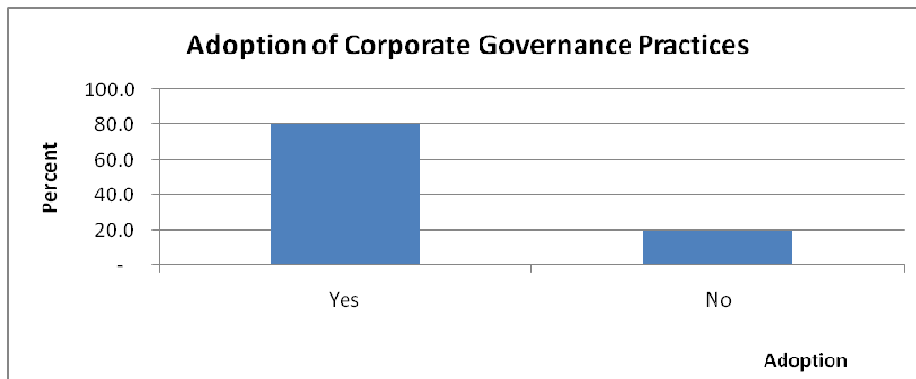
From the table 80% of the SMEs were aware of corporate governance while 20% had not heard of corporate governance. This could be due to little emphasis on corporate governance in growing economies.

Table 4.2: Whether the Respondent firms had adopted corporate governance practices

	Frequency	Percent
Yes	32	80.0
No	8	20.0
Total	40	100.0

Source: Research Data (2011)

From the table 4.2 above 80% of the respondents had adopted the corporate governance practices while 20% had not adopted. The respondents had not indicated why they had not adopted the corporate governance practices but it could be due to their lack of understanding of the practices. However the majority of the respondents had adopted the corporate governance practices. The bar graph below represents the same.



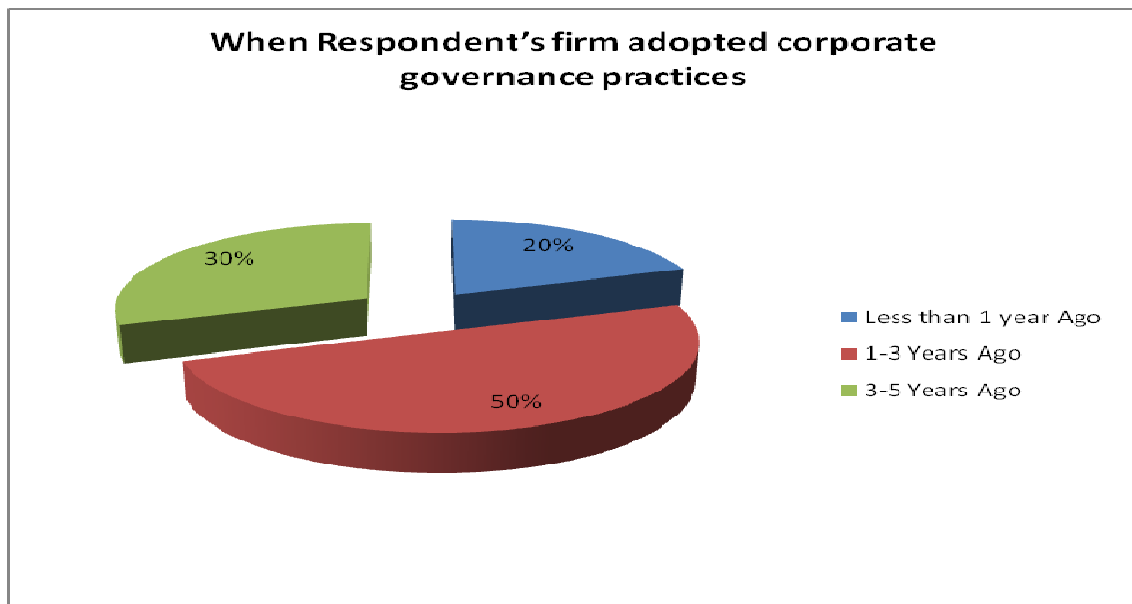
Source: Research Data (2011).

Table 4.3: When Respondent’s firm adopted corporate governance practices

	Frequency	Percent
Less than 1 year Ago	8	20.0
1-3 Years Ago	20	50.0
3-5 Years Ago	12	30.0
Total	40	100.0

Source: Research Data (2011)

Table 4.3 above indicates when the respondents firms had adopted corporate governance practices. Since only 20 of the respondents firms adopted corporate governance practices the researcher projected this to 100%. According to the table 50% of the respondents had adopted 1-3 years ago, 30% had adopted 3-5 Years Ago while only 20% adopted Less than 1 year Ago. Therefore majority of the firms had adopted 1-3 years ago. The same is illustrated by the pie chart below.



Source: Research Data (2011)

The researcher also wanted to get information regarding various statements concerning corporate governance in the firms. Table 4.4 below gives the responses.

4.3 Findings on Corporate Governance Practices

Table 4.1: Statements Concerning Corporate Governance in Firms

	Frequency		Percent	
	Yes	No	Yes	No
Does the SME's annual report, website or public disclosure include information about potential conflicts of interest such as related party transactions?	16	24	40.0	60.0
Does the SME specify in its charter, annual reports or other means sanctions against management in the case of violations of its desired corporate governance	32	8	80.0	20.0
Does the SME produce its legally required financial reports by the required date?	40	0	100.0	-
Does the SME disclose in its website or annual report compensation information for the CEO and board	24	16	60.0	40.0
Does the SME have monitoring committees such as a compensation and/or nominations and/or audit	31	9	76.0	24.0
Is the board of trustees clearly made up of outside and possibly independent trustees?	29	11	72.0	28.0
Is the board size between 5 and 9 members as recommended by the IBCG Code of Best Practices?	33	7	84.0	16.0
Is the SME free of any undergoing inquiry regarding governance malpractices	40		100.0	
Is the SME free of any convictions and/or fining for governance malpractices or other securities law	8	32	20.0	80.0
Does the SME submit to arbitration in place of regular legal procedures in the case of corporate	16	24	60.0	40.0

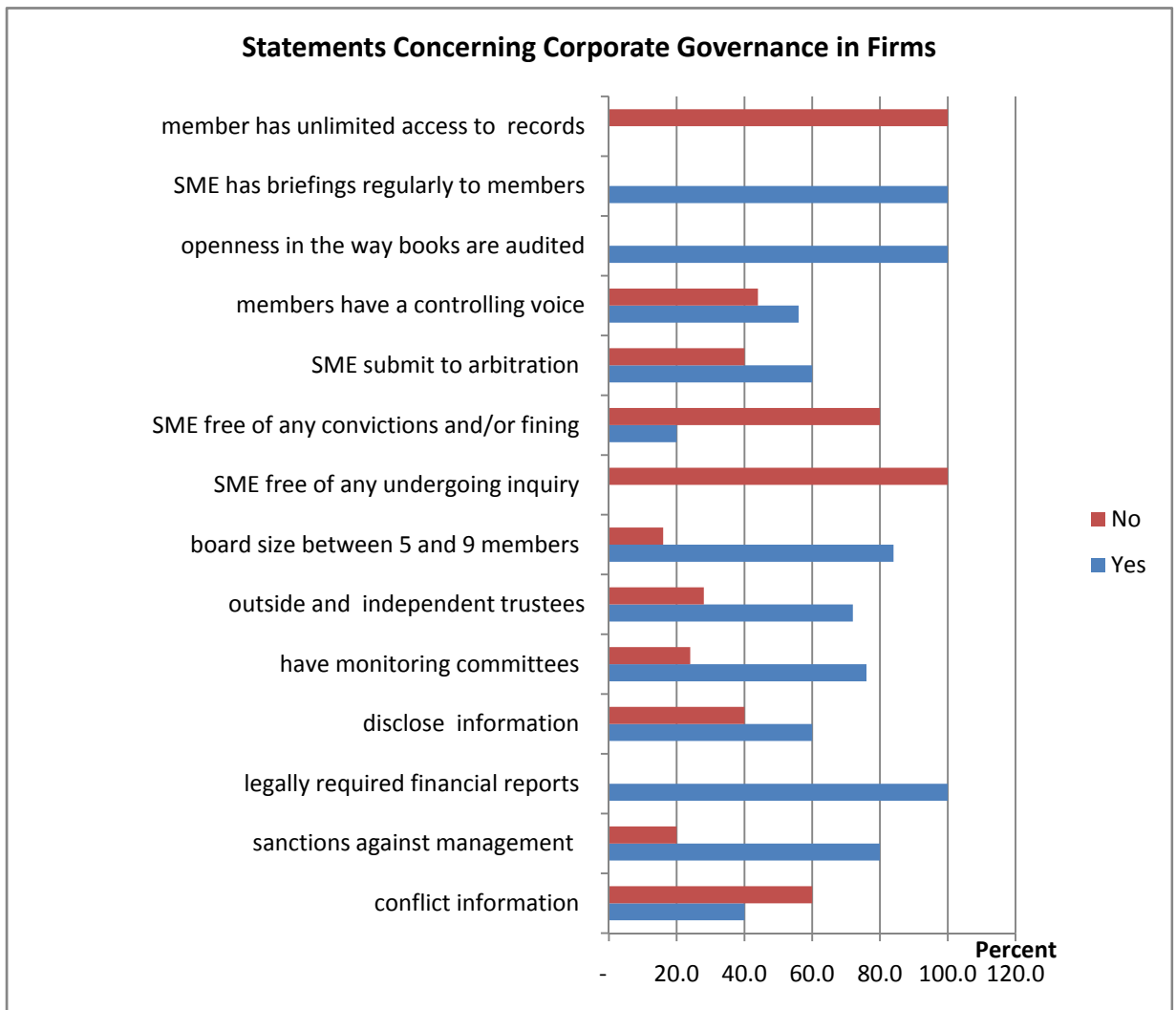
Does members have a controlling voice in the SME	22	18	56.0	44.0
Is there openness in the way books are audited	40	0	100.0	-
Does the SME has briefings regularly to members	40	0	100.0	-
Do a member has unlimited access to SMEs records if he wishes	-	40	-	100.0

From the table all the respondent firms agreed that their firms produced legally required financial reports by the required date, there is openness in the way books are audited in the firms, their SME were free of any undergoing inquiry regarding governance malpractices and that the SME had briefings regularly to members.

A majority of the firms further agreed that their SME specified in their charter, annual reports or other means sanctions against management in the case of violations of their desired corporate governance practices (80%), their board size is between 5 and 9 members (84%), the SME have monitoring committees such as a compensation and/or nominations and/or audit committees (76%), the board of trustees is clearly made up of outside and possibly independent trustees (72%), the SME disclose in their website or annual report compensation information for the CEO and board members (60%), the SME submit to arbitration in place of regular legal procedures in the case of corporate governance malpractices (60%) and that members have a controlling voice in the SME (56%). This could be an indication of good corporate governance in the majority of the firms.

On the other hand all respondents declined that members had unlimited access to SMEs records if they wished. Majority also declined that their SMEs were free of any convictions and/or fining for governance malpractices or other securities law violations in the last five years (80%) and that their SME's annual report, website or public disclosure included information about potential conflicts of interest such as related party transactions (60%). This could be an indication of loopholes in corporate governance in

these enterprises. However majority of the firms were indicated to be performing well in regard to corporate governance. The bar chart below illustrates the same.



Source: Research Data (2011)

Further to the study, the researcher was interested in knowing the the notable changes the respondents had observed since the adoption of corporate governance practices in their firm. The majority of the respondents pointed that new standards of “best practice” regarding board structure have been adopted since the inclusion of outside and independent trustees. According to them this has helped reduce cost in their firms thus improving performance. Few respondents noted that the corporate governance practices failed to nominate a remuneration committee to check on the remuneration of the board.

They said that the board's disclosures were what the auditora relied on and thus there was a need to have an independent remuneration committee to check for correctness on disclosures. Majority of the respondents also indicated to have noted a change in investor confidence with their enterprises which has been enhanced by the continuing practice of good, fair and transparent corporate behaviour. Finally the respondents were asked to give their recommendations concerning corporate governance and its effect on the performance of SMEs.

To begin with those who felt their firms had not adapted corporate governance practices recommended their firms to adopt such practices to help enhance practice of good, fair and transparent corporate behaviour. Others whose firms had adopted the practices, recommended for a continued revision of the practices to improve with the market dynamics. They also called for increased member participation in corporate governance practices to enhance a strong member trust with their enterprise. This could be well checked through Disclosure on corporate governance to the members. Finally a few called for the formation of a remuneration committee to check the board's remuneration, since they believed with the committee the board will be paid less than they were earning. All respondents unanimously called for unlimited access to SMEs records if they wished to help know of their firm's performance.

From the financial records of the SMEs studied, the researcher observed that, those SMEs who had adopted corporate governance practises, had good financial performance as compared to those firms which had not adopted corporate governance practises. Similarly those SMEs that had adopted corporate governance practises but whose practises were ranked lower in terms of being good, fair and transparent, had low financial performance as compared to those who were ranked high. This could be an indication of a positive and direct relationship between corporate governance practises and SMEs performance.

Content Analysis

This section analyzes the data that was qualitative in nature. On a survey of implementation of corporate governance practices in co-operative societies in Kenya, majority of the respondents said that there was poor attitude and a total failure to embrace

change by members of staff was on of the negative impact of the implementation of the corporate governance in the organization. This could be due to the belief of living with old traditional policies and procedures by members of staff

Concerning what could have attributed to the negative impact of the implementation of the corporate governance in the organization, most of the respondents said there was lack of staff commitment, poor management committee and policies as well as lack of advanced facilities and technologies. Other respondents said that there was poor attitude and members of the staff totally failed to embraced change. This could have been due to the fact that the members of staff felt that implementation of such governance could have led to change that could have affected the normal running of the organization. In addition to this the respondents also said there was complain of staff members and shareholders.

Corporate governance can be achieved according to majority of the respondents said there should be proper training, proper strategy, adequacy of information as well as staff members to have positive attitude. This could be so as to have skilled employees as well as the smooth running of the organization.

4.4 Inferential findings

Given the independent variables, the dependent variable and the dependent variable, the model can be formulated as follows:

$$G = \beta_0 + \beta_1 G + \beta_2 O + \beta_3 E_n + \epsilon$$

Where:

G = Practice of corporate governance by SMEs. It is the dependent variable in the variable relation and measured in Index

β_0 = Represents the fixed portion of the model and measured in units

- β_i = It represents the slopes for the regression curve and called the regression coefficients. In this model, it indicates the change in G when each independent variable changes by 1 unit. It is measured in percent/ratio
- E_n = Gives the size of the firm by the number of employees. It is a measure of finance performance of the organization since the higher the number of employees, the better the financial position of the company which directly translates to financial performance.
- O = Gives the form of ownership and calculated through awarding codes to determine the relationship with the corporate governance. It is a measure of financial performance
- P = Gives the overall financial performance of the organization through the level of profit
- ε = A random/error term and a disturbance to the deterministic relationship.

Table 4.4: Coefficients

		Standardized coefficients	
	B	Beta	Sig
Constant	0.71		0.09
Size of the firm (number of employees)	0.07	0.15	0.44
Ownership (limited liability company)	0.09	0.17	0.39
Profitability	0.56	0.64	0.00

Source: Researcher (2011)

Table 4.2 illustrates the analytical coefficients for the variable relations. The researcher considered three variables to be significantly influencing corporate governance practices in the small and medium enterprises along Biashara Street which included the size of the firm (number of employees), ownership (corporate ownership) and profitability. The study revealed that the most prevalent factor among the three mentioned variables was profitability with beta value of 0.64 while ownership (limited liability company) and Size of the firm (number of employees) had beta value of 0.17, 0.15, respectively. The significant level was 5% implying that, the higher the significant level for an explanatory variable, the lower the confidence level and thus the less the variable explains changes in the dependent variable. Results indicate that, profitability is the only explanatory variable explaining corporate governance significantly (gives confidence level greater than 95%) as opposed to other two explanatory variables). The table also illustrates the autonomy values for the variables. The analytical model has an autonomy value of 0.71 while probabilistic values were 0.07 for Size of the firm (number of employees), 0.09 for Ownership (limited liability company) and 0.56 for profitability.

As indicated in Table 4.4, the model can be indicated as:

$$G = 0.71 + 0.15 X_1 + 0.17 X_2 + 0.64 X_3 + \varepsilon$$

From the model, the constant value of 0.71 implies that number of employees in the small and medium enterprises will have an index of 0.71 when coefficients for all variable factors are zero. The results also indicate that a change in Size of the firm (number of employees), Ownership (limited liability company) and profitability by 1 unit in each, will result to a positive change in corporate governance practices in the small and medium enterprises by 15%, 17%, and 64% respectively. This is an indication that the three independent variables under investigation were positively related to the dependent variable (corporate ownership in the small and medium enterprises).

4.4.1 Significance level

To determine the level of significance of the different explanatory variables, the researcher considered the t value, standard error of the estimate, the F significant change as well as the R^2 . These values are presents in both Table 4.5 and Table 4.6.

Table 4.5: Coefficients for significant level

Model Summary									
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	0.79	0.62	0.587	0.18	0.82	17.80	5	54	0.000
Predictors: (Constant), profitability, size of the firm, ownership (limited liability company)									

Source: Researcher (2011)

R^2 is called the coefficient of determination and tells us the proportion of the change in Training in the small and medium enterprises that is caused by the change in explanatory variables. From Table 4.8, the value of R square was found to be 0.82 indicating that size of the firm (number of employees), corporate ownership and profitability explained 82% of any change in corporate governance practices in the small and medium enterprises. The study also reveals that the remaining 18% could be explained by other factors affecting corporate governance in the small and medium enterprises. When F is greater than 1, the set of explanatory variables is considered to be significantly determining any changes in corporate governance in the small and medium enterprises.

The level of significant at single variant level is also analyzed

Table 4.6: Single-variate T-Ratio and R-Square

	T-Value	R-Squared
Size of the firm	4.67	0.27
Ownership (limited liability company)	5.10	0.31
Profitability	9.26	0.60

Source: Researcher (2011)

Table 4.9 shows that profitability carried the highest weight in explaining factors that affect corporate governance in the small and medium enterprises with an index of 60%. Other factors which included corporate ownership and size of the firm (number of employees) had explanation weight of 31% and 27% respectively as shown in Table 4.9.

T-Ratio (t)

This is also called the student ratio and tells us the statistical significance of the explanatory variables. If $t > 2$, the explanatory variable is said to be statistically significant. The opposite is true if $t < 2$.

Regarding the statistical significance of the explanatory variable towards the corporate governance in SMEs, the researcher took a general assumption that those variables with a student ratio greater than two (2) were highly significant and therefore relevant in determining corporate governance practices. Profitability was found to be the most statistically significant with T-Value of 9.26 while Ownership (limited liability company) and Size of the firm (number of employees) had statistical significance of 5.10 and 4.67 respectively. Details of the same are as shown by Table 4.9.

4.5 Discussion of findings

This study found close relationship between corporate governance and the profitability of the SMEs. A majority of the firms further agreed that their SME specified in their charter, annual reports or other means sanctions against management in the case of violations of their desired corporate governance practices (80%), their board size is between 5 and 9 members. As argued by Peasnell et al. (2001), there is convex association between the profitability and corporate control process. From the financial records of the SMEs studied, the researcher observed that, those SMEs who had adopted corporate governance practises, had good financial performance as compared to those firms which had not adopted corporate governance practises.

Similarly those SMEs that had adopted corporate governance practises but whose practises were ranked lower in terms of being good, fair and transparent, had low financial performance as compared to those who were ranked high. This could be an indication of a positive and direct relationship between corporate governance practises and SMEs performance. John and Senbet (1998) report empirical evidence showing that the presence of monitoring committees (audit, nomination, and compensation committees) is positively related to factors associated with the benefits of monitoring.

Klein (2002) shows that independent audit committees reduce the likelihood of earnings management, thus improving transparency. Finally, when the CEO serves on the nominating committee, the audit one is less likely to have a majority of independent directors (Klein, 2002). This was in line with what was indicated by majority of the respondents who pointed out that new standards of “best practice” regarding board structure have been adopted since the inclusion of outside and independent trustees. According to them this has helped reduce cost in their firms thus improving performance.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

On the demographics the study noted out that 80% of the SMEs were aware of corporate governance while 20% had not heard of corporate governance. On adoption of the practices, 80% of the respondents had adopted the corporate governance practices while 20% had not adopted. The respondents had not indicated why they had not adopted the corporate governance practices but it could be due to their lack of understanding of the practices.

Since only 32 of the respondents firms adopted corporate governance practices the researcher projected this to 100% whereby according to the findings 50% of the respondents had adopted the practices 1-3 years ago, 30% had adopted 3-5 Years Ago while only 20% adopted Less than 1 year Ago.

Information regarding various statements concerning corporate governance in the firms revealed that all the respondent firms agreed that their firms produced legally required financial reports by the required date, had openness in the way their books were audited in the firms, their SME were free of any undergoing inquiry regarding governance malpractices and that their SME had briefings regularly to members. A majority of the firms further agreed that their SME specified in their charter, annual reports or other means sanctions against management in the case of violations of their desired corporate governance practices (80%), their board size was between 5 and 9 members as recommended by the IBCG Code of Best Practices (84%), their SMEs have monitoring committees such as a compensation and/or nominations and/or audit committees (76%), the board of trustees was clearly made up of outside and possibly independent trustees (72%), the SME disclosed in their website or annual report compensation information for the CEO and board members (60%), the SME submitted³ to arbitration in place of regular

legal procedures in the case of corporate governance malpractices (60%) and that members had a controlling voice in the SME (56%). This could be an indication of good corporate governance in the majority of the firms.

On the other hand all respondents declined that members had unlimited access to SMEs records if they wished. Majority also declined that their SMEs were free of any convictions and/or fining for governance malpractices or other securities law violations in the last five years (80%) and that their SME's annual report, website or public disclosure included information about potential conflicts of interest such as related party transactions (60%). This could be an indication of loopholes in corporate governance in these enterprises. However majority of the firms were indicated to be performing well in regard to corporate governance.

Further to the study, the researcher learnt of notable changes by the respondents. The majority of the respondents pointed that new standards of "best practice" regarding board structure have been adopted since the inclusion of outside and independent trustees. According to them this has helped reduce cost in their firms thus improving performance. Few respondents noted that the corporate governance practices failed to nominate a remuneration committee to check on the remuneration of the board. They said that the board's disclosures were what the auditors relied on and thus there was a need to have an independent remuneration committee to check for correctness on disclosures. Majority of the respondents also indicated to have noted a change in investor confidence with their enterprises which had been enhanced by the continuing practice of good, fair and transparent corporate behaviour.

Finally the respondents gave their recommendations concerning corporate governance and its effect on the performance of SMEs. To begin with those who felt their firms had not adapted corporate governance practices recommended their firms to adopt such practices to help enhance practice of good, fair and transparent corporate behaviour. Others whose firms had adopted the practices, recommended for a continued revision of the practices to improve with the market dynamics. They also called for increased member participation in corporate governance practices to enhance a strong member trust

with their enterprise. This could be well checked through disclosure on corporate governance to the members. Finally a few called for the formation of a remuneration committee to check the board's remuneration, since they believed that with the committee, the board would be paid less than they were earning. All respondents unanimously called for unlimited access to SMEs records if they wished to help know of their firm's performance.

From the financial records of the SMEs studied, the researcher observed that, those SMEs who had adopted corporate governance practises, had good financial performance as compared to those firms which had not adopted corporate governance practises. Similarly those SMEs that had adopted corporate governance practises but whose practises were ranked lower in terms of being good, fair and transparent, had low financial performance as compared to those who were ranked high. This could be an indication of a positive and direct relationship between corporate governance practises and SMEs performance.

5.2 Conclusion

Corporate governance has dominated policy agenda in developed market economies for more than a decade and it is gradually warming its way to the top of the policy agenda on the African continent. The global economic crisis and the relative poor performance of the corporate sector in Sub-Saharan Africa have made corporate governance a catchphrase in the development debate (Berglof and von Thadden, 1999). Developing countries, of which Kenya is no exception, have increasingly embraced the concept of good corporate governance, because of its ability to impact positively on sustainable growth. It is believed that, good governance generates investor goodwill and confidence. Firms are now improving their corporate governance practices knowing it increases valuations and boosts the bottom line. SMEs have not been left out which has led to their enhanced performance through these practises.

5.3 Recommendations

From the research, the researcher wishes to make the following recommendations;

To begin with the researcher found out that 20% of the respondents had not heard of corporate governance. He wishes to recommend for continued enlightenment on this topic.

Secondly, according to the findings 50% of the respondents had adopted the practices 1-3 years ago which represented the majority. This could indicate that the practise is very new in the SMEs. The researcher recommends for more enlightenment to the SMEs.

Thirdly information regarding various statements concerning corporate governance revealed that members did not have unlimited access to SMEs records if they wished and that SME's annual report, website or public disclosure did not include information about potential conflicts of interest such as related party transactions (60%). These are loopholes in the corporate governance practices that the researcher recommends they be dealt with by the SMEs and other firms.

Finally the researcher wishes to recommend that the recommendations of the respondents be dealt with since they are vital for SMEs performance; firms to adopt corporate governance practices, continued revision of the practices, increased member participation in corporate governance practices, formation of a remuneration committee and unlimited access to SMEs records by members.

5.4 Recommendations for further studies

According to the researcher all has not been explored on the corporate governance issue which necessitates the need for further studies on the topic in other organizations especially in regard to implementation of corporate governance practices.

5.5 Limitations of the study

The study was limited to corporate governance in SMEs. Some respondents were not even conversant with the corporate governance concept and therefore could not answer the research questions effectively. There was the limitation of time given the respondent

need more time to understand the meaning of corporate governance so that they could accurately fill the questionnaire.

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APPENDICES

Appendix I: Research Questionnaire

1. Have you ever heard of corporate governance?

Yes No

2. a) Has your firm adopted corporate governance practices?

Yes No

b) If no, why? (Describe briefly) _____

b) If Yes, when did your firm adopt corporate governance practices?

Less than 1 year Ago

1-3 Years Ago

3-5 Years Ago

3. The table below contains statements concerning corporate governance in firms. Tick where appropriate.

Governance Dimension	#		Yes	No
Disclosure	1	Does the SME's annual report, website or public disclosure include information about potential conflicts of interest such as related party transactions?		
	2	Does the SME specify in its charter, annual reports or other means sanctions against management in the case of violations of its desired corporate governance practices?		

	3	Does the SME produce its legally required financial reports by the required date?		
	4	Does the SME disclose in its website or annual report compensation information for the CEO and board members?		
	5	Does the SME have monitoring committees such as a compensation and/or nominations and/or audit committees?		
	6	Is the board of trustees clearly made up of outside and possibly independent trustees?		
	7	Is the board size between 5 and 9 members as recommended by the IBCG Code of Best Practices?		
Ethics and Conflict of Interest	8	Is the SME free of any undergoing inquiry regarding governance malpractices		
	9	Is the SME free of any convictions and/or fining for governance malpractices or other securities law violations in the last five years?		
	10	Does the SME submit to arbitration in place of regular legal procedures in the case of corporate governance malpractices?		
	11	Does members have a controlling voice in the SME		
	13	Is there openness in the way books are audited		
	14	Does the SME has briefings regularly to members		
	15	Do a member has unlimited access to SMEs records if he wishes		

4. What are the notable changes you have observed since the adoption of corporate governance practices in your firm? (Describe) _____

5. What are your recommendations concerning corporate governance and its effect on the performance of SMEs?) _____

6. What is the role of corporate governance in your organization/Department?

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.....

7. To what extent does corporate governance affect decision making in the following areas.

	Very great extent	Great extent	Moderate extent	Negatively	Not at All
Marketing Strategy					
Financial Outsourcing					
New Product Development					
Human Resource Hiring and Down sizing					
Expansion Strategy					

8. With the introduction of corporate governance in your department, has there been a change in terms of how the organization is run?

Yes [] No []

b) If yes, has the changes led to improvement or decline on how the society is managed?
 Improvement [] Decline []

9. If your answer was decline, indicate the extent to which the decline can be attributed to the following?

	To no extent 1	Small extent 2	Large extent 3	Very large extent 4
The Board and management have concentrated on achieving the goals of corporate governance at the expense of the normal management of the society.				
Implementation of corporate governance consumes a lot of time				
Corporate governance has brought a lot of bureaucracy in management				

10. Salaries for the staff compared to those paid to other government ministries

Lower [] on average equivalent [] Higher []

11. Any other comment? Kindly explain

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