THE EFFECT OF CORPORATE GOVERNANCE ON FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN NAIROBI COUNTY, KENYA

BY:

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DECLARATION

I declare that this project is my original work and has not been submitted for an award of a degree in any other university or Institution of Higher Learning for examination/academic purposes.

Signature……………………..…….. Date ……………………………………

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REG NO: D61/75598/2012

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

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DEDICATION

This project is dedicated to my Family members. My loving husband Pastor Dan Abuya for having encouraged and supported me throughout the entire period. My late mother Esther Kemunto and father Walter Nyawina with whom I would have loved to share my success with. My uncles and aunts for giving me the chance to study. My siblings Eddy, Omondi and Sharon for always being there for me.

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LIST OF ABBREVIATION

ANOVA- Analysis of Variance

BoD- Board of Directors

CEO- Chief Executive Officer

CSR- Corporate Social Responsibility

GCI- Global Corporate Index

GDP- Gross Domestic Product

ILO- International Labor Organization

IRA- Insurance Regulatory Authority

LDCs- Less developed Countries

MSMEs- Micro-Small and Medium Enterprises

NSE- Nairobi Stock Exchange

PR- Public Relations

R&D- Research and Development

ROA - Return on Assets

SACCO- Savings and Credit Cooperative Organizations

SASRA- Sacco Societies Regulatory Authority

SMEs- Small and Medium Enterprises

SPSS- Statistical Package for the Social Science

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ABSTRACT

The SME sector in Kenya has undergone tremendous growth and transformation oyer the past and has come out as the most active sector in the Kenyan economy. Currently, Kenyan SMEs are responsible for about 80% of employment and contributes about 40% of the GDP. However, due to the dynamic nature of the business environment, SMEs are adopting the corporate governance practices in order to maintain a competitive edge in the market. Corporate governance is the means by which an organization is directed and controlled and held accountable. In this regard, it has been noted that well governed firms largely perform better and that good corporate governance practices is of essence to any firm’s financial performance. The main objective of this study was to investigate the effect of corporate governance on financial performance of Small and Medium Enterprises in Nairobi County, Kenya. Specifically, the study examined existence of the various corporate governance practices in the sampled SMEs in Nairobi County such as CEO duality, size of the board, number of board sub-committees, number of subcommittee meetings and size! age of the SMEs and how they affect their financial performance. The performance of SMEs was measured using Return on Assets (ROA).The study adopted descriptive research design. The population included all the SMEs in Nairobi County operating as at 30th December 2013 and a sample from each category of business was identified and used to collect information. The study made use of primary data collected using the questionnaires. Data was analyzed using a multiple linear regression model. The study found that there is a significant strong relationship between the SME’s financial performance and corporate governance. The number of Board meetings, number of board sub-committees’ meetings, and the size!age of the SMEs were found to significantly affect the financial performance of SMEs in a positive direction. The CEO duality was however noted to be common in most SMEs. The study recommends that the government of Kenya be supportive to the SMEs by providing incentives to help them in implementing the corporate governance practices. SMEs are also encouraged to embrace corporate governance to the fullest to achieve better financial performance. SMEs are also recommended to consider financial monitoring to be done by the board of managers and board sub-committees. The board and managers also need to be enlightened on the importance of corporate governance.

CHAPTER ONE
INTRODUCTION

1.1. Background of the Study

Small and Medium Enterprises (SMEs) are significant in the development of any country's economy, especially the LDCs where Kenya is part. The SME sector in Kenya has undergone tremendous growth and transformation over the past and has come out as the most active sector in the Kenyan economy. According to the Economic Survey (2006), the SME sector in Kenya contributed to over 50 percent of all the jobs created in the year 2005. Currently, Kenyan SMEs are responsible for about 80% of employment and contributes about 40% to GDP. The business environment has improved significantly and, in the process, unlocked the great potential of the business community. As the East African common market is put into operation, business opportunities are likely to follow. In all this, SMEs stand to benefit immensely. Therefore, the growth of the Kenyan economy lies on the performance and growth of the SMEs.

However, mostly, people perceive small businesses as lacking the ability to provide quality services and are unable to satisfy more than one critical project simultaneously due to their size and governance practices. Often, larger companies are selected and given business for their clout in the industry and name recognition alone. It is therefore vital that all stakeholders of the economy – the government, banking and finance community, the industry & business bodies and SME service providers collaborate to enable the growth and sustainability of our SMEs. Starting and operating a small business includes a possibility of success as well as failure. Because of their small size, a simple management mistake is likely to lead to sure death of a small enterprise hence no opportunity to learn from its past mistakes (Mead 1998).

One critical enabling factor for SME development and enhanced financial performance is corporate governance. Indeed, practicing good governance will help SMEs establish robust business processes and prepare them for future expansion. Corporate governance lays the foundation for SMEs to be more accountable and transparent in their operations, thus enabling them to be more bankable and investable. Corporate Governance is ultimately concerned with the decision-making processes, procedures, and attitudes that assist the company in achieving its objectives. The understanding and implementation of a good corporate governance framework presents SMEs a structured path to better management practices, effective oversight and control mechanisms which lead to opportunities for growth, financing and improved performance (Ndagu & Obuobi, 2010).

Corporate governance is a concept that involves practices that entail the organization of management and control of companies. It is the means by which an organization is directed and controlled. In broad terms, corporate governance refers to the processes by which organizations are directed, controlled and held accountable. Corporate governance encompasses authority, accountability, stewardship, leadership, direction and control exercised in corporations. It reflects the interaction among those persons and groups, which provide resources to the company and contribute to its performance such as shareholders, employees, creditors, long-term suppliers and subcontractors (Brownbridge, 2007).

1.1.1. Corporate Governance

The concept of corporate governance began to be used and spoken of more commonly in the 1980s (Parker, 1996) but it originated in the Nineteenth Century when incorporation was being advocated for as a way of limiting liability (Fletcher, 1996; Vinten, 2001). Adams (2002) perceives creation of the registered company to be the real starting point for any discussion on corporate governance. According to Francis (2000) the concept of corporate governance gained prominence in the 1980s because this period was characterized by stock market crashes in different parts of the world and failure of some corporations due to poor governance practices. Corporate collapse was the predominant driver for change to corporate governance codes (United Nations, 1999). As more corporate entities in different parts of the world collapsed in 1980s, there was a change of attitude with much higher performance expectations being placed on management sub-committees of firms. There was also a growing realization that managers are to run firms while sub-committees are to ensure that firms are run effectively and in the right direction

(Adams, 2002). Directors and managers require different sets of skills and managers do not necessarily make good directors.

A large number of definitions of corporate governance have been advanced through the years. The traditional definition is related to the protection of shareholder's interests Tirole (2001) and has roots in the issue of separation between management and control. Monks and Minow (1995) maintain that corporate governance studies the relationship among various participants in determining the direction and performance of corporations. Bauer et al., (2004) defined Corporate governance as the process and structure used to direct and manage business affairs of an entity/firm towards enhancing prosperity and corporate accounting with the ultimate objective of realizing shareholders long-term value while taking into account the interest of other stakeholders. Corporate governance may thus be perceived as the set of interlocking rules by which corporations, shareholders and management govern their behavior. These rules refer to individual firm attributes and the factors that allow companies to maintain sound governance practices even where public and private institutions are relatively weak.

There are two key approaches to good corporate governance as shareholders' approach and stakeholders' approach. In shareholders' approach, the Sub-committee of Directors and managers are appointed to represent the interests of shareholders. The BoD is required to act in utmost good faith whilst conducting business agendas; they must be transparent in concluding business transactions. Stakeholders' approach on the other hand takes a broader perspective as being customer oriented and values all the stakeholders of the firm, their employees and suppliers at the same time respecting the community in which they operate in. The principal players are the shareholders, management and the sub-committee of directors. Other stakeholders include employees, suppliers, customers, bankers and other lenders, regulators, the environment and the community at large (Klapper and Love, 2003).

1.1.2. Financial Performance

Financial performance is a measure of how well a firm can use assets from its primary mode of business and generate revenues. The term is also used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. A firm’s financial performance is a measure of how well a firm uses its assets from its core operations and generates revenues over a given period of time. This measure is thus compared to some given industrial average standard of similar firms in the same industry. Brealey et al. (2009) indicate that financial performance can be measured in terms of profitability, liquidity, solvency, financial efficiency and repayment capacity. Profitability is the measures of the profit generated by a firm through the use of its productive assets; liquidity measures the ability of a firm to meet its obligations when they fall due; solvency measures a firm ability to pay all its financial obligations if all of its assets are sold. Therefore, a firm financial performance can be measured using net income or net operating income, its assets performance or even its cash flows.

Kaplan (2001) noted that that accountability is key in ensuring that organizations achieve the level of performance that is in line with their strategic objectives. He further stated that most organizations traditionally measured their overall performance using financial performance. However, most companies have recently recognized that financial measurements by themselves are inadequate and limited for measuring and managing their performance since the financial reports measure past performance and communicate little about long-term value creation. Kaplan and Norton (1996) came up with the Balanced Scorecard to assist in measuring performance for private sector organizations. Their new system retained financial measurements but complemented these with measures from three other perspectives: that of the customer, the internal process, and learning and growth. Yacuzzi (2005) agrees that performance measures have traditionally been financial. However, over time, they are being considered insufficient by themselves. One of the strongest concerns is that financial reporting often does no support investment in new technologies and markets, and this investment is required for enterprise advancement.

The financial performance of institutions is usually measured using a combination of financial ratios analysis, benchmarking, measuring performance against budget or a mix of these methodologies. The common assumption, which underpins much of the financial performance research and discussion, is that increasing financial performance was lead to improved functions and activities of the organizations. The subject of financial performance and research into its measurement is well advanced within finance and management fields. It can be argued that there are three principal factors to improve financial performance for financial institutions; the institution size, its asset management, and the operational efficiency (Foerster and Huen, 2004).In this study, the objective is to establish the effect of Corporate governance practices on the financial performance of SMEs and thus, the organizational performance was be limited on the financial perspective. The financial performance of the SMEs was be measured in terms of ROA and compared over time.

1.1.3: Effect of Corporate Governance on Financial Performance

The governance structure of any corporate entity affects the firm's ability to respond to external factors that have some bearing on its financial performance. Corporate governance is a concept, involves practices that entails the organization of management and control of companies. It reflects the interaction among those persons and groups, which provide resources to the company and contribute to its performance (Brownbridge, 2007). Brown and Caylor (2004) provide insights to relationships between good corporate governance and corporate performance. Research indicates that companies with better corporate governance guarantee the payback to the shareholder and limit the risk of the investment (Brownbridge, 2007).

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

Jensen and Meckling (1976) have proven that better-governed firms might have more efficient operations, resulting in a higher expected future cash-flow stream. Klapper and Love (2002) argued that use of return on assets as measure for performance found evidence that firms with better governance have higher operating performance. Contrast results are seen in Gompers et al. (2003) who found no significant relationship between firms' governance and operating performance. Mak and Yuanto (2003) re-echo the above findings in firms listed in Singapore and Malaysia when they found that firm valuation is highest when a sub-committee has five directors, a number considered relatively small in those markets. According to them, company would enhance their corporate governance when the company's performance is poor because changes in corporate governance structure are expected to bring out positive result on their performance.
In this study, the aim is to establish the corporate governance practices in the SMEs and their ultimate effects on the firms' financial performance. The practices to be considered include the size of the sub-committee, CEO duality, number of Sub-committee meetings and the number of sub-committees within the firm.

1.1.4. SMEs in Nairobi County

An enterprise is defined as any organized effort intended to return a profit or economic outcome through the provision of services or products to an outside group (Carland, Hoy, Boulton & Carland, 1983). Its operation requires the investment of capital and time in creating, expanding or improving the operations of a business (Meredith, 2001). The Small and Medium Enterprises are businesses in both formal and informal sector employing 1-50 workers (Rok, 2009). These enterprises cut across all sectors of employment and provide one of the major sources of employment, income generation and poverty reduction (Rok, 2009). The SME sector in Kenya accounts for 80% of the total persons engaged in employment (Rok, 2009). The importance and contribution of SMEs to achieving macroeconomic goals of nations, especially in developing nations, has attracted the attention of scholars in the entrepreneurship discipline in recent years.

In Kenya, SMEs are generally known for their labor intensive activities and also for their use of local resources. Support for SMEs is a common theme because it is recognized that SMEs contribute to the national and international economic growth. According to Kenya Economic Survey (RoK, 2008) , out of the total 543.3 new jobs created in Kenya in the year 2009, Micro, Small and Medium Enterprises (MSMEs) created 426.9 of them. This was 89.9% of the total new jobs created in Kenya that year. In the same year, the sector contributed KSh. 806,170 million of GDP which is 59 percent of total Gross Domestic Product (RoK, 2009). The Kenya economic survey (2010), notes that this same sector generated 390.4 thousand new jobs which translated into 87.6 percent of the total jobs generated in 2009. Most countries, Kenya included, cluster small and medium enterprises based on employment. (Sessional Paper No. 2, 1992). According to the sessional paper No.2 of (2005), SMEs have high mortality rates with most of them not surviving to see beyond their third anniversaries. This indicates that SMEs have inherent problems either in their internal environment or from the external environment that makes them fail. Currently there are 4,560 registered SMEs operating within Nairobi County in both service and manufacturing sector.

1.2. Research Problem

Corporate governance has received much attention in the accounting literature, with studies focusing on the impact of corporate governance and the financial performance of the firm. Jensen and Meckling (1976), Klapper and Love (2002), Mak and Yuanto (2003) in their studies have proven that better-governed firms might have more efficient operations, resulting in a higher expected future cash-flow stream. According to Cho and Kim (2003), company would enhance their corporate governance when the company's performance is poor because changes in corporate governance structure are expected to bring out positive result on their performance. Brown and Caylor (2004) provide insights to relationships between good corporate governance and financial performance. Research indicates that companies with better corporate governance guarantee the payback to the shareholder and limit the risk of the investment. The association between quality of corporate governance and firms' profitability is quite major focus in corporate governance studies.

In Kenya, SMEs play a vital role in economic development, as they have been the main source of employment generation and output growth. However, the SME sector in Kenya is unique and different from its large counterparts that operate within the country having regulatory bodies. For example, banks in Kenya are regulated by a corporate entity called Kenya Bankers Association (KBA) while insurance companies operating within the country are regulated by Insurance Regulatory Authority (IRA), SME'Ss on the other hand has SASRA as the regulator while public parastatals are regulated by the various Acts of Parliament that formed them. Companies are generally regulated by the Companies act within Kenya. This formal system of regulation is lacking in the SMEs sector in Kenya. Likewise, the sector unlike its counterparts, are mostly family owned and therefore, there is CEO duality. SMEs in Kenya also face limited financing due to their small size as well as non listing in the NSE and thus, most of them may lack the formal management system as well as most of the corporate governance practices existing in the large businesses. One critical enabling factor for SME development in Kenya is corporate governance Indeed, practicing good governance was help SMEs establish robust business processes and prepare them for future expansion.

Locally, Jebet (2001) conducted a study of corporate governances the case of quoted companies in Kenya, the study found that corporate governance practices were positively correlated to the performance of the companies. Manyuru (2005) researched on corporate governance and organizational performance of companies quoted at the NSE and found that separation of ownership and control maximizes shareholders wealth while Ngugi (2007) did a study on the relationship between corporate governance structures and the performance of insurance companies in Kenya and noted that inside directors are more familiar with the firm's activities and they can act as monitors to top management especially if they perceive the opportunity to advance into positions held by incompetent executives. Matengo (2008) conducted a study on the relationship between corporate governance practices and performance of banking industries in Kenya. The studies found that good corporate governance was lead to lower firm risk and subsequently to a lower cost of capital.

Despite the numerous studies in corporate governance, there still exists a gap that has necessitated this particular research. There is no known specific research that has tried to investigate the effect of corporate governance on the performance of SMEs in Kenya addressing their unique characteristics. This study was therefore seek to address this research gap by providing answers to the questions; does corporate governance exist in SMEs and to what extent is the effect of corporate governance on financial performance of SMEs in Kenya?

1.3 Objective of the Study

The general objective of the study was determine the effect of corporate governance on the financial performance of SMEs in Nairobi County, Kenya.

1.3.1 Specific Objectives

From the above general objective, the following specific objectives were derived.

i) To establish the effect of CEO duality on the financial performance of SMEs in Kenya.

ii) To assess the effect of the size of the sub-committee on the financial performance of SMEs in Kenya.

iii) To determine the relationship between number of sub-committee meetings and the financial performance of SMEs in Kenya.

iv) To determine the effect of the sub-committees on the financial performance of the SMEs in Kenya.

1.4 Value of Study

Policymakers at the various levels of management of the SMEs will gain value added information on the corporate governance practices as applicable in the SMEs in Kenya. They will also benefit from the findings of this study by adopting findings which will help them enhance responsible governance which leads to sustained productivity and better financial performance as well as, come up with the tailored corporate governance principles applicable to the them. This will also assist the government to improve on areas that negatively impact corporate governance implementation in SMEs in Kenya in order to enhance performance.

The study will provide information to subject scholars and academicians with regard to the relationship between corporate governance and financial performance of the SMEs. In addition, researchers will be able to gain additional knowledge from the study given that it is focusing on a several SMEs that operate within Nairobi. Future researchers and academic institutions, especially those of higher learning can use the findings of this research as a source of future reference and also to identify further research gaps to be undertaken in the future.

CHAPTER TWO

LITERATURE REVIEW

2.1. Introduction

This chapter summarizes the information from other researchers who have carried out research in the same field of study. The specific areas covered here are theoretical review of Agency theory, Stewardship theory and Stakeholder theory, empirical review and summary of literature review.

2.2. Theoretical Review

The area of corporate governance was mainly developed within financial literature, however, it has become of great interest to different fields of study such as law researchers, economists, political scientists, sociologists and management science specialists. There are three main theories that describe corporate governance in institutions and they include the Agency theory, the Stewardship theory and the Stakeholder theory. These theories attempt to explain how managers in an organization are governed and not how they govern in an attempt to achieving their goals and objectives. (Gerard, 2004)

2.2.1. Agency Theory

Jensen and Meckling (1976) proposed the agency theory based on the conflict of interest of the various contracting parties within an organization such as the shareholders and the corporate managers. They defined the agency relationship as a contract under which one party (the principal) engages another party (the agent) to perform some service on their behalf. As part of this, the principal will delegate some decision-making authority to the agent. Agency theory explains how best the relationship between agents and principals can be tapped for purposes of governing a corporation to realize its goals. Interest on agency relationships became more prominent with the emergence of the large corporation. Since the owners of capital (principals) have neither the requisite expertise nor time to effectively run their enterprises, they hand them over to agents (managers) for control and day-to-day operations, hence, the separation of ownership from control, and the attendant agency problems of the enterprise.

McColgan (2001) argues that the scope of each type of agency conflict will differ from one firm to another, as was the effectiveness of governance mechanisms in reducing them. What is required is a more detailed understanding of what makes these mechanisms important for some firms and ineffective for others.

Historically, definitions of corporate governance also took into consideration the relationship between the shareholder and the company, as per "agency theory", i.e. director-agents acting on behalf of shareholder-principals in overseeing self-serving behaviors of management. However, broader definitions of corporate governance are now attracting greater attention. Indeed, effective corporate governance is currently understood as involving a wide number of participants. The primary participants are management, shareholders and the sub-committees of directors, but other key players whose interests are affected by the corporation are employees, suppliers, customers, partners and the general community and thus, applicable to the SMEs (Solomon and Solomon, 2004).

2.2.2. Stewardship Theory

In the stewardship model, managers are good stewards of the corporations and diligently work to attain high levels of corporate profit and shareholders returns (Donaldson & Davis 1994). Stewardship theory addresses the underlying agency theory assumption that there is a tension between the risk propensity of principals and their agents whereby agents focus their actions upon mitigating their personal risk at the expense of their principals. Unlike agency theory, stewardship theory assumes that managers are stewards whose behaviors are aligned with the objectives of their principals. The theory argues and looks at a different form of motivation for managers drawn from organizational theory. Managers are viewed as loyal to the company and interested in achieving high performance. Stewardship Theory places greater value on goal convergence among the parties involved in corporate governance than on the agent's self-interest (Van Slyke, 2006). The dominant motive, which directs managers to accomplish their job, is their desire to perform excellently. Specifically, managers are conceived as being motivated by a need to achieve, to gain intrinsic satisfaction through successfully performing inherently challenging work, to exercise responsibility and authority, and thereby to gain recognition from peers and bosses. Therefore, there are non-financial motivators for managers.

Stewardship theory also argues that individuals can abandon self-interest. In this case, the managers are not motivated by personal or individual goals but rather by the firm interests (Wesley, 2010). The theory also argues that an organization requires a structure that allows harmonization to be achieved most efficiently between managers and owners. In the context of firm's leadership, this situation is attained more readily if the CEO is also the chairman of the sub-committee. This leadership structure will assist them to attain superior performance to the extent that the CEO exercises complete authority over the corporation and that their role is unambiguous and unchallenged. In this situation, power and authority are concentrated in a single person. Hence, the expectations about corporate leadership will be clearer and more consistent both for subordinate managers and for other members of the corporate sub-committee.

2.2.3. Stakeholder Theory

This theory was first proposed by Freeman (1984) and states that states that a company owes a responsibility to a wider group of stakeholders, other than just shareholders. He recognized it as an important element of Corporate Social Responsibility (CSR), a concept which recognizes the responsibilities of corporations in the world today, whether they are economic, legal, ethical or even philanthropic. Nowadays, some of the world's largest corporations claim to have CSR at the Centre of their corporate strategy. Whilst there are many genuine cases of companies with a "conscience", many others exploit CSR as a good means of PR to improve their image and reputation but ultimately fail to put their words into action.

The stakeholder model takes a broader view of the firm. According to the traditional stakeholder model, the corporation is responsible to a wider constituency of stakeholders other than shareholders. Other stakeholders may include contractual partners such as employees, suppliers, customers, creditors, and social constituents such as members of the community in which the firm is located, environmental interests, local and national governments, and society at large. This view holds that corporations should be socially responsible institutions, managed in the public interest. According to this model performance is judged by a wider constituency interested in employment, market share, and growth in trading relations with suppliers and purchasers, as well as financial performance (Mallin, 2004).

Thus, in governance, the management should not only consider its shareholders in the decision making process, but also anyone who is affected by business decisions. In contrast to the classical view, the stakeholder view holds that the goal of any company is or should be the flourishing of the company and all its principal stakeholders (Freeman et al., 2004).

2.3. Determinants of the Financial Performance of SMEs

Prior research documented that SMEs play a significant role in the economy of a country. Consequently, the performance of the SME sector is closely associated with the performance of the nation. Rutherford and Oswald (2000) observed that determinants of SMEs financial performance fell into three categories: individual characteristics, firm characteristics, and environmental characteristics.

2.3.1 Individual Characteristics

Studies that fell under this category have examined the relationship between individual characteristics and performance of the SMEs. Such factors considered for the individuals within the SMEs include: age, education level, managerial experience, industry experience, leadership practices, race, CEO personality, and gender. Such factors directly relate to the financial performance of these organizations since the individuals

’knowledge, experience and personality are key in the establishing and management of a starting business.

2.3.2 Characteristics of the Firm

Firm characteristics such as strategy/planning, sub-committee and organization structure, competitive orientation, top management team, culture, organizational growth, family control, operations management, and stage of development have an impact in determining the financial performance of the SMES. The factors relate on how the firm is generally managed and the extent of adoption of the corporate governance practices Better management in terms of top management team, strategic plans, sub-committee structure and composition, positively influence financial performance of the SMEs.

2.3.3 Environmental Characteristics

Studies that fell under this category have examined SMEs contacts with their customers, suppliers, competitors, regulatory organizations, consultants, creditors, stockholders, and financial institutions as a contributory factor to their financial performance. The SMEs need to keep a constant communication and good working relationship with all stakeholders in order to thrive in their businesses Other aspects of the environment include perceived uncertainty in the industry environment that requires the SMEs to regularly change and adopt their strategies in order to remain competitive in its operations.

2.4 Empirical Literature Review

There are various studies done by different researchers to look at the effects of corporate governance on financial performance of various firms. These studies are categorized as international and local studies as below.

2.4.1 International Empirical Evidence

Several studies have been done on the effect of corporate governance on the financial performance of various entities throughout the world. Maher and Anderson (1999) conducted a study to establish the effects of corporate governance on firm performance and economic growth. The aim of the study was to examine the various countries and the corporate governance structures available and how they affect performance. The study revealed that the corporate governance framework can impinge upon the development of equity markets, R&D and innovative activity, entrepreneurship, and the development of an active SME sector, and thus impinge upon economic growth. The study suggests that there is no single model of corporate governance and each country has through time developed a wide variety of mechanisms to overcome the agency problems arising from the separation of ownership and control. The study also considered the various mechanisms employed in different systems such as concentrated ownership, executive remuneration schemes, the market for takeovers, cross-shareholdings amongst firms, and examines the evidence on whether or not they are achieving what they were intended to do. It was revealed that for instance, one of the benefits of concentrated ownership is that it brings more effective monitoring of management and helps overcome the agency problems arising from the separation of ownership and control. Some of the costs, however, are low liquidity and reduced possibilities for risk diversification. While dispersed ownership brings higher liquidity it may not provide the right incentives to encourage long-term relationships that are required for certain types of investment. Therefore, one of the challenges facing policy makers is how to develop a good corporate governance framework which can secure the benefits associated with controlling shareholders acting as direct monitors, while at the same time ensuring that they do not impinge upon the development of equity markets by expropriating excessive rents (Maher and Anderson, 1999).

Bauer et al. (2004) argued that good corporate governance leads to higher common stock returns, firm value or operating performance using a sample of 269 firms from the FTSE Eurotop 300 over the period 2000-2001. The authors used Deminor's corporate governance ratings in order to measure the firms' quality of corporate governance. Deminor's rating can be attributed to four categories: shareholder rights, takeover defenses, disclosure on corporate governance and board structure and functioning. They argue that good corporate governance will increase investor trust and subsequently lower corporate risk and a lower expected rate of return; furthermore a lower expected rate of return leads to a higher firm valuation. However, they found an insignificant relationship between corporate governance and firm valuation. Finally, the relationship between corporate governance and firm performance is statistically negative.

Australian Treasury (2009) conducted a study on corporate governance and financial performance in an Australian context. The aim of the study was to examine the relationship of a company's adoption of the corporate governance principles and best practice as outlined by the Australian Securities Exchange and the financial performance of Australia's top listed 300 companies.. The study findings revealed that companies that implemented the corporate governance principles and best practice as outlined by the Australian 20 Securities Exchange had a better financial and overall performance than companies that had poor implementation of the same. The study concluded that corporate governance is a vital concept in most contemporary organizations' financial performance.

Okwee (2011) carried out a study on the influence of corporate governance and financial performance of SME's in Lango sub region of Uganda. The study involved a sample size of 63 SME's that were drawn from a population of 75 SME's in Lango sub region. The questionnaires were used to collect data from the selected SME's. It was found that there was a significant number of SME's that were found to comply less with the corporate governance guidelines. Risk was found to be weakly and negatively correlated with corporate governance and financial performance where as corporate governance and financial performance was found to be strongly positively correlated. The study also outlined a number of corporate governance practices that are likely to impact on the financial performance of organizations. These practices include CEO dualism, sub-committee size and the skills of the sub-committee members.

Oskar (2012) conducted a study to establish the relationship between corporate governance and a firm's performance and dividend payouts during the financial crisis in Poland. Corporate Governance was measured using the Corporate Governance Index (CGI). The study also sought to construct a comprehensive measure of the corporate governance for 298 non-financial companies listed on Warsaw Stock Exchange from the year 2006-2010. The findings from the study confirm that there is a positive relationship between corporate governance and performance of an organization. It was also evident that higher corporate governance leads to an increase in cash dividends. The study was also able to establish a link between corporate governance and with return on assets during the global financial meltdown that also affected Poland. The study also revealed that during the financial crisis, companies with good corporate governance still managed to pay dividends less generously than firms with lower corporate governance standards.

2.4.2 Local Empirical Evidence

Locally, Matengo (2008) conducted a study with the aim of establishing the relationship between corporate governance practices and performance the case of banking industries in Kenya. The study found that good corporate governance was lead to lower firm risk and subsequently to a lower cost of capital. The study also found that separation of ownership and control maximizes shareholders wealth. Otieno (2011) carried out a study into the effect of corporate governance on financial performance of commercial banks in Kenya. The study involved a cross sectional research design of the 44 commercial banks in Kenya. Both secondary and primary data was used for the study. The findings from the study reveal that corporate governance plays an important role on bank stability, performance and bank's ability to provide liquidity in difficult market conditions. The results also indicate that corporate governance factors accounts for 22.4 % of the financial performance of commercial banks.

Liech (2011) also conducted a study on the relationship between corporate governance practices and financial performance of local airlines in Kenya. The aim of the study was to establish how corporate governance practices affect the financial performance of local airline companies. The study measured corporate governance by using a corporate governance index (CGI), which is a score of various corporate governance questions derived from the various corporate governance codes of the Capital markets authority. The codes were grouped into four sub-indices namely: Shareholders rights, Directors composition and structure, Ownership structure, Disclosure and audit and compensation policy. The study used a census approach to collect data from all the 30 local airlines. The findings indicate that there is a significant relationship between corporate governance practices and financial performance of airlines. It was also evident that airlines with strong corporate governance practices also have better financial performance.

Wambua (2011) in his study aimed at establishing the effect of corporate governance on the financial performance of SMEs in Kenya conducted a research on 180 SME'Ss in Nairobi and sampling 100 SMEs. He used the questionnaires to collect the data that was analyzed using SPSS and found that the number of non-executive directors affected the financial performance of the SMEs since the directors were involved in making the internal corporate governance mechanisms for the entities. He concluded that the financial monitoring by the sub-committee affected the performance of the SME'S. Number of meetings held by the sub-committee affected the financial performance of the SME'S and the SME'S leadership played an important role in selecting, monitoring, and replacing the CEO.

Likewise, Ongeri (2011) conducted a study on financial performance and the extent of adoption of corporate governance practices by small and medium enterprises in Kenya. She targeted 30 registered SMEs in Kariobangi and used questionnaire to collect the data. She used SPSS and descriptive method in analyzing the data. The findings showed a positive relationship between the following corporate governance practices and profitability of the SMEs that participated in the study: availability of sub-committee of directors; existence of a system of evaluating sub-committee and individual directors; existence of Bylaws to govern sub-committee meetings; and use of cumulative voting for elections of directors.

Opanga (2013) did a study whose objective was to establish the relationship between CG and financial performance of Insurance companies in Kenya. The study targeted 45 insurance firms registered by the time of the study. The results concluded that there was a strong positive correlation between corporate governance and financial performance of the firms and secondly, the positive regression model confirmed that corporate governance (independent variables) if consistently applied contribute to increase in financial performance (dependent variable).

2.5. Summary of Literature Review

The area of corporate governance and organizational performance has attracted many researchers in the recent past. It is evident that most studies that have so far been conducted have largely focused on corporate governance and general performance of an organization. This general performance includes the financial, social and environmental performance of an organization. There are few studies however, that have examined the relationship between corporate governance and financial performance of organizations more especially in the SMEs sector of the economy.

More literature on corporate governance and financial performance of organizations is available. The theoretical literature has divergent views on corporate governance and performance of organizations. Empirical literature both global and local, show evidence of some relationship between corporate governance and financial performance of organizations. But despite the existence of lots of studies in this area, the SME sector has not been thoroughly studied to find out how corporate governance affects their financial performance as well as the extent of adoption of the corporate governance principles in the SMEs. The fact that there is no study that has attempted to establish the relationship between corporate governance and financial performance of the SMEs in Kenya leaves a research gap that needs to be filled. This study is therefore dedicated to bridge this gap.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1. Introduction

This chapter is a blueprint of the methodology that was used in this research to achieve the stated research objectives. In this chapter the research methodology, population, sample, data collection and data analysis is discussed.

3.2. Research Design

This research problem was studied through the use of a descriptive research design. According to Cooper and Schindler (2003) a descriptive study is concerned with finding out the what, where and how of a phenomenon. Kothari (2004) defined research design as a framework that shows how problems under investigation were solved. This was a descriptive survey of SMEs that are operating in Kenya. It is considered to be appropriate for this study since it was allow the researcher to use both qualitative and quantitative data in trying to establish the effect of corporate governance on the financial performance of SMEs in Kenya. Descriptive survey designs were used in preliminary and exploratory studies to allow researchers to gather information, summarize, present and interpret for the purpose of clarification. The choice of the descriptive survey research design is based on the fact that in this study, the researcher is interested on the state of affairs already existing in the field and no variable would be manipulated. This study therefore was able to generalize the findings to a larger population. The main focus of this study was quantitative. However some qualitative approach was used in order to gain a better understanding and possibly enable a better and more insightful interpretation of the results from the quantitative study.

3.3. Population

Mugenda & Mugenda (2003) defined a population as a well-defined or set of people, services, elements, events, group of things or households that are being investigated and have observable characteristics to which the researcher intends to generalize the results of the study. Population studies are more representative because everyone has equal chance to be included in the final sample that is drawn. The population of interest for the study was the SMEs that are operating in Nairobi County. Data available from the Nairobi City County (2013) reveal that there are 19,176 SMEs operating within the county subdivided into seven mutually exclusive business classes as shown in Appendix II. Nairobi County was chosen since it is the capital city of Kenya and therefore, concentration of SMEs is high.

3.4. Sample

Mugenda & Mugenda (2003) argues that if well chosen, samples of between 10% and 30% of a population can often give good reliability. In this study however, a convenient sample of 200 SMEs was taken; the proportionate stratification was used based on the stratum's share of the total population to come up with the sample in each stratum

Table 3.1: Sampling Frame

SME Category	**Population**	**Percentage of population**	**Sample**
Medium General trade, wholesale, retail & stores	4,155	22%	44
Transport, storage and communication	3,877	20%	40
Accommodation and catering	615	3%	6
Agriculture, forestry and natural resources	3,110	16%	32
Professional and technical services	2,354	12%	24
Private Education, health and entertainment	4,015	21%	42
Industrial plants, factories & workshop	1,050	6%	12
TOTAL	**19,176**	**100%**	**200**

Source: Nairobi City County (NCC, 2013)

3.5. Data Collection

Data collection involved self-administered questionnaires as the main instrument for data collection. The primary research data was collected from the owners, managers and senior employees of the SMEs in Nairobi using the questionnaires. The questionnaire to be used is divided into four sections with section **A** meant to get the general information about the SME including the area of operation, age, size and profitability trends. Section **B** is intended to gather information on the corporate governance practices within the firms whereas section **C** is dedicated to get data on the correlation between corporate governance practices and the financial performance of the firms. Section **D** on the other hand helped to analyze the various challenges faced by the SMEs in adopting and implementing the corporate governance practices. The questionnaire is attached in Appendix I.

3.6. Data Analysis

Data collected was analyzed using the descriptive analysis techniques. The descriptive statistical tools SPSS and Microsoft excel was enable the researcher to describe the data and determine the extent used. Content analysis was also used to analyze qualitative data. The findings were presented using tables and charts, percentages, means and other central tendencies. For this study, the researcher was interested in establishing the relationship between corporate governance and financial performance of SMEs in Kenya.

3.6.1 Analytical Model

The following multiple linear regression analytical model was used in analyzing the relationship between the dependent and independent variables sine the dependent variable was determined by more than one independent variable as indicated below:

$Y= \alpha + \beta_1X_1+\beta_2X_2+\beta_3X_3+\beta_4X_4+\beta_5X_5+ \varepsilon$

Where:

Y- Is the SMEs financial performance as a dependent variable measured by ROA

X_1 is CEO duality

X_2 is size of the sub-committee

X_3 is number of Sub-committee meetings

X_4 is the number of sub-committees

X_5 is age/size of the company, as the control variable in the model.

ε is the Error term normally distributed about the mean of zero

β_i, is the coefficient for variables **ί** that measures the responsiveness of **Y** to changes in **X**

3.6.2. Test of Significance

The test of significance used in this study is Regression Analysis**.** The linear regression analysis was used to show the relationship between the dependent variable which is the financial performance and independent variables which is the various components of corporate governance practices. The coefficient of determination R^2 shows the variation in the dependent variable due to changes in the independent variable. The coefficient of correlation r shows the relationship between the study variables. The findings were then generalized to the population of interest. ANOVA as a statistical tool was also used in determining the variance among the grouped data for statistical significance in determining the impact of the independent variables on the dependent variable in a regression analysis.

CHAPTER FOUR
DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

The purpose of this research paper was to determine the effect of corporate governance on financial performance of small and medium enterprises in Nairobi County, Kenya. This chapter focuses on data analysis, presentation and interpretation of findings. The data was obtained using questionnaires as the research instrument.

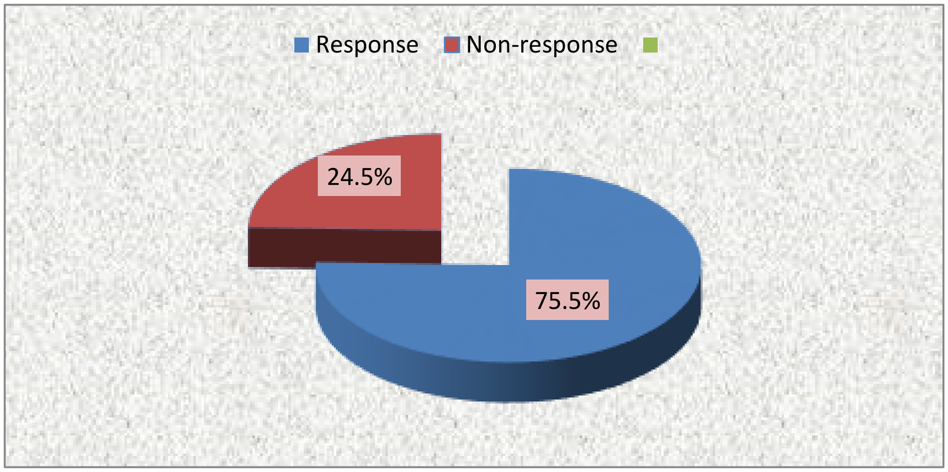
4.2 Findings

The following research findings were obtained from the data collected.

4.2.1 Response Rate

The sample population was consisting of 200 SMEs in Nairobi County. Out of 200 questionnaires distributed to the respondents, 151 questionnaires were returned thus, a response rate of 75.5%. According to Mugenda and Mugenda (2003), a response rate of 50% is adequate for analysis and reporting; a rate of 60% is good and a response rate of 70% and over is excellent. Creswell (2009) also stipulates that the key to accurately arguing that those responding are similar to those not responding is a high response rate of 70 percent to 80 percent. This means that the response rate of 75.5% for this study was excellent and therefore enough for data analysis and interpretation as shown below.

Figure 4.1: Response Rate

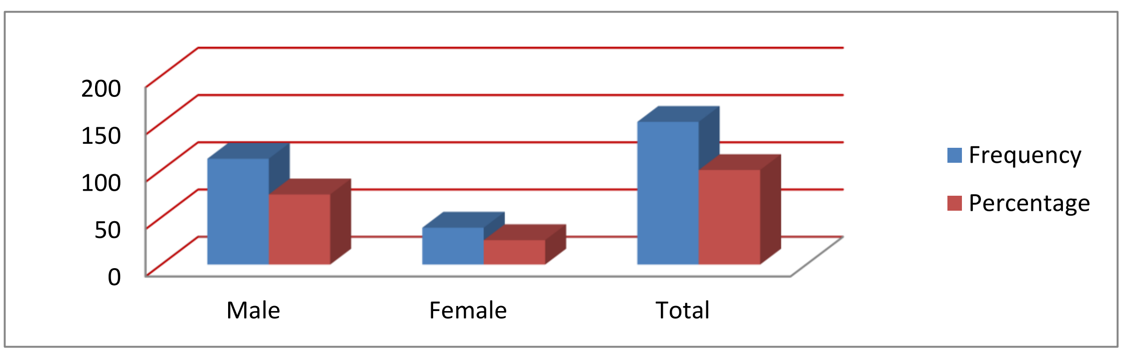


Source: Research Findings

4.2.2 Gender of Respondents

The study found it paramount to determine the respondents' gender in order to ascertain whether there was gender parity in the top positions of the SMEs management. According to the analysis, majority of the respondents were male representing 74.17% while 25.83% were female. It can therefore be deduced that the male were the most dominant gender among the top management of the SMEs in Nairobi County as shown in figure 4.2 below.

Figure 4.2: Gender of the Respondents

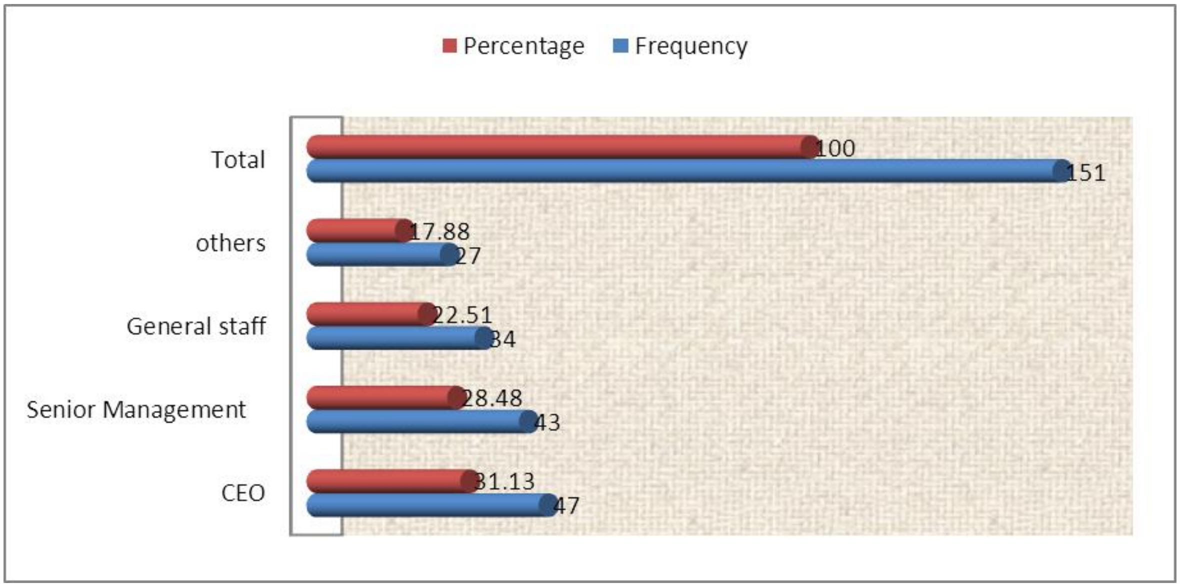


Source: Research Findings

4.2.3 Position of the Respondent

The study found it paramount to determine the position of the respondents in order to ascertain the influence of employment status in the positions indicated by the respondents. The findings of the study are as shown in figure 4.3. According to the analysis, majority (31.13%) of the respondents were CEOs, the senior management comprised of 28.48%, 22.51% of the respondents were among the general staff while 17.88% were among the other staff working in the companies and organizations.

Figure 4.3: Position of the Respondents

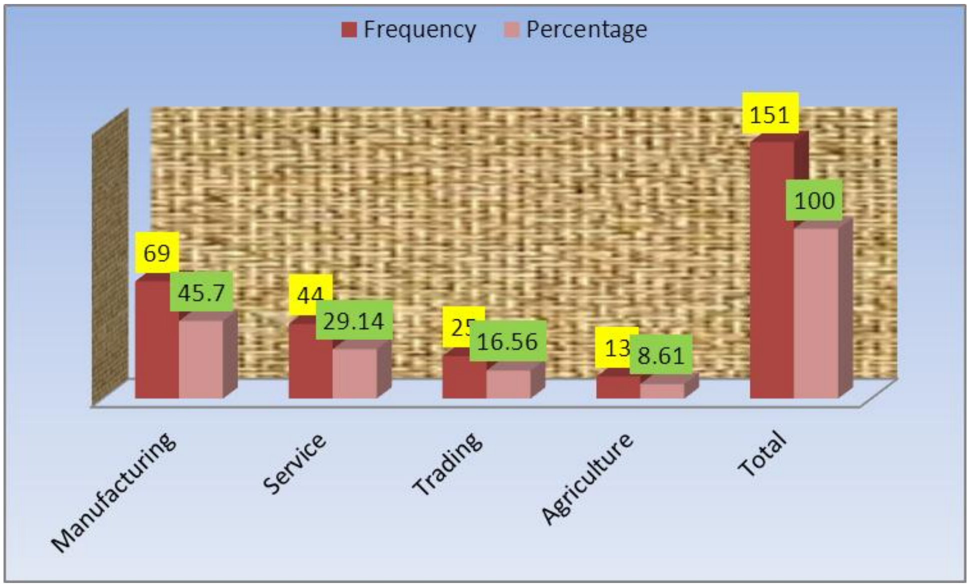


Source: Research Findings

4.2.4 Area of Operation

This is the area the SMEs have been operating in. This included manufacturing, service, trading and agriculture.

Figure 4.4: Area of Operation



Source: Research Findings

The researcher sought to establish the area of operation that the respective SMEs are engaged in. The findings as illustrated in Figure 4.4 above shows that majority of the respondents firms were in manufacturing businesses (45.70%), 29.14% in service provision, 16.56% in trading businesses and lastly, 8.61% in the agriculture industry.

4.2.5 Duration of Operation

This is the period of time the SMEs have been in operation. The table below shows the frequencies and percentages regarding information on the duration which the respondent companies have been in operation.

Table 4.1: Duration of operation

Duration	Frequency	Percent
1-3 years	17	11.26
4-6 years	53	35.10
7- 10 years	49	32.50
11 and above	52	34.44
Total	151	100.0

Source: Research Findings

The findings as illustrated in Table 4.1 above shows that most of the companies have been in operation for more than four years.11.26% of the companies had operated between 1-3 years, 35.10% had operated between 4-6 years. 32.50% had operated between 7-10 years and lastly 34.44% of the companies had operated for 11 years and more.

4.2.6 Number of Employees

The researcher sought to determine the number of employees working for the different SMEs to get the size of most of the SMEs in Nairobi County. Analysis of findings indicated that 24.50% of the SMEs had between 1-20 employees. 27.81% of the SMEs had 21-40 employees, 17.88% of the organizations had 41-60 employees. 11.92% of the SMEs had 61-80 employees and 9.28% of the SMEs had between 81-100 employees. The remaining 8.61% indicated that their organizations had employees ranging from between 101 and above. The finding therefore implies that most of the SMEs in Nairobi County have a number of employees ranging between 1- 100 as illustrated in the Table 4.2 below.

Table 4.2: Number of Employees

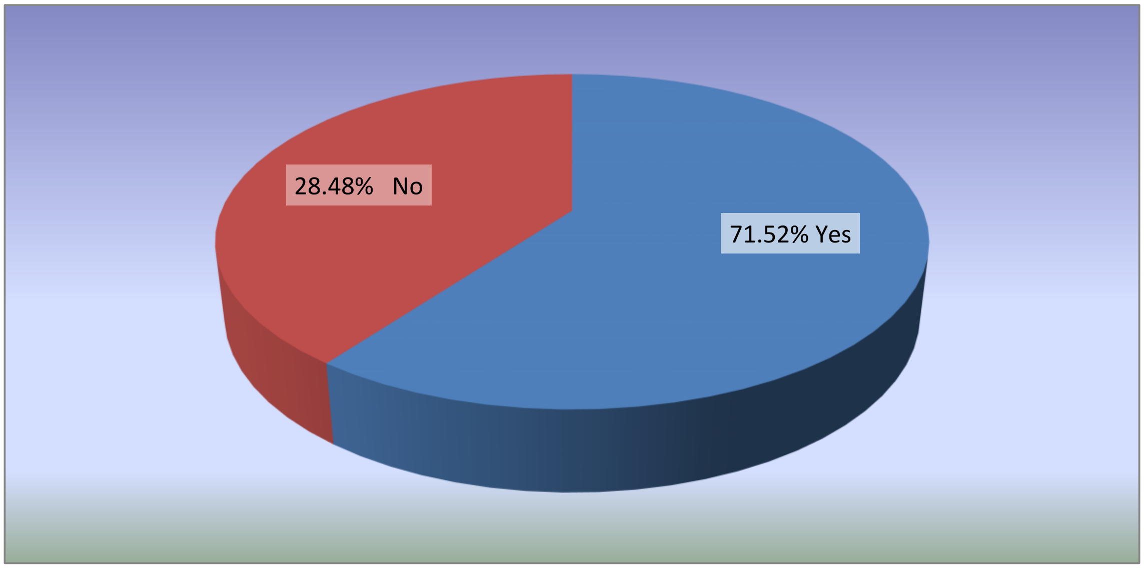
Number	Frequency	Percentage
1-20	37	24.50
21-40	42	27.81
41-60	27	17.88
61-80	18	11.92
81-100	14	9.28
101 and above	13	8.61
Total	**151**	**100.0**

Source: Research Findings

4.2.7 Other Branches.

The researcher sought to find out the growth of the SMEs by trying to find out if they had other branches. Not all the companies had branches but majority of the companies had branches as indicated below.

Figure 4.5: Other branches



Source: Research Findings

The table 4.5 above indicates that a majority of the SMEs where the respondents who were interviewed were working, have other branches some of them in different parts of the city. 71.52% of the SMEs have other branches while only 28.48% indicated that they did not have other branches. This indicated the level of growth of the SMEs and the level of financial success.

4.2.8 Value of Assets

The researcher wanted to determine the value of assets of the companies/organizations where the respondents were working in the last five years.in the year 2009 majority of the companies were worth between Kshs 10,001-20,000. In the year 2013 majority of the companies 89% were worth above Kshs. 100,000. This indicates that majority of the companies had grown financially in the five years.

4.2.9 Estimated Net Income

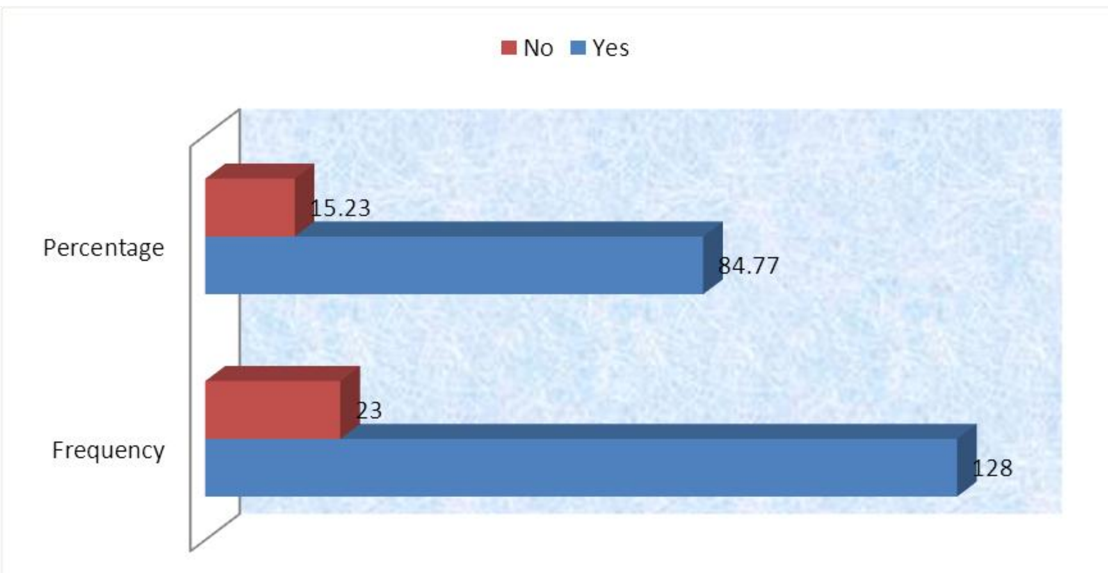
The researcher sought to find out the net income of the companies within the last five years. In the year 2009 the net income of most of the SMEs where the respondents were working had a net income of between Kshs 30,000 - Kshs. 50,000. But in the year 2013, an exponential growth rate was achieved where majority of the SMES' net worth was more than Kshs 150, 000. This also indicates financial growth in the SMEs.

4.3. Corporate Governance practices in the SMEs

4.3.1 Board of Management

The researcher sought to find out if the organizations had board of managements in place and the main decision makers in the SMEs in Nairobi County.

Figure 4.6: Board of Management



Source: Research Findings

The figure 4.6 above indicates that 84.77% of the SMEs, had board of management in place while 15.23% of did not have a board of management and therefore, the owners were the CEOs as well as the decisions makers of their organization. This is a case of CEO duality in the SMEs.

4.3.2 Size of the Board of Management

The researcher sought to determine the size of the board of managers who are involved in the decision making process of the different SMEs where they exist.

Table 4.3: Size of the board of management

Number	Frequency	Percentage (%)
2-5	79	53.32
6-9	53	35.10
10 and above	19	12.58
Total	**151**	**100.0%**

Source: Research Findings

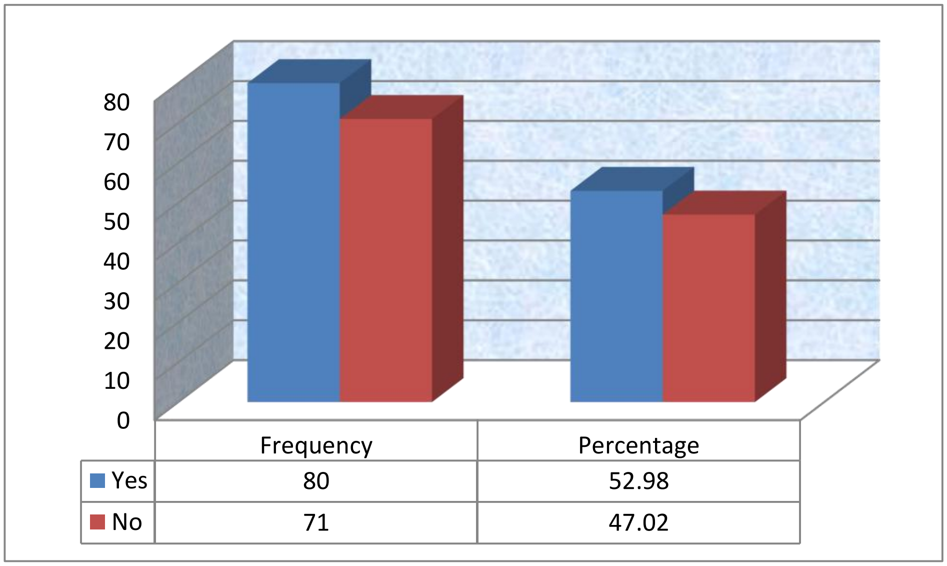
The respondents were required to indicate the size of their board of managers ranging from between 2-5, 6-9, and 10 and above. Majority of the SMEs had board of managers ranging between 2-5 members at 53.32% followed by board with members ranging from between 6-9 at 35.10%. SMEs with a board of 10 members and above had the least percentage of 12.58%. The analysis indicated that most of the SMEs had boards comprising `of utmost nine members.

There has been considerable debate on whether large board size performs better than smaller boards. Daily (1995) argue that greater number of directors might increase available expertise and resource pool while Bonn et al., (2004) contends that expanding the size of the boards provides an increased pool of expertise, information and advice quality not obtained from other corporate staff. In contrast, the difficulty inherent in coordinating the contributions of many members can be complex, hindering them to use their knowledge and skills effectively (Forbes & Daniel 1999, Epstein et al., 2004).

4.3.3 CEO Duality

The researcher wanted to find out if the CEO and the manager are the same and play the same role in the respondents' respective SMEs. The figure 4.7 below indicates that a majority of the organizations interviewed indicated that the CEO and the manager are the same person. Even though, a substantial number of the organizations disagreed that the manager plays the same role as the chief executive officer. 52.98% of the respondents indicated that the manager plays the role of the CEO; while 47.02% outlined that the CEO and the manager are two different entities.

Figure 4.7: CEO Duality



Source: Research Findings

4.3.4 Frequency of Board meetings

The researcher wanted to find out how often the organizations hold board meetings in one financial year.

Table 4.4: Frequency of Board meetings

Number of times In a year	Frequency	Percentage
1-3	43	28.48
4-6	53	35.10
6-9	19	12.58
10 and above	26	17.22
Total	**151**	**100.0%**

Source: Research Findings

The researcher sought to find out how often the SMEs with board of management hold their meetings in one financial year. Majority of the entities held meetings 4-6 times a year (35.10%) followed by 1-3 meetings each financial year (28.48%). Organizations that held their board 10 times and above had a percentage of 17.22% and lastly followed by the organizations which held board meetings between 6-9 times which had a percentage of 12.58%. The analysis indicated that most of the SMEs held their boards between 1 to 6 times in one given year.

4.3.5. Board Sub-committees

The researcher wanted to determine if other sub-committees existed in the different SMEs.

Table 4.5: Sub- committees

Sub- committees	frequency	Percentage
Finance committee	130	86.09
Audit committee	53	35.10
Human resource committee	142	94.04
Procurement committee	47	31.13
Others	49	32.45

Source: Research Findings

Most of the respondents indicated that their SMEs have most of the committees if not all of them. According to the analysis, 86.09% of the SMEs have the finance committee. 94.04% had the human resource committee, 35.10 % had the Audit department committee and 31.13% had the procurement committee while 32.45% included other sub-committees not mentioned in the questionnaire.

Given the complexity of the business environment, it is impossible for the sub-committee to be the sole decision- making body in the company. Instead, each sub-committee needs to work on developing an appropriate method and level of delegation of authority. Obviously this was again varying with the context facing the sub-committee but, in all circumstances, the sub-committee needs to clearly articulate and document the delegations it makes (Gavin and Geoffrey, (2004).

4.3.6. Frequency of Sub- committee meetings

The researcher wanted to find out how often the sub- committees usually meet.

Table 4.6: Frequency of sub- committee meetings

Duration	Frequency	Percentage
Every one month	87	57.62
Every quarter	33	21.85
Twice a year	9	5.96
Others	22	14.57
Total	**151**	**100.00**

Source: Research Findings

The researcher sought to find out how often the organizations held its sub-committee meetings in one financial year. Majority of the organizations interviewed held their sub-committee meetings once every month (57.62%), followed by organizations which held sub-committee meeting every quarter (21.85%). Organizations that held sub-committee meetings every twice a year had a percentage of 5.96% and lastly followed by those that held sub-committee meetings other times not indicated in the questionnaire with 14.57% The analysis indicated that most of the SMEs held their sub-committee meetings on a monthly basis.

4.4. Relationship between Corporate Governance and Financial Performance

All the respondents appreciated the fact that corporate governance has an immense effect on the financial performance of the organization. The implications of Corporate Governance and financial performance outcomes are greatly looked at by Piesse (1999). Few researchers have researched on a direct link between Corporate Governance and financial performance. The researcher sought to find out how corporate governance affects organizational performance in particular the financial performance of the SMEs. In order to do that, a number of questions were fronted to the respondents who gave their responses on a scale of 1-5 where 1 represents to a very large extent and 5 very small extent. Table 4.7 below shows the mean and standard deviation of factors that were used by the researcher to show the relationship between Corporate Governance and financial performance. A mean of 1-3, shows that the factor in question has been adopted by the responding organizations to a low extent. A mean of 4-5, shows the factor in question has been adopted by the responding organizations to a large extent. These findings were supported by prior studies that report positive correlations between Corporate Governance and financial performance.

Table 4.7: Effects of Corporate Governance on Financial Performance

The Extent to which corporate governance affects financial performance of the organization.	**Mean**	**Standard Deviation**
The existence of a sub-committee of management enhances the financial performance of the entity.	4.33	1.692
The size of the sub-committee affects the financial performance of the entity.	3.40	0.497
The number of Sub-committee meetings in a year has significant impact on financial performance of the entity.	4.57	0.630
The manager should be different from the CEO to realize better financial performance of the entity.	4.69	0.841

Source: Research Findings

The findings indicated that 20% of the respondents disagreed, 40% agreed while 40% strongly agreed that there is a relationship between corporate governance and financial performance of organizations.

Matama, (2005) in the study of Corporate Governance and financial performance on selected organizations, obtained a positive relationship between Corporate Governance and financial performance. Masibo, (2005) researched on Sub- committee Governance and organization performance of selected state owned corporations and in listed organizations on Uganda Securities Exchange, obtained a positive direct and indirect link between Sub- committee Governance and Organization financial performance through Sub- committee Effectiveness. Piesses, (2005), carried out empirical research on Corporate Governance and organization performance in an international perspective and obtained conflicting results on the link between Corporate Governance and Organization performance.

4.5. Inferential Statistics

This section presents a discussion of the results of inferential statistics. Correlation analysis was used to measure the strength of the relationship between the independent variables i.e. the relationship between CEO duality, size of the board, number of Sub-committee meetings, the number of sub-committees and the size/age of the SMEs to their financial performance. Regression analysis established the relative significance of each of the variables on the financial performance of the SMEs.

4.5.1. Correlation Analysis

The Pearson product-moment correlation coefficient (or Pearson correlation coefficient) is a measure of the strength of a linear association between two variables and is denoted by r. The Pearson correlation coefficient, r, can take a range of values from +1 to -1. A value of 0 indicates that there is no association between the two variables. A value greater than 0 indicates a positive association, that is, as the value of one variable increases so does the value of the other variable. A value less than 0 indicates a negative association, that is, as the value of one variable increases the value of the other variable decreases.

Table 4.8: Correlation coefficient of financial performance.

	CEO duality	size of the sub-committee	number of Sub-committee	age/size of the company	Financial performance
CEO duality	1				
size of the sub-committee	0.0135	1			
number of Sub-committee meetings	0.1297	0.7914	1		
age/size of the company	0.7612	0.8321	0.7294	1	
Financial performance	0.6913	0.8163	0.7568	0.8679	1

Source: Research Findings

The study above shows that all the predictor variables were shown to have a positive association between them at a significant level of 0.05 and hence included in the analysis. There was strong positive relationship between CEO duality and size of the company, size of the company and size of the sub-committee, number of the sub-committee meeting and size of the company, financial performance and CEO duality and financial performance and size of the sub-committee, financial performance and number of the sub-committee meetings and lastly between financial performance and size of the company.

4.5.2. Coefficient of Determination

The analysis below shows that the coefficient of determination (the percentage variation in the dependent variable being explained by the changes in the independent variables) R square equals 0. 7685, that is, CEO duality, size of the sub-committee, number of the sub-committees, number of the sub- committee meetings and size of the SMEs contribute and to a greater extent (76.85%) on their financial performance.

Table 4.9: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.5713[a]	.7685	.7681	.42127

Source: Research Findings

4.5.3. Regression Analysis

The regression output of most interest is the following table of coefficients and associated output:

Table 4.10: Regression Coefficients Results

Model		Standardized Coefficients		
		Beta	t	Sig.
1	(Constant)	2.254	7.367	0.000
	CEO duality	0.971	2.021	0.045
	Size of the Board	0.739	1.157	0.210
	Number of the sub-committee meetings	0.835	1.194	0.234
	Number of subcommittees	1.271	2.617	0.095
	Size of the company	1.173	1.686	0.093

Source: Research Findings

From the Regression results in table below, the multiple linear regression models finally appear as:

$Y = 2.254 + 0.971X_1 + 0.739X_2 + 0.835X_3 + 1.271X_4 + 1.173X_5 + 0.42127$

The multiple linear regression model above indicates that all the independent variables have positive coefficients. The regression results reveal that there is a positive relationship between dependent variable (SME's financial performance) and independent variables (CEO duality, size of the board, number of sub-committees, and number of the sub- committee meetings and size/age of the company).

4.5.4. Analysis of Variation

The Analysis of Variance (ANOVA) was used to check how well the model fits the data. The results are presented in table 4.11.

Table 4.11: ANOVA

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	1.045	3	.123	.678	.000[a]
	Residual	5.102	28	.177		
	Total	5.628	93			

Source: Research Findings

a. Predictors: (CEO duality, size of the Board, number of sub- committees, number of sub-committee meetings, and size of the company)
b. Dependent Variable: financial performance

The F statistic is the regression mean square (MSR) divided by the residual mean square (MSE). Since the significance value of the F statistic is small (0.000 smaller than say 0.05) then the predictors variables i.e. CEO duality, size of the board, number of the sub-committees, number of sub-committee meetings and size of the company explain the variation in the dependent variable which is financial performance. Consequently, we accept the Hypothesis that all the population values for the regression coefficients are not 0. Contrary, if the significance value of F was larger than 0.05 then the independent variables would not explain the variation in the dependent variable, and the null hypothesis that all the population values for the regression coefficients are 0 should have been accepted.

4.6. Interpretation of the Findings

According to the findings of the study, the ownership of SMEs were found to be dominated by male entrepreneurs of about 74% while the female owners constituted only to 26%. It further revealed that most SMEs studied had cases of CEO duality at 53%, though it was also noted that even where CEO duality was rampant, the firms still had board of management in place.

From the correlation analysis results, the study shows that all the predictor variables had a positive association between them at a significant level of 0.05. There is a strong positive correlation between CEO duality and size of the company denoted by correlation coefficient of 0.7612, size of the company and size of the sub-committee with correlation coefficient of 0.8321, number of the sub-committee meeting and size of the company with correlation coefficient of 0.7294, financial performance and CEO duality had correlation coefficient of 0.6913 and financial performance and size of the sub-committee correlation coefficient was 0.8163, financial performance and number of the sub-committee meetings correlation coefficient was 0.7568 and lastly between financial performance and size of the company correlation coefficient 0.8679.

Coefficient of determination results that shows the percentage variation in the financial performance explained by the changes in the independent variables is indicated as 0. 7685, that is, CEO duality, size of the sub-committee, number of the sub- committees, number of the sub- committee meetings and size of the SMEs determine the financial performance of SMEs up to 76.85%.The financial performance is however determined by other factors outside the model to a small extent of 23.15% Thus, the corporate governance variables included in the model determines SMEs' financial performance to a greater extent

The multiple linear regression model result shows that all the independent variables have positive coefficients. Thus, the regression result reveals that there is a positive relationship between SME's financial performance and independent variables in the model. From the findings, one unit change in CEO duality results in 0.971 units increase in firm's overall performance. One unit increase in size of the board results in 0.739 units increase in institutions financial performance. One unit change in number of sub-committee meetings results in 0.835unit increases in financial performance. One unit change in the number of sub-committees results in 1.271 increase in financial performance. One unit change in size of the company it results 1.173 unit increases in financial performance.

The t statistics helps in determining the relative importance of each variable in the model. As a guide regarding useful predictors, we look for t values well below -0.5 or above +0.5. In this case, the most important variable was number of board sub-committees, CEO duality, size of the firm, number of the sub- committee meetings and size of the board respectively.

The significance value of the F statistic is small (0.000 smaller than 0.05) then the predictors variables i.e. CEO duality, size of the board, number of the sub- committees, number of sub-committee meetings and size of the company explain the variation in the dependent variable which is financial performance. Consequently, we accept the Hypothesis that all the population values for the regression coefficients are not 0.

CHAPTER FIVE
SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

The chapter provides the summary of the findings from chapter four and gives the conclusions based on the findings and results. Recommendations and areas for further studies have also been presented.

5.2 Summary

The study aimed at investigating the effect of corporate governance on the financial performance of SMEs in Nairobi County, Kenya. From the findings, respondents strongly agreed that SMEs leadership played an important role in selecting, monitoring, and replacing the CEO. The respondents also strongly agreed that the manager should be different from the CEO to realize better financial performance of the entity. However, 52.98% of the respondents indicated that the CEO was the same as the managers thus a case of CEO duality was noted to be common with most SMEs.

Out of the 200 SMEs sampled, 84.77% of them had board of management due to the realization that it was a necessity to proper governance that will have an impact on the firm's financial and overall performance. Some SMEs however had not embraced the existence of board of management as a corporate governance practice. Majority of the SMEs had board of managers with 2-5 members at 53.32% and this seemed to be the ideal board number due to their relatively small size. The board meetings were held 4-6 times in any given year as indicated by the majority where the boards exists. The study also found that financial monitoring by the sub-committees affected the financial performance of the SME's positively as shown by a mean of 4.69; number of meetings held by the sub- committee affected the financial performance of the SME's to a very great extent as shown by a mean of 4.50.The sub-committees held meetings once every month as indicated in the findings.

On the correlation of the study variables, the study found that there was strong positive correlation coefficient between financial performance and the number of board sub-committees, the number of subcommittee meetings, size of the board and age/size of the firm with the strongest of all being the age of the firm and the least being CEO duality. In addition, the results of the coefficients further indicated that a unit change in CEO duality, size of the board, number of sub-committee meetings, number of subcommittees and size of the firm would affect financial performance of the SMEs in a positive and to a great extent. Of all the independent variables, number of subcommittees affect most its financial performance by 1.271.

5.3 Conclusion

From the findings on the effects of corporate governance on the financial performance of SMEs in Nairobi County, the study found that most SMEs have common cases of CEO duality thus, in most cases, the manager is the same as the owner of the firm. This was however noted to still have a positive effect on the financial performance. It can also be concluded that the SMEs agree to the fact that there is need to separate the CEO and the manager in order to realize better financial performance through the decisions being made. Most of the SMEs however, have board of management to ensure proper decision and control of the firms' affairs which has a strong positive correlation to the financial performance.

Generally, it can also be concluded that the SMEs appreciate corporate governance practices and their role to enhance financial performance yet majority of have not been able to adopt the practices since most of them still consider the practices applicable to large and established companies. Those adopting the practices have not fully incorporated them citing their size, limited finances and rigid government regulations as their limitations.

Undoubtedly, advancing knowledge regarding the corporate governance–financial performance relationship of SMEs in Nairobi County informs corporate governance policy guidelines and assists policy makers and business owners to improve transparency of governance systems of SMEs. To this end, the leadership of SMEs can be informed of possible combinations of governance mechanisms they can consider, within a specific industry context, to enhance organization financial performance. This paper provides important insights in this regard as it seeks to stimulate further research that will build theory and enhance understanding of how corporate governance mechanisms are associated with market valuation or financial performance of SMEs in small, open, developing economies.

5.4 Recommendation for Policy

From the discussions and conclusions in this chapter, the study recommends that the government be actively involved in the welfare of the SMES by providing flexible policies and guidelines that will enable adoption of corporate governance by the SMEs simple and attractive. This will do away with the notion that corporate governance is only meant for large companies.

The study also recommends that the SMEs owners consider having board sub-committees in place since they directly influence and affect the financial performance of the SMEs. The sub- committees need to comprise of well-educated people since they are actively involved in shaping SME’s strategy. Employees should be encouraged to be more active in financial management aspects of the SMEs.

The study also recommends that financial monitoring of SMEs should be done thoroughly by the board of managers. A constitution which clearly indicates how to select and replace the CEO and directors need to be adopted by the SMES in order to separate the role of the CEO and the manager. Ownership concentration needs to be reduced to avoid few people controlling the financial performance of the organization. The board of managers should comprise of both inside and outside directors to provide a more complete way of managing the SMEs and splitting of the roles of chairman and chief executive roles.

Since it was clear from the study that the SMEs with a small board size had greater performance, the study recommends that board size for SMEs should be maintained as small as possible in order to create a balance between the costs and the benefits. However, the management should ensure that the board size is optimal as a very small board can also be redundant and may not be efficient in governing the SMEs.

Finally, the study also recommends that the SMEs should be well equipped to implement corporate governance practices in their daily activities to the levels acceptable in developing market economies so as to improve accessibility to firm financing and remain relevant in the competitive market. Good corporate governance has a positive economic impact on their overall financial performance over time as it saves the organizations from various losses such as those occasioned by fraud, corruption and similar irregularities. This can be done through corporate governance forums and trainings for SMEs managers and owners.

5.5 Limitations of the Study

A limitation for the purpose of this research was regarded as a factor that was present and contributed to the researcher getting either inadequate information or responses or if otherwise the response given would have been totally different from what the researcher expected. The researcher also encountered the limitation of access to information sought by the study. Some respondents were not willing to be interviewed while others did not want to be identified.

The researcher encountered limitation of time as the research was being undertaken within a short period with limited time for doing a wider research. However, the researcher countered the limitation by carrying out the research across the SME's that were selected which enabled generalization of the study findings on the target population. The respondents approached were reluctant in giving information fearing that the information might be used to intimidate them or print a negative image about their firms. The researcher handled the problem by carrying an introduction letter from the University that assured the respondents that the information was to be treated with confidentiality and purely for academic purpose.

5.6 Recommendation for Further Studies

This study has reviewed the effects of corporate governance on the financial performance of the SMEs in Nairobi County, Kenya. To this end therefore, a further study should be carried out to establish how listed SMEs in the NSE have been able to come up with various strategies, polices and systems to comply with a regulated business environment including the adoption of corporate governance practices.

More studies can also be undertaken to identify cases where CEO duality can contribute to better financial performance of various organizations as indicated in this research finding.

Moreover, a study should also be carried out to establish the challenges SME's face in trying to adopt corporate governance practices such as financing and size/age of the firm. The same study should be carried out in other financial sectors for example banks and microfinance institutions to find the comparison of the corporate governance practices and the extent in which they are applied in the various organizations as well as the challenges that these relatively large firms face in applying corporate governance practices.

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APPENDICES

APPENDIX I

QUESTIONNAIRE

The objective of this research is to find **'The Effect of Corporate Governance on Financial Performance of Small and Medium Enterprises in Nairobi County, Kenya'.**

SECTION A: GENERAL INFORMATION

i. Name of the respondent…………………………………………………………

ii. Gender: Female [ ] Male [ ]

ii. Position of the respondent:

A. CEO [ ] B. Senior Management [ ] C. Others (Specify)………………….

1. Name of your Entity……………………………………………………
2. Area of Operation of your organization, (Please mark below as appropriate)
   Manufacturing ( ) Service ( ) Trading ( ) Agriculture ( )
   Others (Please Specify)……………………………………………………
3. Length of Operation in Market (in years)
   1-3 ( ) 4-6 ( ) 7-10 ( ) 11 and above ( )
4. What is the number of employees within your organization?
   1-20 ( ) 21-40 ( ) 41-60 ( ) 61-80 ( ) 81-100 ( ) 101 and above ( )
5. Does your organization have other branches?
   Yes [ ] No [ ]
   If Yes, specify the number of branches……………………………………
6. What is the estimated value of your total assets in the last five years?

   2009……………………………….

2010……………………………….

2011……………………………….

2012……………………………….

2013……………………………….

7. What is your annual estimated Net Income over the last three years?

2009……………………………….

2010……………………………….

2011……………………………….

2012……………………………….

2013……………………………….

SECTION B: CORPORATE GOVERNANCE PRACTICES WITHIN YOUR ENTITY

1. In your organization, is the CEO the same as the manager?

   Yes [ ]

   No [ ]

2. Does your entity have a board of management?

   Yes [ ]

   No [ ]

   If No, who make the decisions for the organization? (Please specify)

   ………………………………………………………………………………

3. What is the size of your board of management? (Please mark below as appropriate)

   2-5 [ ] 6-9 [ ] 10 and above [ ]

4. How often does your organization hold board meetings in one financial year? (Please mark below as appropriate).

   1-3 [ ] 4-6 [ ] 6-9 [ ] 10 and above (specify) [ ]

5. Do the following sub-committee exist in your organization?

I. Finance committee [ ]

II. Audit committee [ ]

III. Human resource committee [ ]

IV. Procurement committee [ ]

V. Any other, please specify……………………………………

6. How often do the sub-committees conduct meetings?

Every one month ( )

Every quarter ( )

Twice a year ( )

Others..

SECTION C: EFFECT OF CORPORATE GOVERNANCE ON THE FINANCIAL PERFORMANCE OF THE ORGANIZATION

Please indicate the extent to which you agree or disagree with the below statements. The scale of 1-5 was be used where 5= strongly agree 4= Agree 3=Neutral 2= Disagree& 1 =strongly disagree

	5 (Strongly agree)	4 (Agree)	3 (Neutral)	2 (Disagree)	1(Strongly Disagree)
1) The existence of a sub-committee of management enhances the financial performance of the entity.					
2) The size of the sub-committee affects the financial performance of the entity.					
3) The number of Sub-committee meetings in a year has significant impact on financial performance of the					

entity.					
4) The manager should be different from the CEO to realize better financial performance of the entity.					
5) Sub-committee sub-committees enhance financial performance of the entity.					
6) Diversity in sub-committee composition (Independent and dependent directors) affects financial performance of the entity.					

SECTION D: CHALLENGES FACED IN IMPLEMENTING THE CORPORATE GOVERNANCE PRACTICES

In your opinion, kindly state the challenges that your entity faces in trying to implement the corporate governance practices.

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THANK YOU.

APPENDIX II

CATEGORY OF SMES IN NAIROBI COUNTY AS AT 30TH DECEMBER 2013

SME Category	**Population**
Medium General trade, wholesale, retail & stores	4,155
Transport, storage and communication	3,877
Accommodation and catering	615
Agriculture, forestry and natural resources	3,110
Professional and technical services	2,354
Private Education, health and entertainment	4,015
Industrial plants, factories & workshop	1,050
TOTAL	**19,176**

Source: Nairobi City County

APPENDIX III

INTRODUCTORY LETTER

TO WHOM IT MAY CONCERN

RE: RESEARCH DATA COLLECTION

My name is Getrude Moraa Maranga, a student at the University of Nairobi pursuing a Master of Business Administration. Pursuant to the pre-requisite course work, I would like to conduct a research project on '**The effect of corporate governance on the financial performance on Small and Medium enterprises in Nairobi County, Kenya**'. I kindly seek your authority to conduct the research at your Entity through research interviews and questionnaires. The information gathered during the research study will remain confidential and purely for academic purposes only. Enclosed is the University introductory letter. Your assistance is highly appreciated.

If you agree to the above, kindly sign below. Thank you in advance.

……………………………..	……………………	…………………...
Respondent name	**Position**	**Signature/date**

Yours Faithfully,

Getrude Maranga