# THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE OF PREVIOUSLY GOVERNMENT OWNED COMPANIES QUOTED ON THE NAIROBI STOCK EXCHANGE

**BY**

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**A Research Project Report Presented in Partial Fulfilment of the Requirements for the award of Degree of Master of Business Administration, University of Nairobi**

**November, 2011**

**DECLARATION**

I, the undersigned, declare that this is my original work and has not been submitted to any other college, institution or university other than University of Nairobi for academic credit;

Signed:. . . . . . . . . . . . . . . . . . Date:. . . . . . . . !?..\M:*f?U.........

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This project report has been presented for examination with my approval as the University supervisor;

Signed:, Dat J . . f l \ d . U .

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**ACKNOWLEDGEMENT**

My foremost gratitude goes to God the Almighty for enabling and guiding me through my MBA Degree Programme. I am grateful to Nairobi University for admitting me to their MBA programme and School of business. My vote of thanks goes to my supervisor; Dr. Josiah Aduda who guided me as I wrote this paper. Thanks a lot for relinquished without complain many hours of time with me which was rightfully his. Your positive criticism, suggestions and prompt comments has given me the impetus to refine and produce quality work.

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Despite all this able assistance, I accept full responsibility for any ilaws in the writing of this paper. It has been a joy to craft it and 1 hope it will help to advance the field of corporate governance.

## DEDICATION

I dedicate this paper to my family; you all stood by me throughout this programme and inspired me immensely.

## ABSTRACT

Corporate governance is the system by which companies are directed and controlled. It is concerned primarily with management and stewardship issues of companies with an aim of increasing firms' performance and increasing share holders' value. However, this has not been the case as witnessed in some companies especially those that are state-owned. Even with institutionalization of good corporate mechanisms, there is evidence of collapse of some of these companies. Therefore, the purpose of this study was to examine the relationship between corporate governance mechanism and performance of previous state-owned firms listed in Nairobi Stock Exchange. Specifically, the study established whether there is relationship between the return on assets and corporate governance mechanisms measured by auditors' fees, board remuneration and size of board and board composition.

The descriptive research methodology was adopted in this study. Purposively ten previously state-owned companies in the main investment market segment were studied. Data was obtained from financial statements of the ten companies to be covered, and is also published by NSE. Correlation and regression analysis were used to achieve the study objective in data analysis.

Correlation matrix showed that there is a strong correlation between performance and good corporate governance. Regression results revealed that institutionalization of good corporate governance costs: auditors' fees, management fees and director ownership have strong and significant marginal effects on returns on asset and hence they were found to mitigate agency costs and consequently increase firms' performance.

They revealed that there exists positive relationship between corporate governance mechanisms and performance for the firms studied. From the study, it can be concluded that the institutionalization of good corporate governance can help reduce (mitigate) the agency costs resulting to high return on asset for the previous state-owned companies quoted on the Nairobi Stock Exchange.

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## LIST OF ABBREVIATIONS

| | |
|---|---|
| CBK | Central Bank of Kenya |
| CEO | Chief Executive Officer |
| CG | Corporate Governance |
| CMA | Capital Markets Authority |
| KPLC | Kenya Power and Lighting Company |
| KRA | Kenya Revenue Authority |
| MFI | Micro Finance Institution |
| NBFIs | Non Bank Financial Institutions |
| NSE | Nairobi Stock Exchange |

# CHAPTER ONE: INTRODUCTION

## 1.1 Background of the Study

**Corporate** governance generally refers to the set of mechanisms that influence decisions **made by** managers when there is a separation of ownership and control. Claessens (9003), asserts that poorly governed firms are expected to he less profitable, have **more** bankruptcy risks, lower valuations and pay out less to their shareholders, while well-**governed** firms are expected to have higher profits, less bankruptcy risks, higher **valuations** and pay out more cash to their shareholders. Claessens also explains **that** better corporate frameworks benefit firms through greater access to financing, **lower** cost of capital, better performance and more favourable treatment of all **stakeholders.**

The institutions of corporate governance facilitate and stimulate the performance of corporations which are the principal forces behind economic wealth and growth in a society by creating and maintaining a business environment that motivates managers and shareholders to maximize a firm's operational efficiency, returns on investment and long term productivity and growth, contends Oman (2003).

Oman (2003) says that the institutions of coiporate governance ensure corporate conformance with investors' and society's interest and expectations by limiting the abuse of power, the stealing or siphoning-off of corporate assets, and the significant wastage of corporate-controlled resources ('agency problems') that arises from losses and distortions that the self-serving behaviour of managers and other corporate insiders can be expected to impose on investors and society in absence of sound corporate governance. Corporate governance is seen to focus on the principal - agent relationship that exists between the shareholders (the principals) and managers (the agents) and which stems from the separation of ownership and management in the large companies, posits Oman (2003).

In recent times, there has been a great deal of attention given to the issue of corporate governance in the development agenda of most developed and developing economies. This is based on realization that corporate governance has critical impact on the responsive ability of a firm to external and internal factors that impinge on its performance. Well governed firms have been noted to have higher performance (Claessens, 2003).

An organization's ability to perform financially is critical to its survival in the short and in the long run. Financial performance of an organization is dependent upon the Corporate Government practices. Good Corporate Governance is likely to impact to positive financial performance while poor Corporate Governance is likely to result to poor financial performance. The powers of shareholders have been vested in board of directors and the shareholders expect them to act in the best interest of their organizations in order to maximize shareholders wealth. However, recent happenings have shown that directors have not necessarily acted that way and the rights of the shareholders have not been upheld. Corporate governance can be enhanced through various instruments namely, government regulation, shareholders, stakeholders, board of directors, management and societal pressure, among others.

Over the recent years, a series of high profile public companies have experienced collapse in their share prices and substantially eroded market and public confidence. In Kenya, cases where managers and directors have been accused of poor corporate governance include the collapse of Kenya Cooperative Creameries (recently revived), Kenya National Trading Corporation, Ramisi Sugar Company, Muhoroni Sugar Company and Pan Paper Ltd, among others. The near collapses of Unga Group,.Uchumi Supermarkets and National Bank of Kenya are other examples. These are all issues of corporate governance. Wambua (1999), states that good corporate governance should translate to long-term existence of an organization and its continued generation of goods, services and profits. Corporate governance can be enhanced through various ways as mentioned earlier and they include shareholders, regulations, codes of conduct and social forces. The ultimate power in enhancing corporate governance lies with (he BOD which

is the legal authority mandated by law to run a company on behalf of the shareholders. This is according to Dimsdale (1994).

Dimsdale (1994) however says that the shareholders have little contact with the board of directors except during the purely ceremonial Annual General Meeting which is held only once a year. According to observation, the directors are elected in the Annual General Meeting and in turn appoint a Chairman. Most corporations have a large board with directors who have little interest in the company except for the influence, allowances and other perks they draw from being on the board.

In November 1998, a workshop on the Role of Non-Executive Directors was held in Mbagathi, Nairobi. In March 1999, another forum was held at Whitesands, Mombasa to discuss the major topics and principles of good corporate governance. According to observations, the reasons for this development are many and include the fact that the quality of governance was seen as vital for success of the organizations, society and economy in general.

Shareholders have invested heavily in the quoted companies in the Nairobi Stock Exchange (NSE). According to statistics, NSE slumped in 2008, with NSE 20 share index nose diving by 1924 points from 5445 points in 2007. Market capitalisation increased to KSITs one trillion in second quarter of 2008 following Safaricom IPO, but later declined to KSlls 854 billion by end of 2008, only KSHs 3 billion higher than 2007. On average, in 2008, all share prices declined compared to 2007.

This study sought to evaluate the financial implications arising from setting up the necessary structures required for good corporate governance. The focus was ten previously state-owned companies namely ICENGEN, Kenya Power & Lightning company (KPLC), Mumias Sugar Company Ltd, Housing Finance Company of Kenya Ltd( HFCK), Kenya Commercial Bank (KCB), Kenya Re-insuarance company, National Bank of Kenya (NBK), Cooperative Bank, Safaricom Ltd and Kenya Airways all quoted on the Nairobi Stock Exchange. Selection of these companies is informed by (he fact that

although corporate governance is the system by which companies are directed and controlled and is concerned primarily with management and stewardship issues of companies with an aim of increasing firms' performance and increasing share holders' value, this has not been the case as witnessed in some companies especially those that are state-owned. Even with institutionalization of good corporate mechanisms in companies there is evidence of collapse of some of the companies. It will be possible to obtain financial information for previous state-owned firms listed in Nairobi Stock Exchange, as they are required to submit their annual financial reports to NSE and publish the same for public to see.

## 1.2 Statement of Problem

The concept of corporate governance has been a priority on the policy agenda in developed market economies for over a decade especially among very large firms. This concept is gradually warming itself as a priority in the African continent (Kyereboah-Coleman and Biekpe, 2005). Many lessons have been learnt on the importance, of corporate governance in determining the performance of public owned firms. Studies have been conducted on the effectiveness of different corporate structures in enhancing the stability and performance of firms in developed countries. But whether these lessons apply to public commercial institutions in developing nations is not clear (Ching-Yi, 2003).

In Kenya, cases where managers and directors have been accused of poor corporate governance include the collapse of Kenya Cooperative Creameries, Kenya National Trading Corporation, Ramisi Sugar Company, Lohnro Motors East Africa, Muhoroni Sugar Company among others. The near collapses of Unga Group, Uchumi Supermarkets, National Bank of Kenya are other examples. Wambua (1999), states that good corporate governance should translate to long-term existence of an organization and its continued generation of goods, services and profits.

In recent years, Kenya has witnessed the collapse of many business enterprises and incurred tremendous costs due to weak corporate governance structures within the

organizations. Despite the good laws that exist in theory, there is still a window for senior managers to misappropriate shareholders wealth. (Wahome, 2009) identified excessive compensation, improper loans, self-dealing, under performance or shirking as crucial pointers of sinister motives that the public should note. This came in the height of Nairobi Stock Exchange report of low investor confidence levels due to weak corporate governance structures that cost investors billions in losses as traders irregularly traded in clients' shares.

During the Budget Speech of 2009, a number of requirements regarding corporate governance of members of the NSE were proposed. Owing to the collapse of over 6 stockbrokerage firms due to lack of sufficient capital by 2010, December 31 investment banks will be expected to have increased their capitalization to Kshs.250.0 million from the current Kshs.30million and stockbrokers to Kshs.50.0 million from Kshs.5million (Bonyop, 2009). This is to eliminate failure such as the Nyagah Stockbrokers case. Adequate capitalization puts Nyagah Stockbrokers in a position to compensate its investors instead of government covering the costs. Secondly, the members are expected to publish semi- annual and annual financial statements in at least two daily newspapers with national circulation and display the audited accounts in a conspicuous position (Mwangi, 2009).

This further encourages the effective disclosure of information allowing investors to analyze financial markets and make informed decisions. Each firm was to be designated a compliance officer whose powers can even override that of the owner and the director. Stockbrokers were to also take up of professional indemnity that is not less than 5 times their daily average turnover. In addition, business should seek regulatory approval before changes in shareholders, directors, chief executive and key personnel (Mwangi, 2009).

Hendril vse (2004) states that the corporate failures witnessed recently confirmed that many directors put their own interests before those of the company and shareholders. In response the regulators have continuously spelt guidelines and regulations to ensure that there is prudential management in organizations. This is in recognition that prior to 2002,

poor management was one of the factors pointed out to he contributing to serious liquidity problems and collapse of public organizations in Kenya.

In the recent past, there have been changes in the structure of public institutions in Kenya which could have some influence on the performance of these institutions. Also as a result of the privatization programme, formerly government owned organizations floated their shares at the Nairobi Stock Exchange, reducing the government shareholding and therefore changing the composition and structure of the governing boards. These changes in the governance of some organizations raise very important policy research questions. The fundamental of such questions is how do these changes in governance structures affect financial performance? This therefore necessitates the need for a critical examination of governance factors and their impact on the financial performance in public owned organizations. The purpose of this study was to establish the relationship of governance structure and the financial performance of previous state owned commercial companies listed in the Nairobi Stock Exchange.

## 1.3 Objectives of the Study

The main objective of this study was to establish the relationship between corporate governance mechanisms and financial performance of previous government corporations quoted in Nairobi Stock Exchange.

## 1.4 Importance of the Study

This study is of benefit to the following groups of people;

To the shareholders of companies - The study is intended to sensitize them 0l1 the importance of ensuring that the board practices good corporate governance for the sake of maximizing their share value. They will also understand how the activities of the board determine the returns on their investments.

**To** the Board of Directors - This study is intended to make the board more effective and efficient in their activity that leads to the achievement of its objectives such as to deliver

value to the customers and returns to the shareholders' investment. The board will become more aware of how its activities affect the return on shareholders' value.

The academicians - The study is also expected to contribute to the existing body of knowledge on good corporate governance and also make recommendations arising .from its findings for further research on this or other related areas of study.

# CHAPTER TWO: LITERATURE REVIEW

## 2.1 Introduction

This chapter reviews the theories 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 of the research topic.

## 2.2 Theoretical framework

### 2.2.1 The concept of Corporate Governance

The concept "Governance structure" has been defined differently depending on approaches adopted. According to Mayer (1997), corporate governance is concerned with ways of bringing the interests of (investors and managers) into line and ensuring that firms are run for the benefit of 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). It has also been defined by Keasey et al (1997) to include 'the structures, processes, cultures and systems that engender the successful operation of organizations.'

The corporate governance codes and guidelines have been issued by a variety of bodies, ranging from committees appointed by government departments and usually including prominent respected figures from business and industry, representatives from the investment community, representatives from professional bodies, and academics through to stock exchange bodies, various investor representative groups, and professional bodies such us those representing directors or company secretaries.

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of Best Practice (all listed companies in the UK should comply with it.) which states the best practices when it comes to composition, structure and functions of Board of Directors and the OECD Principles of Corporate Governance (1999) developed by the Organisation for Economic Co-operation and Development (OECD).

The OECD principles of Corporate Governance (1999) were adopted by the World Bank and IMF in assessing institutions. The OECD recognizes that 'one size does not lit all', that is there is no single model of corporate governance applicable to all countries. However principles represent certain common characteristics that are fundamental to good corporate governance and are as follows; the rights of the shareholders - The CG framework should protect shareholders rights; the equitable treatment of shareholders the CG framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders; the role of stakeholders in corporate governance The corporate governance framework should recognize the rights of stakeholders as established between corporations and stakeholders in creating wealth, jobs and the sustainability of financial sound enterprises; disclosure and transparency - the CG framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporations, including the financial situation, performance, ownership, and governance of the company; and the responsibilities of the board - the CG framework should ensure the strategic guidance of the company, the effective monitoring of management by the board and the board's accountability to the company and the shareholders.

Corporate governance is also seen as the whole set of measures taken within the social entity that is an enterprise to favour the economic agents to take part in the productive process, in order to generate some organizational surplus, and to set up a fair distribution between the partners, taking into consideration what they have brought to the organization (Maati, 1999). The impact of regulation on corporate governance occurs through its effect on the way in which companies are owned, the form in which they are controlled and the process by which changes in ownership and control take place (Jenkinson and Mayer, 1992).

### 2.2.2 Agency theory

The agency theory identifies the agency relationship where one party, the principal delegates to the other party, the agent (Jensen and Meckling, 1976). In the context of a corporation, the owners are the principals and the directors are the agents. The transaction cost economics theory views the firm itself as a governance structure. The choice of an appropriate governance structure can help align the interest of directors and shareholders (Williamson, 1984). The Stakeholder theory takes into account a wider group of constituents rather than focusing on shareholders. Where there is an emphasis on stakeholders then the governance structure of the company may provide for some direct representation of the stakeholder groups. The stewardship theory regards directors as stewards of the company's assets and will he predisposed to act in the best interest of the shareholders, Donaldson and Davis (1991).

### 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 amongst 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.

### 2.2.4 Class hegemony theory

The Class hegemony theory states that the directors view themselves as elite at the top of the company and will recruit/ promote based on how well the new appointments might fit into those elite (Williamson, 1984). The Managerial hegemony theory indicates that the management of a company, with its knowledge of day-to-day operations, may effectively dominate the directors and hence weaken the influence of the directors. Of these theories, **there** are three that are dominant, the agency theory, the transaction cost economics and the stakeholder theory.

### 2.2.5 Stakeholder Theory

The stakeholder theory takes account of a wider group of constituents rather than focusing on shareholders. A consequence of focusing on shareholders is maintenance of shareholder value as paramount, whereas when a wider stakeholders group such as employees, providers of credit, customers, suppliers, government and the local authority is taken into account the overriding focus on shareholder value becomes less evident. This means that the shareholders have a vested interest in trying to ensure that the resources are used to maximum effect which in turn should be to benefit the society as a whole.

Michael Jensen, (2001) argued that, .the advocates of the stakeholder theory refuse to specify how to make the necessary trade off among these competing interests, leaving managers with a theory that makes it impossible for them to make purposeful decisions. With no way to keep score, stakeholder theory makes managers unaccountable for their actions. It would seem clear that such a theory could be attractive to the self-interest of managers and directors.

Jensen (2001) therefore advocates enlightened value maximization which he says is identical to enlightened stakeholder theory. He states that 'enlightened value maximization utilizes much of the structure of stakeholder theory but accepts maximization of the long run value of the firm as the criterion for making prerequisite tradeoffs among its stakeholders and therefore solves the problems that arise from multiple objectives that accompany the traditional stakeholder theory'. Based on these theories the study seeks to address the following questions:

a) Does the establishment of the structures of good corporate governance increase operating costs?
**b)** Is there a direct correlation between good corporate governance and performance ratios?

2.2.6 **The concept of Financial Performance**

An organization's ability to perform financially is critical to its survival in the short and in the long run. Financial performance of an organization is dependent upon the Corporate Governance practices. Good Corporate Governance is likely to impact to positive financial performance while poor Corporate Governance is likely to result to poor financial performance. The powers of shareholders have been vested in board of directors and the shareholders expect them to act in the best interest of their organizations in order to maximize shareholders wealth. However, recent happenings have shown that directors have not necessarily acted that way and the rights of the shareholders have not been upheld.

Tobin's Q is widely used as a proxy for firm performance when studying the relationship between firm performance and corporate governance. For example, Gompers, Ishii and Metrick (2003) conclude that firms with more shareholder rights are better governed since these firms have a higher Tobin's Q. Other researchers use earnings quality, which is a concept that is context-based and hence does not have a single definition. Earnings quality can be viewed from a number of perspectives. Schipper and Vincent (2003) assess earnings quality from two perspectives. One perspective is decision usefulness, where "because of its context specificity, assessments of earnings quality from the perspective of decision usefulness inevitably confront a myriad of users and uses..." The second perspective of earnings quality used by Schipper and Vincent (2003) is using the Hicksian concept of income (Hicks, 1935), which the authors recognise is not capable of empirical observation.

Other various performance measures are SG&A expenses, sales, number of employees, and return on equity, return on assets, asset turnover and stock returns (see Shleifer, A. and Vishny, R., 1997; Rosenstein and Wyatt, 1990). Others use cash flow - According to free cash flow hypothesis (Jensen 1986) maintains that firms' shareholders where control lies mostly with managers are less likely to receive free cash How via cash dividend payouts. Larger free cash How payouts reduce managers' abilities to invest in value-destroying projects, such as capital expenditures and acquisitions possessing negative net

present values. Consistent with the notion that earnings are retained for empire building rather than for engaging in positive net value projects, Shleifer, A. and Vishny, R. (1997) find that firms with relatively smaller dividend payouts have relatively lower earnings growth, suggesting that better-governed firms pay out more cash to shareholders.

Empirical finance often requires proxies for variables of interest. However, proxies must be chosen carefully since inappropriate proxies can cause a hypothesis to be spuriously rejected or accepted. Indeed, the need for proxies results in joint tests of the stated hypotheses and the validity of the chosen proxies. Ideally, empirical proxies would originate from a theoretical framework that justifies their use under reasonable assumptions.

**2.3 Empirical Studies on Corporate Governance and Firms' Performance**

Chen, et al (2004) showed that the effect of good corporate governance on expected returns is more profound for firms with higher free cash flows but poor investment opportunities and for firms with lower insider ownership, consistent with agency costs of free cash flows as proposed by Jensen and Meckling (1976) agency theory.

Laing & Weir (1999) analysed the extent of Cadbury compliance and its impact on corporate performance in UK in 1992 to 1995 and found little evidence to suggest that the board characteristics recommended by Cadbury lead to improved performance or that moving towards them improves performance and that the only mechanism which does positively affect performance is the presence of remuneration and audit committees. Yakhou & Dorweiler (2004) analysed the effects of the Sarbanes-Oxley Act of 2002 on the principal management and control functions of the business environment

During the last decade, each year has seen the introduction, or revision, of a corporate governance code in a number of countries. These countries have encompassed a variety ol legal backgrounds (for-example, common law in the UIC, civil law in France), cultural ar>d political contexts (for example: public corporations compared to family owned

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firms), and share ownership (institutional investor dominated in the UK and the US, state ownership in China).

However in each of the countries, the introduction of corporate governance codes lias generally been motivated by a desire for more transparency and accountability, and a desire to increase investor confidence (both of potential and existing investors) in the stock market as a whole. The development of the codes has often been driven by a financial scandal, corporate collapse or similar crisis.

Corporate governance mechanisms such as board size, independent director and duality have been found to influence firm performance hence affect family controlled firms. Chen and Wei (2004) corroborated that the size and composition of the board may reflect its ability to be an efficient guide and that firm performance is increased by smaller boards (Kyereboah-Coleman and Biekpe, 2005; Sanda et al, 2003). This is further supported by numerous other studies which confirmed that large boards are not as effective as the small boards (Jensen and Meckling, 1976; Chen and Wei, 2004).

Fama and Jensen (1983) explained that board outsiders could strengthen the firm value by lending experienced and monitoring services and supposed to be guardians of the shareholders' interests via monitoring while Kyereboah-Coleman and Biekpe (2005 support the argument that outside directors are more effective monitors and a critical disciplining device for managers. Jenkinson and Mayer, (1992) found that board independence is in fact negatively correlated with performance. Hermalin and Weishbach (1991) posited no significant relationship between performance and outsiders' proportion on the board of directors. However, Claessens et al., (1999); Gompers et al., (2003) and Bebchuk, Cohen & Fer rell (2004) explained a positive relationship between performance and outsiders' proportion.

Duality can be defined as a board structure control mechanism which is explained as the same person serving as both the chief executive officer (CEO) and chairman of the board. The Cadbury Committee assumed the praciice as unnecessary because it potentially



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provides one person too much power over the decision making process (Cadbury, 1992). Previous studies analyzing the impact of duality on firm performance have been mixed. As such, Gompers el al., (2003) found that duality showed no role as to enhancing firm performance in the U.K. firms whereas in the U.S studied by Boyd (1994) found that duality actually bring to better performance. Yakhou and Dorweiler (2004) found that duality had a moderately strong and negative impact on quality values. In other words, firms where duality did exist performed poorly with respect to those firms where CEO did not occupy both positions

Corporate governance is a company's constitution, which is designed to establish the relations between managers and shareholders so that outside investors can be protected against expropriation by insiders. Corporate governance is a mechanism that is used to reduce agency costs. If the agency- cost risk related to corporate governance is not idiosyncratic, firms with better corporate governance should have higher valuation and lower expected returns. On the other hand if the agency -cost risk associated with corporate governance is idiosyncratic, there should be no relation between corporate governance and expected returns. In neither case, there should not be a positive relation between corporate governance and expected stock returns (Chen &. Wei, 2004).

Firms that have large amounts of free cash Hows, have more severe agency problems and are more likely to be hostile takeover targets. Equally, firms that have a mismatch between financial resources and growth opportunities are more likely to be takeover targets. Hence anti-takeover provisions may be more critical to prevent hostile takeover attempts among those firms with large amounts of free cash flows and poor investment opportunities. Hostile takeover threat is therefore an important mechanism to mitigate the agency problem of free cash flows (Chen & Wei, 2004).

In line with the governance debate and need for harmonization between the objectives of the shareholders and firm managers, there has arisen a debate on the optimal size ot the governing boards. 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

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for a powerful CEO to dominate. On the other hand, Jensen (1993) argues that large boards are less effective and are easier for a CEO to control. It is agued that when a board gets loo big, it becomes difficult to co-ordinate and process problems. Smaller boards also reduce the possibility of free riding by individual directors, and increase their decision taking processes. Eisenberg *et al* (1998) finds negative correlation between board size and profitability when using sample of small and midsize Finnish firms. In Ghana, it has been identified that small board sizes enhances the performance of MFIs, Kyereboah-Coleman and Biekpe, (2005). In a Nigerian study, Sanda et al (2003) found that, firm performance is positively related with small, as opposed to large boards.

Previous empirical studies have provided the nexus between corporate governance and firm performance (Claessens el al., 1999; Gompers et al., 2003). Bebchuk, Cohen & Ferrell (2004) have shown that well governed firms have higher firm performance. The main characteristic of corporate governance identified in these studies include board size, board composition, and whether the CEO is also the board chairman.

Ching-Yi, (2003), investigated the relationship between bank performance and management structure in Shanghai between 1912 and 1937. Using the panel data econometric technique, the study found no significant relationship between management structure and bank performance. It was established that, factors such as bank asset quality, and the bank's line of business influenced performance. Ching-Yi, explained that lack of a direct link between management structure and bank performance in China could he due to the fact that bank owners gave bonuses and benefit packages rather than equity shares to align incentives, and that the ievel of managerial equity stakes contracted was independent of the amount of bonus given. This study established that performance depends more on factors such as the quality of assets, managerial access to information, banks' ability to adjust themselves to changing business environments and managerial prudence and savvy rather than the impl ications of the principal-agent relations.

Klapper and Love (2002) examined corporate governance and performance in a sample of firms in 14 countries, most of which are developing economies. They found that better corporate governance is associated with better performance in the form of Tobin's q and return on asset and that good governance seems to matter more when the legal environment of a country provides investors with weaker protections.

The institutions of corporate governance ensure corporate conformance with stakeholders' interests and expectations by limiting the abuse of power, the stealing or siphoning-off of corporate assets, the wastage of corporate resources arising from the self -serving behaviour of managers and other corporate insiders and address the agency problem. Corporate governance is seen to focus on the principal -agent relationship that exists between the shareholders (the principals) and managers (the agents) and which stems from the separation of ownership and management especially in large companies, Oman (2003).

The Hampel Report (1998) states that the boards of directors are responsible for the governance in companies they oversee. The shareholders' role is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure exists. These institutions and structures are mainly set up to address the agency problem and constitute monitoring costs that ultimately add to the agency costs.

According to Tenev and Zhang (2002) corporate governance is seen as a set of instruments and mechanisms (contractual, legal and market) available to shareholders (as residual claimants) for influencing managers to maximise shareholder value and to fixed claimants such as banks and employees, for controlling the agency costs of equity. There is therefore need to address the issue of agency problem to reduce its impact. In order to deal with agency problems, additional expenditure would be required. The issue of agency costs could arise when the company wants to fund a project and the agents involved have different interests. Debt-holders, old shareholders, new shareholders and the company's management, all are involved in a costly negotiation process, which may lead to a second -best solution. Agency costs can be seen as the value loss to the principal,

arising from divergences of interests between the principal and the agent, McColgan (2001).

Corporate governance is seen to exist to protect the interests of shareholders because the interests of other stakeholders can adequately be protected through contractual relations with the company. This leaves the shareholders as the residual claimants whose interests can only be adequately protected through the institutions of corporate governance (Oman 2003). There is also the possibility that the agent will issue low coupon rate, low risk long-term bonds to attract investors and then increase return and the risk later. This was the case with RJR Nabisco, Brigham (2005). The investors had opted to invest despite the low yield because they were averse to the risk. However, once they were locked in, the level of risk was increased.

## 2.5 Summary of Literature

Studies on corporate governance and performance of firms have been conducted in developed and developing countries. However, the majority of studies conducted concentrated on financial sectors in US and Europe. These studies assessed the performance levels of different sizes of firms and branches and made comparisons between them. Some studies used firms' performance measures to establish correlation with various performance determinants - firm specific, market specific and regulatory environments of their operation. Some studies ranked firms depending on their performance. The literature also indicates that good corporate governance is an important determinant of firm financial performance and growth. The previous studies point to the fact that the performance of some companies in Kenya has been low and unpredictable. However little has been done on the examination of the level of the role of the company boards and ownership structure on the performance of previous state owned commercial companies in Kenya.

# 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

A 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 was adopted in this study. The methodology is 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). The population of interest in this study consists of all previously state-owned companies quoted in the NSE.

## 3.4 Sampling Design and Sample Size

This study was a census focusing on all ten previous state owned companies, namely Kengen Ltd, Kenya Power & Lighting Company (KPLC), Mumias Sugar Co., Housing Finance Company of Kenya Ltd, Kenya Commercial Bank Ltd, Kenya Reinsurance Ltd, National Bank of Kenya Ltd, Cooperative Bank Ltd, Safaricom Ltd and Kenya Airways Ltd quoted on the Nairobi Stock Exchange. Hence, there was no need of sampling.

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### 3.5 Data Collection Method and Instruments

The study used secondary quantitative data to analysis the relationship between corporate governance structure and corporate performance. This data was obtained from financial statements of the ten companies to be covered, and is also published by NSE. These statistics will cover the period 2007 to 2010. The data was collected using data collection tool. Researcher assistance was engaged to collect the data, who worked closely with the key players in the industry. Data collected included the governance factors (Board Size, Board Composition), cost of governance such as management fees anil internal audits fees and financial performance expressed in terms of Return on Assets (ROA).

### 3.6 Data Analysis and Presentation

First, data collected was cleaned, sorted and collated. Then, data was entered into the computer, after which analysis was done. Analysis was done with the help of Statistical package for social scientists (SPSS version 14). First, descriptive analysis was undertaken' to describe the data and target units. Here, statistics such as mean score, frequencies and percentages for each variable were calculated and tabulated using frequency distribution tables, -or pie charts and/or bar charts. In order to test the relationship between the variables the inferential tests including the Pearson Product-Moment Correlation Coefficient and regression analysis were used.

Second, Pearson Product-Moment Correlation Coefficient as measures of association was used to examine the relationship between the independent and dependent variables. The relations was explored with the use of Pearson's correlation coefficient. Pearson's correlation coefficient calculates a relationship between two variables. Correlation co-efficient is definition as a measure of the strength of linear association between two variables. Correlation is always between -1.0 and +1.0. If the correlation is positive, we have a positive relationship. If it is negative, the relationship is negative.

Third, regression analysis was used to analyse the effect corporate governance mechanisms on the firms' performance. The study used Jabbyin (2002) regression specification. Given the four-year panel structure of the sample data to be gathered, regression analysis was conducted to investigate the relationship between the corporate



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Third, regression analysis was used to analyse the effect corporate governance mechanisms on the firms' performance. The study used Jabbyin (2002) regression specification. Given the four-year panel structure of the sample data to be gathered, Agression analysis was conducted to investigate the relationship between the corporate

governance attributes and the proxy dependent variables (return on asset) representing the extent of performance prevalent within sampled firms. The regression model that was evaluated is represented as follows:

$$PERF_{U} = j\backslash BDSZE_{it} + f3_{2}BDC_{it} + p.COCG \ldots\ldots\ldots\ldots \text{equation 1}$$

Equation 1 defines the regression equation to be used in this study where: *PERF* is financial performance represented by return on assets, BDSZE is the variable size of the board, RDC is the variable Board Composition proxied by proportion of executive board members, and COCG is the variable depicting the cost associated with institutionalization of corporate governance (CG) (board of directors remuneration, management fees and external audits fees) in the firm; and where/?- $j = \backslash,2,3and4$ are the slope coefficients whose sign depict the relationship between return on assets as a measure of financial performance and ggovernance structure variables proxied by Board Size (BDSZE), Board Composition (BDC) and cost of CG (COCG).

### 3.7 Measurement of Variables and expected output

#### Measurement of financial performance

This study used Return on Assets (ROA) ratios to capture company performance. The Return on Assets ratio is computed by dividing profits before interest and tax payments by total assets. The ROA is a performance measure equal to net profit after tax per Kenya Shilling of assets. It provides information on how efficiently a firm is being run because it indicates average profits generated by each shilling of assets.

#### Corporate Governance variables

Board Size (BDSZ) - This variable was used to capture the size of the board. It is expressed in terms of the 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 to be less effective as they are difficult to coordinate in decision making (Iskander M and Chemlou, 2000). The effect of the board size may not therefore be determined a priori.

Board Composition (BDC) - 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 total number of directors.

Cost of good corporate governance (COCG) - this is a variable depicting the cost associated with institutionalization of good corporate governance in the firms studied. This includes the cost associated with board director (Management fees) and cost of hiring external auditors. It is measured by the percentage total operating cos. A negative/positive relationship is expected between costs and firm performance.

**Table 3.1: Expected sign for the governance variables**

| Expected Sign | Variable | Measurement |
| --- | --- | --- |
| + or - | BDSZ | Number of Board members |
| + or - | BDC | Ratio of outside directors to total number of directors |
| + or - | , COCG | % of board and auditors costs to total assets |

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# CHAPTER FOUR: DATA ANALYSIS AND FINDINGS

## 4.1 Introduction

This section presents the data analysis and findings of the study. The section is divided into two main parts. The first part present the descriptive statistics of the data of variables used in the study while the other part deals with the broad objective of the study: examination of the relationship between good corporate governance and financial performance.

All the ten firms targeted responded, giving a response rate of 100 percent. The next section describes the description of corporate governance structures existing in the ten firms studied.

## 4.2 Description of Corporate Governance Structures

Respondents were asked to indicate the structure of governance of the respondent companies. Here the respondents were required to give the following information; the number of directors categorizing them as executive directors and non executive directors, the existence internal audits and their associated costs, and the management fees associated with directorships of the companies. The findings of the analysis are. summarized in the following sections.

### 4.2.1 Board Size and Composition

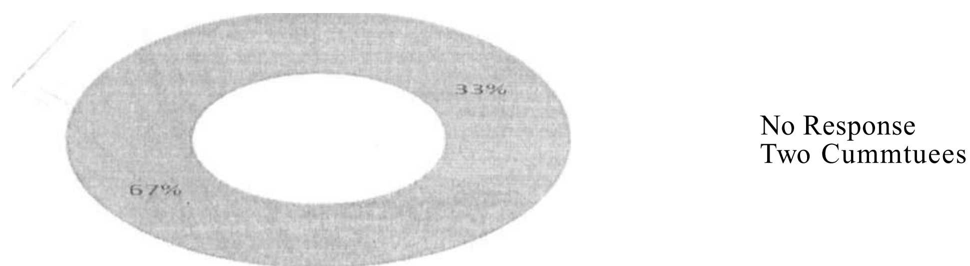
The study established that board size in 6 companies is 8 while the four companies have 10 broad members. The four companies with 10 board members, 60 percent of them were executive directors while 40 percent of were non executive directors. Similarly, among the 8 board members in 6 companies, 5 were executive directors and 3 were non executive directors. All the respondent companies have separate Chief Executive Officers (CEOs) and Chairmen. The details of the finding on the board size and composition are contained in Graph 4.1 below;

**Graph 4.1: Board size and composition among the companies studied**

### 4.2.2 Established committees of Board

The respondent companies were asked to indicate the number of committees of boards that have been established. The results of the study revealed that 67 percent of the respondent companies indicated that 2 committees of boards have been established. The findings of the analysis are represented in the figure **4.1** below.

**Figure 4.1: Number of the established committees of the Board**




### 4.2.3 Frequency of Full Board Meeting

The study sought to establish the frequency of the full board meeting in a year. The result of the analysis shows that five companies hold four full board meetings in a year. Three companies' holds three full board meetings while another two hold two full board meetings. The results of the analysis are shown in the table **4.1** below.

**table 4.1: Frequency of full board meeting**

| | Frequency of Full Board Members | |
|---|---|---|
| | Companies | Percentage |
| .FourFull board meetings | 5 | 50% |
| Three Full board meetings | 3 | 30% |
| JwoFull board meetings | "2 | 20% |

### 4.2.4 Internal Audit Functions

It was apparent from the findings of the analysis that the ten companies studied were either externally audited either by Deloitte and Touche, Pricewaterhouse & Coopers, Ernest & Young or KPMG. These are four main global auditing firms.

It was apparent from the findings of the analysis that all the ten companies have an internal audit department. Similarly, the ten companies hire external auditor who annually audit the books and records. Table 4.2 reveals that 100 percent of the respondent companies indicated that there existed adequately resourced external and internal audit functions. The audited accounts are reported to the board.

**Table 4.2: Existence of audit functions**

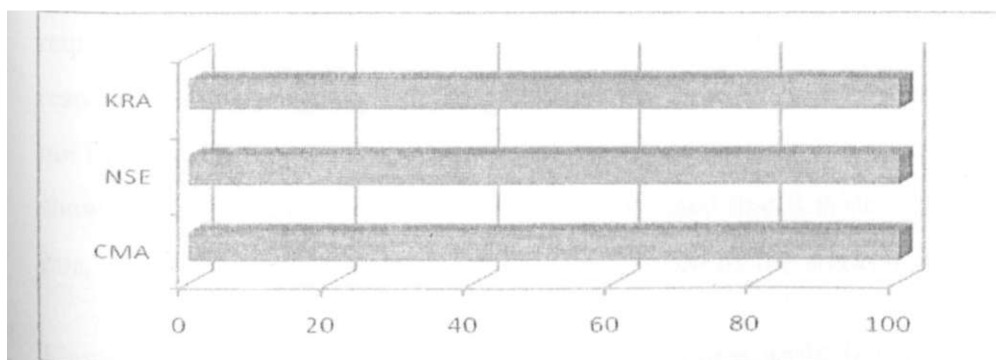
| Remark | Companies |
|---|---|
| Existence of internal audit department | 10 |
| Outsourcing external auditors | 10 |
| Auditors reporting to the boards | 10 |

Respondents companies indicated that external auditor provided other services like management consultancy to the companies.

### 4.2.5 Audited Accounts and Returns

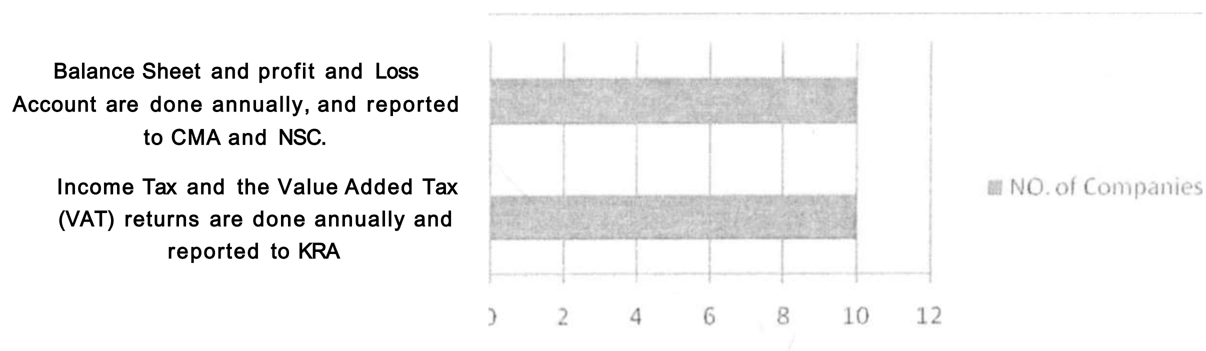
The study sought to establish the kind of returns that the companies make to the CMA, NSE and KRA. The study established as shown in the figure 4.2 below that 100 percent of the respondent companies indicated that they make financial reports to the CMA, NSE and KRA.

**Figure 4.2: Reporting of Audited Accounts and Returns**



The study sought to establish the type of returns that (he companies make to the CMA, NSE and KRA, and from the results of the analysis all the companies indicated that (he make tax returns to the KRA which are mainly the Income Tax and the Value Added Tax *(VAT).* The tax returns are done annually. Similarly, analysis established that 100 percent of the respondent companies indicated that the Balance Sheet and profit and Loss Account are done annually, and reported to CMA and NSE.

**Figure 4.3: Reported Audited Accounts and Returns**



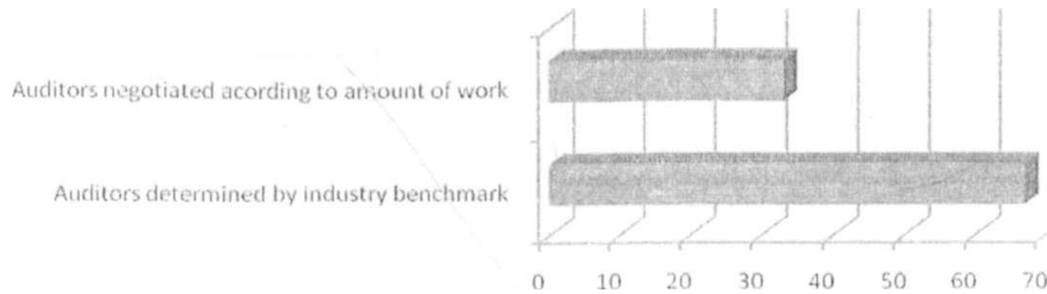

## 4.3 Impact of Institutionalization of Good Corporate Governance on the Organizations' Performance

The study sought to establish if good corporate governance lead to an increase in operating costs. First, this section analysis the cost of institutionalization of good governance among the firms studied. The findings of the analysis are summarized below.

### 4.3.1 Directors Fees, External Auditor Fees and Organizations' Performance

The study revealed that the non executive directors were on contract (100%) while executive directors are on the payrolls. Respondents companies were asked whether requirements for good corporate governance had led to increased operating costs. The respondents unanimously indicated that requirements of good corporate governance have not increased operational costs, (100%). In regard to audit fee, the results of the analysis showed that 67 percent of the respondents indicated that it is determined by the industry rate, while 33 percent indicated that it is determined by the amount of work done.

**Figure 4.4: Respondents Companies opinion on how audit fee is determined**




This research objective sought to verify whether there exist a direct correlation between the cost of good corporate governance and the company financial performance. Secondary data obtained from the annual reports of the ten companies was used.

Audited accounts of respective companies were analysed and the yearly amount of director's emoluments, management fees and audit fees were compared against the net profit for the four years. Hie cost of good corporate governance included agency cost (cost related to directors), and bonding and residual cost. The average yearly director's fees, management fees, Audit fees and other related fees as proxies for cost of good governance and net profits, total assets and return on asset for the ten companies were summarized in the table 4.3 below;

**Table 4.3: Cost of good governance versus financial performance (000's**

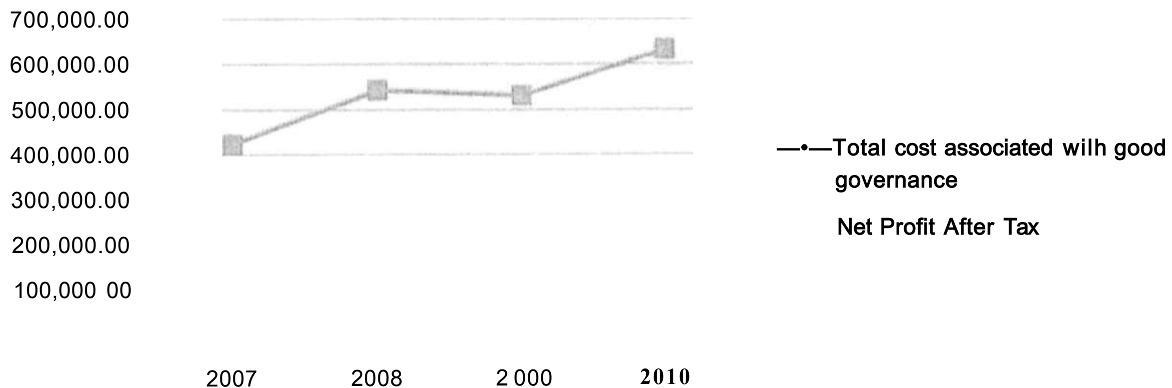
| A cconn t It x p i an at ion | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|
| Directors Fees | 2,353.00 | 1,922.00 | 2,495.00 | 2,922.00 |
| Management fees | 2,562.00 | 3,186.00 | 3,469.00 | 3,186.00 |
| Audit Fees | 1,515.00 | 2,108.00 | 2,964.00 | 3,108.00 |
| Other related fees | 820.00 | 1,432.00 | 2,989.00 | 3,232.00 |
| Total cost associated with good governance | 7,250.00 | 8,648.00 | 11,917.00 | 12,448.00 |
| | | | | |
| Net Profit After Tax | 424,910.00 | 542,975.00 | 531,890.00 | 632,975.00 |
| Total Assets | | | | |

|  | 1,357,928.00 | 1,390,480.00 | 1,453,076.00 | 2,540,480.00 |
|---|---|---|---|---|
| Return on Assets | 0.31 | 0.39 | 0.37 | 0.25 |
| Governance Cost /Total assets | 0.0053 | 0.0062 | 0.0082 | 0.0049 |

### 4.3.2 Graphical Representation of Relationship of Corporate Governance Costs and Organizations' Performance

First, all firms studied, the research established cost of good corporate governance measured as governance costs/Total Assets is less than the performance measured as return to asset ratio as shown in table above. The following section reports graphical representation of variables in figure 4.5.

**Figure 4.5: Graphing Cost of good governance versus financial performance**




The finding of this analysis reveals that the cost of good governance rose steadily throughout the four year period while performance rose between the years 2007 to 2008, before dropping between 2008 and 2009 rising again between 2009 and 2010. This finding means that there was evidence of direct relationship between good corporate governance and performance for the companies studied especially in years 2007, 2008 and 2010. In these years the cost of good governance seems to rise with the increases performance. For the year 2009, the' cost of good governance seemed to rise while the performance in the same period was decreasing. Analysis of this year depicts that that the cost of good governance alone does not determine performance but there exist other influencing factors which are beyond the scope of this study.

To empirically determine (he relationship between cost of good governance and performance of firms under review, first was correlation matrix and then regression analyses were used. The following section outlines the results of the data analysis.

### 4.3.3 Correlation Analysis

The correlation matrix is an important indicator that tests the linear relationship, between the variables. The matrix also helps to determine the strength of the variables that is, strength of the relationship between the dependent variable i.e., performance (return on assets) and the independent variable corporate governance mechanism measured by auditors fees, Directors remuneration and size of board, management fees. Correlation coefficient between two variables range from 1 (highly positively correlated) and -I (highly negatively correlated).

**Table 4.5: Pearson correlation between return on assets and independent variables**

| Variables | Co-efficient |
|---|---|
| Directors Remuneration | .613 |
| Management fees | .524 |
| Auditor fees | .665 |
| Size of Board | .213 |
| Composition of the Board | .226 |

Table 4.5 above shows that there is strong positive correlation between return on asset as a measure of performance and cost of governance proxied by director's remuneration, management fees and auditors fees of 0.613, 0.524 and 0.665 respectively. However, size and composition of board are weakly related with return on asset, as shown by correlation coefficients of 0.213 and 0.226 respectively. This indicates that cost of good corporate governance measured by audits fees, management fees and directors' remuneration influences the performance of the studied organizations.

### ^•3.4 Regression Analysis

Table 4.3 below summarizes regression results. As indicated in the regression statistics ^-squared was 0.397. This means that 39% variations from the expected and actual output of dependent variable i.e., Corporate governance mechanism (measured by return on assets) are explained by independent variable corporate governance mechanisms measured by auditors fees, board remuneration and size of board, management fees and

ownership by directors. Analysis of Variance shows that f-calculated is greater that f-critical (0.762>0.235), this implies that there exist their exist relationship between dependent variable and independent variables used in study.

| **Table 4.6: Summary of Regression Analysis Results** | | | | |
|---|---|---|---|---|
| ***Regression summary: Dependent variable Agency cost*** | | | | |
| R Squared | | | 0.435 | |
| Adjusted R Squared | | | 0.397 | |
| ***A NOVA (Analysis of Variance)*** | | | | |
| | *Df* | *Sum Squares* | *Calculated F* | *Significance F* |
| Regression | 2 | 4.43 | .762 | .235 |
| Residual | 7 | 30.76 | | |
| Total | 9 | 35.19 | | |
| ***On tout of Regression*** | | | | |
| | *Coefficients* | *Standard Error* | *t Statistics* | *Significance* |
| Intercept | 3.705 | 315.151 | .231 | .0824 |
| Auditors fees, | 0.191 | 0.076 | 2.504 | 0.019* |
| Size of the Board | -0.092 | 0.136 | -0.682 | 0.501 |
| Board Composition | 0.014 | 0.026 | 0.5295 | 0.601 |
| Management fees | -4.872 | 2.595 | -1.877 | 0.073* |
| Director remuneration | 0.114 | 0.066 | 1.721 | 0.098* |

* Correlation is at the 10% level of significance (90% confidence level)

The estimated regression equation is

Return Assets (performance = 3.705 - 0.191 Auditors fees + 4.872 management fees -0.114 director remuneration

The estimated equation shows that there is a strong positive marginal effect of independent variable - corporate governance measured by auditors' fees, management fees and directors remuneration on performance (measured by return on assets).

Regression results show that the coefficients of corporate governance mechanism measured by auditors' fees, management fees and directors remuneration are statically significance. This implies that these variables have an effect/impact on the performance proxied by return on assets. However, results reveal that size of board and board composition are not statistically significance and therefore there no relationship between both variables and agency cost (proxied by return on assets).

The coefficient of auditors' fees is 0.191. The coefficient is positive and statistically significant; implying that the probability that hiring audit and their work in advising the company mitigates agency costs. If the cost of hiring auditors increases by 1%, then the return on assets increases by 0.19%. This can only be associated to reduction of costs associated to agencies costs mitigated by auditors. The coefficient of management fees is -4.872 which is negative and significance. This indicates that increase in management fees mitigates the agency costs. The coefficient of directors' remuneration is 0.114, positive and statistically significant; implying that the probability that presence of active board member with ownership interest in firm running daily operations of the firm influences mitigates agency costs and increase returns on assets.

Thus, there exist relationship between good corporate governance mechanisms (auditors' fees, management fees and remuneration/ownership by directors) and performance (measured by return on assets) for the firms studied. Institutionalization of good corporate governance helps in mitigating the agencies costs and hence increases the firm performance.

### 4.4 Summary and Interpretation of Findings

The purpose of this study was to examine the relationship between corporate governance mechanism and performance of previous state-owned firms listed in Nairobi Stock Exchange. Specifically, the study established whether there is a relationship between the dependent variable i.e., return on assets and the independent variable corporate governance mechanism measured by auditors' fees, board remuneration and size of board, management fees and board composition. Descriptive statistics were used to

describe the data. Graphical, correlation and regression analysis were used to analysis to achieve the study objective in data analysis.

The study revealed that that board size in 6 companies is 8 while the four companies have 10 broad members. The four companies with 10 board members, 60 percent of them were executive directors while 40 percent of were non executive directors. Similarly, among the 8 board members in 6 companies, 5 were executive directors and 3 were non executive directors. The results of the study revealed that 67 percent of the respondent companies indicated that 2 committees of boards have been established. The result of the analysis shows that five companies hold four full board meetings in a year. Three companies hold three full board meetings while another two hold two full board meetings. It was apparent from the findings of the analysis that the ten companies studied were either externally audited either by Deloitte and Touche, PriceWaterhouse & Coopers, Ernest & Young or KPMG. These are the four leading global auditing firms.

It was apparent from the findings of the analysis that all the ten companies have an internal audit department. Similarly, the ten companies hire external auditor who annually audit the books and records. The audited accounts are reported to the board, and they make financial reports to the CMA, NSE and KRA. From the results of the analysis all the companies indicated that they make tax returns to the KRA which are mainly the Income Tax and the Value Added Tax (VAT). The tax returns are done annually. Similarly, analysis established that 100 percent of the respondent companies indicated that the Balance Sheet and Profit and Loss Accounts are done annually, and reported to CMA and NSE.

Graphical presentation of variables revealed that the cost of good governance rose steadily throughout the four year period while performance rose between the years 2007 to 2008, before dropping between 2008 and 2009 rising again between 2009 and 2010. 'This finding means that there was evidence of direct relationship between good corporate governance and performance for the companies studied especially in years 2007, 2008 and 2010. In these years the cost of good governance seems to rise with the increases in

performance. For the year 2009, the cost of good governance seemed to rise while the performance in the same period was decreasing. Analysis of this year depicts that that the cost of good governance, alone does not determine performance but there exist other influencing factors which are beyond the scope of this study.

The correlation analysis shows that there is strong positive correlation between return on asset as a measure of performance and cost of governance proxied by director's remuneration, management fees and auditors' fees of 0.613, 0.524 and 0.665 respectively. However, size and composition of board are weakly related with return on asset, as shown by correlation coefficients of 0.213 and 0.226 respectively. This indicates that cost of good corporate governance measured by auditors' fees, management fees and directors' remuneration influences the performance of the studied organizations.

Regression results show that the coefficients of corporate governance mechanism measured by auditors' fees, management fees and directors' remuneration are statically significant. This implies that these variables have an effect/impact on the performance proxied by return on assets. However, results reveal that size of board and board composition are not statistically significant and therefore there is no relationship between both variables and agency cost (proxied by return on assets). Thus, there exists a relationship between good corporate governance mechanisms (auditors' fees, management fees and remuneration/ownership by directors) and performance (measured by return on assets) for the firms studied. Institutionalization of good corporate governance helps in mitigating the agencies costs and hence increases the firm performance.

# CHAPTER FIVE: SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

## 5.1 Summary

Corporate governance is concerned primarily with management and stewardship issues of companies with an aim of increasing firms' performance and increasing share holders' value. However, even with institutionalization of good corporate governance mechanisms in companies there is evidence of collapse of some of these companies. This study sought to examine the relationship between corporate governance mechanism and performance of previous state-owned firms listed in Nairobi Stock Exchange. Specifically, the study established whether there is a relationship between the dependent variable i.e., return on assets and the independent variable corporate governance mechanism measured by auditors' fees, board remuneration and size of board, management fees and board composition.

The descriptive research methodology was adopted in this study. The population of interest in this study consists of all previously state owned companies quoted in the NSE between 2007 and 2010. Purposively ten previously state-owned companies in the main investment market segment were studied. Data was obtained from financial statements of the ten companies to be covered, and is also published by NSE. Descriptive statistics were used to describe the data. Graphical, correlation and regression analysis were used to achieve the study objective in data analysis.

Graphical presentation of variables revealed that, first, institutionalization of corporate governance seems to positively influence performance. Correlation matrix showed that there is a strong correlation between performance and good corporate governance. Institutionalisation of good corporate governance costs: auditors' fees, management fees and directors' remuneration were highly related with return on asset as a measure of performance. Regression results revealed that institutionalization of good corporate governance costs: auditors' fees, management fees and director ownership have strong

and significant marginal effects on returns on asset and hence they were found to mitigate the agency costs and consequently increase firms' performance.

## 5.2 Conclusions

The study revealed that, first, as the cost of institutionalization of corporate governance seems to rise, the firms' returns on asset in the same period was declining; second, the costs seemed to decline while the of performance in the same period was increasing.

Correlation analysis showed that there is a strong correlation between performance and good corporate governance. Institutionalization of good corporate governance costs: auditors' fees, management fees and director remuneration were highly related with return on asset as a measure of performance. This indicates that cost of good corporate governance measured by auditors' fees, management fees and director ownership/remuneration mitigates agency costs consequently the high financial performance by the firms studied. However, board composition and size of the board were weakly related to performance.

Regression results revealed that R-squared was 0.435, implying that 45% variations from the expected and actual output of dependent variable i.e., performance (measured by return on assets) are explained by independent variable corporate governance mechanisms measured by auditors' fees, board remuneration and size of board, management fees and directors' composition. The estimated equation shows that there is no marginal effect of board composition and size of board on return on asset. This implies that between board composition and size of board on return on assets as a measure, corporate governance mechanism has no effect on firms' return on assets. However, institutionalization of good corporate governance costs: auditors' fees, management fees and director remuneration have strong and significance marginal effects on returns on asset and hence they were found to mitigate to agency costs.

Institutionalization of good corporate governance costs: auditors' fees, management fees and director remuneration have strong and significant marginal effects on returns on asset

and hence they were found to mitigate the agency costs. Thus, there exists positive relationship between institutionalization of good corporate governance mechanisms and performance for the previously state-owned firms studied. From the study, it can be concluded that the institutionalization of good corporate governance can help reduce (mitigate) the agency costs resulting to high return on asset for the previous state-owned companies quoted on the Nairobi Stock Exchange. The study also reveals that good corporate governance does not increase the agency costs. Therefore the study concludes that there is no financial burden in institutionalizing corporate governance.

### 5.3 Policy Recommendations

The study also reveals that there is no evident that good corporate governance increases the agency costs. The study concludes that there is no financial burden in institutionalizing corporate governance. On the basis of the result of this study, it is recommended that companies listed in the Nairobi Stock Exchange should institute good corporate governance because it does not lead to financial burden to the company. It is further recommended that all companies, whether listed or not should institute good corporate governance in order to mitigate agency C9sts and hence increase the performance of their companies.

In order to achieve this, it is recommended the following: The companies need to have a moderate board of directors who serve the interest of the companies, who divided to key board committees. There must be a separation between company and personal interest. Having separated a Chief Executive Officer (CEO) and Chairman of the company is emphasized. In addition to competent internal auditors, it is recommended external auditors need be engaged in order to provide the company with professional independent advice on the company performance and strategic goals. Compliances with regulators guidelines and observation of prudential management practices is recommended.

## 5.4 Limitations of the Study

This study is confined to firm quoted at NSE. Therefore this study is limited to a few listed firms at the NSE, which is a relatively small compared non listed firm in the country.

Corporate governance in a capital market can be studied with respect to corporate agency costs, management/director fees, cost of prudential management practices such as cost of external auditors and submitting required returns to regulators. However, this study studied was confined to management/director fees and cost of hiring external auditors only.

Collection and analysis of panel data was difficulty. Therefore the study used cross section data. All the limitations of the analysis tool of cross sectional data used are applicable to this study

## 5.5 Suggestions for further research

This study was done only on the companies quoted on the Nairobi Stock Exchange. The study can also be extended to other companies in Kenya not listed in the Nairobi stock exchange. Further, similar studies can be done for other stock exchanges in other countries.

This study studied was confined to management/director fees and cost of hiring external auditors only. Similar study can be done to cover all the corporate governance costs. Therefore, the study was confined to only one event announcement.

Whereas there are many players in the capital market, this study only targeted the firms listed in the NSE, similar study can be extended to cover the regulator and shareholders and obtain his/their views on the subject matter.

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## APPENDICES

### Appendix I: Previously Government Owned Companies Quoted Firms at the NSE

**Main Investment Market Segment**

**Agricultural**
None

**Commercial and Services**
Kenya Airways Limited
Safari com Ltd

**Finance and Investment**
Kenya Commercial Bank Limited
National Bank of Kenya Limited
Housing Finance Ltd
Cooperative Bank of Kenya
Kenya Reinsurance ltd.

**Industrial and Allied**
Kenya Power & Lighting Company Limited
Kenya Electricity Generating Company (KenGen)
Mumias Sugar Company Limited

/

## Appendix II: Data from Financial Statements of the Firms Quoted at the NSE

| YEAR | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|
| | Kshs '000' | Kshs '000' | Kshs '000' | Kshs '000' |
| | | | | |
| COMPANY | | | | |
| COOPERATIVE BANK | | | | |
| Directors' fees | 8,430 | 9,905 | 9,960 | 10,595 |
| Management fees | – | – | – | |
| Audit fee | 6,600 | 7,000 | 7,359 | 7,500 |
| Other related charges | 9,794 | 11,638 | 11,847 | 12,100 |
| Net Profit After Tax | 1,526,088 | 2,358,308 | 2,958,856 | 4,379,231 |
| Total Assets | 65,312,152 | 83,532,903 | 110,531,373 | 153,983,533 |
| | | | | |
| HFCK | | | | |
| Directors' fees | 20,808 | 24,699 | 25,431 | 31,640 |
| Management fees | 2,472 | 2,296 | 1,988 | 3,039 |
| Audit fee | 4,990 | 6,815 | 6,815 | 6,815 |
| Other related charges | 2,005 | 3,704 | 4,106 | 8,182 |
| Net Profit After Tax | 73,508 | 136,427 | 234,176 | 379,531 |
| Total Assets | 10,414,540 | 14,330,495 | 18,280,761 | 29,325,842 |
| | | | | |
| KCB | | | | |
| Directors' fees | 24,941 | 24,113 | 22,746 | |
| Management fees | 82,924 | 78,682 | 67,663 | |
| Audit fee | 8,300 | 8,800 | 8,950 | |
| Other related charges | | | | – |
| Net Profit After Tax | 2,707 | 3,811 | 4,552 | |
| Total Assets | 112,210,660 | 174,711,564 | 172,384,128 | |

| | | | | |
|---|---|---|---|---|
| **KENGEN** | | | | |
| Directors' fees | 3,450 | 3,600 | 3,600 | 6,000 |
| Management fees | 46,852 | 49,631 | 66,374 | 63,933 |
| Audit fee | 3,000 | 3,520 | 3,520 | 5,000 |
| Other related charges | 10,711 | 19,687 | 14,879 | 16,413 |
| Net Profit After Tax | 2,445,666 | 5,896,879 | 2,070,913 | 1,957,362 |
| Total Assets | 19,966,861 | 99,408,035 | 102,736,136 | 136,641,616 |
| | | | | |
| **KENYA RE-INSURANCE** | | | | |
| Directors' fees | 1,920 | 2,760 | 3,400 | |
| Management fees | 26,382 | 29,210 | 30,612 | |
| Audit fee | 4,676 | 3,400 | 3,500 | |
| Other related charges | 10,280 | 12,000 | 12,612 | |
| Net Profit After Tax | 837,949 | 1,481,100 | 1,735,201 | |
| Total Assets | 12,962,494 | 13,665,599 | 14,665,609 | |
| | | | | |
| **KPLC** | | | | |
| Directors' fees | 3,691 | 2,787 | 4,200 | |
| Management fees | 55,582 | 68,823 | 75,442 | |
| Audit fee | 8,800 | 10,120 | 10,120 | |
| Other related charges | 18,881 | 19,762 | 26,795 | |
| Net Profit After Tax | | | | |

| | | | | |
|---|---|---|---|---|
| J | 1,718,477 | 1,764,870 | 3,225,094 | |
| V<br>J Total Assets | 47,321,864 | 59,812,122 | 70,648,825 | |
| | | | | |
| **KENYA AIRWAYS** | | | | |
| \ Directors' fees | 10,000 | 10,000 | 12,000 | 10,000 |
| Management fees | 69,000 | 78,000 | 73,000 | 63,000 |
| L Audit fee | 10,000 | 10,000 | 10,000 | 11,000 |
| Other related charges | 7,000 | 7,000 | 6,000 | 6,000 |
| Net Profit After Tax | 4,098,000 | 3,859,000 | 4,083,000 | 2,035,000 |
| Total Assets | 78,498 | 78,248 | 78,293 | 75,365 |
| | > | | | |
| **MUMIAS SUGAR CO.** | | | | |
| Directors' fees | 2,971 | 2,971 | 5,207 | 5,500 |
| Management fees | 49,609 | 48,549 | 51,881 | 68,259 |
| Audit fee | 4,829 | 4,798 | 5,207 | 5,200 |
| Other related charges | 50,269 | 52,599 | 54,787 | 49,402 |
| _Net Profit After Tax | 1,393,611 | 1,213,837 | 1,609,972 | 1,572,383 |
| Total Assets | 11,916,809 | 14,152,576 | 17,475,715 | 18,334,110 |
| | | | | |
| **NATIONALBANK ^OF KENYA** | | | | |
| Directors' fees | 8,430 | 9,905 | 9,960 | 10,595 |

| r Management fees | 33,328 | 33,467 | 39,620 | 43,595 |
|---|---|---|---|---|
| ir rtv 1 Audit fee | 6,500 | 6,825 | 7,050 | 7,403 |
| ^ Other related charges | 36,110 | 39,892 | 39,748 | 43,595 |
| r Net Profit After Tax | 1,119,396 | 1,240,610 | 1,462,955 | 2,021,919 |
| y Total Assets | 44,414,272 | 42,695,700 | 51,404,408 | 60,026,694 |
| 1 | | | | |
| **SAFARICOM** | | | | |
| Directors' fees | 1,068 | 1,174 | 1,310 | 13,355 |
| Management fees | - | | | |
| Audit fee | 18,400 | 18,400 | 18,690 | 20,850 |
| Other related charges | 102,402 | 107,310 | 112,695 | 310,694 |
| Net Profit After Tax | 12,010,431 | 13,853,286 | 10,536,760 | 15,287,810 |
| Total Assets | 56,408,239 | 74,366,313 | 91,332,223 | 104,120.850 |