

**RELATIONSHIP BETWEEN LEVEL OF IMPLEMENTATION OF
CMA GUIDELINES ON CORPORATE GOVERNANCE AND
PROFITABILITY OF COMPANIES LISTED AT THE NAIROBI
STOCK EXCHANGE**

CHRISTINE AUMA NAMBIRO

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Declaration

I do hereby declare that this is my original work and that it has not been presented as an academic paper in any university.

Sign

Name Christine Auma Nambiro

Reg. No D61/P/8362/03

This project was presented under my supervision

Sign.

Date.

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Moses Anyangu

University of Nairobi

Acknowledgement

This work would not have been of form were it not for the efforts of very dedicated individuals to whom I am grateful. It may not be possible to thank each of those who assisted in one way or the other in realizing this goal but there are a few individual I wish to recognize.

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Dedication

I dedicate this research project to my sons, Ernest, Austin, and Alfred.

ABSTRACT

The objectives of this study were to establish the level of implementation of CMA guidelines on corporate governance by companies listed on the NSE and to establish the relationship between level of implementation of the corporate governance guidelines and financial performance of the listed companies. Corporate governance is the system through which corporations are directed and controlled. The main goal of a firm is shareholders wealth maximization. CMA guidelines act as a benchmark for companies to follow.

The population of the research consisted of all the companies quoted at the Nairobi Stock Exchange over the period of the study from 2003 - 2006. 2003 was considered suitable because it is immediately after CMA gazetted the Corporate Governance guidelines for firms quoted on NSE while the year 2006 is the most current that has suitable data. A census of companies quoted on the NSE during the period 2003 - 2006 was carried out with exclusion of those companies suspended for whichever reason. This census study ensured that each company is given an equal opportunity of being interviewed. Questionnaires to investigate level of implementation of CMA guidelines were filled by managers. The dependent variable, company performance was measured using Return on Assets (ROA) and Market Based Values. Independent variables were measured using the appointment to the board, proportion of outside directors, accountability and audit, and Board meetings per year. Both independent and dependent variables were classified in market segments and SPSS used to analyze it. The ROA over the study period was averagely 0.554 while the MBV was 0.885

It can be concluded from this study that all the companies listed at NSE have implemented the JMA guidelines on CG. It can also be concluded that the performance of the listed companies at the NSE has been in the increase. The market value and return on asset being the indicators for the improvement. It can also be concluded that the increase in performance can be attributed to the high level of adoption of the CG guidelines, the size of the Boards, proportion of outside directors, and the number of meetings in a year. Therefore these independent variables taken for the study can be authoritatively cited as key determinants of the improved performance as all the categories reported increased performance across these variables.

ABBREVIATIONS

CMA	-	Capital Markets Authority
NSE	-	Nairobi Stock Exchange
CBK	-	Central Bank of Kenya
ROA	-	Return on Assets
MBV	-	Market Book Value
CG	-	Corporate Governance
BOD	-	Board of Directors
OECD	-	Organization for Economic Cooperation and Development
CIPE	-	Center for International Private Enterprise

CHAPTER ONE

1.0 INTRODUCTION

1.1 Background

Corporate Governance is a concept that is currently receiving a lot of attention in both Public and Private sectors. In 1932 Berle and Means noted that initially, corporations were legal devices to enable individuals transact private business. This was later to change with corporations becoming a means of organizing economic life and a major social institution. But economic power was being concentrated with control falling into fewer hands (Berle and Means, 1932). Since the boards now exercised direction over the activities of the company, control ultimately lay with those who had the power to select the board.

Longeneck and Pringle (1981) documented issues relating to Corporate Governance in the 1970's due to rising business scandals in the USA. During the period, failure of companies led to increased scrutiny of boards and action was taken to demand that top management show accountability and prudence in allocation of company resources. Financial failures during this period led to a number of initiatives. For instance the Treadway Commission was formed in 1985. In its report in 1987, it found out that almost 50% of fraudulent financial reporting resulted in part from breakdown in internal controls and recommended that many different internal philosophies be integrated.

By late 1980's the public and corporate boards began to demand a more active role in Corporate Governance having recognized that their intervention could soften the impact of corporate restructuring on workers, communities, operations and profits. These developments are the Brainchild of modern practice of Corporate Governance which examines the legal performance of corporations. Participants include Shareholders, Board Members, the Management of the firm, and other participants including advisors, creditors, employees, customers, suppliers, the Government and its Citizens.

In the 1990s, Tricker (2000) notes that boards began to face increased pressure from institutional investors, investigating Media and the threat of litigation.

Cadbury 1992 report defined Corporate Governance as a *'System through which business corporations are directed and controlled.'* It also refers to it as *the way in which boards and officers handle the affairs of the corporation*. The report emphasized the importance of independent Non-executive directors, and the need for audit committees. It called for separation of the chair of the board from the Chief Executive. The argument was that governance is about performance as well as conformance.

A lot of research has been done on Corporate Governance seeking to attain a vibrant alternative way to assure that power was exercised, over every type and form of corporate entity in a way that ensured both effective performance and social ;iccountability and responsibility.

The World Bank and the Organization for Economic Cooperation and Development (OECD) established the Global Governance Forum whose mandate was to build consensus in favour of coming up with an appropriate policy on regulatory and corporate reforms and to coordinate and disseminate Corporate Governance activities. Corporate Governance is closely related to financial performance since it aims at improving the financial performance especially how the corporate owner can secure or motivate the corporate managers to -deliver a competitive rate of return (Mathiesen, 2002).

In the past companies assumed that efficiency could be attained with full participation of employees. But Mc Ritchie (2005) notes that shareholders participation also add value. Ownership based governance reduces unaccountability and corruption. According to the CMA managers of business should incorporate all stakeholders' interests in their decision making. They have developed mandatory guidelines to be complied with by companies listed on the stock exchange in their effort to ensure investors demand good governance.

Wambua (1999) in his research on corporate governance practices in the banking sub-sector in Kenya noted that, accountability requires some agent to monitor management performance because of significant weaknesses noted among boards of directors. He also points out that private and individual investors lack clout to make significant impact on corporate governance because of certain fundamental weaknesses in these groups of shareholders. Mwangi (2001) found a positive relationship between levels of governance and ownership and financial performance. Corporate

Governance defines sense of right and wrong, fair and just, work ethics and continuing social responsibility (Murungi and Maina 2004)

Principles of corporate governance include: definition of authority and duties of members, appointments to the board and top management, nature of organizational structure, corporate performance, viability and financial sustainability, corporate compliance with relevant laws and authorities, corporate communication and accountability to members. Others include; the balance of power, internal control procedures, assessment of BOD performance, corporate culture, social responsibility, recognition and utilization of professional skills and competencies and the relationship between the Board and Management (Centre for Corporate Governance Trust, 2002).

1.2 Statement of the problem

Many activities have been there on Corporate Governance with understanding that it will improve company performance. It is not clear if companies have complied with the guidelines thus need for research to check the level of implementation. Despite many attempts to improve corporate governance there are company failures and complains from shareholders.

An effective board is one that carries out its responsibilities with integrity and competence. The board should hire a competent CEO and give him/her authority to run the company. Some companies have no clear distinctions between the role of Directors and Management, which often result in conflict of interest. The board must ensure full and timely disclosure of performance of the business to its owners and to the investment community at large (Colley *et al* 2005). The board

of director's practices can provide clues about a company's posture towards risks and even preferred strategic approaches (Porter, 1985). Most corporate failures are associated with ineffectiveness of the board. This research will be educative to the various boards concerning the CMA guidelines. Efforts such as AFL-CIO's (America's Union Movement) Executive pay watch and SEIU's (Service employees International Union) capital stewardship program have been in the forefront on corporate governance issues, such as movement to get access to the corporate ballot to nominate directors (CIPE, op. cit) The East Asian financial crises, the financial crises in Mexico, Brazil and other crises of the 1990's are manifestations of a number of structural reasons why corporate governance has become more important for economic development and a more important policy issue in many countries (Mutisya, 2006)

Privatization has raised corporate governance issues in previously state owned firms. Firms are on the stock market to raise more capital. Due to technological progress, liberalization and opening of financial markets, price deregulation and the removal of restrictions on products and ownership the allocation of capital within and across countries has become more complex (Cf. Claessens, 2003). This shows the importance of good governance. Capital mobilization is by the institutional investor and not the principal owner thus good governance is very important to ensure that the capital is appropriately used in the interest of the shareholder.

In Kenya, there has been a history of poor governance by boards and management. The collapsed banks being a good example. Some CMA guidelines are not followed and instead trustees put their priorities before that of members. There are conflicts on most policy decisions made by the board.

The remuneration of Board members, travel allowances, medical and other benefits are determined by themselves sometimes resulting in conflicts of interest.

Whereas a number of studies have been done on CG concept, only a few (Wang'ombi 2003, Mwangi 2002, Mucuvi 2002, Ademba 2006 and Mutisya 2006) have looked at the practices of corporate governance. But they did not address the level of implementation of CMA guidelines and how it relates to performance of companies listed on NSE. This study seeks to narrow the existing gap by answering the question: What are the corporate governance practices found in companies listed in the NSE? And at what level has the CMA guidelines been implemented? How does the level of implementation relate to performance?

1.3 Objectives of the study

- To establish the level of implementation of CMA guidelines on corporate governance by companies listed on the NSE.
- To establish the relationship between level of implementation of the corporate governance guidelines and performance of the listed companies

1.4 Importance of the study

The study is useful to shareholders since it will help them choose right persons to constitute the board and enable them evaluate the mandates. The research project shall be useful to the board of directors of these companies as it will assist them in understanding their role and responsibilities more clearly, determine separation of duties between themselves and the management determine the training needs of directors and evaluate their practices to ensure that they enhance

effectiveness in the various companies. The research will be useful to the management in understanding their role more clearly and determine separation of duties between themselves and the board of directors.

Researchers will be able to understand the management structure of companies the role of leadership and explore issues of corporate governance. The study will reveal to those companies that have not adopted CMA guidelines to see how lack of adoption may influence performance. Investors will use the study to assess which companies to invest in since the study is focusing on performance as influenced by aspects of corporate governance. The study will be important to CMA and NSE to gauge its policies and may be used as a yardstick to develop other regulators.

CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Introduction to the concept of Corporate Governance

The concept of corporate governance has been defined by many people in different ways that reflect their special interest in the topic. According to Cadbury (1992 p. 15), corporate governance refers to the way organizations are directed and controlled. It is a set of mechanisms through which firms operate and are controlled when ownership is separated from management. It encompasses authority, accountability, stewardship, leadership, direction, and control exercised in an organization.

Shleifer and Vishny (1997) view corporate governance from the point of view of finance. They argue that 'corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. 'The Financial Times (1997) define CG as the relationship of the enterprise to shareholders. Zingales' broad definition (1998) spells out corporate governance as 'The complex set of constraints that shape the ex post bargaining over the quasi rents (profits) generated by the firm.' His focus is on division of claims.

The CMA of Kenya (2000) defines corporate governance as the manner in which the power of a corporation is exercised in the running of the corporation's total portfolio of assets and resources with the objective of maintaining and increasing shareholders' long-term value while taking into account the interest of other stakeholders.

Financial Stability Forum (2001) defines corporate governance as the sum of processes, structures and information used for directing and overseeing the management of an organization. Arun and Turner (2002) view CG as the mechanism through which shareholders are assured that managers will act on their behalf. Shleifer and Vishm (1997), Vives (2000) and Oman (2001) agree that there is a broader approach which views the subject as the methods by which suppliers of finance control managers to ensure that their capital cannot be expropriated and that they earn maximum returns on their investment.

Mathiesen, (2002) defines corporate governance as a 'field in economics that investigates how to secure/motivate efficient management of corporations by the use of incentive mechanisms, such as contracts, organizational designs and legislation. According to Claessens (op. cit.p.4), corporate governance falls in two categories i.e. the first set of definitions cover the behavioral patterns such as the actual behavior of corporations in terms of measures as performance, efficiency, growth, financial structure and treatment of shareholders and stakeholders while the second covers the normative framework, i.e. the rules under which firms operate. Corporate Governance is concerned with resolution of collective action problems among dispersed investors and the reconciliation of conflict of interest between various corporate claim holders (Marco *et al*, 2004).

Leaders and investors must be assured that the basic principles of good corporate governance are in place and will be followed, dealings with the shareholders are fair and transparent, the board of directors can be held accountable and the company deals responsibly with stakeholders. All this

are keys to a company's integrity, efficiency, long term growth and profitability. Firms must aim at optimizing economic results.

Different scholars have defined the CG concept in their own perspectives thus the importance to clarify the definition of this concept, the OfCD (1999) defined corporate governance as a system on the basis of which business companies are directed and managed. It is upon this system that specifications are given for the division of competencies and responsibilities between individual parties, such as the board of directors, the supervisory board, the management and other shareholders and formulates rules and procedures for adopting decisions on corporate matters, this definition is consistent with the one presented by Cadbury (2002). It includes the relationship between shareholders, creditors and corporations, between financial markets, institutions and corporations and between employees and corporations, this is the definition we will adopt since captures most of the governance areas.

According to Margaret Blair, the issues in CG revolve around ownership and control.. 'Ownership of private property is the central mechanisms by which incentives are created for the efficient use of resources in a free market economy.' Although numerous individuals from suppliers to employees have a stake in the success of companies, the strategic decisions are made by the Corporate Executives. Thus the main problem in CG is how do you make this executives accountable to the shareholders whose investment is at risk, while still giving them the freedom, the incentives and the control over the resources they need to create and seize investment

opportunities and to be tough competitors. A number of mechanisms are being used to align the interests of the executives and those of the shareholder. These include:

- Internal mechanisms: boards of directors, executive compensation, active use of ownership prerogatives by large shareholders like institutional investors, and
- External mechanisms: the market for corporate control (here, the threat of hostile acquisitions).

The term corporate governance has come to mean two things namely the processes by which all companies are directed and controlled and a field in economics which studies many issues arising from separation of ownership and control.

2.2 Corporate Governance in Kenya

In 1982 the government relaxed the rules that governed issuance for licenses to banks. This led to many banks coming up without proper CG structures resulting in poor governance and management culture in the industry. (Center for Corporate Governance, 2004, p.5) Rural Urban Credit Finance was placed in interim liquidation by 1984. The Government then made changes in the Banking act and the CBK act to curb instabilities in the banking industry. The capital adequacy requirement increased and Depositors Protection Fund was created. Despite efforts to streamline the sector, over 32 banks have been liquidated or put under receivership. The collapse was due to weak internal controls, bad governance and management practices.

In 1986 Continental Bank of Kenya and Continental Credit Finance Ltd collapsed. Capital Finance collapsed in 1987. Consolidated bank was formed by a merger of seven banks that collapsed. The major reasons for the collapse of most of the banking institutions in Kenya were attributed to:

- Poor risk management strategies
- Weak corporate governance practices
- Lack of internal controls
- Weak regulatory and supervisory systems
- Insider lending and conflict of interest (ibid., p. 6) Mutisya (2006)

CMA developed corporate governance guidelines that were gazetted on 31st May 2002 for companies that are listed at the NSE. Some of the principles of good governance recommended by CMA are:

1. The Board: every listed company must have an effective Board of Directors to guide the company and be accountable to shareholders.
2. The Chairperson and the Chief Executive must have roles that are clearly outlined and separated, to provide checks and to ensure a power balance.
3. Shareholders must approve all major decisions of the company.
4. Accountability and audit: The board must present a true and fair picture of the companies operating position and prospects.
5. Public disclosure of all agency contracts is important.

The Private Sector Corporate governance Trust of Kenya was established in September 2000. It brings together regulatory authorities, the private sector and representatives of various stakeholder groups to promote good corporate governance.

2.3 Global Corporate Governance Practices

The Cadbury committee was appointed in Ylay 1991 by the UK Government. This was due to a collapse of many companies like Colorol Group, Ferranti, and Maxwell communication et.c due to scandals. Cadbury was to ".....address the financial aspects of corporate governance" (Report of the Committee on the Financial Aspects of Corporate Governance, 1992 section 8).

In the US before 1980. most corporate managers thought they represented the corporations and not the shareholders. The firm's goals were not shareholder wealth maximization but to ensure growth and stability. Corporate boards were dominated by management, making board oversight weak. 1980's brought about takeovers, and restructuring activities. CG guidelines were put in place. In 1990's there was greater involvement of board of directors and shareholders.

The 1990's saw the East Asian crises and other financial.crisis across the world. The collapse of Enron, Global crossing and WorldCom and accounting abuses at Arthur Anderson, lawmakers and activists are calling for more accountability by American firms. The King's committee report and code of corporate governance (published in 1994) in South Africa continues to stimulate corporate Governance debate in Africa.

In recent years, groups like employees, social-issue shareholder resolution advocates, and large pension funds (and other institutional holders) have sought to insert themselves in CG processes—with varying degrees of success (Mutisya)

In future it is anticipated that there will be greater expectations for transparency in financial and social reporting, increased expectations for board involvement in strategy setting and developing responses to social issues, greater involvement by large-block shareholders in CG processes, and greater oversight of boards and managers by the Securities and Exchange Commission, attorneys general etc (Javed and Iqbal,2002)

2.4 Principle of Corporate Governance

The key elements that have been acknowledged as critical in CG are honesty, trust, and integrity, openness, performance orientation, responsibility and accountability mutual respect and commitment to the organization. The commonly accepted principles of CG include the rights and equitable treatment of shareholders, interest of other stakeholders, the role and responsibilities of the board, integrity and ethical behavior, and disclosure and transparency

2.5 Link between Corporate Governance and Performance

One of the questions asked most often about current corporate governance activities - and one of the hardest to answer - is how such activities affect the level of corporate performance. A global investor opinion survey conducted in 2002 (McKinsey, 2002) found that 80% Of the respondents would pay a premium for well governed companies. According to the study a well governed company is a company that had most outsider directors, who had no management ties, undertook formal evaluation of its directors and was responsive to investors' requests for information on governance .The size of such premium varied by market from 11% for

Canadian companies to around 40% for companies where regulatory backdrop was least certain.

Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to capital. In emerging markets good CG serves a number of public policy objectives. It reduces vulnerability of financial crises, reinforcement property rights; reduces transaction cost and cost of capital and leads to capital market development Attiya Y Javed and Iqbal.

Studies have shown that good governance practices have led to the significant increase in economic value added firms, higher productivity and lower risk of systematic financial failure for countries. Shleifer and Vishny (1997) have a lot of literature in this area. US firms have a broad measure of CG Gov-score prepared by Brown and Caylor (2004) with 51 factors, 8 sub categories for 2327 firms based on dataset of Institutional shareholder service (ISS). Their findings show that better governed firms are relatively more profitable, more valuable and pay cash to their shareholders. Gompers, Ishii and Metrick (2003) use Investor Responsibility Research Centre (IRRC) data and conclude that firms with fewer shareholder rights have lower firm valuations and lower stock returns. Their findings show that firms with stronger shareholders rights have higher firm value, higher profits, and higher sales growth. Lowest capital expenditures and made fewer corporate acquisitions.

It is expected that limiting board size is to improve firm performance because the benefits by larger boards of increased monitoring are outweighed by the poorer communication and decision making of larger groups (Limpton and Lorsch 1992; Jensen 1993). The study of

Yermack 1996 provides an inverse relation between board size and profitability, asset utilization, and Tobins Q.

Fosberg (1989) finds no relation between the proportion of outsider directors and various performance measures. In contrast, Baysinger and Butler 1985 and Rosenstein and Wyatt 1990 show that the market rewards firms for appointing outside directors; Brickley, Coles and Terry 1994, find a positive relation between the proportion of outsider directors and the stock market reaction to poison pill adoptions. The evidence on the association between audit related governance factors and firm performance is mixed. Brown and Caylor (2004) show that independent audit committees are positively related to dividend yield, but not to operating performance or firm valuation. They also find that the consulting fees paid to auditors less than audit fees paid to auditors are negatively related to performance measures and company has a formal policy on auditor rotation is positively related to return on equity but not to their performance measures. Klein (2002) documents a negative relation between earnings management and audit committee independence. Anderson *et al* 2004 finds that entirely independent audit committees have lower debt financial costs. However Ashbaugh *et al* 2003 and Larcker and Richardson 2004 come up with contradictory evidence.

The separation of CEO and chairman affects firm's performance because the agency problems are higher when the same person holds both positions Yermack (1996) Shows that firms' are more valuable when the CEO and board chair positions are separate by analyzing a sample of 452 US public firms' between 1984 and 1991. Core *et.al* 1999 find that CEO compensation is lower when the CEO and board chair positions are separate. Botosan and Plumlee (2001) find a material effect of expensing stock options on return of assets. Brown and Caylor on the other

hand come up with a contradictory conclusion and find no evidence that operating performance or firm valuation is positively related either to stock option expensing or to directors receiving some or all of their fees in stock

2.6 Financial Performance Measures

Performance evaluation of companies listed on the NSE may be done using Market based risk measures or accounting based measures. *Market based risk measures* take advantage of the information on the investors' expectations for the future contained in bonds and share prices. They are founded on assumptions as to the efficiency of the financial markets and as to whether the assets are sufficiently liquid for the price development to reflect information about the level of risk. In addition, market based indicators are influenced by general trends in the financial markets. *Accounting based measures* involve analysis and interpretation of financial statements that are historic and static in nature. Users are more concerned about what happened but more important about what will happen. The analysis and interpretation of financial statements assist users in predicting the future by means of comparison, evaluation and trend analysis (Okleahalam and Murinde 2004)

Ratios are the most commonly used in analyzing financial statements. Ratios are meaningful only when compared over time or with other companies, or within a particular industry. While no ratio is all encompassing, ratios can provide a basis on which to form a judgement (Cornett & Saunders 1999) Ratios may be classified into three broad categories; Short-term liquidity ratios also known as working capital management ratios, Long-term risk and Capital structure

ratios also known as leverage or debt management ratios, and operating efficiency ratio and profitability ratios. Financial Ratios have been used by different people in different ways; Investors use ratios to evaluate the stocks and bonds of various companies, managers use ratios for planning and evaluation of performance, ratios are used in identification and assessment of potential merger candidates, etc Mutisya (2006): Performance~measurement answers the question 'what has happened in a company?' Authors from different management disciplines tend to categorize the various performance indicators that are available as follows:

- Competitive advantage.....flexibility
- Financial performance.....resource utilization
- Quality of service.....innovation

Performance measures here would include relative market share and position, sales growth, profitability, liquidity, capital structure, market ratios, efficiency.

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Introduction

This chapter dealt with the various steps that facilitated execution of the study to satisfy the study objectives. These included; research design, population of interest, data collection instruments and procedures and data analysis.

3.2 Research design

The research was carried out through descriptive survey method. Mugenda and Mugenda (1999) noted that a descriptive research attempts to collect data from members of a population. It helps the researcher to get the description of existing phenomena by asking individuals about their perceptions, attitudes, behavior or values. Moreover, it explores the existing status of two or more variables at a given position in time; hence most suited in analyzing the general conditions of corporate governance practice and its relation to financial performance in Kenyan companies listed on the Nairobi stock exchange.

3.3 Population

The population of the research consisted of all the companies quoted at the Nairobi Stock Exchange over the period of the study from 2003 - 2006. This period was considered suitable because it was after CMA gazetted the Corporate Governance Guidelines for firms quoted on NSE. It is also the most current, thus data was easily available. Choice of

all companies listed in NSE gave this study a chance to look at all sectors of economy that is Agricultural, industrial, Financial and Investment and Service Sectors. A list of companies on Nairobi Stock Exchange as at 31st Dec 2006-was obtained. A census of companies quoted on the NSE during the period 2003 - 2006 was carried out, with exclusion of those companies suspended for whichever reason. This census study ensured that each company was given an equal opportunity of being interviewed.

3.4 Data Collection

Both primary and secondary data was used. Primary data was collected using a "drop and pick later" structured questionnaire. In the questionnaire both open ended and closed question were asked. Follow ups were made to ensure collection of the questionnaires was on time, as well as assist respondents in any difficulties encountered in completion of questionnaires. In each company, senior management staff or the Company secretary were required to fill the questionnaire. A structured questionnaire was used since it is easier to administer and analyze. Mugenda and Mugenda (1999) notes that a questionnaire is one of the best tools of collecting primary data. Secondary data was used to compute financial performance. The financial statements of individual companies were used to show the information on board size, executive and non executive directors, number of meetings per year, proportion of shares held by directors and major shareholders. Secondary data from NSE was also used to show the share price.

3.5 Data Analysis

Data was obtained from questionnaires filled by company secretaries or managers with sufficient knowledge of the corporate governance practices in the listed companies. The data was then analyzed using SPSS. The financial ratios[^]were calculated from the financial statements to evaluate performance. The financial statements also gave some guidance on elements of CG like the directors remuneration.

Regression analysis was applied to the data to examine the effect of various aspects of corporate governance on financial performance of companies. The independent variables were the CG guidelines like board size, proportion of inside directors, proportion of outside directors, number of meetings in a year, shareholding by directors.

CG as an independent variable **was** measured using **the** managerial perspective and content analysis. The dependent **variable**, corporate performance was measured using **the** ROA and MBV (Market based **value**). ROA was defined **forThe purpose of this study, as the net** profit after tax divided by **total** assets of the company. MBV is the ratio **of** market value **to** book value. It was arrived **at by** dividing the market value **of the** company by the book value of the same company.

CHAPTER FOUR

4.0 RESEARCH FINDINGS AND DISCUSSIONS

4.1 General Demographics

Thirty nine questionnaires were distributed during the study. By the close of the data collection twenty six questionnaires were received back fully filled. This represents a response rate of 67% and therefore falls within the range of other studies (Ondigo, 1996; Oyoo, 2002)

The analysis of the respondents firms was made on two issues namely sector and period in which the firms were first listed in the NSE. The sector with the highest representation was industrial and allied at 31%, commercial at 27%, Finance and investment at 19% and lastly agriculture and alternative investment segment at 11% each. The analysis of the respondents based on the sector is as summarized in table 1

Sector	Frequency	Percent %
Agriculture	3	12%
Commercial	7	27%
Finance & Investment	5	19%
Industrial & Allied	8	30%
Alternative Investment Segment	3	12%
Total	26	100%

Table 1: Respondent Based on Sector

(Source Research data)

The analysis of the respondents was further made on the basis of when the firms were incorporated. The majority of the firms, at 42% were set up before 1980, those incorporated between 1980 - 1990 at 27%, and the youngest between 1991 - 2000 at 31%. The cut off date for the study were those firms listed in the NSE as at 2003. Therefore those firms which were listed after the cut off period were not included in the study and thus not analyzed even though they might have been set up before this cut-off date. The analysis of the respondents firms based on age is given in table 2

Year of incorporation	Frequency	Percent (%)
Before 1980	11	42%
1980- 1990	7	27%
1991-2000	8	31%
Total	26	100%

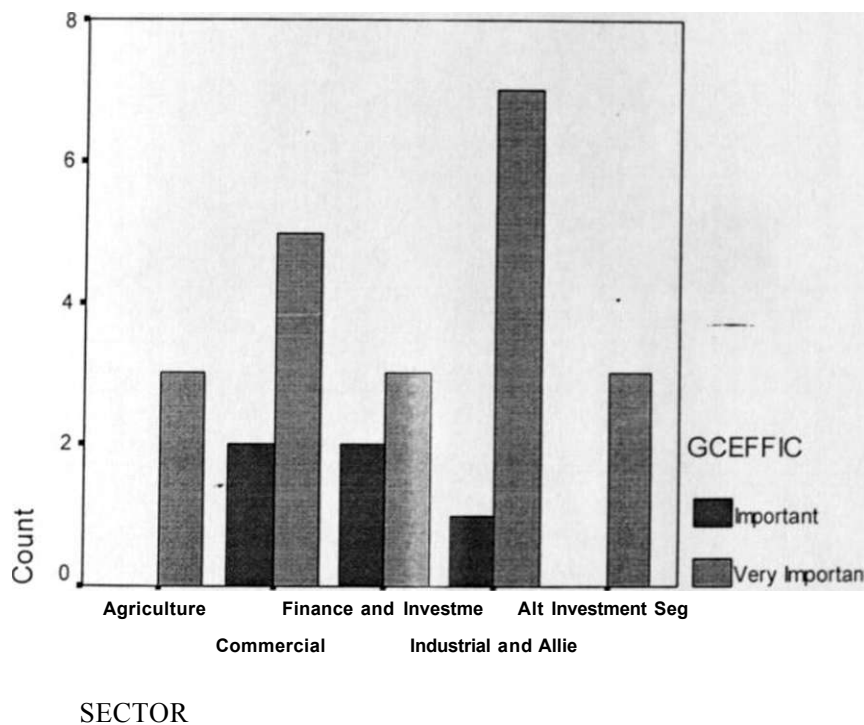
Table 2: Age of the respondent firms

4.2 Features of corporate government

Questionnaires were constructed to establish firms' understanding of the need for corporate governance structures. It is worth noting at this particular time that corporate governance has been a global issue and campaigns have been "mounted across the divide to propagate for the adoption of corporate governance structure. Kenya has not been an exception and in particular amongst the top corporate entities which are quoted in its stock exchange, NSE. This can be deduced from the response given by the firms which took part in the study. It is noted that all the respondents indicated that they have a policy and or strategy that address corporate governance issues. It is not only left in the books but the respondents make follow ups to test the working of the established procedures and policy.

All the respondents (100%) have established procedures for tracking and analyzing the effectiveness of their corporate governance practices. The foregoing condition is

reinforced by the respondents position on a number of issues related to the importance of corporate governance. The perception of the respondents on the importance of CG was reaffirmed with the acknowledgement of the ability of corporate governance to promote efficient, effective and sustainable corporations that contribute to the welfare of society, by creating wealth, employment and solutions to emerging challenges. The sector wise analysis of response indicates the importance of corporate governance as depicted in graph 4.01. All the respondents view CG as important.



Graph 4.01: efficient, Effective, and Sustainable Corporation

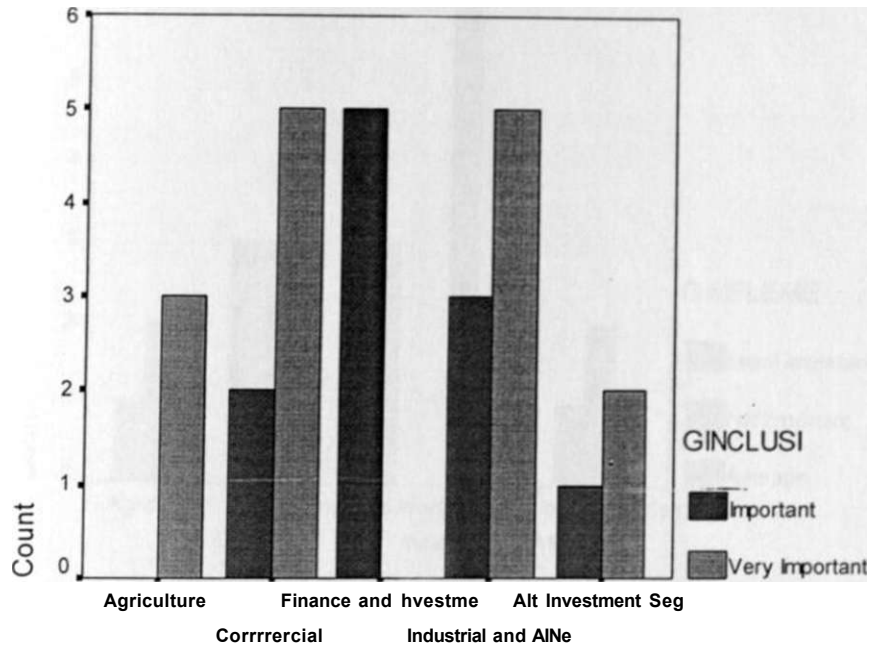
The separation of ownership from management creates the conflict between owners and management over pursuit of interest to be pursued - the owners or management. All the respondents viewed the issue of management with integrity, probity and transparency as a very important reason for developing corporate governance structures within an organization. The response on the degree of importance was overwhelmingly very important across the board. The response based on the sector is given in graph 4.02 and

Agriculture	Finance and Investment	Alt Investment Seg
	Commercial	Industrial and Allied

SECTOR

Graph 4.02: Integrity, probity and Transparency'

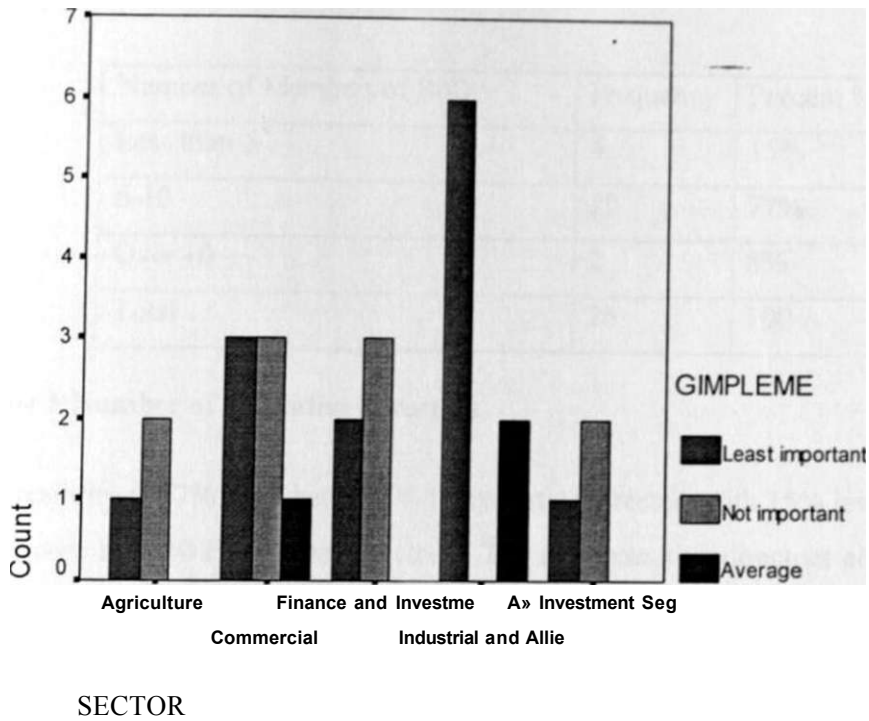
Stakeholders play different roles in the development and sustainability of organization in which they lay claim. The identification, recognition and protection of their rights are very important for the effective performance of the organization. The recognition and protection of stakeholders' rights is a critical issue that is addressed by corporate governance structures. The respondents across all the sectors viewed it as a very important issue addressed by corporate governance. This is also reinforced by the perception that corporate governance is an approach based on demonstration ideals, legitimate representation and participation. The response ranges from important to very important based on how high the respondents ranked the issue. The summary is represented in Graph 4.03.



SECTOR

Graph 4.03 Inclusiveness of Corporate Governance

The implementation of any program is normally affected by the cost and complexity of the mode. The issue of cost was addressed by funds being made available and that of complexity by capable personnel. The ranking of cost and complexity of implementation corporate governance received varied response from those who ranked it as being a least important factor to average. None of the respondents treated it as an important factor. This may be an indication of how the structures related to the development and implementation of corporate governance structures is concerned. The response is given in graph 4.04



Graph 4.04: Cost and Complexity of CG

4.3.1 Composition of Board of Directors(BOD)

Amongst the pillars of corporate governance is the composition of BOD which must not only contain a blend and mix from various backgrounds but their incorporation must reflect independence and processes perceived to be above board. Towards these requirements issues of executive directors versus non-executive directors, BOD meetings and appointments were scored. The analysis of the composition of the BOD was summarized in table 3 and 4 and table 5 and 6 respectively. The numbers of executive directors were given in the clusters as per table 3

Number of Members of BoD	Frequency	Percent %
Less than 5	4	15%
6-10	20	77%
Over 10	2	8%
Total	26	100

Table 3: Number of Executive Directors

The majority at 77% have between 6-10 executive directors with 15% less than 5, and 8% with more than 10 Executive Directors. The non-executive directors are assumed to be normally a lower percentage of the executive directors. The response indicate a continuity from the foregoing response with majority of respondents indicating that they have less than 5 non - executive directors being 92% and the rest with 8%. This confirms the response given on the position of the number of executive directors. The summary of response over the number of non-executive directors is as per table 4

Number of Non- Executive Directors	Frequency	Percent %
Less than 5	24	92%
6-10	2	8%
Total	26	100%

Table 4: Number of Non executive

When the response of the number of executive director is analyzed across the sector the response a similar distribution is found across all the sectors as per table 5

SECTOR	NUMBER OF EXECUTIVE DIRECTORS			
	Less than 5	6-10	Over 10	Total
Agriculture	0	3	0	3
Commercial	3	2	2	7
Finance and Investment	0	5	0	5
Industrial and Allied	1	7	0	8
Alt. investment Sector	0	3	0	3
Total	4	20	2	26

Table 5: Distribution of BOD on sector

4.3.2 : BOD Meetings

The Company Act Cap 486 stipulates /provide for various meetings for companies. The decision to hold board meetings depend on a number of issues and therefore the number varied from company to compan and year to year. Other factors aside, the normal number of meetings of the board seems to be three meetings per year. This cuts across all sectors. There is therefore no difference as provided by the statistics in table 6

	No	Min	Max	Mean	Std. Dev
Board meetings	26		3	3	00000

Table 6: BOD Meetings in a year

4.3.3 Appointment of the BOD

The guidelines provide for the best practice through the establishment of a nomination committee for members of the board. This is to ensure that those who have interest and capability to serve in the board are selected. The analysis of the response indicates that

this structure has been put in place and all the boards have a nomination committee. It is worth noting that whereas all systems might be in place for a well balanced BoD, the appointment as a member of BOD depends on ones shareholding position and relation with major shareholders. The present Kenya law (company Act) does not provide for the protection of the minority rights through special provision for appointment into the board.

The role of the chairman of the BOD and that of CEO has for some instances created conflict. The campaign has been to separate these roles and set clear guidelines on their areas of operations. The provision as per the roles of CEO and chairman is provided by the guidelines issued by the Capital Market Authority (CMA). The provision has totally been taken up as per the response received which indicates that there is a clear policy on the roles of chairman and the CEO. This is very important for effective management by CEO and the ability to evaluate performance.

4.4 Information

The supply of information to the BOD is very important as far as the decision making and performance evaluation is concerned. The need to cut down on information overload requires the adoption of the concept of management by exception (MOE). That is, only relevant information should be passed over to those at the top. The response indicate that the BoD is supplied by both financial and operational information that is relevant to them and where there is need to catch up with other non-critical operating information, the firms have web sites where the BoD may update themselves.

4.5 Shareholders' Relation

A major stakeholder in the management of the corporation is the shareholder. They bear the highest risk as they are the residual earners after all other claimants have been paid. The law (Cap 486) provides for an annual general meeting at least once a year. Notwithstanding this provision, there is also room for any extra ordinary meeting. Therefore, there is common feeling that normal AGM occurs only once a year due to cost and

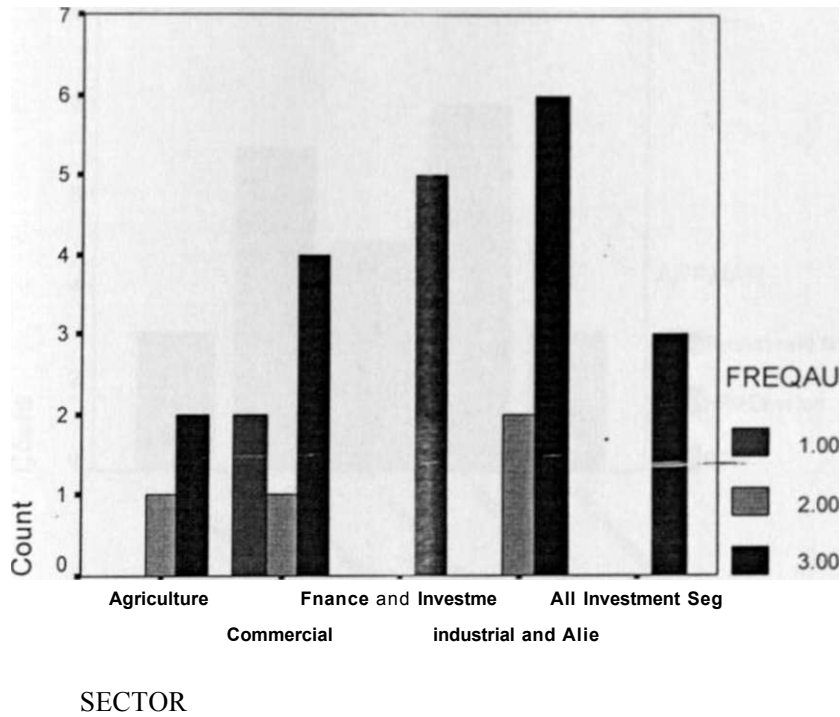
logistics involved. The cost of doing hard copy reports and the need for real-time information has seen the setting up of web sites where up to date information is posted regularly. The respondents have adopted the use of web sites apart from one - off advertisement on the print media as away of communicating with the shareholders and other stakeholders.

4.6.1: Accountability'and Audit

The Company Act (Cap 486) provides guidelines for auditing of companies. The Act also provide for the role of the auditor and the information content of published financial reports (annual report). There is clear separation of roles as far as the preparation and expression of opinion is concerned. The preparation of annual report is the role of the BOD and this responsibility must be disclosed. The published accounts of Public companies must contain both the BOD responsibility in the preparation of the report and statement of external auditor. These two responsibilities are requirements which have fully been met by all the respondents.

4.6.2 Internal Audit

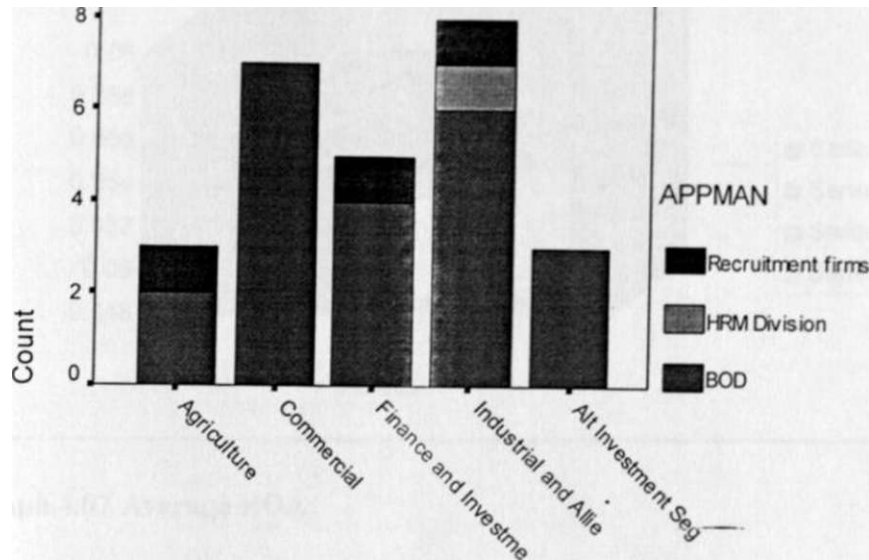
The Internal audit is to ensure compliance with internal control and management policies and to implement the recommendations made by the external auditor. The response indicate 100% compliance to the requirement for the establishment of audit function review of system of internal control and the establishment of board audit committees system annually. The response is summarized in graph 4.05



Graph: 4.05: Regularity of Review of Internal Controls

4.6.3 Management and Employees

Employees form a core pillar in the success of any organization. Their selection and placement is an important and necessary ingredient for the successful implementation and achievement of organizations. Clear guidelines must be provided on the role and conduct of employees. The recruitment is done by recruitment firms, HRM divisions and BOD response is as per graph 4.07



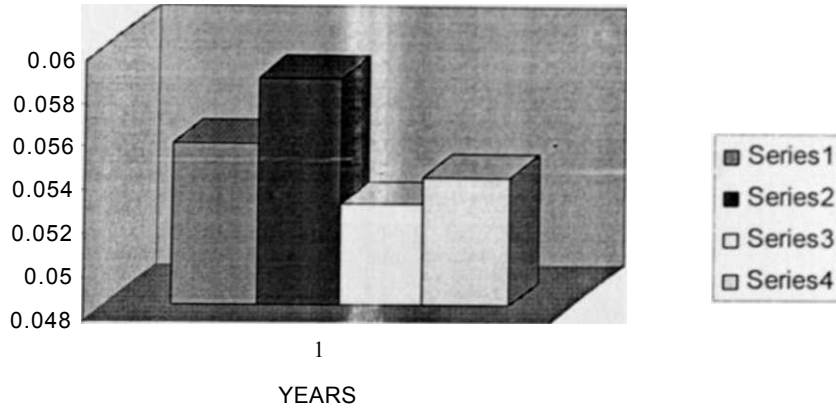
SECTOR

Graph 4.06 Recruitment Bodies

4.7 Analysis of the Return on Assets (ROA)

An analysis was made on the reported ROA over the period of 2003 to 2006 the latest date of filling financial reports. The analysis was made for each individual respondent followed by the averaging of all the firms that participated in the study. A standard deviation for the respondents was then calculated to establish whether there are any critical differences amongst the firms and periods of study. The average return on assets over the period of study indicates erratic pattern with unbalanced increase and decrease which picks up later in 2006. There is a remarkable increase in the year 2004 followed by a decrease in 2005. The average increase of ROA over the study period being 0.554 which is above average.

RETURN ON ASSETS



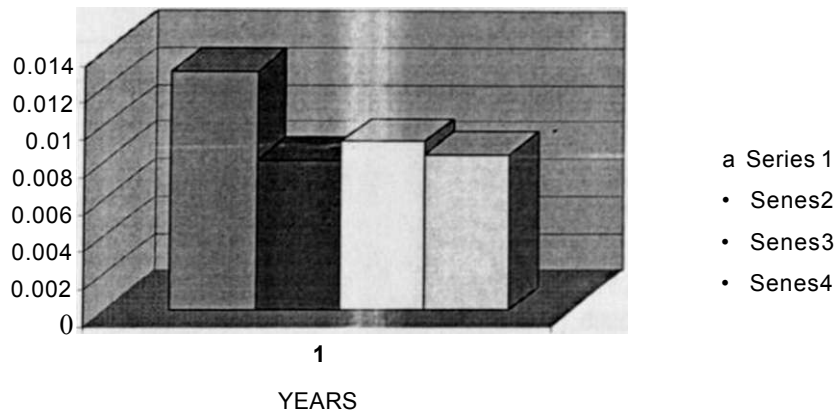
Graph.4.07 Average ROA

The data when subjected to further analysis using standard deviation indicate insignificant differences of the average means over time. The year 2003 reflect critical differences in reported average ROA which then stabilizes for the other remaining periods 2004-2006 with an insignificant volatility of 0.028 as reflected in table 4.06. The sector wise reflect same mean average with minor differences in terms of volatility in terms of sector variations.

SECTOR	Mean	N	Std. Deviation
Agriculture	.053000	3	.0240208
Commercial	.059714	7	.0089016
Finance and Investment	.053200	5	.0114543
Industrial and Allied	.053000	8	.0141926
Alt Investment Seg.	.058333	3	.0125831
Total	.055462	26	.0128444

Table 7: Average ROA and Standard Deviation

RETURN ON ASSETS(STANDARD DEVIATION)



Graph.4.08: ROA (Standard Deviation)

4.8 Market Based Value (MBV)

The market based value of the respondents has been on the increase over the period 2003-2006 with significant variation as reflected both in the average of MBV and computed standard deviations for the period (table 8 and Graph: 4.09)

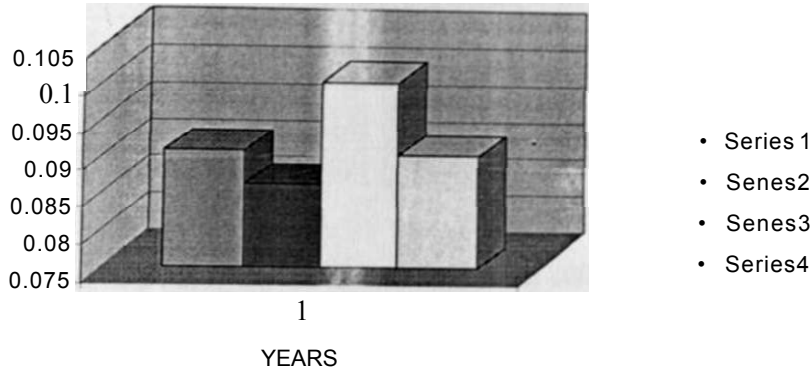
Report

SECTOR	1	MBV03	MBV04	MBV05	MBV06
Agriculture	Mean	543333	606667	670000	720000
	N	3	3	3	3
	Std Deviation	0862168	0702377	0854400	0608276
Commercial	Mean	532857	647143	680000	731429
	N	7	7	7	7
	Std. Deviation	0965599	.0782548	0892562	0958173
Finance and Investment	Mean	.600000	692000	738800	767400
	N	5	5	5	5
	Std Deviation	0930054	0990959	.1547811	1418936
Industrial and Allied	Mean	606250	658750	.707000	749750
	N	8	8	8	8
	Std Deviation	1025305	.1011982	0963209	0781605
Alt Investment Seg	Mean	.570000	608000	640000	693333
	.N	3	3	3	3
	Std Deviation	0200000	.0628649	0529150	0513160
Total	Mean	.573846	650154	693846	738269
	N	26	26	26	26
	Std Deviation	0908219	0862312	.1004007	0902741

Table 8 Average MBV

(Key: MBV03: market based value for 2003)

MARKET BASED VALUE(STANDARD DEVIATION)



Graph 4.09: MBV Standard Deviation

4.9 Regression Analysis

A regression analysis was then carried out between the various components of CG and performance indicators for each item. Return on Assets (ROA) and Market Based Value (MBV) were regressed against items of Corporate Governance. The result indicates that there is no critical difference amongst the various aspects of CG when looked at from the perspective of the performance indicators.

CG/ROA	ROA 03	ROA 04	ROA 05	ROA 06	Average
Meetings	0.110	0.085	0.07371	0.068903	0.084403
Ext Directors	0.103	0.080	0.070	0.065811	0.079703
Internal Directors	0.094	0.0827	0.068	0.070707	0.078852
Independent Audit	0.114	0.0917	0.096	0.087192	0.097223
Financial Reporting	0.114	0.030	0.009	-0.03453	0.029618
Appointment Of Management	0.0303	0.049610976	0.079	0.046223	0.051283
Average	0.09486	0.070118063	0.06635	0.050718	

Table 9: Regression Analysis based on ROA from 2003 to 2006

CG/MBV	MBV 03	MBV 04	MBV 05	MBV 06	Average
Meetings	0.18002	0325929	0400986	0110692	0.254407
Ext Directors	-0.1687	-0.09269	028162	0103899	0.031032
Internal Directors	0.19644	0.358884	0437729	0479501	0.368139
Independent Audit	04617	0.621153	0899755	0.907991	0.72265
Financial Reporting	049368	0.648435	0.427391	0.53413	0.525909
Appointment Of Management	-0.00437	0.247473	0.28162	0.279188	0.200853
Average	0.193043221	0.35153	0.45485	0.402567	

"Table 10: Regression Analysis based on MBV from 2003 to 2006.

Meetings per year was found to be significant when using the Market to Book Value and less significant with Return on assets. This shows number of meetings as an important aspect of performance. When performance was measured using MBV, the proportion of external directors was less significant than the proportion of internal directors. When using ROA both internal and external directors had almost-the same not so significant impact. Independent audits were highly significant using both ROA and MBV compared to other factors of corporate governance. This makes it a major factor using both measures of performance. Both financial reporting and appointment of management had significance using MBV than ROA.

CHAPTER FIVE

5.0 SUMMARY OF FINDING'S, CONCLUSIONS AND RECOMMENDATIONS

5.1 Discussion

The provision of corporate governance guidelines by the CMA and the adoption of the same by listed companies at the NSE have witnessed a number of positive aspects in the management of public corporations in Kenya. The understanding of the need and importance of the said guidelines by the companies in general encouraged as that all the respondents observed and acknowledged this critical tool of management. Observed is the need to institutionalize the concept of non executive directors who at this point in time are appointed based on their relationship with the substantial shareholders. The overall adoption of the guidelines as observed above is near perfect or to say perfect.

The overall corporate performance has also been on the increase in terms of reported profits with the financial institutions on the lead. This may be attributed to a number of factors key amongst them being the adoption of CG guidelines. The Kenyan economy has also witnessed growth that has been in the range of 10%. The activities at the NSE have also been on the increase with reported NSE index going high within this period of 2003-2006.

Whereas the BOD have been in the fore front in the process of adopting given codes, the management too have brought in the bracket of changes envisaged as critical to corporate management. One area that has witnessed change is the recruitment and placement that is being conducted by independent recruitment firms. This not only enables the right selection and placement of capable individuals but also ensures non participation by management which may influence the selection and placement

5.2 Conclusion

It can be concluded from this study that all the companies listed at NSE have implemented the CMA guidelines on CG. It can also be concluded that the performance of the listed companies at the NSE has been on the increase. The market value and return on asset being the indicators for the improvement. It can also be concluded that the increase in performance can be partly attributed to the adoption of the CG guidelines, the size of the Boards, proportion of outside directors, and the number of meetings in a year. Therefore these independent variables taken for the study can be authoritatively cited as key determinants of the improved performance as all the categories reported increased performance across these variables.

5.3 Recommendation for further research

- Recommendation for further research

Further research should be carried out to determine the composition of audit committees in terms of their background (academic and areas of specialization) shareholding, and duration that they have taken in the Board.

Further study need to be taken on the external auditors of the listed companies to establish how many companies they audit and the number of years they have taken in each company.

- Recommendation for Practice

The companies should incorporate policies that allow shareholders with insignificant shareholding to be incorporated into the Boards and to allow more interactive session with the other stakeholders through the development of web sites where more information about the operation of the companies are posted regularly.

5.4 Limitation of the Study

One major limitation of the study was time which had a bearing on the feedback that resulted in some companies failing to send back their questionnaires back. Further the

overall performance of the corporations depend on a number of factors that range from the products that they sell, the management team to the performance of the economy in general. Therefore the adoption of CG cannot be singly tied to the performance of an organization. It (CG) can be said to be part but the cause and effect relationship cannot be authoritatively be traced to performance.

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QUESTIONNAIRE

Please answer the following questions according to instructions given.

1 .Name of company and year of establishment

2.Which sector? () Commercial & Services () Agricultural () Industrial and Allied () Finance and Investment () Alternative Investment Market

3.Does your company have a policy or strategy that addresses corporate governance issues? () Yes () No

4.Does your firm have a procedure for tracking and analyzing the effectiveness of your corporate governance practices? () Yes ()No

5.In your opinion which of the following statements are true about good corporate governance? (Rank in order of the degree using the scale of 1-5 with 1 being the least important and the most important).

a.It seeks to promote efficient, effective and sustainable corporations that contribute to the welfare of society, by creating wealth, employment and solutions to emerging challenges. ()

b.Creates legitimate corporations that are managed with integrity, probity and transparency. ()

c.Helps in recognition and protection of stakeholder right ()

d.It's an inclusive approach based on democratic ideals, legitimate representation and participation. ()

e.Though important, it's difficult to implement due to its complexity and the cost involved. ()

The following statements are indicators of factors that favor good corporate governance practices.

Board of Directors

6. How many members constitute your board?

a.Executive Directors

b.Non-Executive Directors

7. How often are board meetings held in a year?

Once () Twice () Thrice () other () (please specify)

8. How many meetings of the full board were held during the past financial year?

9. How is the issue of less quorum addressed during board meetings where decisions have to be made?

10. What matters are reserved for the board

a) .

b) —

11. How do you ensure that there is no conflict of interest among the directors' private business *Viz. a Vis* that of the organization with regard to?

Strategy
Performance
Resources
Standards of Conduct

Appointment to the Board

12. Is there a nomination committee for members of the board?
Yes () No ()
If yes, what is the committee's terms of reference?
13. If there is no nomination committee, what is the procedure for appointing members to the board?

Chairman and Chief Executive Officer

14. Who appoints the CEO?
15. Is there a corporate policy to combine the roles of Chairman and the CEO? Yes ()
No ()
16. What factors does the Board consider when assessing the performance of the CEO?
(a)
(b)
(c)

Supply of Information

17. What kind of strategic information does management supply to the board Financial ()
Operational () Other (specify)
18. How often is this information relayed to the board?
Once a year () Twice () Other (specify) :

Share Holder Relationship

19. How often do you hold general meetings annually?
Once () Twice () Other (Specify)
20. How do you ensure effective shareholder communication apart from holding the general meetings?
21. How many meeting are held with institutional shareholders to exchange views and information on;
Strategy
Performance
Board membership

Accountability and Audit

Financial reporting

22. Does the annual report contain a statement on directors' responsibility for preparing the accounts? Yes () No ()
23. Does the annual report contain a statement on external auditors reporting responsibility? Yes () No ()

Internal Audit

24. Is there an internal audit function? Yes () No ()
25. Do the directors review the effectiveness of the company's system internal control? Yes () No ()
26. If the answer above is yes, how often are internal controls reviewed? Once a year () Twice () other ()
27. Does the board have an audit committee? Yes () No ()

Management and Employees

28. Who is responsible for appointing the managers of the company?.....:
29. Does the organization have a clear and written down code of conduct? Yes () No ()
30. What are the key focus points of mission statement?
- a) Customers
 - b) Quality
 - c) Wealth maximization for shareholders
 - d) Others
31. Please outline any challenges that your organization is facing to implement the corporate governance policies as regards the following:
- a) Shareholders
 - b) Middle level management.
 - c) Employees
 - d) Government
 - e) Board of Directors
 - f) Creditors

Regression

Variables Entered/Removed^f

Model	Variables Entered	Variables Removed	Method
1	EXT.MEET		Enter

a All requested variables entered

^b Dependent Variable: RQA03

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.503 ^a	.253	.222	.0113285

a Predictors: (Constant), EXT.MEET

ANOVA^f

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.001	1	.001	8.138	.009 ³
	Residual	.003	24	.000		
	Total	.004	25			

a Predictors: (Constant), EXT.MEET

^t Dependent Variable: RQA03

Coefficients³

Model		Unstandardized Coefficient		Standardized Coefficients	~ t	Sig
		B	Std. Error	Beta		
1	(Constant)	.111	.019		5.680	.000
	EXT.MEET	-.001	.000	-.503	-2.853	.009

a- Dependent Variable: RQA03

Regression

Variables Entered/Removed^f

Model	Variables Entered	Variables Removed	Method
1	EXT.MEET	.	Enter

a All requested variables entered

b- Dependent Variable: RQA04

Model Summary

Model	R	R Square	Adjusted R Square	Std Error of the Estimate
1	.398 ^a	.159	.124	.0075481

a Predictors: (Constant), EXT MEET

ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.000	1	.000	4526	.044 ^a
	Residual	.001	24	.000		
	Total	.002	25			

a. Predictors: (Constant), EXT.MEET

b Dependent Variable: RQA04

Coefficients?

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.086	.013		6.618	.000
	EXT.MEET	.000	.000	-.398	-2.127	.044

a Dependent Variable: RQA04

Regression

Variables Entered/Removed

Model	Variables Entered	Variables Removed	Method
1	EXT.MEET		Enter

^a All requested variables entered,

b Dependent Variable: RQA05

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.270 ^a	.073	.034	.0089415

a. Predictors: (Constant), EXT.MEET

ANOVA^f

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.000	1	.000	1.892	.182 ^a
	Residual	.002	24	.000		
	Total	.002	25			

a. Predictors: (Constant), EXT MEET

b. Dependent Variable: ROAQ5

Coefficients³

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.074	.015		4.792	.000
	EXT.MEET	.000	.000	-.270	-1.375	.182

a. Dependent Variable: RQA05

Regression

Variables Entered/Removed

Model	Variables Entered	Variables Removed	Method
1	EXT.MEET		Enter

^a- All requested variables entered,

b. Dependent Variable: RQA06