CORPORATE GOVERNACE AND WEALTH CREATION BY COMPANIES QUOTED IN THE NAIROBI STOCK EXCHANGE

BY

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DECLARATION

This research project is my original work and has not been submitted for a degree in any other university.

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This research project has been forwarded for examination with my approval as the university supervisor.

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May God abundantly bless and reward you all.

DEDICATION

I dedicate this project work to my parents Mr. and Mrs. Eliud Karani Murimi, siblings Late Eric Njau Murimi and Sheila Murugi Murimi whom I respect for their love and support during my formative years as a student. They always encouraged me during this course and have been a pillar of my hope and success.

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ABSTRACT

Corporate governance is a system in which companies are directed and controlled. In the recent past, there has been renewed interest in corporate governance practices of modern corporations since 2008, due to the collapse of a number of large United States of America with seven of some of the largest bankruptcies in American history happening in the year 2002. Corporate governance is important in management mainly because it ultimately leads to greater investor confidence which often leads to more wealth creation. Investors are willing to pay more for a corporation's stocks if it is known to have good corporate governance.

This study was designed to fill the gap that existed in earlier studies, undertaken in the field of corporate governance. These studies have not been clear on the relationship between corporate governance and wealth creation by companies quoted in the Nairobi Stock Exchange. The earlier studies tended to have concentrated on compliance issues and structures regarding corporate governance. This study sought to address the effect of adopting corporate governance on wealth creation by companies quoted in the Nairobi Stock Exchange. The objective of this study was to determine the relationship between adoption of corporate governance and .wealth creation among companies quoted in the Nairobi Stock Exchange.

The research was a cross sectional survey design involving companies quoted and trading in the Nairobi Stock Exchange as at 16th August 2011. A total of 42 companies were interviewed and there results presented. The findings of the survey are that most companies that are listed in the Nairobi Stock Exchange are complying

with the Capital Markets Authority guidelines on corporate governance. There was found to be a significant increase in company share prices five years after adoption of corporate governance as compared to five years before adoption of the practice. During this period the NSE 20 share index increased to a high of 6,161.47 points in year 2007 as compared to a high of 3,675.44 points in 1997. This has in turn led to wealth creation by the quoted companies for their shareholders and even themselves more so when they sell their shares to the public. It is also worth noting that 60% of the total respondents reported benefits outweighed costs of implementing corporate governance.

It recommended for both public and private companies to adopt corporate governance practices since it is expected to increase wealth of at least the share holders. Further, in order to have convincingly functional audit committees, ways of ensuring corporate governance guidelines are adhered to should also be strengthened in order to avoid misleading compliance.

One of the limiting factors experienced by the researcher was lack of total and outmost disclosure by the respondents regarding the details of their directors especially when dealing with the negative aspects were being touched on. Response time was also limited since response was given during normal working hours Interruptions during response time could have affected the quality of output. Finally, it has been suggested that more research be conducted regarding adoption of corporate governance by unquoted firms as well as benefits that may arise thereafter for this organizations and related parties.

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CHAPTER ONE: INTRODUCTION

1.1 Background

All over the world businesses strive to attract funding from investors for expansion and growth. Before any investor decides to put money in a business he will want an assurance that the business is financially sound and will continue as such in the foreseeable future. Thus investors do require some level of confidence that the business is being properly managed and is profitable. However, many stakeholders have faced frustration with performance of companies, necessitating the focus on corporate governance and it's crucial importance to world economies. Hence corporate governance mechanisms and controls are intended to reduce inefficiencies which may arise in an organization from moral hazards and/ or adverse selection (Ng'ang'a, 2007). Corporate governance has been defined as the system by which companies are directed and controlled (Cardbury,1992).

There has been renewed interest in corporate governance practices of modern corporations since 2008. This was particularly due to the collapse of a number of large USA firms that included Lehman Brothers. Prior to that corporate governance had aroused public interest in 2002 when large USA companies had collapsed. Seven of some of the largest bankruptcies in American history were filled in 2002 alone. Some of the companies that tumbled included Enron, Tyco, Alpephia, WorldCom and Global Crossing (Monks & Minow, 2004).In Kenya corporate governance seems to have

received the most public attention in March 2007 when Francis Thuo and Partners Stockbrokers collapsed followed by Discount Securities in year 2008.

Although research is still inconclusive there is reason to believe, in the aggregate and in the long run, that better governed firms will be rewarded with a lower cost of capital and consequently better firm performance. In other words, as firms increasingly match each other on products, services and technologies, corporate governance may become one of the last frontiers of competitive differentiation, thus urging firms to "race to the top" (Peng, 2009). This important statement can be supported by a leading IT firm in India known as Infosys which has emerged as an exemplar in corporate governance and has become financially successful as a result. In interviews, Infosys executives dismiss the idea that its governance practices are fueled by its interest in attracting capital, of which it has plenty. Instead, the primary reason cited is to gain credibility with Western customers in the rough and tumble software product market. In other words, excellent governance practices make Infosys stand out in the product market (Khanna & Palepu, 2004).

1.1.1 Concept of corporate governance

The concept of "governance" is as old as human civilization. Governance simply means the process of decision making and the process by which decisions are implemented or not implemented. On the other hand, corporate governance is a relatively new area, although the issues it addresses have been around for a long time. These issues draw from various disciplines such as management, economics, finance, accounting, law and organization

behaviour (Mallin, 2007). To appreciate the importance of corporate governance it is essential to get a clear understanding of its definition.

The Organization for Economic Co-operation and Development (OECD,1999), describes corporate governance as a set of relationships between a company's board, its shareholders and other stakeholders. Corporate governance can also be defined as the system by which companies are directed and controlled (Cardbury ,1992). In addition, corporate governance is the manner in which the power of a corporation is exercised in the stewardship of the corporation's total portfolio of assets and resoarces with the objective of maintaining and increasing shareholders value and satisfaction of other stakeholders in the context of its corporate mission (PSCGT, 1999).

Despite the numerous definitions given for corporate governance, the following principles relating to the concept seem to be generally accepted. Organizations should respect the rights of shareholders and help shareholders to exercise these rights and should also recognize that they have legal and other obligations to all legitimate shareholders. The board needs a range of skills and understanding to be able to be able to deal with various business issues and have the ability to review and challenge management performance. It needs to be of sufficient size and committed to fulfill its responsibilities and duties. There needs to be an appropriate mix of executive and non executive directors. Ethical and responsible decision making is important for public relations and avoiding law suits. It is important to understand that reliance by a company on the integrity and ethics of individuals is bound to eventual

failure. Due to this, many organizations establish compliance and ethics programs to minimize the risk that the firms steps outside of ethical and legal boundaries.

Finally, organizations should clarify and make publicly known the roles and responsibilities of board and management to provide shareholders with a level of accountability, implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information (PSCGT, 1999).

Since the late 1970's, corporate governance has been the subject of significant debate in the U.S. and around the world. Bold, broad efforts to reform corporate governance have driven the needs and desires of shareholders to exercise their rights of corporate ownership and to increase the value of their shares and, therefore wealth (Mallin, 2007).

Over the past three decades, corporate directors' duties have expanded greatly beyond their legal responsibility of duty and loyalty to the corporation and its shareholders. The increase in corporate directors' duties and corporate governance interests were generally sparked by the wave of CEO dismissals (such as in IBM, Kodak and Honeywell) in the early 1990's by their boards, the California Public Employees' Retirement System (Calpers) which lead to a wave of institutional shareholder activism (something very rarely seen before), as a way of ensuring that corporate value would not be destroyed by the traditionally cozy relationship between the CEO and the board of directors. The increase in duties and responsibilities was

also sparked by, the 1997 East Asian Financial Crisis that saw the economies of Thailand, Indonesia, South Korea, Malaysia and the Philippines severely affected by the exit of foreign capital after property assets collapsed. The lack of corporate governance mechanisms in these countries highlighted the weaknesses of the institutions in their economies. Other factors that have led to an increase in directors responsibilities and duties were the early 2000s, massive bankruptcies and criminal malfeasance of Enron and WorldCom, as well as lesser corporate debacles, such as Adelphia Communication, American Online, Auther Andersen, Global Crossing, Tyco and the collapse of Lehman Brothers in September 2008 which has led to the largest bankruptcy in history so far (Monks & Minow, 2004).

1.1.2 Wealth creation

According to O'Malley (1998), the most successful organizations understand that the purpose of any business is to create wealth or value for customers, employees, and investors, and that the interests of these groups are inextricably linked. Therefore sustainable value cannot be created for one group unless it is created for all of them. The first focus should be on creating value for the customer, but this cannot be achieved unless the right employees are selected, developed, and rewarded, and unless investors receive consistently attractive returns. Value for the customer entails making products and providing services that customers find consistently useful. In today's economy, such value creation is based typically on products and process innovation and on understanding unique customer needs with ever increasing speed and precision. But companies can innovate and deliver

outstanding service only if they tap the commitment, energy and imagination of their employees. Value must therefore be created for those employees in order to motivate and enable them. Value for employees includes being treated respectfully and being involved in decision making. Employees also value meaningful work, excellent compensation opportunities, continued training and development. Creating value for investors means delivering consistently high returns on their capital. This generally requires both strong revenue growth and attractive profit margins. These, in turn, can be achieved only if a company delivers sustainable value for customers.

If the purpose of business is wealth or value creation, it follows that the mission of any company should be defined in terms of its primary value adding activities. Simply put, Honda should think of itself primarily as a maker and marketer of quality automobiles. McDonald's should think of itself as providing meals of consistent quality throughout the world, in a clean, friendly atmosphere. Managers are expected to address shareholders wealth, earnings growth, and return on assets, but the most successful firms understand that those measures should not be the primary targets of strategic management. Achieving attractive financial performance is the reward for having aimed at (and hit) the real target, that is, maximizing the value created for the primary constituents of the firm. Paradoxically, it is when an organization thinks of itself as a financial engine whose purpose is to generate attractive returns that the company is least likely to maximize those returns in the long run. Often, finance people end up shuffling a portfolio of assets in a self destructive quest for growth business or superior returns with no real understanding of the value creating dynamics of the business they are acquiring and selling. Or, as with the automotive service

chain, attempts to profit without delivering superior value end in lost business, long term customer alienation, and corporate disgrace.

Thus, an organization can take one of two broad approaches to doing business. It can embrace the idea of pragmatic idealism, challenging itself to create value for customers, employees, and shareholders in a positive, win/win cycle. Or it can pursue a more narrowly defined (and illusory) self interest by attempting to exploit the lack of perfect information held by the firm's constituencies or by taking advantage of other inefficiencies in the market that allow the company to temporarily benefit at the expense of other parties and the economy as a whole. The later approach is increasingly unworkable, even in the short run, owing to the nature of the emerging information economy (O'Malley, 1998). It is also worthwhile noting that the latter approach also goes against one of the main principles of corporate governance set out by The Private Sector Corporate Governance Trust (PSCGT, 1999). The principle states that, the board should ensure that a proper management structure (organization, systems and people) is in place and make sure that the structure functions to maintain corporate integrity, reputation and responsibility (O'Malley ,1998).

1.1.3 Nairobi stock exchange

The Nairobi Stock Exchange is the principal stock exchange in Kenya. It began in 1954 as an overseas stock exchange while Kenya was still a British colony with the permission of the London Stock Exchange. Currently the Nairobi Stock Exchange is a member of the African Stock Exchange Association and was in year 2010 Africa's fourth largest stock

exchange in terms of trading volumes and the fifth largest in terms of market capitalization as a percentage of the gross domestic product. The Nairobi Stock Exchange conducts trading through the electronic trading system which was commissioned in 2006. A wide area network platform was implemented in 2007 and this eradicated the need for brokers to send their staff (dealers) to the trading floor to conduct business. This platform has greatly improved transparency in the trading of shares as well as reduced the turn around time of conducting transactions. Trading is now mainly conducted from the stock brokers' and investment bankers' offices through the wide area network. However, traders can under certain circumstances still conduct trading through the floor of the Nairobi Stock Exchange.

Two indices are popularly used to measure performance at the Nairobi Stock Exchange. The NSE 20 – Share Index has been since 1964 and measures the performance of 20 blue chip companies with strong fundamentals which have consistently returned positive financial results. The blue chip companies used in the NSE 20 – Share index are however, reviewed and changed from time to time to reflect changes in performance by companies quoted in the Nairobi Stock Exchange. In 2008, the Nairobi Stock Exchange All Share Index was introduced as an alternative index. The later index incorporates all the traded shares of the day. Its intention is therefore on the overall market capitalization rather than the price movements of selected counters.

1.2 Research problem

Corporate governance is important in management mainly because it ultimately leads to greater investor confidence which often leads to more wealth (value) creation. Investors are willing to pay 16% more for a corporation's stocks if it is known to have good corporate governance. Some investors explained that they would pay more because in their opinion, good governance leads to better performance over time, reduces the risk of the company getting into trouble, and it is a major strategic issue (Wheelen & Hunger, 2008).Wealth and value creation is the purpose of all business organizations. Creation of value is a systematic process that involves creating value for the customer, employees and ultimately the investor or shareholder. According to Moxey (2004), previous research suggests that good corporate governance may correlate with superior share prices and increase in wealth but also shows that there are conflicting views about links between good corporate governance and other aspects of company performance.

The Nairobi Stock Exchange is the principal stock exchange in Kenya. Companies that are quoted in the Nairobi Stock Exchange have a major advantage of being able to raise funds in the form of capital from the investing public unlike their unquoted counterparts. For these companies to enjoy this privilege they must always comply with the prescribed Capital Markets Authority guidelines. In exercise of the powers conferred by section II (3)(V) and 12 of the Capital Markets Act, the Capital Markets Authority issued guidelines for good corporate governance by companies quoted in the Nairobi Stock Exchange. These guidelines made it mandatory for all companies quoted in the Nairobi Stock Exchange to

practice corporate governance as prescribed by the law. Complying with the corporate governance requirements is a lengthy and continuous exercise that utilizes a great deal of an organization's resources.

A number of studies have been done on corporate governance structures and company performance (Lang'at, 2006; Mululu, 2005; Gitari, 2008). While some (Wang'ombe, 2003; Ademba, 2006; Mwangi, 2002; Jebet, 2001; Ng'ang'a, 2007) have merely surveyed the corporate governance practice and systems adopted by various entities. The studies have not been clear on the relationship between corporate governance and wealth (value) creation by companies quoted in the Nairobi Stock Exchange. What is the relationship between corporate governance and wealth creation by companies quoted in the Nairobi Stock Exchange?

1.3 Objective of the study

The objective of this study is to determine the relationship between adoption of corporate governance and wealth creation among companies quoted in the Nairobi Stock Exchange.

1.4 Value of the study

The survey will benefit exchange between academics of various backgrounds and policy makers to help define a research agenda for the future. Further it may help policy makers

such as the Capital Markets Authority in determining whether the costs of implementing corporate governance outweigh the benefits and vice versa.

The findings of the study will also assist practitioners of corporate governance, in this case, companies quoted in the Nairobi Stock Exchange to know whether adoption of corporate governance has led to a general increase in wealth by practitioners. Finally, to scholars, the study will form a basis for further research into factors that could influence creation of wealth by organizations.

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CHAPTER TWO: LITERATURE REVIEW

2. 1 Overview of corporate governance

Corporate governance is the manner in which the power of the organization is exercised in the stewardship of the corporation's total portfolio of assets and resources with the objective of maintaining and increasing shareholders value and satisfaction of other stakeholders in the context of its corporate mission (PSCGT, 1999).Corporate governance can also be defined as the set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled. Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. The principal stakeholders are usually the shareholders, the board of directors, executives, employees, customers, creditors, suppliers and the community at large.

The following are some of the trends in governance that are likely to continue. Boards are getting more involved not only in reviewing and evaluating company strategy but also in shaping it, shareholders are demanding that directors and top managers own more token amounts of stock in a corporation, institutional investors such as pension funds and insurance companies are becoming active on boards and are putting pressure on top management to improve corporate governance. Also non affiliated outside (non management) directors are increasing their numbers and power in publicly held corporations as CEOs loosen their grip on boards. Outside members are taking charge of annual CEO evaluations. Except for the executive, finance and investments committees, board committee

are moving towards complete outside composition, boards are getting smaller, partially because of the reduction in the number of insiders but also because boards desire new directors to have specialized knowledge and expertise instead of general experience. As corporations become more global, they are increasingly looking for board members with international experience. Society in the form of special interest groups, increasingly expect board of directors to balance the economic goal of profitability with the social needs of society. Issues dealing with workforce diversity and the environment are now increasingly reaching the board level (Wheelen & Hunger, 2008).

2.2 Developments in corporate governance

In the early 2000s, the massive bankruptcies and criminal malfeasance of Enron and WorldCom, lead to increases shareholder and government interest in corporate governance. This lead to the passage of the Sarbanes-Oxley Act of 2002.Sarbanes-Oxley (known as SOX) is a US law passed in 2002. Named after the two politicians who sponsored it, the law aims to restore investors' trust in companies' accounts through proper corporate governance. This includes placing more controls on annual reports and directors' behaviour. This law is aimed at accountants and the directors and managers of public companies and makes them personally responsible. Accordingly CEOs and CFOs must certify the accuracy of their company accounts. This means top officers can no longer plead ignorance. They are personally responsible for the integrity of an audit. They can be fined up to USD 5 million and imprisoned for 20 years for failing to obey the law (Sadgrove, 2009).

The following are the requirements of Sarbanes-Oxley Act (Sadgrove, 2009). Companies many not make loans to directors and executive officers. This means that directors can no longer treat the company as their personal piggy bank. Such controls might have prevented the scandal at Hollinger International, the newspaper that accused the Chief Executive, Lord Black of plundering its assets on things such as summer drinks worth USD 24,950/=, jogging attires and exercise equipment for his wife worth USD 2,223/=, a leather briefcase costing USD 2,057/= among other personal expenses. Companies must have an independent audit committee that will appoint, compensate and oversee the work of the auditing firm and to which the auditing firm must report directly. Members of the committee may not do other work in the firm. The accountancy practice must rotate the partners in charge of a corporate client every five years. This will prevent the relationship from getting too cozy.

In addition to the above the law bans accounting firms from providing a number of non audit services. These services include bookkeeping, design, and implementation of information systems. Other services are appraisal or valuations services, management and human resource services, investment advisor or banking services. This means the accounting firm cannot advise on acquisitions and then approve them in the annual report. Section 404 of the law also requires the company's annual report to contain an internal control report, assessing the effectiveness of the company's internal financial controls. This will require more stringent internal auditing. According to a survey by Financial Executives Institute (FEI), it will greatly increase the company's costs, including a 40% increase in external audit fees (Sadgrove, 2009).

Some UK and European companies such as Fugro, a Netherlands based engineering consultancy have chosen to avoid floating US subsidiaries on grounds of increased complexity (Sadgrove, 2009).Other companies have complained bitterly about the added burden that Sarbanes-Oxley imposes. But if the business wants, US funds, there may be no alternative. Even if organizations do not have US listed businesses, the Sarbanes-Oxley Act may still have an impact because it is setting a new global standard for "best practice". Leaders, accountants, business customers and partners may come to expect it. Other countries have also been implementing their own reforms of company laws, such as Australia's Corporate Law Economic Reform Program and South Africa's "King II" report.

During the October 1997 Commonwealth Heads of Government meeting in Edinburgh it was resolved that, capacity should be established in all Commonwealth countries to create or reinforce corporations to promote good corporate governance in particular. Also codes of good practice establishing standards of behavior in public and private sector should be agreed to secure greater transparency and reduce corruption. The Commonwealth Association for Corporate Governance was subsequently established and developed the CACG Guidelines - Principles for Corporate Governance in the Commonwealth. These were adopted at the November 1999 Commonwealth Head of Government meeting in Durban, South Africa, as guidelines for all Commonwealth countries to develop or enhance their own corporate governance principles (Gatamah, 2008).

The following matters are worth noting about corporate governance in Africa. The African Capital Markets Forum is undertaking a study in the state of corporate governance in Africa.

Kenya, Zimbabwe, Ghana, Uganda and South Africa have put in place national institutional mechanisms to promote good corporate governance and training. Technical and awareness rising support have been extended by the World Bank and the Commonwealth Secretariat to various African countries such as Botswana, Senegal, Tunisia, Mali, Mauritania, Cameroon, Gambia, Mozambique, Mauritius, Sierra Leone, and Zambia to help them put in place appropriate mechanisms to promote good corporate governance (Gatamah, 2008).

2.3 Principles of good corporate governance

Good corporate governance indicates that the board of directors governs the corporation in a way that maximizes shareholders value and in the best interest of society. It is neither in the long term interest of the enterprise or society to short change customers, exploit labour, pollute the environment or engage in corrupt practices.

The Private Sector Corporate Governance Trust (PSCGT, 1999) sets out 21 principles of corporate governance as follows. Members or shareholders (as owners) of the corporation shall jointly and severely protect, preserve and actively exercise the supreme authority of the corporation in general meetings. Every corporation should be headed by an effective board that should exercise leadership, enterprise, integrity and judgment in directing the corporation so as to achieve continuing prosperity and to act in the best interest of the enterprise in a manner based on transparency, accountability and responsibility. Appointments of the board of directors should be through a managed and effective process, ensure that a balanced mix of proficient individuals is made and that each of those appointed

is able to add value and bring independent judgment to bear on decision making process. The board of directors should determine the purpose and values of the corporation. determine the strategy to achieve that purpose and implement its values in order to ensure that the corporation survives and thrives. Also that procedures and values that protect the assets and reputation of the corporation are put in place.

In addition. The Private Sector Corporate Governance Trust (PSCGT. 1999) principles state that. the board should ensure that a proper management structure (organization. systems and people) is in place and make sure that the structure functions to maintain corporate integrity. reputation and responsibility. The board should monitor and evaluate the implementation of strategies. policies and management performance criteria and the plans of the corporation. Further, the board should constantly review the viability and financial sustainability of the enterprise at least once a year. The board should ensure that the corporation complies with all relevant laws, regulations, governance practices. accounting and auditing standards. The board should ensure that the corporation communicates with all its stakeholders effectively. The board should serve the legitimate interests of all members and account to them fully. The board should identify the corporation's internal and external shareholders. agree on a policy or policies determining how the corporation should relate to and with them. in creating wealth. jobs and the sustainability of a financially sound corporation while ensuring that the rights of stakeholders (whether established by law or custom) are respected. recognized and protected. The board should ensure that no one person or group of persons has unfettered power and that there is an appropriate balance of power on the board so that it can exercise objective and independent judgment. The board should regularly review

systems, processes and procedures to ensure the effectiveness of its internal systems of control so that its decision making capability and the accuracy of its reporting and financial results are mentioned at the highest level.

Also according to The Private Sector Corporate Governance Trust (PSCGT, 1999) principles, the board should regularly assess its performance and effectiveness as a whole and that of individual members, including the Chief Executive Officer. A summary of the minor findings together with a statement confirming that the board has carried out a self assessment exercise should be made during the annual general meeting. The board should recognize the need for new members to be inducted onto their roles and for all board members to develop and strengthen their governance skills in light of technological developments, changing corporate environment and other variables. The board should accordingly organize for the systematic induction and continuous development of its members. The board should appoint the Chief Executive Officer and participate in the appointment of all senior management, ensure motivation and protection of intellectual capital crucial to the corporation, ensure that there is appropriate and adequate training for management and other employees and put in place a succession plan for senior management.

The Private Sector Corporate Governance Trust (PSCGT, 1999) principles also advice that the board must recognize that to survive and thrive it has to ensure technology, skills and systems used in the corporation are adequate to run the corporation and that the corporation constantly reviews and adopts the same in order to remain competitive. The board must

identify key risk areas and key performance indicators of the corporation's business and constantly monitor these factors. The board should define, promote and protect the corporate ethos, ethics and beliefs on which the corporation premises its policies, actions and behaviour in its relationship with all who deal with it.

The Private Sector Corporate Governance Trust (PSCGT, 1999) principles further state that the board should recognize that it is in the enlightened self interest of the corporation to operate within the mandate entrusted to it by society and shoulder its social responsibility. For this reason, a corporation does not fulfill its social responsibility by short changing beneficiaries or customers, exploiting its labour, polluting the environment, failing to conserve resources, neglecting the needs of the local community, evading taxation or engaging on other anti social practices. The board should recognize and encourage professional development and, both collectively and individually, have the right to consult the corporation's professional advisers and, where necessary, seek independent professional advice at the corporation's expense in the furtherance of their duties as directors. This is in addition to and not in substitute to their personal duty to acquire competence, training and information that would help them make informed, independent and astute decisions on issues relevant to the corporation. Finally, members of the corporation have a right to receive any information that would materially affect their members, to participate in any meeting of members and participate in the elections of directors and be facilitated to fully participate in all other resolutions of interest to them as members.

2.4 Wealth creation

According to Michael, Melanie and Kent (1997) wealth equals the value of physical capital and natural capital that is the total value of the physical and natural capital of households, firms and government. In creating wealth, the corporate sector is hampered by weakness in two vital areas, the corporate governance system and the accounting system. Generally treated separately, both problem areas can be improved simultaneously by having management provide value relevant, long term track records to the investing public (Madden, 2007).Criticism of corporate governance has focused on at least three issues. First, managements (with explicit and implicit board approval) operate with an extreme focus on at least meeting, and hopefully beating, quarterly earnings expectations. But this is to the detriment of long term value creation (Rappaport, 2005). Second, boards fail to adequately tie management compensation to wealth creation (Bebchuk and Fried, 2004). Third, management dominance of the nominating process for board members denies the firms' common stock owners effective representation (Bebchuk, 2007).

Accounting rule makers are struggling with ways to deal with the new business environment in which investments in intangible assets (expensed outlays for resources that contribute to cash flow over multiple future periods) are overtaking investments in booked tangible assets. As a consequence, today's transaction based accounting system understates assets and distorting earnings, due to a mismatch between revenues and expenses. These accounting distortions are not only a major problem for individual firms, but also impact the usefulness of national income accounts (Corrado, Haltiwanger and Sichel, 2005). The

challenge is how best to transition to value relevant accounting system, one that better allows for intangibles, and thus better informs decision making for both management and investors. Better decisions lead to improved resource allocation and more wealth creation. Both the corporate governance system and the accounting system have the ultimate objective of facilitating wealth creation. Consistent with that objective, shareholders should demand that management and boards provide value relevant, long term track records for the firm and its major business units. Also in the context of these track records, provide substantive explanations of why key corporate decisions are consistent with the long term value maximization (Charron, 2007).

In their self interest, shareholders in general, and institutional money managers in particular, should pressure boards of directors and managements to periodically produce a Shareholder Value Review. It should display value relevant, long term track records for the firm and its major business units. These track records should be the centerpiece of a substantive discussion about maximizing shareholder value. Potential benefits include, expedited learning by management and boards about how firms' economic performance connects to shareholder value, expanded role for Chief Finance Officers and their staff to provide the most useful track records displays and to organize related supplemental disclosures providing useful information (Christensen and Demski, 2002) about intangibles and other important issues. In addition, a more productive dialogue among the board, management, and investors, leading to quicker and better decisions for maximizing shareholders value, greater willingness by management to commit to value creating projects that may reduce near term earnings and to explain their decisions to shareholders and more attention by

accounting rule makers to the experiences of primary users of accounting data in dealing with measurement problems critical to wealth creation (Bebchuk, 2007).

2.5 Corporate governance and wealth creation

According to Charron (2007), corporate governance has the ultimate objective of facilitating wealth creation. All over the world, countries are struggling to expand their economies and improve living standards. This struggle is particularly poignant in Africa, which has, for a long time, been mired in declining economic performance. Rising unemployment, deteriorating national infrastructure, inequality and increasing abject poverty. It is also increasingly evident that our continued prosperity as nations, as communities and even dignified individuals is closely linked with the ability to create, strengthen and maintain profitable, competitive and sustainable enterprises. The viable, competitive and sustainable modern enterprise requires an organization of basic resources (capital, material and human) concentrated in large aggregations giving the men and women entrusted to run those enterprises power over resources such that their decisions have great impact upon the society. To achieve their objectives and effectively discharge their responsibilities, corporations must have quality and effective leadership which is responsive, transparent and accountable and which has the focused intelligence to acquire and apply knowledge and know how for the production and creation of wealth. Good corporate governance is thus the lifeblood of a wealth creating and prosperous society (Gatamah, 2008).

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Research design

According to Saunders, Lewis and Thornhill (2009) research design is the arrangement of conditions for collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure. The research setting is the listing of all companies that are quoted in the Nairobi Stock Exchange.

The research was carried out using cross sectional survey design. Arguments for this method are as follows. Cross sectional survey belongs to descriptive methods of research providing descriptive information, which enables generalizations to be made. It also gathers data at a certain point in time to describe the existing conditions, events or systems based on the impressions or reactions of respondents of the research. Therefore, it is economical. The method also is suitable for measuring similar variables across all respondents.

3.2 Population

The target population for investigation was drawn from all of the companies quoted and trading in the Nairobi Stock Exchange since they are all required to comply with the Capital Markets Act (Cap. 485A), which is a guideline on corporate governance

practices, by public listed companies. The companies that were trading were 47 in number (annexure 1).

A census was carried out of all the companies quoted in the Nairobi Stock Exchange as at 16th August 2011. From the population size of 47 companies, 42 companies responded (89% response rate). This is an acceptable response number for the stated population size. 13 companies were from the Commercial Service Sector, 10 from Alternative Investment Sector, 7 from Financial and Investment Sector, 7 from Industrial Allied Sector and 5 from the Agricultural Sector.

3.3 Data collection

Both primary and secondary data was used in the cross sectional survey. Primary data was collected using a self administered questionnaire consisting of both open ended and closed ended questions. The questionnaire was emailed and hand delivered to the respondents. The questionnaire was used to elicit information on aspects that are not subject to disclosure or those that cannot be obtained from the annual reports or from the Nairobi Stock Exchange. On the other hand, secondary data was obtained from the annual accounts and reports of listed companies and from the Capital Markets Authority. A copy of the relevant questionnaire is attached as appendix 2.

A questionnaire is suitable and widely used in cross sectional surveys as it allows data collection from a larger and widely spread group of participants and has fair reliability. It

provides structured, often numerical data capable of being administered without presence of the researcher, and comparatively straight forward to analyze. Questionnaires are also less costly to circulate and reduce interviewer biasness since similar questions are posed to all potential respondents. A letter of introduction was kindly provided by the University of Nairobi was forwarded together with the questionnaire to assist in avoiding suspicion and to assure the respondent that the study is genuine, important and strictly confidential for academic purposes. The main advantage of using secondary data is that it takes a short time to collect data from existing reports.

3.4 Data analysis

The completed questionnaires were then be checked and verified for completeness, consistency and accuracy. The data collected from both primary and secondary data was then analyzed and presented using descriptive statistics frequency and percentages. Descriptive statistics were also used to allow the data and measures to be summarized in a simple and logical manner.

In addition, trend analysis and simple graphic analysis was used to present quantitative descriptions. Correlation of co-efficient will be used to measure the relation between adoption of corporate governance and wealth (value) creation.

CHAPTER 4: DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

Data was collected from 42 (89%) respondents out of the targeted 47 (100%) companies quoted in the Nairobi Stock Exchange. Out of the companies that responded 13 companies were from the Commercial Service Sector, 10 from Alternative Investment Sector, 7 from Financial and Investment Sector, 7 from Industrial Allied Sector and 5 from the Agricultural Sector.

4.2 Social – Demographic Characteristics of Board Members

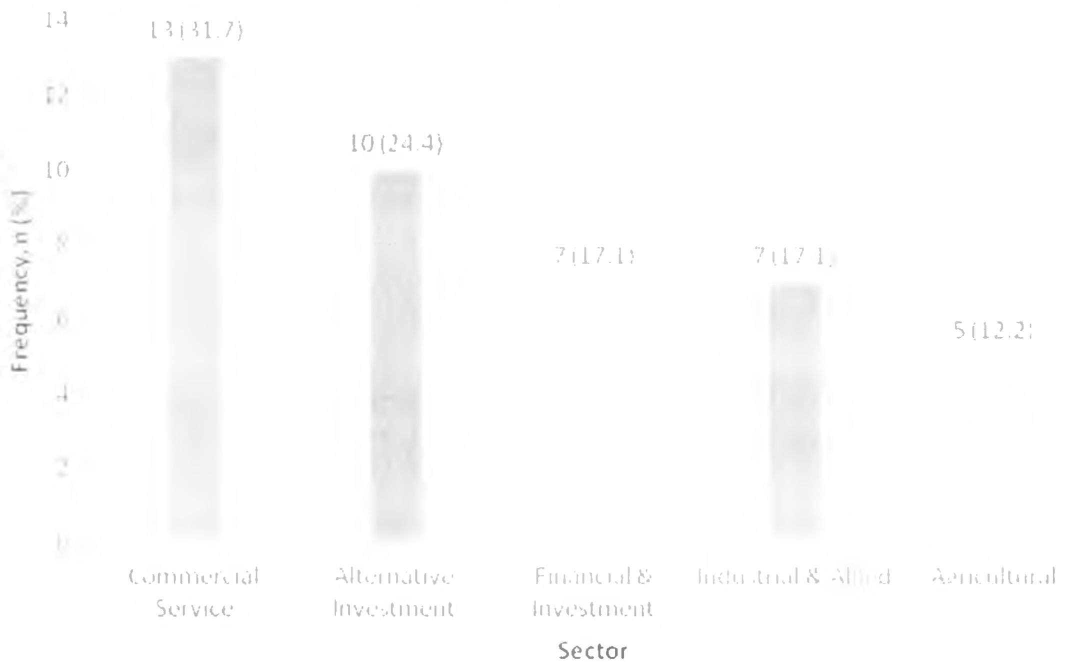
As shown in Table 4.1 below 83.3% board members were male and 16.7% female. Majority (48%) of the board members were in the 50+ age cohort followed by 40% of the 40-49 cohort. 50% of the respondents had attained university education, followed by 38% had post graduate qualifications.

Eighty three point three percent of the board members were male and 16.7% female. This is an indication that the male sex still has dominance in the senior management circles of most quoted companies in the country. Female counterparts need to uphold the challenge and actively participate in the stewardship of the quoted companies.

Table 4.1: Baseline Characteristics (n=42)

Characteristic	Percentage
Sex	
Male	83.3
Female	16.7
Age (years)	
30-39	12.0
40-49	40.0
50+	48.0
Level of Education	
College (mid level)	12.0
Degree	50.0
Post Graduate	38.0

Figure 4.1: Sectors of the Stock exchange Interviewed



Commercial sector formed the majority of the companies interviewed at 32% followed by Altenative investment at 24%. The least was agriculture with 12% of the total respondents.

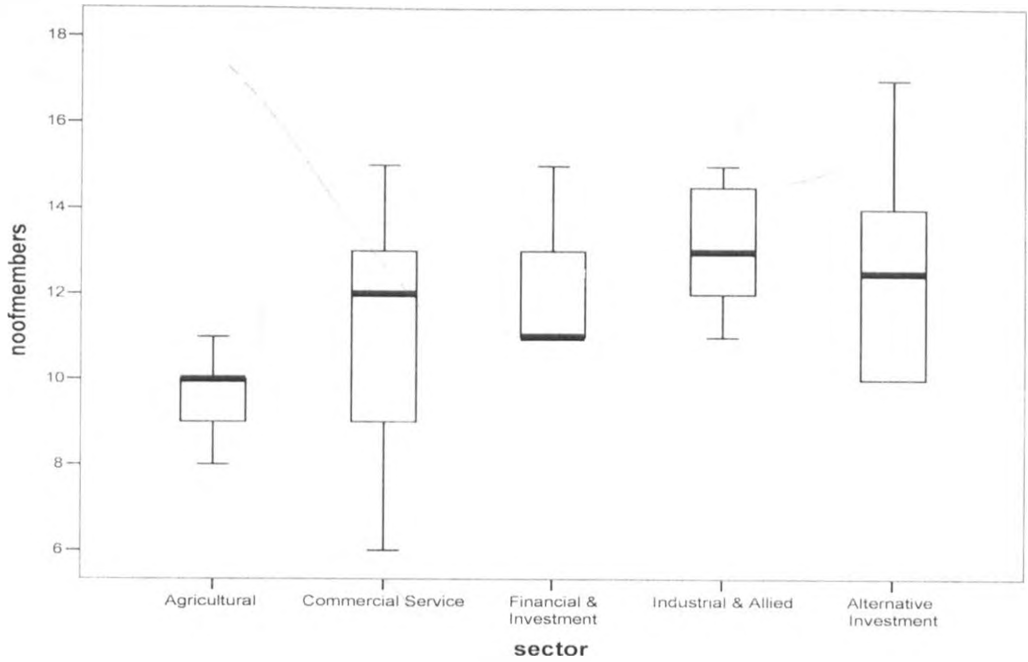
4.3 Recruitment – Criteria of Board Members

Out of the 42 respondents, 30 respondents (71%) recruited board members after consulting with stakeholders and the local nominating authority comprised of administrators of the companies, 8 (19%) without consultation and 4 (10%) were not aware on how their board members were recruited. The respondents said that the recruitment process of board members was not very clear, though it was suspected that, experience was the mostly considered criterion, skills and qualifications in planning and management.

4.4 Average number of board members

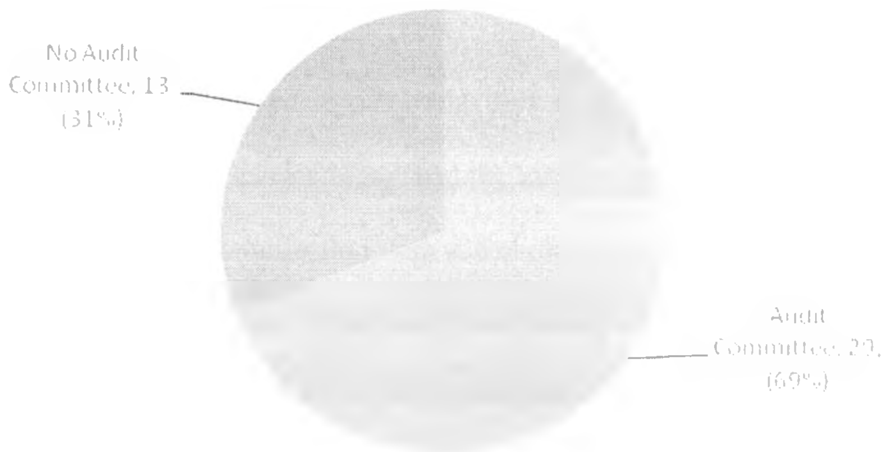
There were a varied number of board members across the sectors from the interviewed companies with a mean number of 12 members with executive directors being almost a third of the total members.

Figure 4.2: Number of members



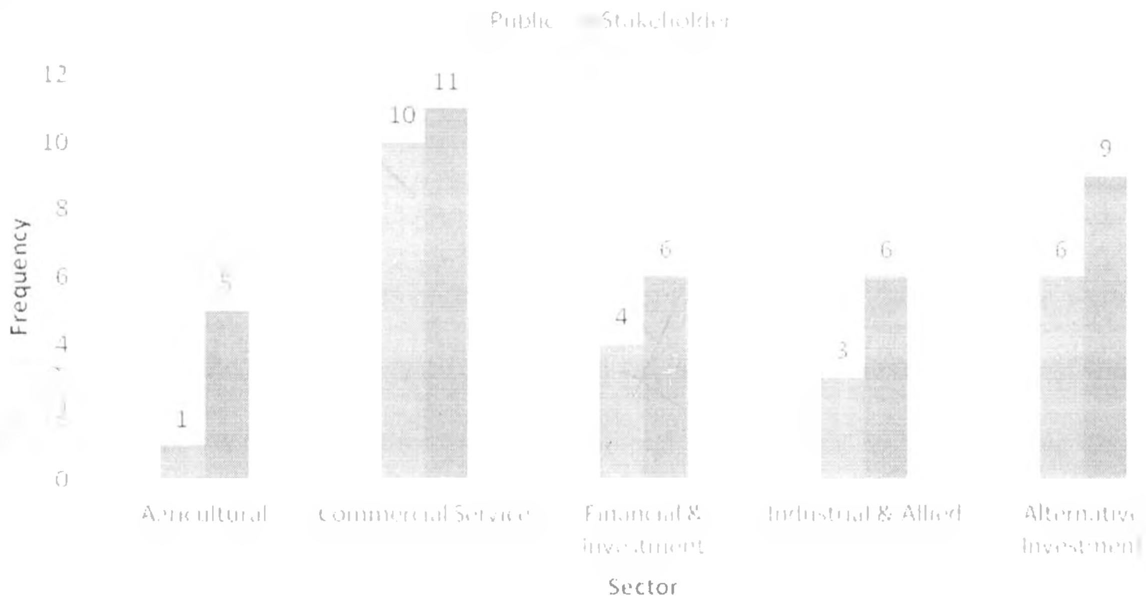
Industrial and allied companies had the highest number of board members among the interviewed companies.

Figure 4.3: Presence of a working Audit Committee (n=42)



Majority 69% had a working audit committee in place while those companies without the audit committee were 31 percent of the total respondents. All respondents agreed that there was a formal procedure for setting up the remunerations of the director with 37 (88%) boards remunerations been approved by the board members.

Figure 4.4: Communication Strategies (n=42)



Majority of the respondents (88%) had communication strategies to deal with stakeholders as compared to 57% who had communication strategies to deal with the public. Commercial Service sector had the most compliance with 26% companies having a strategy of its communication with stakeholders as opposed to 24% when dealing with the public. All companies confirmed that they give shareholders adequate time to ask questions and get answers during annual and special general meetings.

Table 4.2: Full implementation of corporate governance

Full implementation of corporate governance	Sector				
	Agricultural	Commercial Service	Financial & Investment	Industrial & Allied	Alternative Investment
	Percent	Percent	Percent	Percent	Percent
Strongly Agree	4.8	19.0	7.1	7.1	9.5
Agree	4.8	11.9	0.0	4.8	2.4
Neutral	0.0	0.0	0.0	2.4	9.5
Disagree	2.4	0.0	4.8	0.0	2.4
Strongly Disagree	0.0	0.0	4.8	2.4	0.0

71 percent of the respondents supported that there was full implementation of corporate governance in their companies as required by the Capital Markets Authority. These were the respondents who strongly agreed and agreed (as per Table 4.2 above). Most of the implementations were noted among the commercial sector with 30.9% adopting the corporate governance aspects.

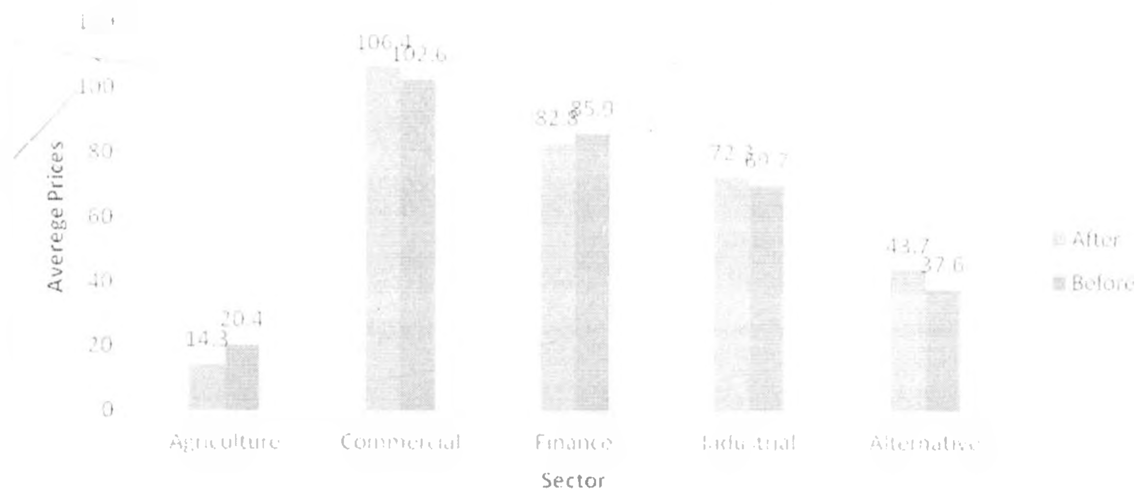
4.5 Shares price five years before and after adoption of corporate governance

Share prices of quoted companies five years before year 2002 when corporate governance guidelines were introduced by the Capital Markets Authority were taken to have been influenced very lightly by adoption of corporate governance since it was then not mandatory to adopt the practice. On the other hand, share prices of quoted companies five years after corporate governance guidelines were made a mandatory practice were taken

to have been highly influenced by results of the practice. This is because five years was taken to be a period in which corporate governance had already taken root in the Nairobi Stock Exchange and benefits or costs arising as a result would have already been significantly filtered into various market share prices.

As such the market share prices of the various companies five years before adoption of corporate governance were compared with five years after adoption of corporate governance. Changes in prices were taken to be as a result of adopting corporate governance.

Figure 4.5: Comparison of the Prices in the two trading periods



The Alternative Investments sector registered the highest growth in market prices with an increase of 16% between the two trading period. This was followed by the Industrial and Allied sector. The Agricultural sector however, had a negative growth of 29%. This could

have been as a result of drought that was in Kenya in year 2007. Drought usually has a huge impact on prices of companies in this sector.

In overall, there was a significance increase of the companies average share price performance five years after the adoption of the corporate governance than five years before the companies had adopted the practice (p-value 0.034). This is indicated in the figures (4.5) above. As a confirmation to this, it was noted that the highest level that the NSE 20 share index rose to in year 1997 was 3,675.44 points while the highest was 6,161.47 points in year 2007.

Lastly, 60% of the total respondents reported benefits outweighed costs of implementing corporate governance with the rest either reporting fewer benefits than costs at 30% or no change at only 10%.

4.6 Discussion of findings

4.6.1 Comparison with theory

Data was collected from 42 (89%) respondents out of the targeted 47 (100%) companies quoted in the Nairobi Stock Exchange. The findings revealed that 83.3% of board members of quoted companies in Kenya were male while women occupied a mere 16.7% of the board seats. This confirmed suspicions that women are still under privileged at the board level here in Kenya. The study also revealed that 48% of the board members were

over the age fifty years and that 50% of the board members had a degree while 38% of them had post graduate qualifications. It was encouraging to note that over 88% of the board members had a degree and thus could be said to be qualified and competent as required by corporate governance principles (PSCGT, 1999).

30 (71%) of the respondent companies recruited their board members after consultations with stakeholders and the local nominating authority. However, it was discovered that all of the responding companies did not have a clear cut process of recruiting board members but experience, skill and qualifications were suspected to be the guiding criterion. Proper corporate governance principles require that board of directors be appointed through a managed and effective process (PSCGT, 1999). Therefore all companies listed in the Nairobi Stock Exchange need to improve in this area so as to adhere to the laid down principles. The average number of directors from the respondent companies was found to be 12 with, a third of these members being executive and two thirds non executive. This is in line with global trends of corporate governance which advocate for less insider directors than outside directors (Wheelen & Hunger, 2008).

69% of the respondent companies had working audit committees while 31% of the committees were found to be non functional. All companies are required to have working and independent audit committees that among other duties, appoint, compensate and oversee the work of the requisite audit firms and to which the audit firm must report directly. Such controls are likely to prevent financial scandals (Sadgrove, 2009). In

accordance with principles of corporate governance all respondent companies confirmed having a formal procedure for setting up remunerations of directors.

Majority of the respondents (88%) had communication strategies to deal with stakeholders as compared to 57% who had communication strategies to deal with the public. Corporate governance guidelines require that companies communicate with all stakeholders effectively (PSCGT, 1999). Communication should therefore be taken more seriously by all companies that lack communication strategies to deal with stakeholder and/ or the public. It was encouraging to note that all respondents advised that they do give shareholders adequate time to ask questions and get answers during annual and special general meetings.

71 percent of the respondents supported that there was full implementation of corporate governance in their companies as required by the Capital Markets Authority. According to the Capital Markets Authority guidelines, this is still not enough since all companies quoted in the Nairobi Stock Exchange are required to practice corporate governance as prescribed by the law.

In overall, there was a significance increase of the companies average share price performance five years after the adoption of the corporate governance than five years before the companies had adopted the practice (p-value 0.034). As a confirmation to this, it was noted that the highest level that the NSE 20 share index rose to in year 1997 was 3,675.44 points while the highest was 6,161.47 points in year 2007. In addition, 60% of

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the total respondents reported benefits outweighed costs of implementing corporate governance with the rest either reporting fewer benefits than costs at 30% or no change at only 10%.

4.6.2 Comparison with other empirical studies

The study revealed that all companies quoted in the Nairobi Stock Exchange give adequate time for directors to ask questions and get answers during annual and special general meetings. This was exactly similar to the findings of Ng'ang'a (2007). Also according to Ng'ang'a (2007), 67% of quoted companies were complying with corporate governance guidelines that had been set out during the year 2007. This is consistent with this study's findings that show that 71% of the respondent companies adhere to the guidelines laid out by the Capital Markets Authority.

69% of the respondent companies had working audit committees while 31% of the committees were found to be non functional. According to Gitari (2008), all companies quoted in the Nairobi Stock Exchange had functional and working audit committees. Thus, the two studies had different findings regarding this aspect.

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1. Introduction

This chapter presents a summary of the findings of the study, conclusion and suggests some recommendations. At the end of this chapter areas of further study and research are suggested. These are areas that in future can be explored to further the knowledge and research on the practice of corporate governance.

5.2. Summary of Findings

Data was collected from 42 (87%) respondents out of the targeted 47 (100%) companies quoted in the Nairobi Stock Exchange. It was found that more than half of the directors of companies quoted in the Nairobi Stock Exchange had a degree and that the positions were mainly male dominated. Further it was established that most companies did not have a clear policy on recruitment of directors while there was a formal procedure for setting up their remuneration with this being approved by the board members 88% of the time.

From the survey it was noted that the average number of directors in each company quoted in the Nairobi Stock Exchange is 12 while most respondents advised that they appreciated the role that corporate governance plays in their originations. 69% of the quoted companies have a working audit committee while the rest do not have a functioning one. It was also noted that more companies have communication strategies

when dealing with stakeholders (88%) than the general public (57%). The Commercial Service sector had the most companies with communication strategies with 27% of the companies having a strategy of communicating with stakeholders and 23% with strategies for communicating with the public coming from this sector.

To sum it up, the study reveled that adoption of corporate governance had led to an increase of share prices by companies that adopt the practice. This has in turn led to an increase in wealth of shareholders and the companies themselves. 60% of the total respondents reported benefits outweighed costs of implementing corporate governance with the rest either reporting fewer benefits than costs at 30% or no change at only 10%.70% of the respondents were of the opinion that corporate governance had been fully implemented in their organizations in accordance with the Capital Markets Authority guidelines while the other 30% thought otherwise.

5.3. Conclusion

Corporate governance guidelines were introduced in the Nairobi Stock Exchange in the year 2002. Five years later it has been noted that there was a significant change of the company average share price than five years before the adoption of the corporate governance (p-value=0.034). The leading sector in terms of increase in share prices was the Commercial and Services sector.

In addition, 60% of the practitioners reported benefits outweighed costs of implementing corporate governance with the rest either reporting fewer benefits than costs at 30% or no change at only 10%. The highest that the NSE 20 share index rose to in year 1997 was 3,675.44 points while the highest was 6,161.47 points in year 2007. This was a 68% increase according to the NSE 20 share index.

5.4. Recommendations

The findings revealed that 83.3% of board members of quoted companies in Kenya were male while women occupied a mere 16.7% of the board seats. It is therefore recommended that companies listed in the Nairobi Stock Exchange should generally increase the number of women who sit in their boards in order to achieve gender balance. This should however, not be done at the expense of reducing the boards' value and independence as stipulated by corporate governance principles.

The study revealed that all of the responding companies did not have a clear cut process of recruiting board members. It is therefore recommended that board members be appointed through a managed and effective process in accordance with proper corporate governance principles.

It is also highly recommended for both public and private companies to adopt corporate governance practices since it is expected to increase wealth of at least the share holders. It was noted that a significant percentage of listed companies seem not to be having

convincingly functional audit committees. Ways of ensuring corporate governance guidelines are adhered to should also be strengthened in order to avoid such misleading compliance.

5.5. Limitations of the Study

One of the limiting factors experienced by the researcher was lack of total and outmost disclosure by the respondents regarding the details of their directors especially when dealing with the negative aspects were being touched on. One of the respondents pointed out that this could be "confidential" information.

Response time was also limited since response was given during normal working hours and some respondents complained of lack of time. Interruptions during response time could have affected the quality of output.

5.6. Suggestions for Further Research

There are areas that still need further research and this can seek to expand the body of knowledge when it comes to dealing with adoption of corporate governance. This study mainly dealt with quoted companies while unquoted companies were left out of the picture. More research can be conducted regarding adoption of corporate governance by unquoted firms as well as benefits that may arise thereafter.

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Appendix 1:

LIST OF COMPANIES QUOTED IN THE NAIROBI STOCK EXCHANGE

Serial No.	Name of listed Company
1.	KAKUZI
2.	REA VIPINGO PLANTATIONS
3.	SASINI LTD
4.	ACCESSKENYA GROUP
5.	CAR & GENERAL (K)
6.	CMC HOLDINGS
7.	KENYA AIRWAYS
8.	MARSHALLS (E.A)
9.	NATION MEDIA GROUP
10.	SAFARICOM LTD
11.	SCANGROUP
12.	STANDARD GROUP
13.	TPS EA (SERENA)
14.	BARCLAYS BANK
15.	CENTUM INVESTMENTS
16.	CFC STANBIC HOLDINGS
17.	DIAMOND TRUST BANK

18.	EQUITY BANK
19.	HOUSING FINANCE CO.
20.	JUBILEE HOLDINGS
21.	KENYA COMMERCIAL BANK
22.	KENYA RE CORPORATION
23.	NATIONAL BANK OF KENYA
24.	OLYMPIA CAPITAL HOLDINGS
25.	PAN AFRICA INSURANCE
26.	STANDARDCHARTERED
27.	CO-OP BANK OF KENYA
28.	ATHI RIVER MINING
29.	B.O.C KENYA
30.	BAMBURI CEMENT
31.	BAT KENYA LTD
32.	CARBACID INVESTMENTS
33.	CROWN BERGER
34.	E. A. CABLES
35.	E. A. PORTLAND
36.	EAST AFRICAN BREWERIES
37.	EVEREADY
38.	KENGEN
39.	KENOL/KOBIL LTD
40.	KP&LC
41.	MUMIAS SUGAR
42.	SAMEER AFRICA

43.	TOTAL KENYA
44.	UNGA GROUP
45.	NIC BANK
46.	CFC INSURANCE HOLDINGS
47.	UCHUMI SUPERMARKET

Appendix 2: Questionnaire

Section A: Company Information

Questionnaire No. ....

Company Name (optional):____

Sector of the Company

1. Agricultural [ ] 2. Commercial Service [ ] 3. Financial & Investment [ ]
4. Industrial & Allied [ ] 5. Alternative Investment [ ]

Respondent Name (Optional) : ______________________

Department : ______________________

Position held : ______________________

Company Management Aspects

1. How many Board members does your company have? ....

   (a) Of these, how many are men ....

   (b) How many are women ....

   (C) How many are between age; 30 – 39 years .... 40 – 49........... and 50+........

2. Do you have a working audit committee? 1. Yes [ ] 2. No [ ]

3. Do you have a formal process for recruiting board members?

   1. Yes [ ] 2. No [ ]

4. Who recruits board members?

5. Who approves directors' remuneration?

6. What is the composition of the board in terms of professional and academic qualifications?

Shareholders

7. Is there a communication strategy that enables the board and management to effectively communicate with its;

   Shareholders? 1. Yes [ ] 2. No [ ]

   Public? 1. Yes [ ] 2. No [ ]

8. Are all shareholders given adequate time to ask questions and get answers during annual and special general meetings? 1. Yes [ ] 2. No [ ]

Corporate governance implementation and financial impact on the company

9. Would you say that your company has fully implemented corporate governance as set out by the Capital Markets Authority guidelines? (please tick against the appropriate answer below)

   Strongly agree ....
   Agree ....
   Neutral ....
   Disagree ....
   Strongly disagree ....

10. Would you say that the benefits of implementing corporate governance outweigh the costs? 1. Yes [ ] 2. No [ ]

11. Would you say that implementation of corporate governance is a complex and costly exercise? 1. Yes [ ] 2. No [ ]