CORPORATE GOVERNANCE AND FIRM VALUE FOR FIRMS LISTED AT THE NAIROBI SECURITIES EXCHANGE

BY

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A RESEARCH PROJECT PROPOSAL IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE AWARD OF THE MASTER OF BUSINESS ADMINISTRATION (MBA) DEGREE, SCHOOL OF BUSINESS

UNIVERSITY OF NAIROBI

2015

DECLARATION

This research project is my original work, and has not been presented for any degree award in any other university.

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D61/69772/2011

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

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DEDICATION

To my parents, John Okumu Odundo and Emilly Atieno Ochanda and my siblings Jackline, Eunice, Anne, Robert and my niece Quinter for the love, support and sacrifice they have made in my education to propel me this far.

ACKNOWLEDGEMENT

I wish to express my gratitude to all individuals who contributed to this study. First I wish to thank the Almighty God for the wisdom, knowledge, skills and understanding He provided to enable me undertake this research. I am so much indebted to my mentor and supervisor Luther Otieno whose guidance enabled me to complete this research project.

I acknowledge the contributions of my able colleagues and classmates whose critical contributions realigned the research. Lastly, I wish to thank my employer Impact Research for the ample time and resources propelled me complete the entire MBA program.

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LIST OF ABBREVIATIONS AND ACRONYMS

CEO- Chief Executive Officer

NSE- Nairobi Securities Exchange

CMA- Capital Markets Authority

NED- Non Executive Directors

ROA- Return on Assets

ABSTRACT

The study focused on corporate governance and firm value of firms listed at the Nairobi Securities Exchange. The study sought to find out the relationship between corporate governance attributes of board size, board composition, CEO duality, and audit committee composition compared against measures of firm value such as Return on Assets and Market to book values of quoted firms.

The data was analyzed using regression analysis to build the relationship between corporate governance attributes and firm value. Descriptive research methodology was adopted. The study found that corporate governance attributes have a significant influence on Return on Assets while corporate governance attributes have an insignificant influence on Market to book value ratio as measures of firm value.

However, audit committee as a corporate governance attribute significantly stood to influence both Returns on Assets and Market to book value ratio as measures of firm value. This depicts the idea of more external members in the audit committee than insider ones thus enhancing corporate governance through external independent directors and brings new dimension for effective running of a corporate entity thereby propelling a firm's corporate entrepreneurship and competitiveness.

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

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

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

The argument has been advanced time and again that the governance structure of any corporate entity affects the firm's ability to respond to external factors that have some bearing on its performance. In this regard, it has been noted that well governed firms largely perform better and that good corporate governance is of essence to firms. The

subject matter of corporate governance has dominated the policy agenda in developed market economies for some time especially among very large firms. Subsequently, the concept is gradually warming itself to the top of policy agenda in the Africa continent. Indeed it is believed that the Asian crisis and the seemingly poor performance of corporate sector in Africa have made the concept of corporate governance a catchphrase in the development debate (Berglof and von Thadden, 1999).

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

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

1.1.1 Corporate Governance

Corporate governance is defined as a field in economics that investigates how to secure or motivates efficient management of corporations by use of incentives mechanism, such as contracts, organization design and legislation (Mathiesen, 2002). Abor, (2007) defines corporate governance as the system by which companies are directed and controlled. It also refers to the way in which corporations are handled by corporate boards and officers. Hampel (1998) observes that good governance ensures that stakeholders with the relevant interest in the company business are fully taken into account thus enhancing the financial performance of the firm. Brown and Caylor (2004) also share the foregoing views seeing corporate governance as the relationship among various participants in determining the direction and performance of the companies consistent with the public good.

Corporate governance is not just about board structure and interests alignments for its own end. It is very much about perceived benefits in terms of attraction of capital and its retention. For corporations it could well mean enhanced market capitalization. An international corporate governance survey showed that investors are prepared to pay more for corporations with more effective governance structures and practices. This resulted in lower share premiums for, Asian, Latin American and other emerging economies; a comparatively higher premium for those in continental Europe where there are still pressures for better disclosure of information to shareholders; and an even higher premium for those in the UK and US capital markets where information disclosure to shareholders is enhanced either through strict securities laws or codes of best practices (McKinsey & Co., 2005)

1.1.2 Value of a Firm

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

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

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

1.1.3 Corporate Governance and the Value of the Firm

It is well established that state and national laws of corporate governance affect firm value. La Porta et al. [2001] show that firm value is positively associated with the rights of minority shareholders. Daines [2001] finds that firms incorporated in Delaware have higher valuations than other U.S. firms.

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

1.1.4 Nairobi Securities Exchange

The Nairobi Securities Exchange (NSE) is a public market for the trading of securities issued by publicly quoted companies in Kenya. The Nairobi stock exchange is the Centre point of Kenya capital market; stocks are listed and traded on the exchange. The apex regulatory body is the Capital market authority. The regulation authority is under a government body the Ministry of finance and governed through the Capital Markets Authority Act Cap 485A (the CMA Act). The Authority was established to regulate and oversee the orderly development of Kenya's Capital markets (2006, NSE handbook).

The NSE has been one of the most popular investments in Kenya in the recent past due to its high return. It has become an integral part of the Kenya economy and any fluctuation in this market influences financial lives of individuals as well as corporate entities. Presently 61 companies are listed at NSE and two indexes are computed daily; the NSE-20 share index which is equal weighted geometric mean for twenty large and most active stocks that represents of all sectors and the NSE all stock index which is value weighted arithmetic mean. Companies listed in NSE are categorized into five segments; Agriculture, Commercial and services, Financial and investments, Industrial and Allied and finally Alternative Investment Market Segment (AIS) (2006, NSE handbook). Investors expect returns on their investments and given a certain level of risks a rational investor expects to maximize his returns.

1.2 Statement of the Problem

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

between firms and operating performance. Eisenberg et al. 1998) also found negative correlation between board size and profitability when using small and midsize Finnish firms. Mak and Yuanto (2003) re-echo the above findings in firms listed in Singapore and Malaysia when they found that firm valuation is highest when a board has five directors, a number considered relatively small in those markets. According to Cho and Kim (2003), companies would enhance their corporate governance when the company's performance is poor because changes in corporate governance structure are expected to bring out positive results on their performance.

Even though corporate governance principles have always been important for getting good rating scores for large and publicly held companies, they are also becoming much more for investors, potential investors, creditors and government (Gompers et al.,2001). Because of all these factors corporate governance receives high priority on the agenda of policymakers, financial institutions, investors, companies and academics (Heracleous, 2001). In literature a number of studies have sought to investigate the relation between corporate governance mechanisms and financial performance (e.g. Berglof, Von Thadden, 1999) most of the studies have shown mixed results without a clear cut relationship. E.g. a study by Becht et al., (2002) show that corporate governance practices positively influences the profitability of the organization while MacAvoy and Millstein (2003) found that board composition does not have any effect on financial performance. This study seeks to investigate the relationship that exists between corporate governance and value of firms at NSE. Further, the limited studies in the area have focused mainly on developed economies (E.g. Becht et al., 2002). It is crucial to examine the relationship in the context of a developing economy. Locally, Jebet (2001) conducted a study of corporate governances the case of quoted companies in Kenya, Muriithi (2005) did a study on

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

1.3 Objective of the Study

The main objective of the study was to establish the relationship between corporate governance and firm value at the NSE.

1.4 Importance of the Study

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

The aim of this study was be to investigate the effects of corporate governance on the value of firms at the NSE. This study therefore attempted to find out the effect of corporate governance on firm value at the NSE.

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

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter reviews the theory of governance structure. The empirical evidence on the relationship between governance structure and performance of a firm is outlined. Literature review is the analysis of the existing knowledge on a particular line of study. It focuses on the existing studies done by other researchers and scholars and provides some basic knowledge on the research topic.

2.2 Theoretical Review

2.2.1 Agency Theory

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

board process (especially consideration of how board members work together as a group and the competencies and behaviors both at the board level and the level of individual directors). As a result, the current scholarly discourse about the nature of corporate governance has come to reflect this body of research.

2.2.2 Shareholder Theory

There are two main theories of shareholders - oriented governance: the principal-agent or finance model and the myopic market model. The principal agent model starts from an assumption that the social purpose of corporations is to maximize shareholders wealth (Coelho et al., 2003;Friedman, 1970).the principal- agent model regards the central problem of corporate governance as self- interested managerial behavior in a universal principal- agent relationship. Agency problems arise when the agent does not share the principal's objectives. Furthermore, the separation of ownership and control increases the power of professional managers and leaves them free to pursue their own aims and serve their own interests at the expense of shareholders (Berle and Means, 1932). There are two problems occurring in the agency relationship with which agency theory is concerned. The first is that because it is difficult or expensive for the principal to verify what the agent is actually doing, the principal cannot verify that the agent behaves appropriately. The second is that the principal and the agent might prefer different actions because of the different attitudes towards risk (Eisenhardt, 1989, p.58).

The myopic market model shares a common view with the principal-agent model that the corporation should serve the shareholders' interests only, but criticizes the Anglo-American model of corporate governance because of "competitive myopia" (Hayes and Abernathy, 1980) and its consequent pre- occupation with short- term gains in return, profit and other performance measures induced by the markets pressures. The

myopic market model holds that what is wrong with corporate governance is that the system encourages managers to focus on short – term performance by sacrificing long-term value and competitiveness of the corporation. The financial markets often force managers to behave in a way divergent from the maximization of the long term wealth for shareholders (Blair, 1995). The myopic market view contends that corporate governance reform should provide an environment in which shareholders and managers are encouraged to share long term performance horizons. Shareholders loyalty and voice should increase whereas the ease of shareholders exit should reduce.

2.2.3 Transaction Cost Economics

Transaction cost economics (TCE) as expounded by the work of Williamson (1984) is often viewed as closely related to agency theory. TCE views the firm as a governance structure whereas agency theory views the firm as a nexus of contracts. Essentially the latter means that there is a connected group or series of contracts among the various players, arising because it is seemingly impossible to have a contract which perfectly aligns the interest of the principal and agent in a corporate control situation. As firms grow in size, as may be caused by desire to achieve economies of scale amongst other factors, there is an increasing need for more capital which needs to be raised from the capital markets and thus possibility of widening the shareholder base.

2.3 Empirical Studies on Corporate Governance and Firm value

In developed countries, statistically significant effects are often not found, and when found, are often economically small (Gompers, Ishii & Metrick, 2002, is a recent exception). Black (2001) argues that large effects are more likely to be found in transition and developing countries, because variations in corporate governance practices are likely to be larger.

Most of the empirical literature studying the link between corporate governance and firm performance concentrate on a particular aspect of governance, such as board, shareholders' activism, compensation, anti-takeover provisions, investor protection, and soon. To name a few, Millstein and MacAvoy (1998) and Bhagat and Black (1999) investigate the relationship between board characteristics and firm performance. Karpoff, Malatesta, and Walking (1996) and Carleton, Nelson, and Weisbach (1998) link firm performance with shareholders' activism. Bhagat, Carey, and Elson (1999) look at the relationship between outside directors' pay and firm performance. Sundaramurthy, Mahoney, and Mahoney (1997) links firm performance with anti-takeover provisions and LLSV (2002) analyses the relationship between investor protection and firm performance.

Corporate governance has attracted various definitions. According to Mayer (1997), corporate governance is concerned with ways of bringing the interests of investors and managers into line and ensuring the firms are run for the benefit of the investors. Corporate governance is concerned with the relationship between the internal governance mechanisms of corporations and society's conception of the scope of corporate accountability (Deakin and Hughes, 1997). Metrick and Ishii (2002) define corporate governance from the perspective of the investor as both the promise to repay a fair return on the capital invested and the commitment to operate a firm efficiency given investment. They argue that firm level governance may be more important in developing markets with weaker institutions as it helps to distinguish among firms.

The theory on corporate governance stems from the thesis "the modern Corporation and Private Property" by Berle and Means (1932). The thesis highlights a fundamental agency problem in modern firms where there is a separation between

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

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

Separation between ownership and control of corporations characterizes the existence of a firm. The design of mechanisms for effective corporate control to make managers act in the best interest of shareholders has been a major concern in the area of corporate governance and finance (Allen and Gale, 2001) and continuing research in agency theory attempts to design an appropriate framework for such control. In a

corporation, the shareholders are the principals and the managers are the agents working on behalf of, and for the interest of, the principals. In agency theory, a well-developed market for corporate control is assumed to be non – existent, thus leading to market failures, non-existence of markets, moral hazards, asymmetric information, incomplete contracts and adverse selection among others. Various governance mechanisms have been advocated which include monitoring by financial institutions, prudent market competition, executive competition, executive compensation, debt developing an effective board of directors, markets for corporate control, and concentered holdings. Developing an effective board of directors remains an important and feasible option for an optimal corporate governance mechanism.

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

In contrast, Demesetz (1983) and Fama and Jensen (1983) suggest that the primary monitoring of managers comes not from owners but from managerial labour market. It is argued that managerial control of a large corporation is completely separate from its security ownership. Efficient capital markets provide signals about the value of a company’s securities and thus about the performance of its managers. If the managerial labour market is competitive both within and outside the firm, it will tend

to discipline the manager. Therefore, the signals given by the changes in the total market value of the firms securities become very important.

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

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

Jensen and Meckling (1976) further define agency relationship and identify agency costs. Agency relationship, according to them, is a contract under which "one or more persons (principal) engage other person (agent) to perform some service on their behalf, which involve delegating some decision making authority to the agent". The scenario normally generates a conflict of interests. This scenario between managers and the controlling shareholder, and outside or minority shareholders refers to the tendency that the former might extract perks out of a firm's resources and be less

interested to pursue new profitable ventures. Agency costs in this case include monitoring expenses by the principal such as auditing, budgeting, control and compensation systems, bonding expenditures by the agent and residual loss due to divergence of interests between the principal and the agent. Usually, the share price paid by the shareholders (principal) reflects such agency costs. This is one way to view the linkage between corporate governance and corporate performance. Fama (1980) aptly comments that separation of ownership and control can be explained as a result of efficient form of economic organization.

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

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

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

2.4 Summary of Literature

As is evident from the above literature, academic research on corporate governance continues to occupy the minds of many scholars due to the perceived importance on corporate growth and social economic improvement. The academic literature and corporate governance regulators acknowledge the impact of corporate governance attributes on the performance of firms. A number of propositions emerge from the discussion of this chapter. The propositions relate to the links among corporate governance attributes and earnings. The evidence relating corporate governance and firm performance varies. It is certain that there is a positive relationship between size of Board and corporate performance; it is however less certain of the optimal size. Ownership structure, and in particular presence of block equity holders has been demonstrated to have a positive relationship to corporate performance. This follows from the fact that they do have sufficient interests and resources to closely monitor management performance. Independence of the Board has also been studied with more studies finding a direct relationship between this attribute and performance. It is also acknowledged that separation of the CEO role from that of the chair of the Board increases performance.

In Kenya, corporate governance studies have been few and those few have tended to be focused on either specific sectors like banking and Cooperatives or limited to one corporate governance attribute. Studies have been conducted relating privatization, ethics, voluntary corporate disclosure and Corporate Governance. Mucuvi (2008) evaluated the adequacy of laws governing Corporate Governance; Mwangi (2002)

looked at the Corporate Governance practices adopted by insurer while Njuguna (2006) checked the level of compliance with the CMA guidelines by listed companies.

This study fills the gap in having current research findings linking corporate governance to performance across the sectors by looking at all the listed companies.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlines the general methodology to be used to conduct the study. It specifies the research design, target population, data collection method and instruments, and data analysis and interpretation.

3.2 Research Design

The research design is a plan, structure and strategy conceived so as to obtain answers to research questions. It provides a framework for planning and conducting a study. The descriptive research methodology will be adopted in this study. The methodology was most preferred because the study used quantitative statistical data to describe the relationship between corporate structure and firm performance.

3.3 Population

Cooper and Emory (1995) define population as the total collection of elements about which the researcher wishes to make some inferences. Element is the subject on which the measurement is being taken and is the unit of study, according to Cooper and Shindler (2003). Target population in statistics is the specific population about which the information is desired. For the purpose of this study to avoid ambiguity, the target population of the study was a sample of 30 companies from all the 61 companies listed at the Nairobi Stock Exchange, under the main Segment. This will built more cross sector evaluation contrary to prior studies that have concentrated on specific segments. The information was obtained from the Capital Market Authority (CMA).

3.4 Data Collection Method

The study used secondary data sources available at the companies' financial statements at the NSE or Capital Market Authority offices. The secondary data sources were chosen owing to the fact that they are cheaper and more quickly available than primary data and helped clarify and answer the research question. Every listed company is required to report the extent to which they complied with the Corporate Governance Principles in their annual reports, information about corporate governance was readily accessible at the CMA. Data on firm value was collected on return on assets and market-to-book values while data on corporate governance was collected on board size, board composition, chief executive status and audit committee.

3.5 Data Analysis

The study used multiple linear regression equation and the method of estimation was market- to book ratio as well as return on assets so as to establish the relationship between corporate governance and firm value.

The study used regression to estimate the model with measures firm value as the dependent variable and corporate governance attributes as the independent variables. The objective of the model was to provide an assessment of the impact of corporate governance on firm value.

The economic models used in the study were given by:

$$Y = \beta_0 + \beta F_{it} + \varepsilon_{it}$$

Where, Y is the dependent variable, β_0 is the constant, βFit is the coefficient of the explanatory variable (corporate governance attributes), and ε_{it} is the error term

assumed to have zero mean and independent across time period. From the economic model in the equation above, equation below will evolve:

$R.O.A=\beta_0+\beta_1BSIZE+\beta_2BCOMP+\beta_3CEO+\beta_4AUDCOM+\varepsilon it$……..*equation 1*

$MBV=\beta_0+\beta_1BSIZE+\beta_2BCOMP+\beta_3CEO+\beta_4AUDCOM+\varepsilon it$……..*equation 2*

Where, R.O.A, MBV are the dependent variables, βo is the constant, $\beta_{1,2,3,4}$ is the coefficient of the explanatory variable (corporate governance attributes), and ε_{it} is the error term assumed to have zero mean and independent across time period.

Board Size (BSIZE) – This variable will be used to capture the size of the board. It is expressed in terms of number of members serving on the board of a particular firm. Despite the argument that larger boards have a range of expertise to help make better decisions, and are harder for a powerful CEO to dominate, some studies find the large boards are less effective as they are difficult to coordinate in decision making (Islander M and Chemlou, 2000). The effect of the board size may not therefore be determined as a priority.

Board Composition (BCOMP) – this variable captures the board composition in terms of the ratio of executive directors to the total number of directors. It is calculated as the number of executive directors divided by the total number of directors.

Audit Committee (AUDCOM) – this is the number of independent directors on audit committee divided by the total number of directors in the audit committee.

Return on Assets (ROA) - An indicator of how profitable a company is relative to its total assets. ROA gives an idea as to how efficient management is at using its assets to generate earnings. Calculated by dividing a company's annual earnings by its total

assets, ROA is displayed as a percentage. Sometimes this is referred to as "return on investment.

Table 3.1: Expected sign for the governance variables

Expected Sign	Variable	Measurement
+ or -	BSIZE	Number of Board members
+ or -	BCOMP	Ratio of outside directors to total number of directors
+ or -	AUDCOM	Ratio of independent directors to total directors in audit committee

CHAPTER FOUR: DATA ANALYSIS AND PRESENTATION

4.1 Introduction

The purpose of this study was to determine the relationship between corporate governance and performance of firms listed on the Nairobi securities exchange. The study specifically sought to examine the relationship between return on assets and market to book values as a measure of firm value and corporate governance attributes which were board size, board composition, the status of the CEO and the composition of the audit committee.

The study relied solely on secondary data which was extracted from the companies' annual financial statements for the years ending between December 2010 to December 2012. The populations of companies under study were a sample of 30 companies listed in the Nairobi Securities Exchange (NSE). Data was captured in MS Excel and SPSS for analysis. Regression analysis was used to drive the model in order to determine the relationship between performance and aspects of corporate governance.

4.2 Descriptive Statistics for corporate governance

The study examined the relationship between some measures of corporate governance such as board size, board and audit committee composition, and CEO duality and firm performance of listed institutions in the Nairobi Securities Exchange.

Table 4.1: Descriptive Statistics

Statistics						
		boardsize	boardcomp	auditcom	Roa	MTBV
N	Valid	90	90	90	90	90
	Missing	0	0	0	0	0
Mean		8.47	.03	.53	.03	1.03
Std. Deviation		2.007	.181	.502	.181	1.441
Variance		4.027	.033	.252	.033	2.078
Minimum		5	0	0	0	0
Maximum		12	1	1	1	6

Source: Author

Of the firms studied, the mean board size was 8.47 suggesting that the firms in the Nairobi Stock Exchange have relatively moderate board sizes. With a maximum of 12 and a standard deviation of 2.007, the implication is that firms at the NSE have relatively similar board sizes. This is essentially good for firm performance according to researchers such as Jensen (1993).

As far as Board composition was concerned the difference is statistically significant in that the majority of the firm in the stock exchange having a ratio of 0.03 with a standard deviation of 0.181 meaning that on average most companies had more external independent directors. On the other hand the ratio of independent directors to those from within the firms had a mean of 0.53 with a standard deviation of 0.502. from this analysis, most of the firms in the stock exchange embraced the idea of more external members in the audit committee than insider ones.

4.3 Regression Analysis

Model 1

Coefficients:

Table 4.2: Regression results model 1

	Estimate	**Std. Error**	**t-value**	**P-Value**
(Intercept)	0.248895	0.101243	2.4584	0.0159611 *
boardsize	-0.033353	0.009193	-3.6281	0.0004837 ***
boardcomp	-0.032339	0.162569	-0.1989	0.8427912
auditcom	0.262185	0.059893	4.3776	3.362e-05 ***

Source: Author

Significant. Codes: 0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1

Total Sum of Squares: 2.8466

Residual Sum of Squares: 2.1449

R-Squared : 0.24649 Adj. R-Squared: 0.23553

F-statistic: 9.37749 on 3 and 86 DF, p-value: 1.9864e-05

As shown in the above table Return on Assets as a dependent variable is significant to the study with a p value of 0.00019864. Board size has a negative coefficient of -0.033353 which means that for any change in board size the return on assets reduces by the same magnitude. Board composition has a negative coefficient of -0.032339 with a p value of 0.8427912 which is insignificant and shows that board composition does not contribute to return on assets. Audit committee has positive coefficient of 0.262185 with a significant p value of 0.00003362 which is interpreted to mean that the composition of the audit committee has a great impact on Return On Assets as a variable.

The overall p value is 0.000019864 which means that there is a positive relationship between Return on Assets as a measure of firm value and corporate governance attributes such as board size and board composition.

Model 2

Coefficients:

Table 4.3: Regression results model 2

	Estimate	Std. Error	t-value	**P-Value**
(Intercept)	-0.552976	0.839562	-0.6586	0.51188
boardsize	0.077648	0.076233	1.0186	0.31127
boardcomp	1.534509	1.348110	1.1383	0.25817
Auditcom	1.065514	0.496667	2.1453	**0.03475 ***

Source: Author

Significant. Codes: 0 ‘***’ 0.001 ‘**’ 0.01 ‘*’ 0.05 ‘.’ 0.1 ‘ ’ 1

Total Sum of Squares: 159.07

Residual Sum of Squares: 147.5

R-Squared : 0.072722

Adj. R-Squared: 0.06949

F-statistic: 2.2482 on 3 and 86 DF, p-value: 0.088466

In the second model, market –to-book value ratio is used to determine the relationship between firm value and corporate governance attributes. Board size has a positive insignificant relationship with market to book value ratio with a positive coefficient of 0.077648 and a p-value of 0.31127. Boardsize also has a positive insignificant influence on market to book value ratio with a coefficient of 1.534509 and a p-value

of 0.25817.Audit committee composition has a positive influence on market to book value ratio with a coefficient of 1.065514 and a p-value of 0.000003475.

Overally, market to book value ratio as a measure of firm value in relation to corporate governance is insignificant with a p-value of 0.088466. The composition of the audit committee proved to be a strong contributing factor to both Return on Assets and Market-to-Book value ratio as a measure of firm value. This means that firms with corporate governance attribute of a higher number of independent directors in their audit committee are more likely to experience a higher Return on Assets and favorable Market-to-Book value ratio The study examined the relationship between some measures of corporate governance such as board size, board composition, and audit committee composition and firm value of firms listed at the NSE.

The findings have shown a significant relationship between board size and Return on Assets. This means an increase in number of board members negatively influences the return on assets. The findings have shown board composition have a negative insignificant influence on Return on Assets. There is a great positive significant contribution, (0.262185) that the composition of the audit committee impacts on the Return on Assets with p value of 0.00000362.The corporate governance variables have a significant influence on the Return on Assets with p-value of 0.000019864.There is a positive insignificant relationship between board size and Market-to-Book value ratio with p-value of0.31127. There is positive insignificant influence between board composition and Market-to-Book value ratio with p-value of 0.25817.There is a positive significant influence of Audit committee composition on Market-to-Book value ratio with p-value of 0.03475.Board audit committee composition as an independent variable has a great influence on both Return on Assets and Market-to-Book value ratio as measures of corporate governance.

The linear model for estimating liquidity in terms of Return on Assets can be expressed thus as:

ROA = 0.248895 – 0.033353 Board Size -0.032339 Board Size + 0.262185 Audit Committee

The linear model for estimating illiquidity in terms of Market-to-Book Value can be expressed in terms of:

MBVR=-0.552976+ 0.077648 Board Size+ 1.534509 Board Composition + 1.065514 Audit Committee

The empirical results of this study generally indicate both a negative and positive relationship (mixed results). This means that the corporate governance attributes do affect both Return on Assets and Market-to-Book value ratio as measures of firm value of a company. In the light of the foregoing analysis it is obvious that there is relatively mixed results regarding corporate governance and firm value. It must however be stated that this is consistent with other studies; Forsberg (1989), Hermalin and Weisbach (1991) found no relation between the proportion of independent directors and various firm level performance measures. However, for efficient performance of firms, the adoption of two-tier board structure and maintaining smaller board sizes that of about seven members is critical.

Corporate governance embraces a broader set of variables, such as economic and legal environment, progressive practices, existence of internal control measures, ownership and compensation structure within an institution, the nature and quality of information flow and the level of involvement in staff in the day today decision of corporate entity. The mean board size for the sample was found to be 8.47 and the

maximum of twelve and deviation of 2.007. this is consistent with the study of Mwangi (2004) who found out that the average board size was eight members and the outside representation constitute about 71.23% . With regard to the board composition, the mean ratio of about 63% implies the use of more outside directors on the board in the overall sample.

4.4 Test of Hypothesis

This study was guided by the following hypotheses:

1. *H0*: There is no significant relationship between corporate governance and firm value for firms listed at the NSE.
2. *H1*: There is a significant relationship between corporate governance and firm value for firms listed at the NSE.

From the study findings there is no significant relationship between corporate governance and firm value for firms listed at the NSE using Market-to-Book value as a measure of Firm Value. Therefore the null hypothesis is accepted. On the other hand measuring firm using Return on Assets the null Hypothesis is rejected.

CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

The objective of the study was to investigate the relationship between corporate governance and firm value for firms listed in the Nairobi Securities Exchange. In order to attain this objective, statistical analysis was done for 30 companies out of a population 63 companies listed in the Nairobi Securities Exchange in the period between December 2010 and December 2012.

This chapter gives a summary of the study findings. It also presents the limitations and recommendations for further research. The data was analyzed by use of SPSS package to produce the regression analysis. Tables were used to describe data and draw conclusions on the findings. Regression results reveal that institutionalization of good corporate governance attributes: board size, board composition, audit committee have strong and significant marginal effects on return on assets while the institutionalization of good corporate governance attributes have positive but insignificant effects on market to book value ratio

5.2 Conclusion

The importance of corporate governance cannot be over emphasized since it enhances the organizational climate for the internal structure and performance of a company. Indeed, corporate governance brings to bear through external independent directors, new dimension for effective running of a corporate entity thereby enhancing a firm's corporate entrepreneurship and competitiveness.

Since the wave of corporate scandals began, a consensus has developed around the importance of good corporate governance to individual companies and to the global

economy as a whole. Companies are under more pressure than ever before to adopt governance best practices and to convince investors that their governance is responsible. The easy course may be simply to adopt a one-size-fits-all model, and there are features such as independent board committees that make sense across the board. But as the academic research shows, there is no governance “magic bullet” and no substitute for thoughtful, contextual analysis.

Regression results revealed that R-squared was 0.435, implying that 43.5% variations from the expected and actual output of dependent variable i.e. ,firm value (measured by return on assets) are explained by independent variable corporate governance mechanisms measured by audit committee, board size, board composition. The R-squared for firm value measured by market to book ratio was 0.7272 implying that 72% variations are explained by corporate governance mechanisms.

5.3 Limitations of the Study

The major limitation encountered is that data on financial performance on quoted companies in the NSE was not readily available which resulted in the use of time in locating individual financial statements from CMA. The number of companies listed at the NSE is rather small as compared to other stock exchanges in the world. Furthermore, the study is limited to a few listed firms at the NSE, which is relatively small compared to non-listed firms in the country.

5.4 Recommendation for further research.

The study focused on the relationship between corporate governance and firm value for firms listed at the NSE. Other mechanisms can be employed as a proxy for corporate governance e.g. Legal/ regulatory requirement, markets for corporate control, product / labor markets, managerial compensation, and by law/ charter

provisions among others. With regard to stock market liquidity, studies could be carried out to investigate the effect of capital structure, dividend policy, insider trading, market power, stock splits on liquidity of stocks.

It is also critical that we evaluate whether in Kenya we employ corporate governance attributes as tools for strategic management (competitive advantage) or merely to fulfill compliance obligations, in which case, no gainful benefit can be realized.

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APPENDICES

APPENDIX 1: LISTED COMPANIES AT THE NAIROBI SECURITIES EXCHANGE

Agricultural sector

1. Eaagads Limited
2. George Williamson Kenya Ltd
3. Kakuzi Limited
4. Kapchorua Limited
5. Limuru Tea Company Limited
6. Rea Vipingo plantation limited
7. Sasini tea & coffee limited

Commercial & Services sector

1. Express Kenya Limited
2. Kenya Airways Limited
3. Nation Media group
4. TPS Serena limited
5. Standard group
6. Uchumi Supermarkets
7. Hutching Biemer
8. Longhorn Kenya
9. Scan group

Construction& Allied sector

1. Athi river Mining
2. Crown Paints Kenya
3. Bamburi cement Limited
4. E.A. Cables
5. E.A. Portland cement Ltd

Automobile & Accessories

1. Car & general Kenya Limited
2. CMC holdings
3. Marshall E.A Limited
4. Sameer Africa

Energy & Petroleum

1. KenGen
2. Kenol Kobil
3. Kenya Power & Lighting Co Ltd
4. Total Kenya Limited
5. Umeme Ltd

Insurance

1. British American Investments Co.
2. CIC Insurance Group
3. Jubilee Holdings
4. Kenya Re Corporation
5. Liberty Kenya Holdings
6. Pan Africa Insurance

Investment

1. Centum Investment Company
2. Olympia Capital Holding
3. Trans – Century Ltd
4. Nairobi Security Exchange
5. B.O.C. Kenya

Manufacturing

1. Baumann & Co.
2. Kenya Orchards Ltd
3. Unga group Ltd
4. BAT Kenya Limited
5. East Africa Breweries Ltd
6. Mumias Sugar Co.
7. Eveready E. A.

Telecommunication

1. Safaricom Ltd

Growth & Enterprise Market Segment

1. Home Africa Ltd

APPENDIX 2: DATA COLLECTION TOOL

COMPANY	BOARD SIZE	BOARD COMPOSITION	AUDIT COMMITTEE	CEO DUALITY	RETURN ON ASSETS	SALES