THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE OF INSURANCE COMPANIES IN KENYA

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A MANAGEMENT RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE AWARD OF THE DEGREE OF MASTERS OF BUSINESS ADMINISTRATION, SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI

NOVEMBER, 2011

DECLARATION

This management project is my original work and has not been presented for a degree course in any university.

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This management project has been submitted for examination with my approval as university supervisor. . / / /

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DEDICATION

This study is dedicated to my loving family, for their support, encouragement and patience during the entire period of my study and for their continued prayers. May God bless you.

ACKNOWLEDGEMENT

I wish to sincerely thank my family for their unending support in all ways while I pursued my education, my supervisor Mr. J. Barasa for his guidance all through this project.

My gratitude goes to all my friends for their moral support. Finally, to God be the glory, for the great things He has done.

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ABBREVIATIONS

BOD - Board of Directors

CEO - Chief Executive Officer

NSE - Nairobi Stock Exchange

MBV - Market to Book Value

ROA- Return on Assets

ROE - Return on Equity

EVA - Economic Value Added

ROCE - Return on Capital Employed

IRA - Insurance Regulatory Agency

CMA - Capital Markets Authority

ABSTRACT

The study investigates into the relationship between corporate governance and financial performance of insurance companies. Corporate governance has been believed to be one of the factors that influence the financial performance of insurance companies.

The study comprised of 41 insurance companies licensed by IRA during the period of study 2006 to 2009. The study found out that there is a significant influence of board size, non-executive directorships, insider shareholding, board meeting frequency and CEO-Chairman duality on the financial performance of the insurance companies.

The study found out that there is a negative relationship between the Board size and non-executive directorships with ROA whereas Insider shareholding and board meeting frequency had a significant positive relationship with ROA. On the other hand, board size, non-executive directorships, insider shareholding and board meeting frequency had a positive relationship with ROE.

The study recommends that the regulator should draw minimal requirements for corporate governance in the insurance industry to serve as guideline for the insurance firms; this will improve the financial performance of these firms.

CHAPTER ONE

INTRODUCTION

1.1Background

Corporate governance could be defined as "ways of bringing the interests of investors and managers into line and ensuring that firms are run for the benefit of investors (Mayer, 1997). 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'. From the foregoing analysis, it is argued that corporate governance is represented by the structures and processes laid down by a corporate entity to minimize the extent of agency problems as a result of separation between ownership and control. It must also be indicated that different systems of corporate governance will embody what are considered to be legitimate lines of accountability by defining the nature of the relationship between the company and key corporate constituencies.

Corporate governance has become a popular issue for listed companies, which plays an important role for their growth. Characteristics of BOD, as one of its important component, have also become the focus of the relative study. The U.S. Securities and Exchange Commission and the Financial Accounting Standards Board have emphasized its important role in financial accounting as the board shoulders the serious responsibility of monitoring, evaluation and rewarding the senior managers. The early literatures mainly focus on four areas on the study of the board characteristics, namely: (1) board size; (2) board independence; (3) frequency of board meeting; (4) if the CEO is also the board chair.

Several scholars have focused on board size. Kogan and Wallach (1966) argued that the larger the board, the more difficult to reach the agreement. Small-scale board is better than the larger one. Yermack (1996) argues that there exists negative correlation between board size and the companies' Tobin Q, and the smaller board is more efficient than the larger one on monitoring the top managers. Eisenberg et al (1998) argued this result applies in Finland as well. Lehn et al.

(2004) argued that board size and firm size are positively correlated, but board size and company's growth opportunity are negative correlated. In addition, board size will affect the directors' monitoring and controlling on the top managers. The lager the board, the oversight to the top managers is better (Adams and Mehran, 2002).

Board independence also has important effect on company's value and performance. Directors have a primary responsibility of overseeing the firm's financial reporting process. Previous literatures generally posited that independent directors or outside directors could effective monitor and control firm activities, which would value the company. Boone et al. (2007) suggested that board structure would affect the company's competitive environment and the management team the number of members of the board that have ties with the CEO. Raheja (2005) argued that insiders are key information channels for board, but sometimes the information would be distorted for personal interest. Different from the insiders, outsiders are more independent, which will monitor top managers efficiently, but they are lack of company information. But it is hard to find empirical research to prove that. Coles et al (2008) found there was no significant correlation between board composition and firm value. Bhagat and Black (1999) also obtained the similar conclusion ten years ago. In China, Hu Qinqin and Shen Yifeng (2002) found the proportion of independent directors not affect company performance.

Board meeting frequency also exhibits a negative relation to firm value. Jensen (1993) argued that, the board meetings tend to be formal, and the contents are more concentrated in the daily affairs rather managers' assessment, which will increase costs. The vast majority of the board is passive, they would interfere with management decisions only in exceptional circumstances. Vafeas (1999) argued that board meeting frequency and firm value are negative correlation, which is consistent to Jensen's point.

The dual role of board chair and CEO is another hot issue. Pi and Timme (1993) argued that when CEO is not board chair, it could increase company performance, because it could weaken the Proceedings of the 7th International Conference on Innovation & Management internal control. But some literatures find no statistically significant relationship between them (Baliga, 1996).

In our Kenyan context there is little information on studies done to establish the relationship between corporate governance and financial performance of insurance sector. A study by the centre of corporate governance in 2004, found that there was very minimal disclosure and financial reporting in the insurance industry. Aholi (2004) identified many shortcomings in disclosure, consistency and accuracy in the reporting of financial information of the insurance companies in his compliance review of the 2003 financial statements of insurance companies. The findings from the study by centre of corporate governance and the collapse of insurance companies such as Standard Assurance Company and United Insurance Company shows the need to establish corporate governance structures and practices.

1.2 Statement of the problem

The separation of ownership and control in publicly held corporations induces conflicts of interest between managers and shareholders (Berle and Means, 1932). Shareholders are interested in maximizing the value of the firm, but managers' objectives may also include the increase of perquisite consumption and job security. A number of governance mechanisms may help aligning the interests of managers with those of shareholders. This includes equity ownership by managers (Jensen and Meckling, 1976), by outside blockholders (Kaplan and Minton, 1994) and executive compensation (Mehran, 1995). In addition, the board of directors may play a central role in monitoring managers (Fama, 1980). Board size, board composition and the leadership structure of the board are important characteristics that affect the effectiveness of the board in monitoring management (Jensen, 1993).

The role of ownership structure (Morck et al., 1988, and McConnell and Servaes, 1990) and board structure (Baysinger and Butler, 1985; Rechner and Dalton, 1991; Yermack, 1996, and Eisenberg et al., 1998, and Bhagat and Black, 2002) in monitoring management and so improving firm performance has been largely investigated in empirical corporate governance literature. While the results are mixed the approach used in studying the relation between governance mechanisms and financial performance is mostly the same. Underlying these studies on the effect of ownership and board structure on performance is the assumption that there is an optimal ownership and board structure which is common to all firms, and that firms which diverge from the optimal level of these characteristics will experience lower performance.

Because of inconsistencies in the previous studies; this study will seek to find out what the corporate governance structures prevalent specifically in insurance companies in Kenya and whether performance is better in those companies whose corporate governance structures are considered to be better.

The underlying assumption is that companies exist to add benefit to their shareholders and society at large by operating profitability. In Kenya while many studies have been conducted on corporate governance, few studies have touched on some aspects of the value like linking corporate governance to performance. Jebet (2002), Makobe (2004) and Ndung'u (2010) conducted research on corporate governance. Makobe studied companies listed in the NSE found out that corporate governance is still a major issue. Mwangi (2002) and Lilian (2010) studied on relationship between corporate governance, ownership structure and financial performance focusing on insurance companies in Kenya but was not able to establish the full impact of corporate governance practices on financial performance. Kerugoh (2002) notes that, corporate governance is at infancy stage in Kenya and calls for further studies. Musikali (2008) reviewed corporate governance and law, and noted inadequate shareholder rights, inadequate training of directors and poor shareholder activism as some of the factors holding back development of corporate governance. The above studies were carried out in different economies over time, given this fact and the difference in literature and the operating environments; it is therefore a research question whether corporate governance have any relationship with the financial performance of insurance companies in Kenya.

The study in fulfilling the afore-mentioned objective has to address the following research questions; what are the effects of corporate governance on financial performance on insurance companies in Kenya? The dominant question therefore shall be; does corporate governance lead to financial performance?

1.3 Research Objectives

The study aims to determine the relationship between corporate governance and financial performance of insurance companies in Kenya.

1.4 Importance of the study

Academicians: The study is intended to make a significant contribution to study of corporate governance and especially on its practice among insurance companies in Kenya. It will also fill a gap of knowledge and lay a foundation for further research.

Policy makers: The results of this study will go a long way in emphasizing the strong role corporate governance plays in an entities' objective and hence the social wellbeing of the society. Policy makers will use the findings to build on our corporate government environment in that it will help the regulator develop legal and regulatory frameworks which if adopted will help consolidate gains made in insurance industry governance with firm performance.

Investment Analyst: This is a very group in the efficient allocation of capital, knowledge of corporate government indices and the relationship to profitability of firm will help them make better and informed investment decisions.

Shareholders: Shareholders are the real investors, they will get to have an insight on the corporate governance practices and be able to predict future performance using models developed.

CHAPTER TWO

LITERATURE REVIEW

2.0 Introduction

In literature review, past studies as well as theoretical frameworks on the areas of corporate governance and firm performance are reviewed with the objective of gaining a deeper understanding of the history, evolution, direction and gaps in earlier studies.

2.1 Theoretical Framework

2.1.1 Agency theory of corporate governance

Agency theory (Jensen and Meckling, 1976; Eisenhardt, 1989) has been a dominant approach in the economics and finance literatures (Hermalin and Weisbach, 2000). Agency theory is concerned with aligning the interests of owners and managers (Jensen and Meckling, 1976; Fama, 1980; Fama and Jensen, 1983) and is based on the premise that there is an inherent conflict between the interests of a firm's owners and its management (Fama and Jensen, 1983).
The clear implication for corporate governance from an agency theory perspective is that adequate monitoring or control mechanisms need to be established to protect shareholders from management's conflict of interest - the so-called agency costs of modern capitalism (Fama and Jensen, 1983). Agency theory leads to normative recommendations that boards should have a majority of outside and, ideally, independent directors and that the position of chairman and CEO should be held by different persons (Bosch, 1995; Committee on the Financial Aspects of Corporate Governance, 1992; OECD, 1999; Toronto Stock Exchange Committee, 1994).

It is an acknowledged fact that the principal-agent theory is generally considered the starting point for any debate on the issue of corporate governance emanating from the classical thesis on The Modern Corporation and Private Property by Berle and Means (1932). According to this thesis, the fundamental agency problem in modern firms is primarily due to the separation between finance and management. Modern firms are seen to suffer from separation of ownership and control and therefore are run by professional managers (agents) who cannot be held accountable by dispersed shareholders. In this regard, the fundamental question is how to ensure

that managers follow the interests of shareholders in order to reduce cost associated with principal-agent theory. The principals are confronted with two main problems. Apart from facing an adverse selection problem in that they are faced with selecting the most capable managers, they are also confronted with a moral hazard problem: they must give agents (managers) the right incentives to make decisions aligned with shareholder interests.

In further discussion of agency relationships and cost (Jensen and Meckling, 1976) describe agency relationship as a contract under which "one or more persons (principal) engage another person (agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent". In this scenario, there exists a conflict of interests between managers or controlling shareholders, and outside or minority shareholders leading to the tendency that the former may extract "perquisites" (or perks) out of a firm's resources and be less interested to pursue new profitable ventures. Agency costs include monitoring expenditures by the principal such as auditing, budgeting, control and compensation systems, bonding expenditures by the agent and residual loss due to divergence of interests between the principal and the agent. The share price that shareholders (principal) pay reflects such agency costs. To increase firm value, one must therefore reduce agency costs.

2.1.2 Stewardship theory

Stewardship theory claims that managers are essentially trustworthy individuals and therefore good stewards of the resources entrusted to them (Donaldson, 1990; Donaldson and Davis, 1991; 1994). Proponents of stewardship theory contend that superior corporate performance will be linked to a majority of inside directors as they work to maximize profit for shareholders. This is because inside directors understand the business they govern better than outside directors and so can make superior decisions (Donaldson, 1990; Donaldson and Davis, 1991). Underlying this rationale is the assertion that since managers are naturally trustworthy there will be no major agency costs (Donaldson, 1990; Donaldson and Preston, 1995). Stewardship theorists also argue that senior executives will not disadvantage shareholders for fear of jeopardizing their reputation (Donaldson and Davis, 1994). Stewardship theory argues that the board should have a significant proportion of inside directors to ensure more effective and efficient decision making.

2.1.3 Resource dependent theory

This theory introduces accessibility to resources, in addition to the separation of ownership and control, as a critical dimension to the debate on corporate governance. Again, the theory points out that organizations usually tend to reduce the uncertainty of external influences by ensuring that resources are available for their survival and development. By implication, this theory seems to suggest that the issue of dichotomy between executive and non-executive directors is actually irrelevant. How then does a firm operate efficiently? To resolve this problem, the theory indicates that what is relevant is the firm's presence on the boards of directors of other organizations to establish relationships in order to have access to resources in the form of information which could then be utilized to the firm's advantage. Hence, this theory shows that the strength of a corporate organization lies in the amount of relevant information it has at its disposal.

2.1.4 Stakeholder's theory

Stakeholder theory argues that apart from the shareholders or stockholders, investors, employees and suppliers there are other parties involved in a firm, including governmental bodies, political groups, trade associations, trade unions, communities, associated corporations, prospective employees, prospective customers, and the public at large. Sometimes even competitors are counted as stakeholders. The stakeholder view of strategy is an instrumental theory of the corporation, integrating both the resource-based view as well as the market-based view, and adding a socio-political level.

Given the potential consequences of corporate governance on economic performance, the notion that corporation has responsibilities to parties other than shareholders merit consideration. What matters is the impact that various stakeholders can have on the behaviour and performance of the firm and on economic growth. Assessment undertaken of the implication of corporate governance on economic performance must consider the incentives and disincentives faced by all participants who potentially contribute to firm performance (Kester, 1992).

2.1.5 Shareholder theory

According to the shareholder theory, the objective of the firm is to maximize shareholder wealth through allocative, productive and dynamic efficiency. The criteria by which performance is judged in this model can simply be taken as the market value (i.e shareholder value) of the firm. Therefore, managers and directors have an implicit obligation to ensure that firms are ran in the interests of shareholders (Blair, 1995).

Shareholder wealth maximization is a long-term decision and its success largely depends on solid value-based management practice. Scholars such a Brenley and Myers (2002) and Block and Hirt (2000) agree that shareholder wealth maximization should be the overall goal of every corporate entity. Maximization of shareholder wealth ensures that shareholders are adequately compensated for risk undertaken (Defrene and Wong, 1996) shareholder wealth is the total benefit to shareholders from investing in a company.

2.2 Mechanisms of corporate governance

2.2.1 CEO-Chairman duality

Under CEO-chairman duality, the CEO of a company plays the dual role of chairman of the board of directors. There are two schools of thought on CEO- Chairman duality. Several researchers argue that CEO-Chairman quality is detrimental to companies as the same person will be marking his "own examination papers". Separation of duties will lead to: (i) avoidance of CEO entrenchment; (ii) increase of board monitoring effectiveness; (iii) availability of board chairman to advise the CEO, and (iv) establishment of independence between board of directors and corporate management (Baysinger and Hoskisson, 1990; Fama and Jensen, 1983; Rechner and Dalton, 1991).

On the other hand, other researchers believe that since the CEO and chairman are the same person, the company will: (i) achieve strong, unambiguous leadership; (ii) achieve internal efficiencies through unity of command; (iii) eliminate potential for conflict between CEO and board chair, and (iv) avoid confusion of having two public spokespersons addressing firm stakeholders (Davis, Schoorman and Donaldson, 1997; Donaldson and Davis, 1991). Consistent with these arguments, Cannella and Lubatkin (1993) report a positive link between a dual

leadership structure and financial performance, Brickley, Coles, and Jarrell (1997) find a negative market reaction upon the announcement of splitting roles, and Dedman and Lin (2002) find no evidence of significant abnormal returns upon the announcement of splitting roles in the post-Cadbury period, and Simpson and Gleason (1999) report that companies that combine the roles the CEO and chairman are less likely to be financially distressed. A closer look at the empirical evidence reveals that the relationship between CEO-chairman duality and company performance is mixed and inconclusive.

2.2.2 Board composition

Board composition refers to the number of independent non-executive directors on the board relative to the total number of directors. An independent non-executive director is defined as an independent director who has no affiliation with the firm except for their directorship (Clifford and Evans, 1997). There is an apparent presumption that boards with significant outside directors will make different and perhaps better decisions than boards dominated by insiders. Fama and Jensen (1983) suggest that non-executive directors can play an important role in the effective resolution of agency problems and their presence on the board can lead to more effective decision-making. However, the results of empirical studies are mixed. A number of studies, from around the world, indicate that non-executive directors have been effective in monitoring managers and protecting the interests of shareholders, resulting in a positive impact on performance, stock returns, credit ratings, auditing, etc. Dehaene et al. (2001) find that the percentage of outside directors is positively related to the performance of Belgian firms. Connelly and Limpaphayom (2004) find that board composition has a positive relation with profitability and a negative relation with the risk-taking behaviour of life insurance firms in Thailand. Rosenstein and Wyatt (1990) find a positive stock price reaction at the announcement of the appointment of an additional outside director, implying that the proportion of outside directors affects shareholders' wealth. Bhojraj and Sengupta (2003) and Ashbaugh-Skaife, Collins and Kinney (2006) also find that firms with greater proportion of independent outside directors on the board are assigned higher bond and credit ratings respectively.

2.2.3 Board Size

This is considered to be a crucial characteristic of the board structure. Large boards could provide the diversity that would help companies to secure critical resources and reduce environmental uncertainties (Pfeffer, 1987; Pearce and Zahra, 1992; Goodstein et al., 1994). But, as Yermack (1996) said, coordination, communication and decision-making problems increasingly impede company performance when the number of directors increases. Thus, as an extra member is included in the board, a potential trade-off exists between diversity and coordination. Jensen (1993) appears to support Lipton and Lorsch (1992) who recommend a number of board members between seven and eight. However, board size recommendations tend to be industry-specific, since Adams and Mehran (2003) indicate that bank holding companies have board size significantly larger than those of manufacturing firms.

2.2.4 Board meeting frequency

Jensen (1993) argued that, the board meetings tend to be formal, and the contents are more concentrated in the daily affairs rather managers' assessment, which will increase costs. The vast majority of the board is passive, they would interfere with management decisions only in exceptional circumstances. Vafeas (1999) argued that board meeting frequency and firm value are negative correlation, which is consistent to Jensen's point.

Mululu (2005) shows that boards increases the frequency of their meetings following poor performance and consequences of such increases the performance of firm giving support to Jensen (1993) and Vafeas (1999) that the role of boards become increasingly important during crisis, when shareholder's interest are in visible danger. However, the association between board meeting frequency and firm performance remains unclear, and the linkage between the board activity and monitoring difficult to establish.

2.2.5 Insider shareholding

The first argument to address the problem of agency concerns the use of insider shareholding several researchers (McConnell and Servaes, 1990 Nor *et al,* 1999, Yeboah-Duah, 1993) have undertaken research on this aspect, McConnell and Servaes (1990) find significant curvilinear relationship between insider ownership and firm performance. While Loderer and Martin (1997)

find no significant relationship, Nor *et al* (1991) reported a non-linear relationship, drawing conclusions contrary to those of Yeboah-Duah (1993).

2.3 Financial Performance

Performance refers to the extent to which an organization's goals and objectives are achieved effectively and efficiently. Performance can take many forms depending on who and what the measurement is intended for. Different stakeholders require different performance indicators to enable them make informed decisions. The content, format and frequency of reports depend on who needs the information and for what purpose (Kahara, 2006). Shareholders will want to be certain about the viability, sustainability, profitability, return on investment and continued firm sustainability of the firm (Brown *et al,* 2003).

Blair (1995) puts forward major areas in which performance can be examined. These include: liquidity, profitability, financial efficiency and repayment capacity. The association between quality of corporate governance and firm's profitability is quite of corporate governance and firm's profitability is quite a major focus in corporate governance studies, but one cannot predict much on the direction as prior literature show mixed results.

2.4 Measures of financial performance

There are various measures of performance. Some are discussed below:

2.4.1 Market to book value (MBV)

Institutional investors in the USA use the Market to book value ratios to assess performance when selecting target firms Xu and Wang (1997) used MBV ratio as a measure of the market performance of 100 Chinese town and village enterprises listed in two Chinese stock exchanges. MBV ratio is calculated as the share prices on the last day of trading of each year times the number of total outstanding share divided by the book value of equity (Xu and Wang, 1997).

MBV= Market Price X Number of shares/Book value of equity.

2.4.2 Return on Equity

The amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. If the ratio is higher than the industry average, this may indicate poor management of working capital. If the ratio is too low, this may not be 'bad' if the current assets are very liquid (Cash and securities) Xu and Wang (1997) calculated as:

Return on Equity = after tax profit/Shareholder's Equity.

2.4.3 Return on Assets

An indicator of how profitable a company is relative to its total assets. ROA gives an idea as to how efficient management is at using its assets to generate earnings. ROA is calculated by dividing a company's annual earnings by its total assets. ROA is displayed as a percentage. Sometimes this is referred to as "return on investment". Some investors add interest expense back into net income when performing this calculation because they would like to use operating returns before cost of borrowing. Calculated as follows:

Return on Assets = after tax profit + Interest (Before tax)/Shareholder's Equity.

2.4.4 Tobin's Q

Tobin's Q has been used as a major indicator of firm's performance (Xu and Wang, 1997) The correlation between the 'simple Q' and a measure of Q that attempt to use market value throughout is as high as 0.97. Tobin's Q measures expected future profitability due to valuable growth opportunities and/or competitive advantage. Calculated as;

Tobin's Q= Market value of debt + Market value of equity/Replacement costs of all assets.

2.4.5 EVA

This was popularized by Stern Stewart & Co. and is based on company's accounts. Its mechanism which is accounting simplified to the following relationship:

EVA=Sales-Operating expenses-tax-Financial requirements.

2.5 Corporate Governance and Financial Performance

It is widely claimed that good corporate governance enhances a firm's performance (Brickley et al, 1994; Brickley and James, 1987; Byrd and Hickman, 1992; Chung et al, 2003; Hossain et al, 2000; Lee et al, 1992; Rosenstein and Wyatt, 1990; Weisbach, 1988). In spite of the generally accepted notion that effective corporate governance enhances firm performance, other studies have reported negative relationship between corporate governance and firm performance (Bathala and Rao, 1995; Hutchinson, 2002) or have not found any relationship (Park and Shin, 2003; Prevost et al. 2002; Singh and Davidson, 2003; Young, 2003). Several explanations have been given to account for these apparent inconsistencies. Some have argued that the problem lies in the use of either publicly available data or survey data as these sources are generally restricted in scope.

It has also been pointed out that the nature of performance measures (i.e. restrictive use of accounting based measures such as return on assets (ROA), return on equity (ROE), return on capital employed (ROCE) or restrictive use of market based measures (such as market value of equities) could also contribute to this inconsistency (Gani and Jermias, 2006). Furthermore, it has been argued that the "theoretical and empirical literature in corporate governance considers the relationship between corporate performance and ownership or structure of boards of directors mostly using only two of these variables at a time" (Krivogorsky, 2006). For instance, Hermalin and Weisbach (1991) and McAvoy et al. (1983) studied the correlation between board composition and performance, whiles Hermalin and Weisbach (1991), Himmelberg et al. (1999), and Demsetz and Villalonga (2001) studied the relationship between managerial ownership and firm performance. Baysinger & Butler (1985) find that more independent boards are associated with superior performance.

2.6 Empirical Evidence

In its 'Global Investor Survey' of over 200 institutional investors first undertaken in 2000 and update 2002, McKinsey found that 80% of the respondents would pay a premium for well-governed companies. They defined a well-governed company as one that had mostly outside directors, who had no management ties, undertake formal evaluation of its directors and was

responsive to investors requests for information on governance issues. Other studies have linked broad perception of the quality of companies to superior share price performance.

It is often alleged that boards of directors are more independent as the proportion of their outsider directors increases (John and Senbet 1998). However, Fosberg (1989) finds no relation between the proportion of outsider directors and various performance measures (i.e., SG&A expenses, sales, number of employees, and return on equity); Hermalin and Weisbach (1991) find no association between the proportion of outsider directors and Tobin's Q. In contrast, Baysinger and Butler (1985) and Rosenstein and Wyatt (1990) show that the market rewards firms for appointing outside directors; Brickley, Coles and Terry (1994) find a positive relation between the proportion of outsider directors and the stockmarket reaction to poison pill adoptions; and Anderson, Mansi and Reeb (2004) show that the cost of debt, as proxied by bond yield spreads, is inversely related to board independence.

Thus, the relation between the proportion of outside directors, a proxy for board independence, and firm performance is mixed. Studies using financial statement data and Tobin's Q find no link between board independence and firm performance, while those using stock returns data or bond yield data find a positive link. Consistent with Hermalin and Weisbach (1991) and Bhagat and Black (2002), we do not find Tobin's Q to increase in board independence (in fact, we find the opposite), but we do find that firms with independent boards have higher returns on equity, higher profit margins, larger dividend yields, and larger stock repurchases, suggesting that board independence is associated with other important measures of firm performance aside from Tobin's Q.

Klein (2002) documents a negative relation between earnings management and audit committee independence, and Anderson et al. (2004) find that entirely independent audit committees have lower debt financing costs. Frankel, Johnson and Nelson (2002) show a negative relation between earnings management and auditor independence (based on audit versus non-audit fees), but Ashbaugh, Lafond and Mayhew (2003) and Larcker and Richardson (2004) dispute their evidence. Kinney, Palmrose and Scholz (2004) find no relation between earnings restatements and fees paid for financial information systems design and implementation or internal audit services, and Agrawal and Chadha (2005) find no relation between either audit committee independence or the extent auditors provide non-audit services with the probability a firm

restates its earnings. They provide additional evidence on the association between audit-related governance factors and firm performance by showing that: (1) solely independent audit committees are positively related to dividend yield, but not to operating performance or firm valuation; (2) auditors ratified at the most recent annual meeting are unrelated to all of our performance measures; (3) consulting fees paid to auditors less than audit fees paid to auditors are negatively related to four of our six performance measures; and (4) company has a formal policy on auditor rotation is positively related to return on equity but not to any of our other five performance measures.

Limiting board size is believed to improve firm performance because the benefits by larger boards of increased monitoring are outweighed by the poorer communication and decision-making of larger groups (Lipton and Lorsch 1992; Jensen 1993). Consistent with this notion, Yermack (1996) finds an inverse relationship between board size and firm value; in addition, financial ratios related to profitability and operating efficiency also appear to decline as board size grows. Anderson et al. (2004) show that the cost of debt is lower for larger boards, presumably because creditors view these firms as having more effective monitors of their financial accounting processes. They add to this literature by showing that firms with board sizes of between six and 15 have higher returns on equity and higher net profit margins than do firms with other board sizes. Dehaene et al. (2001) find that board size is positively related to company performance. However, the results of Haniffa et al. (2006) are inconclusive. Using a market return measure of performance, their results suggest that a large board is seen as less effective in monitoring performance, but when accounting returns are used, large boards seem to provide the firms with the diversity in contacts, experience and expertise needed to enhance performance. Finally, Connelly and Limpaphayom (2004) find that board size does not have any relation with firm performance.

Several studies have examined the separation of CEO and chairman, positing that agency problems are higher when the same person holds both positions. Using a sample of 452 firms in the annual Forbes magazine rankings of the 500 largest U.S. public firms between 1984 and 1991, Yermack (1996) shows that firms are more valuable when the CEO and board chair positions are separate. Core, Holthausen and Larcker (1999) find that CEO compensation is

lower when the CEO and board chair positions are separate, consistent with Yermack (1996), they show that firms are more valuable when the CEO and board chair positions are separate.

Botosan and Plumlee (2001) find a material effect of expensing stock options on return on assets. They use Fortune's list of the 100 fastest growing companies as of September 1999, and compute the effect of expensing stock options on firms' operating performance. In contrast, we use a larger sample and compare firms that do and do not expense. Based on Fortune 1000 firms during 1997-1999, Fich and Shivdasani (2004) find that firms with director stock option plans have higher market to book ratios, higher profitability (as proxied by operating return on assets, return on sales and asset turnover), and they document a positive stock market reaction when firms announce stock option plans for their directors. In contrast, we find no evidence that operating performance or firm valuation is positively related either to stock option expensing or to directors receiving some or all of their fees.

In their study, Muth and Donaldson (1998) investigated the validity of agency theory and stewardship theory as well as considering the implications of resource dependence theory. Their final sample size was 145 companies, based on board structure data for 1992 and including performance measures for 1992, 1993 and 1994. The study revealed that network connections are a separate dimension from board independence and that stewardship theory only holds "where directors are strongly network connected" (Muth and Donaldson, 1998: 26). Their results challenge the assumption under agency theory that the monitoring role of the board is valuable and are in direct conflict with Lawrence and Stapledon (1999) in reporting that despite a lack of consistent evidence the proportion of independent directors had a negative effect on shareholder wealth and sales growth.

Drobetz et al. (2004) estimate that an investor who invested in firms with high corporate governance quality and shorted on those displaying low corporate governance quality would have earned a 16.4% abnormal return per annum between 1998 and 2002 on the German market. Finally, a study of the Russian market indicates that better governance is linked to higher market valuation (Black et al. 2006).

2.7 Conclusion

This chapter has covered past studies as well as theoretical frameworks on the areas of corporate governance and firm performance with the objective of gaining a deeper understanding of the history, evolution, direction and gaps in earlier studies. This chapter has also gone a long way to elaborate on the various mechanisms of corporate governance, firm performance, measures of firm performance, empirical studies carried in the area of corporate governance and firm performance.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Research Design

The research is cross-sectional survey of insurance companies licensed in Kenya. This is to find out whether there exists a relationship between the independent variable, corporate governance and dependent variable, financial performance.

3.2 Population and sample design

The population of interest is all the 41 licensed insurance companies in Kenya during the period 2006 to 2009. All the 41 licensed insurance companies will be studied.

3.3 Data collection

The study will utilize both primary and secondary data; primary data which shall be obtained from information gatekeepers of the insurance companies with the help of the questionnaire (Appendix 2) and secondary data which shall be obtained from published and unpublished material and media reports. The researcher is to request for annual financial statements from IRA, NSE, CMA or respective insurance company offices. The primary data has the advantage of its originality and the Secondary data has the advantages of being less costly and less time consuming. With the help of the questionnaire, past four years information of the insurance companies shall be collected on board meeting frequency, board composition, CEO-Chairman duality, board size and Insider share ownership. The secondary data shall provide information on financial statements and ratios for the past four years which will help analyze financial performance.

3.4 Data Analysis

Data will be analyzed using SPSS statistical package since it is best suited for providing a means of establishing quantitative association between variables. To determine the performance of firms the financial ratios used include; Return on Equity and Return on Assets.

Return on Equity = after tax profit/Shareholder's Equity.

Return on Assets = after tax profit + Interest (Before tax)/Shareholder's Equity.

Given the fact that we are looking for the association between financial performance measure with a number of corporate governance measures, linear regression will be best suited to quantify the strength of the relationship. The equation to establish the relationship between corporate and performance of the firm therefore will be:

$Y=a + (31X1+ P2X2+ p3X3+ p4X4+ p5X5+e$

Y - Financial performance measured by ROA and ROE.

XI - measure of board size (measured by the number of directors sitting on firm's board),

X2 - measure of board composition (measured by the proportion of directors on firm's board which is fully independent),

X3 - measure of Insider share ownership (measured by the proportion of company shares owned by the CEO and internal directors),

X4 - measure of board meeting frequency (measured by the number of board meetings held during the year),

X5 - measure of CEO-Chairman duality (Establishing the separation of the position of CEO from the Chairperson),

a - constant term explained by other factors other than corporate governance structure,

PI, P2, , p5 - Co-efficients of corporate governance, &

e - error term.

CHAPTER FOUR

DATA ANALYSIS AND FINDINGS

4.1 Introduction

In this chapter, the descriptive statistics of the study variables is discussed. This chapter also discusses the empirical findings of this study and also gives a summary of the findings and interpretations with regard to the study objective. The objective of this study was to find out if there exists a relationship between corporate governance and financial performance of insurance companies in Kenya.

4.2 General Overview

4.2.1 Positions held by respondents in the organization

This section of the study sought to find out the various positions of the employees in the insurance companies who responded to the questionnaires.

Table 1: Positions of employees in the organization who responded

Respondents' Job Title	Frequency	Percent
Accountant	8	40
Administrator	2	10
Claims officer	1	5
General Manager	1	5
Human Resource		10
Marketing	1	5
Operations	1	5
Pensions	1	5
Risk and compliance manager	1	5
Underwriter	1	5
Total	20	100

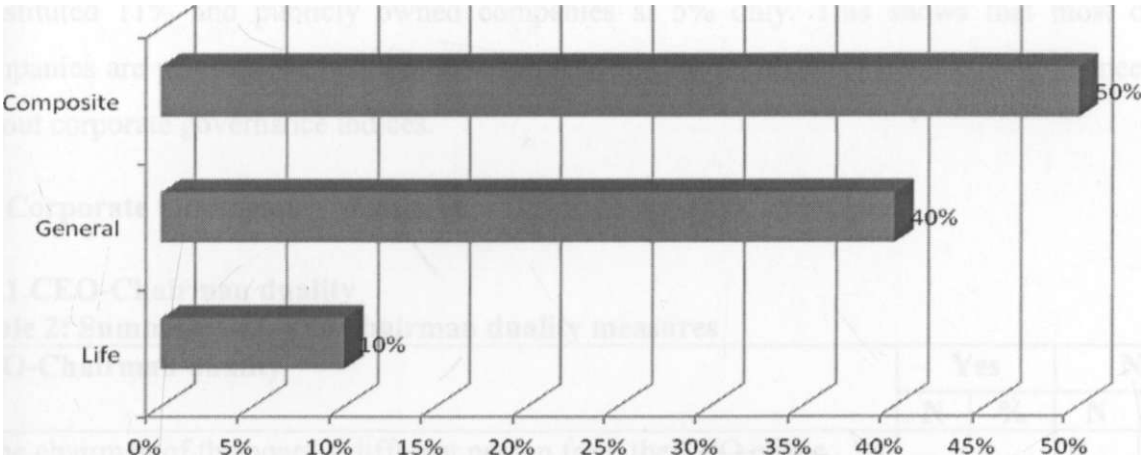
From Table 1, it was found out that most of the respondents, 40% were accountants.

4.2.2 Main business of the companies studied

p

This study set to find out the class of insurance business that the respondent companies were involved in.

Jar chart 1: Main business of companies studied

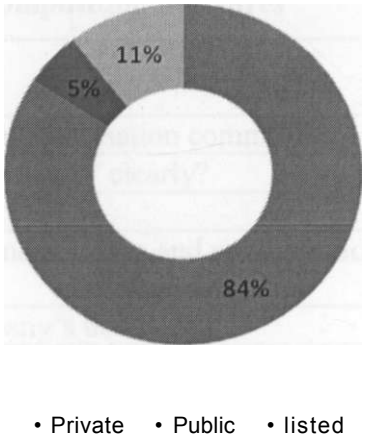


The study revealed that the main insurance business majority of the companies were involved in was composite, 50%, followed by those in general business, 40%. Only 10% were in long term business, life insurance. The higher number of firms in composite and general insurance perhaps is as a result of the fact that there is diversified portfolio which enables them spread risks and in fact generates more revenue compared to life insurers.

4.2.3 Nature of ownership

The study sought to establish the ownership of the respondent companies.

Pie chart 1: Nature of ownership of companies studied



Majority of the insurance were found to be private companies, 84%. Listed companies constituted 11% and publicly owned companies at 5% only. This shows that most of the companies are privately owned and there is need for the regulator to enhance compliance with set out corporate governance indices.

4.3 Corporate Governance Measures

4.3.1 CEO-Chairman duality

Table 2: Summary of CEO-Chairman duality measures

CEO-Chairman duality	Yes		No	
	N	%	N	%
Is the chairman of the board a different person from the CEO of the company?	20	100	0	0
Is role of Chairperson and CEO split?	17	85	2	10
Is there a political connection between the CEO and the Chairman?	3	15	16	80
Is the division of their responsibilities clear, set out in writing and agreed by the board?	16	80	2	10

The study revealed that in all the insurance companies surveyed, the chairman of the board was a different person from the CEO of the company hence refuting the CEO-Chairman duality theory. Also, 85% admitted that the role of Chairperson and CEO was split, whereas the division of their responsibilities was clear and set out in writing and agreed by the board, 80% thus the spread of powers and decision making. Interestingly, 80% declined that there was a political connection between the CEO and the Chairman.

4.3.2 Board Composition

Table 3 (a): Summary of board composition measures

Board Composition	Yes		No	
	N	%	N	%
Do you have audit, remuneration and nomination committees?	18	90	2	10
Does your company define 'independence' clearly?	16	80	4	20
Is the Chairman independent?	15	75	5	25
Is there a clear distinction between nomination and remuneration committees?	9	45	8	40
Do your directors sit on other company's boards?	17	85	2	10

From Table 3 (a), it was found out that most companies, 90% did have audit, remuneration and nomination committees. Eighty five percent admitted that their directors sat on other company's boards, while 80% said that their company defined 'independence' clearly.

Table 3 (b): Summary of board composition measures

Board Composition	More than 67%		Less than 67%	
	N	%	N	%
"What is the percentage of directors on your board fully independent (are not management, relatives to, or do business with the company)?	8	**40**	**11**	**55**
What percentage of your Audit committee is fully independent?	**11**	**55**	**7**	**35**
What is the percentage of the remuneration committee (committee that determines executive pay) that is fully independent?	**6**	**30**	**9**	**45**
What percentage of the nomination committee (recommending new directors to join board) is fully independent?	**4**	**20**	8	**40**

On board composition, a majority of 55% admitted that more than 67% of their audit committee was fully independent. As such less than 67% of directors on the board were fully independent (were not management, relatives to, or do business with the company), as represented by 40%.

4.3.3 Board Size

Table 4 (a): Summary of board size measures

Board Size	5 directors	7 directors	10 directors
	No. of firms	No. of firms	No. of firms
What is the size of the board?	6	**13**	**1**

Majority of the respondents, 65% stated that the size of the board comprised seven directors. Thirty percent had the fewest number of directors of five, whereas a minority of 5% had the largest number of directors of ten.

Table 4 (b): Summary of board size measures

Board Size	3 directors		4 directors		5 directors	
	Yes	No	Yes	No	Yes	No
What is the size of the remuneration committee (committee that determines executive pay)?	0	0	0	0	0	0
What is the size of the audit committee?	12		2		2	
What is the size of the nomination committee (recommending new directors to join board)?	11		1		1	

Still, on board size, most respondents, 60% stated that the size of the audit committee constituted few directors, three. Similarly, the size of the nomination committee (recommending new directors to join board) had only three directors as represented by 55%.

4.3.4 Insider Shareholding

Table 5: Summary of insider shareholding measures

Insider shareholding	Yes		No	
	N	%	N	%
Do the board members own companies stock?	14	70	5	25
Is the CEO required to own shares in the company?	8	40	12	60
Does the CEO own shares in the company?	8	40	12	60
Do the internal directors own companies stocks?	10	50	9	45
Does the company give loans to its senior executive?	13	65	6	30
Is there a guideline on stock ownership by internal executives?	7	35	9	45
Is there a guideline on stock ownership for board members?	11	55	4	20

From the study, it was found out that in most companies, 70%, the board members owned companies stock. Also, 65% admitted that their companies gave loans to its senior executive. On the contrary, a proportion of 60% each, declined that the CEO was required to own shares in the company or that the CEO actually owned shares.

4.3.5 Board meeting frequency

Table 6 (a): Summary of board meeting frequency measures

Board Meeting Frequency	Yes		No	
	N	%	N	%
Does the full board meet in accordance with the stipulations in the company's by-laws and articles?	20	100	0	0
Did board members attend more than 75% of the board meetings?	19	95	1	5
Did the non-executive meeting in the absence of chairman takes place?	11	55	8	40
Does the Chairman hold meetings with independent directors in the absence of executive directors?	7	35	12	60
Do independent directors meet without management?	12	60	6	30

The study revealed that all the companies surveyed had the full board meeting in accordance with the stipulations in the company's by-laws and articles. Further, 95% agreed that board members attended more than 75% of the board meetings. Also, independent directors met without management, as represented by 60%. On the contrary, 60% denied that the Chairman held meetings with independent directors in the absence of executive directors.

Table 6 (b): Summary of board meeting frequency measures

Board meeting frequency	Every one month	Every quarter	Twice a year
	N	N	N
How often do the board conduct meetings?	3	12	4
How often do the sub-committees conduct meetings?	8	8	3

The frequency of board meeting was majorly found to be on a quarterly basis, as indicated by 60% of the respondents. Twenty percent met twice a year whereas 15% met every month. On the frequency of sub-committees, a proportion of 40% each either indicated that it was on monthly or quarterly basis.

4.4 Regression Statistics

4.4.1 Regression analysis I

In this part of the study, regression analysis was done using ROA and ROE against specific factors from the corporate governance sub-indices. These factors are taken to be the critical factors for the corporate governance index. They include, for board size-what is the size of the board? For board meeting frequency-how often do the board conduct meetings? For CEO-Chairman duality-is the chairperson of the board a different person from the CEO of the company? For board composition-what is the percentage of directors on your board fully independent? For insider shareholding-do the internal directors own company stocks?

USING RETURN ON ASSETS AGAINST SPECIFIC ASPECTS CORPORATE GOVERNANCE MEASURES

Table 7: Model Summary (a)

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.402(a)	.162	-.118	.03146

Predictors: (Constant), what is the percentage of directors on your board fully independent (are not management, relatives to, or do business with the company), Board Size: What is the size of the board, How often do the board conduct meetings? Do the internal directors own companies stocks?

The coefficient of determination (R square) measures the proportion of variability in a data set that is accounted for by a statistical model. In this case it can be seen that there is fairly strong relationship between corporate governance and ROA. For all the 20 insurance companies involved in the study 16.2% of return on asset is explained by the key corporate governance factors.

Adjusted R squared attempts to correct R squared to more closely reflect the goodness of fit of the model in the population but since we used only one model, we can only rely on R square. Standard error is a measure of variability and as such measures the variability that a constant would be expected to show during sampling.

Table 8: ANOVA (a)

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	.002	4	.001	.578	.684(a)
	Residual	.012	12	.001		
	Total	.014	16			

Predictors: (Constant), what is the percentage of directors on your board fully independent (are not management, relatives to, or do business with the company), Board Size: What is the size of the board, How often do the board conduct meetings? Do the internal directors own companies stocks?

Dependent Variable: ROA.

Analysis of variance (ANOVA) is a method of testing the null hypothesis that several group means are equal in the population, by comparing the sample variance estimated from the group means to that estimated within the groups. Sum of squares measures the variability of a data set. For all the insurance companies, the regression model on the sum of squares is less than residual. Thus we can conclude that our model does not account for most of the variation on the dependent model, which is return on asset. The significance level being above our threshold of 0.05 confirms that the significance of corporate governance factors to return on asset is low and confirmed by the F test.

Table 12: Coefficients (b)

Model		Unstandardized Coefficients		Standardized Coefficients	T
		B	Std. Error	Beta	
1	(Constant)	2.958E-05	.064		.000
	Insider shareholding	.014	.017	.230	.801
	Board meeting frequency	.016	.014	.323	1.138
	Board Size	-.002	.017	-.034	-.124
	Board composition	-.006	.017	-.102	-.355

Dependent Variable: ROA

The unstandardized coefficients are the coefficients of the estimated regression model. With this information, we can be able to write the following equations:

Y=a + P1X1+ P2X2+ P3X3+ p4X4+ p5X5+e

ROA = 0.000 -0.002X1 -0.006X2 + 0.14X3 + 0.016X4 +0.64

The study indicates that board size, non-executive directorships, Insider shareholding, board meeting frequency had a significant impact on return on assets. Board size and non-executive directorships had a negative relationship with ROA indicating that an increase in the number of directors sitting on a company's leads to a decrease in ROA. Increase in board size makes it more difficult to reach to an agreement during decision making process hence less efficiency which reduces results.

Insider shareholding and board meeting frequency had a significant positive relationship with ROA, this perhaps could be attributed to the fact that increased number of meetings held during the year would lead to better control and review of operations resulting to correction of any inconsistencies in good time leading to better performance of the firm. The insider shareholding increase leads to increase in ROA because of the fact that insider shareholding reduces the agency problem hence improvement in firm performance.

USING RETURN ON EQUITY AGAINST SPECIFIC CORPORATE GOVERNANCE FACTORS

Table 10; Mode! Summary (b)

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.487(a)	.237	-.017	.12271

Predictors: (Constant), What is the percentage of directors on your board fully independent (are not management, relatives to, or do business with the company), Board Size: What is the size of the board, How often do the board conduct meetings? Do the internal directors own companies stocks?

In terms of financial performance with a consideration on return on equity, it is evident that for all the insurance companies involved in the study, 23.7% of the return on equity is explained by the corporate governance factors.

Table 11: ANOVA (b)

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	.056	4	.014	.934	.477(a)
	Residual	.181	12	.015		
	Total	.237	16			

Predictors: (Constant), What is the percentage of directors on your board fully independent (are not management, relatives to, or do business with the company), Board Size: What is the size of the board, How often do the board conduct meetings? Do the internal directors own companies stocks?

Dependent Variable: ROE

The study reveals that the regression model is lower than the residual model which means that the corporate governance factor does not account to much of the variability on return on assets. The significance level being above our threshold of 0.05 confirms that the significance of corporate governance factors to return on asset is low and confirmed by the F test.

Table 12: Coefficients (b)

Model		Unstandardized Coefficients		Standardized Coefficients	t
		B	Std. Error	Beta	
1	(Constant)	-.219	.249		-.880
	Insider shareholding	.097	.066	.402	1.467
	Board meeting frequency	.083	.054	.418	1.546
	Board Size	.000	.064	.001	.003
	Board composition	.028	.066	.117	.428

Dependent Variable: ROE

The unstandardized coefficients are the coefficients of the estimated regression model. With this information, we can be able to write the following equations:

Y=a + p1X1+ p2X2+ P3X3+ 04X4+ p5X5+e

ROE = -0.219 + 0.000X1+ 0.028X2 + 0.097X3 + 0.083X4 +0.249

The study indicates that board size, non-executive directorships, Insider shareholding, board meeting frequency had a significant impact on return on equity. Board size had a neutral relationship with ROE meaning that no matter the number of directors sitting on a company's board ROE will not be affected. Non-executive directorships, insider shareholding and board meeting frequency had a positive relationship with ROE. The higher the number of non-executive directors on board would lead to an increase in ROE this perhaps can be attributed to the fact that the more independent directors could effectively monitor and control firm activities, which could be of value to the company.

In addition, the increased number of meetings held during the year would lead to better control and review of operations resulting to correction of any inconsistencies leading to better performance of the firm. The insider shareholding increase leads to increase in ROE because of the fact that insider shareholding reduces the agency problem hence improvement in firm performance.

4.4.2 Regression analysis II

In this part of the study, regression analysis was done using ROA and ROE against the corporate governance sub-indices: CEO-Chairman duality, board composition, board size, insider shareholding and board meeting frequency as well as the combined corporate governance index.

USING RETURN ON ASSETS AGAINST CORPORATE GOVERNANCE SUB-INDICES

Table 13: Model Summary (c)

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.445[a]	.198	-.089	.0283823

a. Predictors: (Constant), board meeting frequency, board composition, insider shareholding, CEO-Chairman duality, board size

The coefficient of determination (R square) measures the proportion of variability in a data set that is accounted for by a statistical model. In this case it can be seen that there is fairly strong relationship between corporate governance and ROA. For all the 20 insurance companies involved in the study 19.8% of return on asset is explained by the key corporate governance factors.

Adjusted R squared attempts to correct R squared to more closely reflect the goodness of fit of the model in the population but since we used only one model, we can only rely on R square. Standard error is a measure of variability and as such measures the variability that a constant would be expected to show during sampling.

Table 14: ANOVA (c)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.003	5	.001	.690	.640[b]
	Residual	.011	14	.001		
	Total	.014	19			

a. Dependent Variable: ROA

b. Predictors: (Constant), board meeting frequency, board composition, insider shareholding, CEO-Chairman duality, board size

Analysis of variance (ANOVA) is a method of testing the null hypothesis that several group means are equal in the population, by comparing the sample variance estimated from the group means to that estimated within the groups. Sum of squares measures the variability of a data set. For all the insurance companies, the regression model on the sum of squares is less than residual. Thus we can conclude that our model does not account for most of the variation on the dependent model, which is return on asset. The significance level being above our threshold of 0.05 confirms that the significance of corporate governance factors to return on asset is low and confirmed by the F test.

Table 15: Coefficients (c)

Model		Unstandardized Coefficients		Standardized Coefficients	T
		B	Std. Error	Beta	
1	(Constant)	.014	.058		.248
	CEO-Chairman duality	.073	.063	.427	1.160
	Board composition	-.016	.033	-.170	-.495
	Board size	-.001	.038	-.014	-.037
	Insider shareholding	-.004	.024	-.039	-.147
	Board meeting frequency	-.047	.046	-.320	-1.032

Dependent variable: ROA

The unstandardized coefficients are the coefficients of the estimated regression model. With this information, we can be able to write the following equations:

Y=a + p1X1+ p2X2+ p3X3+ (34X4+ p5X5+e

ROA = 0.014 -001X1 - 0.016X2 - 0.04X3 - 0.047X4 + 0.073X5+0.058

The study indicates that board size, non-executive directorships, Insider shareholding, board meeting frequency and CEO-Chairman duality had a significant impact on return on assets. Board size, non-executive directorships, Insider shareholding, board meeting frequency had a negative relationship with ROA. The study also reveals that CEO-Chairman duality had a positive relationship with ROA.

USING RETURN ON EQUITY AGAINST CORPORATE GOVERNANCE SUB-INDICES

Table 16: Model Summary (d)

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	***A9T***	.247	-.021	.1143407

a. Predictors: (Constant), board meeting frequency, board composition, insider shareholding, CEO-Chairman duality, board size

In terms of financial performance with a consideration on return on equity, it is evident that for all the insurance companies involved in the study, 24.7% of the return on equity is explained by the corporate governance factors.

Table 17: ANOVA (d)

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	.060	5	.012	.920	.496"
	Residual	.183	14	.013		
	Total	.243	19			
a. Dependent Variable: ROE						
b. Predictors: (Constant), board meeting frequency, board composition, insider shareholding, CEO-Chairman duality, board size						

The study reveals that the regression model is lower than the residual model which means that the corporate governance factor does not account to much of the variability on return on assets. The significance level being above our threshold of 0.05 confirms that the significance of corporate governance factors to return on asset is low and confirmed by the F test.

Table 12: Coefficients (b)

Model		Unstandardized Coefficients		Standardized Coefficients	T
		B	Std. Error	Beta	
1	(Constant)	.143	.235		.608
	CEO-Chairman duality	.254	.253	.358	1.004
	Board composition	-.070	.133	-.176	-.529
	Board size	-.028	.151	-.068	-.186
	Insider shareholding	-.048	.096	-.126	-.497
	Board meeting frequency	-.226	.183	-.369	-1.230

Dependent variable: ROE

The unstandardized coefficients are the coefficients of the estimated regression model. With this information, we can be able to write the following equations:

Y=a + P1X1+ 02X2+ (33X3+ (34X4+ 05X5+e

ROE = 0.143 - 0.028X1- 0.070X2 - 0.048X3 - 0.226X4 + 0.254X5 + 0.235

The study indicates that board size, non-executive directorships, Insider shareholding, board meeting frequency had a significant impact on return on equity. Board size, board composition, insider shareholding and board meeting frequency had a negative relationship with ROE whereas CEO-Chairman duality had a positive relationship with ROE.

USING RETURN ON ASSETS AGAINST COMBINED CORPORATE GOVERNANCE INDEX

Table 19: model summary (e)

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	,248[a]	.062	.009	.0270694

a. Predictors: (Constant), Combined corporate governance index

In terms of financial performance with a consideration on return on assets, it is evident that for all the insurance companies involved in the study, 6.2% of the return on equity is explained by the corporate governance factors.

Table 20: ANOVA (e)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.001	1	.001	1.181	.291[b]
	Residual	.013	18	.001		
	Total	.014	19			

a. Dependent Variable: ROA

b. Predictors: (Constant), Combined corporate governance index

The study reveals that the regression model is lower than the residual model which means that the corporate governance index does not account to much of the variability on return on assets. The significance level being above our threshold of 0.05 confirms that the significance of corporate governance index to return on asset is low and confirmed by the F test.

Table 21: Co-efficients (e)

Model		Unstandardized Coefficients		Standardized Coefficients	T
		B	Std. Error	Beta	
1	(Constant)	.071	.033		2.186
	Combined CG index	-.057	.052	-.248	-1.087

Dependent variable: ROA

The unstandardized coefficients are the coefficients of the estimated regression model. With this information, we can be able to write the following equations:

Y=a + p6X6+e

ROA = 0.71 - 0.057X6 + 0.033

This analysis indicates that there is a negative relationship between corporate governance indices with ROE for insurance firms in Kenya.

USING RETURN ON EQUITY AGAINST COMBINED CORPORATE GOVERNANCE INDEX

Table 22: Model Summary (f)

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	**.343[a]**	**.118**	**.069**	**.1091629**

a. Predictors: (Constant), Combined corporate governance index

In terms of financial performance with a consideration on return on equity, it is evident that for all the insurance companies involved in the study, 11.8% of the return on equity is explained by the corporate governance factors.

Table 23: ANOVA(f)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.029	1	.029	2.406	.138[b]
	Residual	.214	18	.012		
	Total	.243	19			

a. Dependent Variable: ROE

b. Predictors: (Constant), Combined corporate governance index

The study reveals that the regression model is lower than the residual model which means that the corporate governance factor does not account to much of the variability on return on assets. The significance level being above our threshold of 0.05 confirms that the significance of corporate governance factors to return on asset is low and confirmed by the F test.

Table 24: Coefficients (f)

Model		Unstandardized Coefficients		Standardized Coefficients	T
		B	Std. Error	Beta	
j	(Constant)	.333	.132		2.530
	Combined CG Index	-.327	.211	-.343	-1.551

Dependent variable: ROE

The unstandardized coefficients are the coefficients of the estimated regression model. With this information, we can be able to write the following equations:

Y=a + p6X6+e

ROE = 0.333 - 0.327X6 + 0.132

This analysis indicates that there is a negative relationship between corporate governance index with ROE for insurance firms in Kenya.

4.4.3 Conclusion

From the regression analysis 1 it is evident that there is a significant influence of the specific factors measuring corporate governance on ROA and ROE. The analysis indicates that board size and non-executive directorships had a negative relationship with ROA while insider shareholding and board meeting frequency had a positive relationship with ROA. Further, the analysis reveals that board size, board meeting frequency, board composition and insider shareholding had a positive relationship with ROE. CEO-Chairman duality had no relationship with ROA and ROE.

From the regression analysis 2, where corporate governance sub-indices and combined index are used, it is evident that the results are different from the results in regression analysis 1. In regression analysis 2, board size, board composition, board meeting frequency and insider shareholding had a negative relationship with both ROA and ROE while CEO-Chairman duality had a positive relationship with both ROA and ROE. The two analyses reveal conflicting results but past studies in the same area also have had inconsistencies in results.

CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter concludes the study and the implications of the main findings. The responses were based on the objectives of the study. The researcher has intended to determine the relationship between corporate governance and financial performance of insurance firms in Kenya.

5.2 Summary of findings and interpretations

The study found out that all the insurance companies have the position of the Chairperson and the CEO separated, their role split and their responsibilities clear, set out in writing and agreed by the board. It was also established that most of the insurance companies have their boards consisting of more than 67% fully independent directors. Most of the firms also have audit, remuneration and nomination committees composing of less than 67% independent directors.

The study also indicated that the average number of board members for Kenyan Insurance companies ranging between 5 and 7 with the number of directors sitting on these companies' sub-committees ranging between 3 and 5. In addition, board members, internal directors and CEOs own company stocks with the senior executive given loans by the company.

It was found that most insurance companies have their board meetings held quarterly and sub-committee meeting either quarterly or monthly. All the boards of the insurance firms studied met in accordance with company's by-laws and articles with board members attending more than 75% of the board meetings.

The study indicates that board size, non-executive directorships, Insider shareholding, board meeting frequency had a significant impact on return on assets. Board size and non-executive directorships had a negative relationship with ROA indicating that an increase in the number of directors sitting on a company's leads to a decrease in ROA. Increase in board size makes it more difficult to reach to an agreement during decision making process hence less efficiency which reduces results.

Insider shareholding and board meeting frequency had a significant positive relationship with ROA, this perhaps could be attributed to the fact that increased number of meetings held during the year would lead to better control and review of operations resulting to correction of any inconsistencies in good time leading to better performance of the firm. The insider shareholding increase leads to increase in ROA because of the fact that insider shareholding reduces the agency problem hence improvement in firm performance.

The study indicates that board size, non-executive directorships, Insider shareholding, board meeting frequency had a significant impact on return on equity. Board size had a neutral relationship with ROE meaning that no matter the number of directors sitting on a company's board ROE will not be affected. Non-executive directorships, insider shareholding and board meeting frequency had a positive relationship with ROE. The higher the number of non-executive directors on board would lead to an increase in ROE this perhaps can be attributed to the fact that the more independent directors could effectively monitor and control firm activities, which could be of value to the company.

In addition, the increased number of meetings held during the year would lead to better control and review of operations resulting to correction of any inconsistencies leading to better performance of the firm. The insider shareholding increase leads to increase in ROE because of the fact that insider shareholding reduces the agency problem hence improvement in firm performance.

When corporate governance sub-indices and combined corporate governance index are used, conflicting results from early results, board size, board composition, board meeting frequency and insider shareholding had a negative relationship with both ROA and ROE while CEO-Chairman duality had a positive relationship with both ROA and ROE. The two analyses reveal conflicting results but past studies in the same area also have had inconsistencies in results. Such inconsistencies were experienced in earlier studies for example in the subsequent lines we can confirm that results may produce differing results.

Yermack (1996) finds an inverse relationship between board size and firm value; in addition, financial ratios related to profitability and operating efficiency also appear to decline as board size grows. Anderson et al. (2004) show that the cost of debt is lower for larger boards,

presumably because creditors view these firms as having more effective monitors of their financial accounting processes. They add to this literature by showing that firms with board sizes of between six and 15 have higher returns on equity and higher net profit margins than do firms with other board sizes. Dehaene et al. (2001) find that board size is positively related to company performance. However, the results of Haniffa et al. (2006) are inconclusive. Using a market return measure of performance, their results suggest that a large board is seen as less effective in monitoring performance, but when accounting returns are used, large boards seem to provide the firms with the diversity in contacts, experience and expertise needed to enhance performance. Finally, Connelly and Limpaphayom (2004) find that board size does not have any relation with firm performance.

5.3 Conclusions and policy recommendations

The findings of the study indicate that there is a significant relationship between board size, non-executive directorships, insider shareholding and board meeting frequency with both ROA and ROE. Board size and non-executive directorships had a negative relationship indicating that an increase in the number of directors sitting on a company's leads to a decrease in ROA whereas Insider shareholding and board meeting frequency had a significant positive impact on ROA. On the other hand, Non-executive directorships, insider shareholding and board meeting frequency had a positive relationship with ROE. This confirms the fact that corporate governance has an important role in indicating financial performance of insurance companies in Kenya.

Where corporate governance sub-indices and combined index are used, it is evident that the results are different from the results in specific factors from the corporate governance sub-indices are used. In regression analysis 2, board size, board composition, board meeting frequency and insider shareholding had a negative relationship with both ROA and ROE while CEO-Chairman duality had a positive relationship with both ROA and ROE. The two analyses reveal conflicting results but past studies in the same area also have had inconsistencies in results. The second analysis indicates that corporate governance has a negative relationship with both ROA and ROE, this differs from what would be expected this leads to need for further study in this area to be able to give a conclusive view.

In terms of policy recommendations, this study not only contributes to the literature around corporate governance and performance of insurance companies. Insurance companies need to review their corporate governance structures with a view of improving on their financial performance in future. The board sizes, non-executive directorships and leverage should be monitored and be addressed to ensure effectiveness in operations and hence value addition.

The regulator should draw minimal requirements for corporate governance in the insurance industry to serve as guideline for the insurance firms; this will improve the financial performance of these firms.

5.4 Limitations

Care must be taken to generalize the results of this study as there were some limitations.

i. The major limitation faced was the inability to access the information required from the insurance companies to enable the completion of the study.

ii. The use of regression analysis also means that there is an assumption of linearity with the various models which may not be the case.

iii. Resource constrains in terms of Money and time.

iv. This research was carried out within a time boundary and thus an in depth study could not be conducted.

v. The inability access information which would have been used as the control factors during the study.

5.5 Recommendations for further studies

The following are the recommendations for further research:

a) The current research was based on a case study on the insurance industry. Future studies should be undertaken through a descriptive research to obtain information concerning the current status of the phenomena to describe "what exists" with respect to variables or conditions in a situation.

b) Further research should be undertaken to investigate the full impact of corporate governance index on financial performance of insurance companies in Kenya.

c) Further research should be undertaken to investigate the impact of other corporate governance measures not captured in this study on financial performance of insurance companies.

d) Further research should be undertaken in the same area with the inclusion of control factors to bring out the full effect of corporate governance on financial performance.

e) Further research should be done to using other financial performance measures apart from return on equity and return on assets.

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APPENDIX 1: LIST OF LICENSED INSURANCE COMPANIES IN KENYA

1. AIG Kenya Insurance Co Ltd
2. A P A Insurance Limited
3. Africa Merchant Assurance Co Ltd
4. Aon Minet Insurance Brokers Ltd
5. Apollo Insurance Co Ltd
6. Blue Shield Insurance Co Ltd
7. British American Insurance Co (K) Ltd
8. CFC Life Assurance Ltd
9. Chartis Kenya Insurance Company
10. Co-Operative Insurance Co of Kenya Ltd
11. Concord Insurance Co Ltd
12. Co-operative Insurance Company
13. Corporate Insurance Co Ltd
14. Directline Assurance Co Ltd
15. Fidelity Shield Insurance Co Ltd
16. First Assurance Co Ltd
17. Gateway Insurance Company
18. Geminia Insurance Co Ltd
19. General Accident Insurance Co Kenya Ltd
20. Heritage Insurance Company Limited
21. Insurance Co of East Africa Ltd
22. Intra Africa Assurance Co. Ltd
23. Jubilee Insurance Co Ltd
24. Kenindia Assurance Co Ltd
25. Kenya Alliance Insurance Co Ltd
26. Kenya Orient Insurance Co Ltd
27. Lion of Kenya Insurance Co Ltd
28. Madison Insurance Co Kenya Ltd
29. Maj Insurance Agency Ltd

30. Mayfair Insurance Co. Ltd
31. Mercantile Life & General Assurance Co Ltd
32. Metropolitan Life Insurance Co. Ltd
33. Monarch Insurance Co.
34. Old Mutual Life Assurance Co.
35. Pacis Asssurance Co. Ltd
36. Pan African Life Assurance Co.
37. Pioneer Assurance Co. Ltd
38. Phonex of East Africa Assurance Co.
39. Real Assurance Co.
40. Tausi Assurance Co.
41. Trinity Life Assurance Co.

APPENDIX 2: INTERVIEW QUESTIONNAIRE

General

1. Name of your company
2. Your job title
3. What is the main business of the company?

4. Which region is your company based?

4. What is the nature of the company?

(i) Private [ ]

(ii) Public [ ]

(iii) Listed [ ]

(iv) State owned [ ]

(v) Others

5. How do you grade your organization in the following statements (Tick where applicable)

CORPORATE GOVERNANCE MEASURE	MEASURE	TICK
A. CEO-Chairman duality		
1. Is the chairman of the board a different person from the CEO of the company?	YES NO	
2. Is role of Chairperson and CEO split?	YES NO	
3. Is there a political connection between the CEO and the Chairman?	YES NO	
4. Is the division of their responsibilities clear, set out in writing and agreed by the board?	YES NO	

B. Board Composition		
1. Do you have audit, remuneration and nomination committees?	YES NO	
2. Does your company define 'independence' clearly?	YES NO	
3. Is the Chairman independent?	YES NO	
4. What is the percentage of directors on your board fully independent (are not management, relatives to, or do business with the company)?	>67% <67%	
5. What percentage of your Audit committee is fully independent?	>67% <67%	
6. What is the percentage of the remuneration committee (committee that determines executive pay) that is fully independent?	>67% <67%	
7. What percentage of the nomination committee (recommending new directors to join board) is fully independent?	>67% <67%	
8. Is there a clear distinction between nomination and remuneration committees?	YES NO	
9. Do your directors sit on other company's boards?	YES NO	
C. **Board** Size		
1. What is the size of the board?	5 directors 7 directors 10 directors Other	

2. What is the size of the remuneration committee (committee that determines executive pay)?	3 directors 4 directors 5 directors Other	
3. What is the size of the audit committee?	3 directors 4 directors 5 directors Other	
4. What is the size of the nomination committee (recommending new directors to join board)?	3 directors 4 directors 5 directors Other	
D. Insider shareholding		
1. Do the board members own companies stock?	YES NO	
2. Is the CEO required to own shares in the company?	YES NO	
3. Does the CEO own shares in the company?	YES NO	
4. Do the internal directors own companies stocks?	YES NO	
5. Does the company give loans to its senior executive?	YES NO	
6. Is there a guideline on stock ownership by internal executives?	YES NO	
7. Is there a guideline on stock ownership for board members?	YES NO	
E. Board meeting frequency		
1. Does the full board meet in accordance with the stipulations in the company's by-laws and articles?	YES NO	

2. Did board members attend more than 75% of the board meetings?	YES NO	
3. How often do the board conduct meetings?	Every one month Every quarter Twice a year Others	
4. How often do the sub-committees conduct meetings?	Every one month Every quarter Twice a year Others	
5. Did the non-executive meeting in the absence of chairman takes place?	YES NO	
6. Does the Chairman hold meetings with independent directors in the absence of executive directors?	YES NO	
7. Do Independent directors meet without management?	YES NO	

APPENDIX 3: OUTPUT FROM REGRESSION

CASE 1: RETURN ON ASSETS BEING THE DEPENDENT VARIABLE

Descriptive Statistics			
	Mean	Std. Deviation	N
ROA	.0376	.02976	17
q6a1	1.00	.000	17
q6b4	1.59	.507	17
q6d4	1.41	.507	17
q6e3	2.00	.612	17
q6c1	1.65	.493	17

Correlations							
		ROA	q6a1	q6b4	q6d4	q6e3	q6c1
Pearson Correlation	ROA	1.000		-.225	.198	.290	.014
	q6a1		1.000				
	q6b4	-.225		1.000	-.271	-.201	-.118
	q6d4	.198		-.271	1.000	-.201	-.132
	q6e3	.290		-.201	-.201	1.000	.207
	q6c1	.014	.	-.118	-.132	.207	1.000
Sig. (1-tailed)	ROA		.000	.192	.224	.130	.478
	q6a1	.000		.000	.000	.000	.000
	q6b4	.192	.000		.146	.219	.326
	q6d4	.224	.000	.146		.219	.306
	q6e3	.130	.000	.219	.219		.212
	q6c1	.478	.000	.326	.306	.212	
N	ROA	17	17	17	17	17	17
	q6a1	17	17	17	17	17	17
	q6b4	17	17	17	17	17	17
	q6d4	17	17	17	17	17	17
	q6e3	17	17	17	17	17	17
	q6c1	17	17	17	17	17	17

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	,402[a]	.162	-.118	.03146
a. Predictors: (Constant), q6c1, q6b4, q6e3, q6d4				

ANOVA[3]						
Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	.002	4	.001	.578	.684°
	Residual	.012	12	.001		
	Total	.014	16			
a. Dependent Variable: ROA						
b. Predictors: (Constant), q6c1, q6b4, q6e3, q6d4						

Coefficients[9]						
Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	2.958E-005	.064		.000	1.000
	q6b4	-.006	.017	-.102	-.355	.729
	q6d4	.014	.017	.230	.801	.439
	q6e3	.016	.014	.323	1.138	.277
	q6c1	-.002	.017	-.034	-.124	.903
a. Dependent Variable: ROA						

CASE 1: RETURN ON EQUITY BEING THE DEPENDENT VARIABLE

Descriptive Statistics			
	Mean	Std. Deviation	N
ROE	.1284	.12170	17
q6a1	1.00	.000	17
q6b4	1.59	.507	17
q6d4	1.41	.507	17
q6e3	2.00	.612	17
q6c1	1.65	.493	17

Correlations							
		ROE	q6a1	q6b4	q6d4	q6e3	q6c1
Pearson Correlation	ROE	1.000		-.076	.286	.314	.020
	q6a1		1.000				
	q6b4	-.076		1.000	-.271	-.201	-.118
	q6d4	.286		-.271	1.000	-.201	-.132
	q6e3	.314		-.201	-.201	1.000	.207
	q6c1	.020		-.118	-.132	.207	1.000
Sig. (1-tailed)	ROE		.000	.386	.133	.110	.469
	q6a1	.000		.000	.000	.000	.000
	q6b4	.386	.000		.146	.219	.326
	q6d4	.133	.000	.146		.219	.306
	q6e3	.110	.000	.219	.219		.212
	q6c1	.469	.000	.326	.306	.212	
N	ROE	17	17	17	17	17	17
	q6a1	17	17	17	17	17	17
	q6b4	17	17	17	17	17	17
	q6d4	17	17	17	17	17	17
	q6e3	17	17	17	17	17	17
	q6c1	17	17	17	17	17	17

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	,487[a]	.237	-.017	.12271
a. Predictors: (Constant), q6c1, q6b4, q6e3, q6d4				

ANOVA*						
Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	.056	4	.014	.934	.477°
	Residual	.181	12	.015		
	Total	.237	16			
a. Dependent Variable: ROE						
b. Predictors: (Constant), q6c1, q6b4, q6e3, q6d4						

Coefficients*						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-.219	.249		-.880	.396
	q6b4	.028	.066	.117	.428	.677
	q6d4	.097	.066	.402	1.467	.168
	q6e3	.083	.054	.418	1.546	.148
	q6c1	.000	.064	.001	.003	.997
a. Dependent Variable: ROE						

KEY

q6a1- Is the chairman of the board a different person from the CEO of the company?

q6b4- What is the percentage of directors on your board fully independent (are not in management, relatives to, or do business with the company)?

q6c1- What is the size of the board?

q6d4- Do the internal directors own companies stocks?

q6e3- How often do the board conduct meetings?

	SUMMARY OF FINDINGS								
	COMPANY	ROA	ROE	DUALITY	INDEPENDENCE	SIZE	INSIDER	MEETINGS	COMBINED
1	AIG	0.08	0.34	1.00	0.44	0.25	0.43	0.43	0.45
2	AMACO	0.05	0.13	1.00	1.00	1.00	0.71	0.86	0.85
3	APA	0.03	0.1	1.00	0.44	1.00	1.00	1.00	0.79
4	CANNON	0.03	0.11	0.75	0.44	1.00	0.14	0.57	0.48
5	CORPORATE	0.04	0.14	1.00	0.44	0.50	0.57	0.86	0.61
6	FIDELITY SHIELD	0.06	0.19	1.00	1.00	0.75	0.57	0.57	0.64
7	ICEA	0.02	0.18	1.00	0.22	0.25	0.14	0.71	0.42
8	INTRA AFRICA	0.01	0.08	0.50	0.67	1.00	0.43	0.43	0.55
9	JUBILEE	0.03	0.37	1.00	0.22	0.50	0.71	0.71	0.55
10	LION OF KENYA	0.05	0.17	1.00	0.67	0.50	0.00	0.57	0.48
11	MERCANTILE	0.03	0.08	1.00	1.00	1.00	0.29	0.71	0.73
12	OLD MUTUAL	-0.02	-0.18	1.00	0.56	0.50	0.86	1.00	0.73
13	PACIS	0.04	0.09	1.00	0.56	1.00	0.14	0.71	0.58
14	PHOENIX OF E.A	0.02	0.05	0.50	0.11	1.00	0.71	0.71	0.52
15	REAL	0.04	0.21	1.00	0.89	1.00	0.14	1.00	0.73
16	UAP	0.1	0.12	1.00	0.11	0.50	0.57	0.86	0.52
17	BRITAK	0.03	0.17	1.00	0.57	0.75	0.71	1.00	0.73
18	PIONEER	0.01	0.07	1.00	0.89	1.00	0.14	0.71	0.67
19	GEMINIA	0.07	0.19	1.00	0.56	0.50	0.71	0.57	0.61
20	DIRECTLINE	0.01	0.04	1.00	0.44	0.75	0.86	0.57	0.67