

**RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND FINANCIAL
PERFORMANCE: A CASE OF COMPANIES LISTED AT NAIROBI STOCK
EXCHANGE**

BY

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DECLARATION

STUDENT'S 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 the University of Nairobi for academic credit.

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DECLARATION BY SUPERVISOR

This project has been presented for examination with my approval as the appointed supervisor

Signed:

Date:

Mr. Karanja James

DEDICATION

In the memory of my father

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CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

Writing in *The Wealth of Nations*, Adam Smith was quite skeptical about the future of publicly traded corporations or what was then called 'joint stock Company'. Given the role of self interest in human affairs, the proposition that a faceless and uncoordinated group of outside investors could be brought to entrust their savings to professional corporate managers- people whose interests were almost sure to diverge from their own- was doubtful at best (Chew & Gillan , 2005). They assert that Smith turned out to be wrong because during the past almost three centuries, publicly traded corporations with dispersed ownership have come to dominate business activity in the U.S. and U.K and in the continental Europe and Asia and account for an expanding share of GDP. Corporate Governance is concerned with holding the balance between the economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally require accountability for the stewardship of those resources, especially with the now much bigger worldwide companies. The aim is to align as nearly as possible the interests of individuals, corporations and society (Cadbury, 2005). What it means is that companies that embrace better corporate governance practices ought to be more profitable and more beneficial to society than their peers (Chew & Gillan, 2005). Here in Kenya, Safaricom, is the biggest company by market capitalization of about KShs140 billion (about 17% of the entire market as on 24th August 2009- NSE Market report). Smith had failed to foresee development of effective corporate governance systems capable of profitably managing such huge resources. Kenya's new constitution promulgated in August 2010 has huge elements of Corporate Governance attributes that are expected to result in better management of the country resources and improved accountability.

But the failure of some of the largest corporate in the world, namely; Enron, Tyco International, Peregrine Systems and WorldCom and the US financial crisis amongst others have lead to a much deeper re-think and critique of corporate governance. A significant change in approach to corporate board composition, conduct and responsibility has occurred at legal and regulatory

levels, largely in response to a perceived failure by the Enron board to have prevented management conduct that led to the company failure. At last, the belief held by some government activists that effective corporate governance leads to a greater management accountability and enhanced corporate performance has become widely and popularly accepted (Elson Charles, 2005). Corporate performance is indicated by either internal or external measures (Walsh and Seward, 1990). Internal measures comprise of the accounting reports by the organization while external measures are market driven and determined e.g. Share price (Chew and Gillan, 2005).

Corporate governance is the set of processes, customs, policies, laws, and institutions affecting the way a corporation (company) is directed, administered or controlled. Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. The principal stakeholders are the shareholders/members, management, and the board of directors. Other stakeholders include labor (employees), customers, creditors (e.g., banks, bond holders), suppliers, regulators, and the community at large (Cadbury, 2000). Some of the indicators of good corporate governance include separation of ownership and management, independent boards, performance based pay systems, shareholder involvement and accurate financial reporting.

In Kenya, a retail giant, Uchumi Supermarkets, was placed under receivership and its directors formally charged in courts. A few stock brokerage houses, namely; Nyaga, Discount, Shah Munge, Thuo & Partners have all had their licenses revoked in the recent past. The days of multiple bank failures in the 80's are still not too distant memories. The country has lost billions of shillings through poor governance structures like the Goldenberg scam. In 2002, the Capital Markets Authority-CMA issued corporate governance guidelines aimed at improving corporate governance climate in the country. Companies quoted at the Nairobi Stock Exchange are required to comply with these guidelines. This makes the study on these companies relevant especially noting that local corporate governance studies have been industry specific mainly on non listed businesses.

Corporate governance, despite some feeble attempts from various quarters, remains an ambiguous and often misunderstood phrase. For quite some time it was confined only to corporate management. It is something much broader, for it must include a fair, efficient and transparent administration and strive to meet certain well defined, written objectives. Corporate governance must go well beyond law. The quantity, quality and frequency of financial and managerial disclosure, the degree and extent to which the board of Director (BOD) exercise their trustee responsibilities (largely an ethical commitment), and the commitment to run a transparent organization- these should be constantly evolving due to interplay of many factors and the roles played by the more progressive/responsible elements within the corporate sector. In most developing countries, a stringent demand for evolving a code of good practices by the corporation, written by each corporation management, is emerging. This in line with the need to address other aspects to the corporate governance subject, such as the stakeholder view and the corporate governance models around the world (Lowry, 2006).

The importance of corporate governance lies in its contribution both to business prosperity and accountability. Indeed governance must prioritize the needs and aspirations of the poor to overcome human deprivation (Jain NK, 2009). Companies with high quality governance mechanisms have a better quality of financial reporting and can get external financing at a cheaper cost, which means overall better performance (investor returns), (Jensen, 2001). How do directors and management develop a model of governance that aligns the values of the corporate participants and then evaluate this model periodically for its effectiveness? In particular, senior executives should conduct themselves honestly and ethically, especially concerning actual or apparent conflicts of interest and disclosure in financial reports. Key elements of good corporate governance principles thus include honesty, trust and integrity, openness, performance orientation, responsibility and accountability, mutual respect and commitment to the organization (Chew and Gillan, 2005).

In an attempt to improve corporate governance practices in the corporate world, a number of countries have entrenched compliance legislations. The most comprehensive of the corporate

governance laws is the Sarbanes Oxley legislation (SOX). The US Sarbanes-Oxley Act was passed in the wake of a myriad of corporate scandals relating to skewed reporting of selected financial transactions. For instance, companies such as Enron, WorldCom and Tyco Ltd covered up or misrepresented a variety of questionable transactions, resulting in huge losses to stakeholders and a crisis in investors' confidence. The government then sought a resolution aimed at enhancing corporate governance and strengthening corporate accountability through this Act which was specifically designed to 'protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws' (Wallison, 07/03/2008). In general, some of the issues the Act establishes are; formalization and strengthening internal checks and balances within corporations, instituting various new levels of control and sign-off designed to ensure that financial reporting exercises full disclosure and corporate governance transacted with full transparency.

1.2 Statement of the Problem

Past researches across many countries into this subject have yielded mixed results. Gompers and Metrick (2003) found that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and fewer corporate acquisitions. The study also found out that investors who bought firms with the strongest democratic rights and sold those with the weakest rights would have earned abnormal returns of 8.5 percent per year during the sample period. The results thus revealed that, well-governed firms have higher equity returns, command higher values and their financial statements show a better operating performance compared to their poorly governed counterparts.

Similarly, Brown and Caylor (2005), find that better-governed firms are relatively more profitable, more highly priced, and pay out more cash to their shareholders. In a similar vein, Drobetz *et al.*, (2004), document a positive relationship between governance practices and firm valuation for German public firms. Black *et al.* (2006) find a positive relationship between their

corporate governance index and Tobin's Q for a sample of 526 Korean public firms. Durnev and Kim (2005) find that firms with better corporate governance and better disclosure standards have, on average, higher Tobin's Qs and larger investments.

MacAvoy (1998) finds a positive correlation between corporate performance and having an effective board. He used metrics for independence such as independent board leadership, periodic meetings of directors in the absence of management and having formal rules. He concluded that boards have become more active and more independent of management in pursuing shareholder interests. Increased board activism in monitoring management against the company's competitive strategy, especially when combined with well designed management incentive compensation plans has become an important internal force pushing management to produce higher levels of corporate performance.

On the other hand, Fosberg (1989) found no relation between the proportion of independent directors and various firm level performance measures. Hermalin and Weisbach (1991) and Bhagat and Black (2002) also found no link between the proportion of independent directors and value of the firm as measured by Tobin's Q.

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) did an evaluation of the relationship between the proportion of outside directors and corporate performance. He found no relation between the proportion of outside directors and various performance measures (i.e., SG&A expenses, sales, number of employees, and return on equity); In similar studies, Hermalin and Weisbach (1991) found no association between the proportion of outside directors and Tobin's Q; and Bhagat and Black (2002) found no linkage between the proportion of outside directors and Tobin's Q, return on assets, asset turnover and stock returns. In contrast, Baysinger and Butler (1985) and Rosenstein and Wyatt (1990) showed that the market rewards firms for appointing outside directors; Brickley, Coles and Terry (1994) found a positive relation between the proportion of outsider directors and the stockmarket reaction to poison pill adoptions; and Anderson, Mansi and Reeb (2004) showed 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 and varied. These conflicts make this paper relevant and important.

The underlying assumption is that companies exist to add benefit their shareholders and society at large by operating profitably. In Kenya while many studies have been conducted on corporate governance, few studies have touched on some of the aspects of its value like linking corporate governance to performance. None of the studies, however, has sought to concentrate of the holistic impact of corporate governance on firm profitability and it is this gap in literature that the study seeks to fill. Karugoh Gatamah (2002) notes that Corporate Governance is at infancy stage in Kenya and calls for further studies. Musikali L (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. Case study on corporate governance disclosures in Kenya (2003) by UNCTAD notes that remarkable progress has been made in Kenya to improve corporate Governance environment. Billow Kerrow (2010) says that many Government institutions, including state corporations and ministries, have major weaknesses in corporate governance, which has led to corporate failures, poor performance, wealth destruction, fraud and corruption. Barako DG (2006) found a positive correlation between corporate Governance and Disclosure for companies listed at the NSE.

In addition and particularly in the governance context, after reviewing the corporate governance literature in the African context, Okeahalam & Akinboade (2003) concluded that: “there has been limited published research on corporate governance in Africa and even less rigorous academic or empirical research. There is an urgent need to embark on a meaningful analysis of corporate governance [research] in Africa”. The purpose of the study therefore was to establish and document the relationship between corporate governance in Kenya by analysing the improved performance or lack of it that companies listed at the NSE derive from corporate governance.

The study in fulfilling the afore-mentioned objective, addressed the following research questions:

What are the effects of corporate governance on performance of listed companies in Kenya?

If better corporate governance is related to better firm performance, better-governed firms should perform better than worse-governed firms. The dominant research question then was; does corporate governance lead to enhanced corporate performance?

1.3 Research Objectives

The study was guided by the aim of establishing the relationship between corporate Governance practices of listed companies and performance. Two preliminary hypotheses were developed:

H₀: there is no significant relationship between the corporate governance and the performance of the firm.

H₁ there is a significant relationship between corporate governance and the performance of the firm.

The null hypothesis was to be rejected if the corporate governance shows a statistically significant impact on performance of the firm.

1.4 Importance of the Study

Corporations

The Group knows that transparent disclosure of its organizational and management structure as well as other aspects of its corporate governance helps stakeholders to assess the quality of the Group and its management and assists investors in their investment decisions.

The motivation for this study was to examine whether the variables that researchers have found to be significant in explaining voluntary disclosure practices of companies in developed countries apply in a developing country like Kenya. Corporate governance has become an important issue in many countries and the response has varied from a legislative response like

the Sarbanes-Oxley Act in the USA to an adoption of best practice principles in countries like the UK and Australia. The results of this research may be useful for regulators in Kenya as they continue to deliberate the appropriate corporate governance requirements. This study also adds to the literature on voluntary disclosure in developing countries and extends that literature by including corporate governance variables as possible explanatory variables for voluntary disclosure.

Academicians and Researchers

This study is intended to make a significant contribution to the study of corporate Governance and especially on its practice among listed companies in Kenya.

Policy makers; Government and regulators

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 society. Policy makers will use this knowledge to build our corporate governance environment.

Investment Analysts

This is a very important group in the efficient allocation of capital. Knowledge of corporate governance indices and the relationship to profitability of firms will help them make better and informed investment decisions.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

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

Theoretical Framework

2.1.1 Corporate Value

Jensen (2001) defines corporate value as being much broader than just the value of equity, but the sum of the values of all financial claims on the firm; debt, warrants, preferred stock as well as equity. It is this value that corporate managers aim to maximize and it is the same value corporate governance should enhance.

2.1.2 Agency Theory and Corporate Governance

The theoretical framework for corporate governance is the agency theory which indicates that the existence of information asymmetry allows managers of a corporate entity, who are referred to as agents, to pursue objectives that may be at variance with that of owners or shareholders (Ross, 1973 and Fama, 1980). According to Berle and Means (1932), corporate governance gains its strength from a fundamental agency problem in modern firms where there is a separation between management and finance or ownership and control.

Jensen and Meckling (1976) defined an agency relationship as “a contract under which one or more persons (the principal(s) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent” (p.308). The

theory models the relationship between the principal and the agent. In the context of the firm, the agent (manager) acts on behalf of the principal (shareholder) (Eisenhardt, 1989; Fox, 1984; Jensen and Meckling, 1976; Ross, 1973).

A major issue with respect to the firm is the information asymmetry between managers and shareholders. In agency relationship, insiders (managers) have an information advantage. Owners therefore face moral dilemmas because they cannot accurately evaluate and determine the value of decisions made. Thus, the agent takes advantage of the lack of observability of his actions to engage in activities to enhance his personal goals. To mitigate these agent-shareholder conflicts, formal contracts are thus negotiated (Ross, 1973).

In its initial development, the agency theory was seen as directly applicable to managers and equity holders with no explicit recognition of other parties interested in the well-being of a firm. This is what is regarded as the shareholder theory and is seen by many as a narrow definition in an attempt to address the interests of the various constituents of a corporate entity. Other studies, thus, widened the scope and included not only equity holders but all other stakeholders including employees, creditors, governments and others. This approach, which seeks to align the interests of managers with that of all interested parties, is known as the stakeholder theory. John and Senbet (1998) undertook a comprehensive review of corporate governance with particular emphasis on the stakeholder theory. In Senbet's study, there was the recognition of the fact that a firm has several constituencies who often have competing interests. For instance, while equity holders would welcome and support investment in high yielding but risky projects, such investment would be seen as detrimental to the interest of debt holders.

The principal-agent problem is also an essential element of the 'incomplete contracts' view of the firm developed by Jensen and Meckling (1976), Fama and Jensen (1983) and Hart (1995). This is because the principal-agent problem would not arise if it were possible to write a 'complete contract'. In this case, the investor and the manager would just sign a contract that specifies ex-ante what the manager does with the funds and how the returns are shared. In addressing this problem there have been propositions within both market and non-market mechanisms. Demsetz

and Lehn (1985) provide an elaboration on the drawbacks of the market-induced mechanisms for securing the interests of stakeholders. Thus, corporate governance is identified as a non-market mechanism to deal with and reduce agency problems in a firm. There is a considerable amount of empirical work on using corporate governance mechanisms to reduce agency cost and to examine its linkage with firm performance.

2.1.3 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 run 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 as Brealey and Myers (2002), and Block and Hirt (2000) agree that shareholder wealth maximization should be the overall goal of every corporate entity. Maximization of shareholders' wealth ensures that shareholders are adequately compensated for risk undertaken (Dufrene and Wong, 1996). Shareholder wealth is the total benefit to shareholders from investing in a company. This includes dividends and perhaps more importantly capital appreciation of the shareholders' investments. Woods and Randall (1989) generally accept shareholder wealth as the aggregate market value of the common shares which in turn is assumed to be the present value of the cash flows which accrue to shareholders discounted at their required rate of return on equity.

2.1.4 Stakeholders Theory

The stakeholder model takes a broader view of the firm. According to the traditional stakeholder model, the corporation is responsible to a wider constituency of stakeholders other than shareholders. Other stakeholders may include contractual partners such as employees, suppliers, customers, creditors, and social constituents such as members of the community in which the

firm is located, environmental interests, local and national governments, and society at large. This view holds that corporations should be 'socially responsible' institutions, managed in the public interest. According to the theory, performance is judged by a wider constituency interested in employment, market share, and growth in trading relations with suppliers and purchasers, as well as financial performance (Blair, 1995).

Given the potential consequences of corporate governance for economic performance, the notion that corporations have 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. Any assessment of the implications of corporate governance on economic performance must consider the incentives and disincentives faced by all participants who potentially contribute to firm performance (Kester, 1992).

According to the stakeholder theory, corporate governance is primarily concerned with how effective different governance systems are in promoting long term investment and commitment amongst the various stakeholders (Williamson, 1985). Kester (1992), for example, states that the central problem of governance is to devise specialised systems of incentives, safeguards and dispute resolution processes that will promote the continuity of business relationships that are efficient in the presence of self-interested opportunism. Blair (1995) also defined corporate governance in this broader context and argued that corporate governance should be regarded as the set of institutional arrangements for governing the relationships among all of the stakeholders that contribute firm specific asset

2.1.3 Value Maximization and Corporate Performance

The most basic issue of governance is how to accomplish an organization's objectives. The question then arises as what constitutes an organization's objectives. Michael Jensen (1976), in his paper Value maximization, stakeholder theory, and the corporate objective function, proposes two lines of thoughts; value maximization and stakeholder theory. Value Maximization proposes that organizations operate to maximize the value of the firm. Value means not just the value of

equity but the sum of values of all financial claims on the firm- debts, warrants, preference shares and equity. This value maximization proposition has its roots in 200 years of research on economics and finance.

The main contender to value maximization as the corporate objective is called stakeholder theory. This theory says that the managers should make decisions take into account interests of the various stakeholders i.e. employees, customers, suppliers, government and stockholders. In contrast to the grounding of value maximization on economics, stakeholder theory has its roots in sociology, organization behavior and politics, it portrays managerial self interest. This theory is widely popular and has received formal endorsement in many organizations across the globe. Michael Jensen (1976) argues that stakeholder theory should not be viewed as a legitimate contender to value maximization because it fails to provide a complete specification of the corporation purpose or objective function. Whereas value maximization provides the corporate manager with a single objective, stakeholder theory directs corporate managers to serve many masters with the attendant risks of losing focus.

Companies embracing the stakeholder theory will experience managerial confusion, conflict, inefficiency and perhaps even corporate failure. Jensen then offers a hybrid solution where the support of all corporate stakeholders is enlisted to drive forward the company. This he calls enlightened value maximization. It uses much of the structure of stakeholder theory but accepts that maximization of the long term value of the firm as the criterion for making the requisite tradeoffs amongst its stakeholders.

2.2 Corporate Governance and Internal Control Problem

There are four basic control forces bearing on the corporation that act to bring about a convergence of managers decisions with those that are optimal from society's standpoint. Michael Jensen (1993) identifies them as; the capital markets, legal/political / regulatory system, product and factor markets, and internal control system headed by the board of directors.

The legal/political and regulatory system is far too blunt an instrument to handle the problems of wasteful managerial behavior effectively. Product and factor is too slow to act as control force even though companies that supply products that customers do not need eventually fizzle out. It often checks in too late when so much wastage has already been incurred.

This brings us to the role of internal control systems and the need to reform them. The purpose of internal control systems is to provide early warning system and to put the organization back on track before difficulties reach a crisis stage. There is large evidence of corporate restructurings and improved corporate performance.

The problems with corporate internal control systems start with the board of directors. The board at the apex of internal control system has the final responsibility for the functioning of the firm. It sets the rules of the game for the CEO.

2.3 Corporate Governance and Ethics

With the recent wave of corporate scandals has come increased focus on managerial incentives and ethics. Indeed, the Sarbanes Oxley Act of 2002 mandates corporations to disclose whether they have adopted a code of ethics for senior financial officers and the contents of that code. Change or waiver of the code of conduct this require immediate public disclosure. In US, for example, at Enron, the Board waived the code of ethics on two occasions to allow the Chief Financial Officer (CFO) to engage in transactions with Enron in the CFO capacity as head of external entities. In Kenya, Uchumi directors also faced charges leaning on ethical considerations; insider trading and conflict of interest. From the two examples, there is a general agreement that corporate managers should abide by the rule of law; should be honest and forthright in their dealings with customers and fellow employees.

In the article, *The Nature of Man*, Jensen and Meckling (1976) developed a REMM (Resourceful, Evaluative and Maximizing Model) model of human behavior. Jensen and Meckling, define REMM in part by showing how it addresses the failings of four other models commonly used in social science; the economic model- which views people as single minded

money maximizers; sociological model which views behavior as largely a process of acculturation (even to the point of turning people into social victims); psychological model based on Maslow's hierarchy of needs and the Political model which views people as the perfect agents for their organizations.

Zimmerman, Brickley and Smith, (2002), also adopted an economic perspective. Zimmerman, Brickley and Smith, argued that effective corporate leadership involves more than developing a good strategic plan and setting high ethical standards. It also means developing an organization design that encourages managers and employees to carry the firms plan and maintain its ethical standards. In the article, Zimmerman, Brickley and Smith, used organizational architecture to refer to three key elements of a company's design; assignment of decision making authority - who gets to make what decisions, performance evaluation - the key measure of performance for evaluating business units and employees and compensation structure - how employees are rewarded for meeting performance goals.

In well designed companies, each of these elements is mutually reinforcing and supportive of the company's overall business strategy. Decision making authority is assigned to managers and employees who have the knowledge and experience needed to make the best decisions, the corporate systems used to evaluate and reward their performance are based on measures that are linked as directly as possible to the corporate goal of creating value (Brickley and Smith Jr, 2003). Moreover, a flawed organization design can lead to far worse than missed opportunities to create value. The recent corporate scandals involved not just improper behavior by senior executives but corporate structures that far from safeguarding against such behavior, in some ways encouraged it.

2.4 Principles of Corporate Governance

Key elements of good corporate governance principles include honesty, trust and integrity, openness, performance orientation, responsibility and accountability, mutual respect, and commitment to the organization. Commonly accepted principles of corporate governance

include: The first principle concerns the rights and equitable treatment of shareholders; Organizations should respect the rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by effectively communicating information that is understandable and accessible and encouraging shareholders to participate in general meetings. Secondly, organizations should recognize that they have legal and other obligations to all legitimate stakeholders.

The third principle entails the role and responsibilities of the board of directors of the company. The composition of the board needs to represent a range of skills and understanding to be able to deal with various business issues and have the ability to review and challenge management performance. It needs to be of sufficient size and have an appropriate level of commitment to fulfill its responsibilities and duties. There are issues about the appropriate mix of executive and non-executive directors.

The fourth principle of corporate governance is the practice of integrity and ethical behaviour. Ethical and responsible decision making is not only important for public relations, but it is also a necessary element in risk management and avoiding lawsuits. Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making. It is important to understand, though, that reliance by a company on the integrity and ethics of individuals is bound to eventual failure. Because of this, many organizations establish Compliance and Ethics Programs to minimize the risk that the firm steps outside of ethical and legal boundaries.

Disclosure and transparency is another principle of corporate governance. Organizations should clarify and make publicly known the roles and responsibilities of board and management to provide shareholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information. Issues involving corporate governance principles include; internal controls and internal auditors, the independence of the entity's

external auditors and the quality of their audits, oversight and management of risk, oversight of the preparation of the entity's financial statements, review of the compensation arrangements for the chief executive officer and other senior executives, the resources made available to directors in carrying out their duties, the way in which individuals are nominated for positions on the board, dividend policy.

2.5 Local Corporate Governance Practices

Corporate governance in Kenya is increasingly taking centre stage, with the privatization and corporatization of the economies globally; there is thus a greater expectation from society that corporate organizations, especially private ones, should take a more leading role in the debate and implementation of economic revival strategies. Shareholders, especially in publicly listed companies in the country are also becoming increasingly vocal demanding better transparency and disclosure of information from their directors. Regulatory bodies, notably the CMA and the NSE, are already hinting that they would require good corporate governance practices amongst the publicly listed companies.

The Kenya Government initiated reforms at the Nairobi Stock Exchange (NSE) aimed at transforming the exchange into a vehicle for mobilizing domestic savings and attracting foreign capital investment. A key aspect of this reform is related to corporate governance practices. In 2002, the CMA Corporate Governance guidelines outlining significant guidelines to listed companies' corporate governance practices. These spell out the establishment and structure of Board of directors and subcommittees; right from qualification for appointment, duties and responsibility, separation of duties of CEO and Chairman, and remuneration. Audit Committee is identified as a critical governance tool. Its functioning is well spelt out and its relationship with the internal audit function. Empowerment of shareholders through provision of information and enforcing approval of major management decisions by them. The Regulations require disclosure of certain information to the public and that Chief Financial Officers and Company Secretaries of listed companies be qualified and registered amongst other provisions.

In summary, the guidelines were developed in line with global trends especially in the more developed economies. It was in recognition of the close positive relationship of corporate governance with performance as clearly explained in the introduction to the guidelines. Compliance to these guidelines forms part of continuing listing obligations and companies must disclose in annual financial statements the level of compliance/non compliance to them.

2.6 Models of Corporate Governance

Of importance is how directors and management develop a model of governance that aligns the values of the corporate participants and then evaluate this model periodically for its effectiveness. In particular, senior executives should conduct themselves honestly and ethically, especially concerning actual or apparent conflicts of interest, and disclosure in financial reports. There are many different models of corporate governance around the world. These differ according to the variety of capitalism in which they are embedded. The liberal model that is common in Anglo-American countries tends to give priority to the interests of shareholders. The coordinated model that one finds in Continental Europe and Japan also recognizes the interests of workers, managers, suppliers, customers, and the community.

Each model has its own distinct competitive advantage. The liberal model of corporate governance encourages radical innovation and cost competition, whereas the coordinated model of corporate governance facilitates incremental innovation and quality competition. However, there are important differences between the U.S. recent approach to governance issues and what has happened in the UK. In the United States, a corporation is governed by a board of directors, which has the power to choose an executive officer, usually known as the chief executive officer. The CEO has broad power to manage the corporation on a daily basis, but needs to get board approval for certain major actions, such as hiring his/her immediate subordinates, raising money, acquiring another company, major capital expansions, or other expensive projects. Other duties of the board may include policy setting, decision making, monitoring management's performance, or corporate control.

The board of directors is nominally selected by and responsible to the shareholders, but the bylaws of many companies make it difficult for all but the largest shareholders to have any influence over the makeup of the board; normally, individual shareholders are not offered a choice of board nominees among which to choose, but are merely asked to rubberstamp the nominees of the sitting board. Perverse incentives have pervaded many corporate boards in the developed world, with board members beholden to the chief executive whose actions they are intended to oversee. Frequently, members of the boards of directors are CEOs of other corporations, which some see as a conflict of interest. So as to deviate from the sound rule, they should be able to convincingly explain those to their shareholders.

2.7 Importance of Corporate Governance Regulation

It is in the interests of companies and their management to implement mechanisms that mitigate the agency problems mentioned above. Companies that can credibly commit themselves to act in the best interests of their constituents benefit from lower costs of equity and debt capital, labor, and other inputs and from a higher value of their products or services to clients (Becht, Bolton and Roell, 2005). The mechanisms available to companies to resolve the agency problems include managerial compensation contracts, (hostile) takeovers, concentrated ownership structures, delegation to and concentration of control by the board of directors which acts independently from executive directors and controlling shareholders, and clearly defined in corporate bylaws fiduciary duties. However, if companies were able to provide adequate protection to their investors, regulatory intervention is unnecessary. This raises a question as to why we need corporate governance regulation aimed at protecting the rights of corporate (minority) shareholders and creditors.

The theoretical literature gives a number of reasons. First, regulatory intervention helps markets to achieve the maximization of social welfare rather than the welfare of individual investors (Pigou, 1938). To illustrate this in the context of corporate governance regulation, consider an example of the disclosure requirements related to corporate activities. In the absence of the disclosure requirements, managers may be tempted to conceal some details of the projects in

which their company is involved for perfectly legitimate reasons, e.g. to keep their competitors uninformed and gain a competitive advantage in the future. However, more detailed information about corporate projects allows investors to assess the corporate growth potential better and to invest their money into companies that can generate the highest returns. Therefore, if all companies were to conceal information about their activities, a more inefficient allocation of capital would arise, leading to lower economic growth. Hence, a re-distribution of wealth between competing companies caused by a higher level of disclosure seems less harmful for the economy than the misallocation of capital caused by the lack of transparency. As such, mandatory rules that impose more disclosure enable economies to achieve a more optimal outcome.

The second reason for adopting a specific corporate governance regulation is that it forces companies to commit credibly to a higher quality of governance (Becht et al., 2005). Even if companies initially design efficient governance rules, they may break or alter them at a later stage. Investors anticipate this and are willing to provide firms with funds at lower costs only when companies find ways to commit credibly to good governance. However, credible pre-commitment mechanisms may be expensive or unavailable in countries lacking an effective institutional framework (Dojige et. al., 2004). For instance, a well-functioning infrastructure (in terms of internal control structures, audit mechanisms, voting procedures at the annual meetings etc.) is required to enable investors to verify the information that companies disclose (Black, 2001).

The importance of corporate governance regulation for corporate activities and economic growth has been further emphasized in a growing number of empirical studies. These papers show that a corporate governance regime has a significant impact on the availability and cost of capital, corporate performance, and the distribution of corporate value between the firm's stakeholders: shareholders, creditors, employees, consumers, and suppliers. Weak legal environment combined with weak enforcement of the law distorts an efficient allocation of resources, undermines the ability of companies to compete internationally, and hinders investment and economic development (Levine, 1998, La Porta et al., 2002 and Djankov et al., 2004).

2.10 Corporate Governance Strategies

The economic literature suggests two main approaches to resolve principal-agent problems: create incentives such that agents act in the interest of their principals and enhance the disciplining power of principals (Becht et al, 2005). To implement these approaches, the law can deploy a number of governance strategies. Hansmann and Kraakman (2004) suggest the following classification of such strategies: strengthening the appointment rights of principals, reinforcing the decision rights of principals, augmenting the trusteeship, enhancing corporate transparency and adopting an affiliation strategy. The appointment rights strategy regulates shareholders' power to select or remove directors. The decision rights strategy grants shareholders with the power to intervene and initiate or ratify managerial decisions. The trusteeship strategy allows shareholders to appoint an independent body (a trustee) that will represent their interests in the firm and monitor managers. The transparency strategy seeks to eliminate conflicts of interests by enforcing strict disclosure requirements on corporate policies and contracts directly related to managers. Finally, an affiliation strategy sets the terms on which shareholders affiliate with managers. These typically involve shareholder rights to entry and exit on fair terms. The strategies are not limited to reducing the agency problem between shareholders and managers, but can also be deployed to address any other agency problems (between minority and majority shareholders or between shareholders and creditors).

The analysis of regulatory provisions within the framework of the above governance strategies enables us to understand better how corporate law works in a particular country and which strategies regulators adopt to achieve their goals. Hence, we classify the regulatory provisions by type of agency problems and, by governance strategies within each type of agency problem. We model our corporate governance indices as a sum of sub-indices that indicate the scope of legal protection through different strategies.

2.11 Performance Measures

For over 15 years, there's been significant criticism of how corporate performance is measured and understood. Corporate leaders, shareholder advocates, and academic authors have all pointed out the shortcomings of traditional financial reports for managing accountability and driving performance, Frost (2004). They say that the reports tend to be geared toward tax and regulatory matters; they mix controllable and uncontrollable performance factors; they present many investments as expenses; they routinely mix tangible, real dollars with intangible accounting dollars; and so forth. There has been a parallel trend underway toward more accurate pictures of performance. From the shop floor to the boardroom, we've seen a steady stream of new ideas and better formulas for understanding performance—things like EVA, Balanced Scorecard, EBIT, EBITDA, ROE, Activity Based Costing, SPC, Process Measures, Customer Metrics, Free Cash Flow and others.

These new measurement approaches have tried to disentangle some of the factors noted earlier. And they've brought very positive changes, including: better accountability and performance, Sharper focus on productivity of capital, and better tracking of the variables that determine future financial performance.

2.12 Empirical Framework

2.12.1 Corporate Governance and Performance

Corporate governance mechanisms assure investors in corporations that they will receive adequate returns on their investments (Shleifer and Vishny, 1997). If these mechanisms did not exist or did not function properly, outside investors would not lend to firms or buy their equity securities. Businesses would, thus, be forced to rely entirely on their own internally generated cash flows and accumulated financial resources to finance ongoing operations as well as profitable investment opportunities. Overall economic performance likely would suffer because

many good business opportunities would be missed and temporary financial problems at individual firms would spread quickly to other firms, employees, and consumers.

Corporate governance mechanisms assure investors in corporations that they will receive adequate returns on their investments (Shleifer and Vishny, 1997). If these mechanisms did not exist or did not function properly, outside investors would not lend to firms or buy their equity securities. Overall, economic performance would likely suffer because many good business opportunities would be missed and temporary financial problems at individual firms would spread quickly to other firms, employees and consumers. Previous evidence suggests that corporate governance has a positive influence over corporate performance. For example, based on industry-level view Rechner and Dalton (1989) find that firms in industries that require large amounts of external financing grow faster in countries with high scores on their measures of financial development. Thus, corporate governance (measured through better accounting standards, stronger legal protection of investors, and a stronger rule of law) appears to matter for corporate performance. In addition Alves and Mendes (2002), Drobetz *et al.* (2003) and Gemmill and Thomas (2004) concluded in their respective studies that there is a positive relationship between good corporate governance practices and firm value.

2.12.2 Board Size and Corporate Performance

There is mixed evidence in the empirical literature linking board size to corporate performance. One group of researchers (Dalton, Daily, Ellstrand and Johnson, 1998 and Pearce and Zahra, 1992) predicts board size to have a positive association with firm performance. Proponents of this view argue that a larger board will have representation of people with diverse backgrounds, who bring knowledge and intellect to the board and thus improve the quality of strategic decisions. Size is thus assumed to be associated with the breadth of perspectives in the planning process. Board size is also found to be related to strategic change in an organization. From this perspective, smaller boards are assumed to have inadequate recognition of the need to initiate or support strategic change, a lack of clear understanding of alternatives, and/or lack of confidence in recommending strategic change (Becht, Bolton and Röell A, 2005). An alternative explanation

relates this relationship to board composition. Larger boards could consist of more outsiders who foster more careful decision-making policy in firms since the reputation cost, if the firm fails, is likely to be high in comparison with their private benefit if a project turns out to be profitable. This basically refers to the difference in risk preference of inside and outside directors (Eisenberg, Sundgren and Wells M., 1998).

The other view suggests that larger board would be less effective than smaller boards. This view is based on the social psychological research and group dynamics. As larger boards suffer from the problem of diffusion of responsibility or social loafing, wherein individual members of the board discount the likelihood that others will detect their poor contributions. Larger board size may also make it difficult for the members to use their knowledge and skills effectively due to problems of coordinating the contributions. The board thus becomes more symbolic and less a part of the management process (Black B, Jang H and Kim W., (2006). Various researchers presented empirical evidence which supports this view and finds a negative relationship between board size and corporate performance (Young, Stedham and Beekun, 2000, Eisenberg et al., 1998 and Thomas, Litschert and Ramaswamy, 1991).

Yet another view assumes the relationship between board size to be an inverted "U" shaped, with an optimal board size existing midway. Below this optimal or the most efficient board size, there is a positive relation between board size and corporate performance followed by a negative relationship (Goilden and Zajac, 2001 and Zahra and Pearce, 1989). The assumption here is that while certain minimum board size is required to get the requisite intellect on the board, if the size becomes too large the problems of group dynamics and coordination set in.

2.12.3 Ownership Structure and Performance

The presence of block equity holders is considered to have a positive impact on corporate performance and is explained by the "cost of capital" and "effective monitoring" hypotheses. The cost of capital argument (Black B, Jang H and Kim W., 2006) maintains that increased ownership concentration decreases financial performance, because it raises the firm's cost of

capital as a result of decreased market liquidity or decreased diversification opportunities on behalf of the investor. The second argument states that large shareholders or block holders may be better monitors of the management as they may be represented in the board of directors, and hence would have the power to influence boards' decision-making process (Singh M. and Davidson W, 2003). Characteristics of the block holders themselves are found to influence firms' decisions. For example, Brown L.D. and Caylor M.L., (2005), show that diverse ownership groups adopt different postures in monitoring and/or influencing organizational diversification.

Major shareholders in most of the Indian firms are the FIs, foreign institutional shareholders, business houses, and Indian public. While public shareholding mainly consists of small individual shareholders, it is fragmented. The other three types of shareholding are in big blocks. Also, most big business houses have their representatives on corporate boards.

2.12.4 Board Ownership and Performance

The effect of managerial or board ownership on corporate governance, and hence firm performance, is generally explained by the "incentive alignment argument." As per this argument, more equity ownership by the managers leads to superior corporate performance because it results in a better alignment of shareholders' and managers' interests (Jensen and Meckling, 1976). An alternative explanation is the "takeover premium argument," which states that if managers hold significant equity in firms, they would be in a better position to thwart a takeover threat from the market for corporate control and as a result, the raiders in this market will have to pay higher takeover premiums (Short H, 1996).

Doidge C., Karolyi A and Stulz R, (2004) in their "entrenchment argument" indicate a negative relationship between board ownership and corporate performance at high ownership levels. As per them, at higher ownership levels, managers may be so wealthy that they no longer intend to maximize profit but get more utility from maximizing market share or technological leadership. Gompers P., Ishii J and Metrick A., (2003), through a combination of the above two explanations, predicted a non-linear relation between board ownership and firm value. While the

positive association at lower levels is explained by the "alignment of interest theory," the negative association at higher level of share ownership is explained by the "entrenchment theory.

2.12.5 Board Independence

Board independence has also received attention in the literature. John and Senbet (1998) argue that the independence of a corporate board can be measured by the number of outside or non-executive directors (NEDs) on the board. A general consensus, however, is that non-executive directors are deemed to act as 'professional referees' to ensure shareholder value maximization (Fama, 1980). Thus, the appointment of NEDs enhances firm performance (Brickley and James, 1987; Weisbach, 1988; Byrd and Hickman, 1992; Brickley et al., 1994). Other empirical studies have found no significant relationship between board independence and performance (Hermalin and Weisbach, 1991; Yermack, 1996; Bhagat and Black, 2002).

2.12.6 CEO Duality

Should a CEO double as a board chairman? Considerable attention has been given to the role of boards in monitoring managers and in removing non-performing CEOs. Jensen (1993) voices a concern that a lack of independent leadership makes it difficult for boards to respond to failure in a top management team. Fama and Jensen (1983) also argue that concentration of decision management and decision control in one individual reduces a board's effectiveness in monitoring top management. For example, when a CEO doubles as board chairman, this results in conflict of interests and increases agency costs (Berg and Smith, 1978; Brickley et al., 1997). Thus, the separation of the two positions enhances shareholder value.

2.12.7 Disclosure

Several prior studies have investigated various determinants of companies' voluntary disclosure practices. A consistent finding is that size is an important predictor of corporate reporting behaviour. In meta-analysis of 29 disclosure studies, conducted by Ahmed and Courtis (1999), size, listing status and financial leverage were found to have a significant impact on disclosure

level. Other company attributes associated with corporate disclosure include, industry type (Cooke, 1989; 1992), performance (Singhvi and Desai, 1971), multinationality (Raffournier, 1995; Owusu-Ansah, 1998), and country of origin (Meek, Roberts, & Gray, 1995). Similarly, a number of studies documented a significant relationship between ownership and the extent of disclosure (Chau and Gray 2002; Haniffa and Cooke 2002; Ho & Wong 2001; Hossain et al. 1994; Singhvi and Desai 1971).

Recently, Ho & Wong (2001) provided empirical evidence of a positive association between corporate disclosure practices and the existence of an audit committee. Similarly, with regard to corporate governance, Chen and Jaggi (2000) observed a positive relationship between the proportion of independent non-executive directors and comprehensiveness of financial disclosures, and the relationship is weaker for family controlled firms. In addition, Ho and Wong (2001) and Haniffa and Cooke (2002) documented evidence of a negative association between voluntary corporate disclosure and the proportion of family members on the board. Forker (1992) examined the relationship between corporate governance and corporate disclosure. The focus of his study was the disclosure of share options. The results indicated that CEO dominance (defined as combined roles of CEO and the board chair) had a negative impact on the level of disclosure.

2.12.8 Other Determinants of corporate performance

Numerous studies have been conducted on factors that influence corporate performance. These are numerous and varied. Naser K (2004) established that ISO certification was a significant determinant of Malaysian companies. Other determinants are; capital structure, size of the company, listing, mergers and acquisitions, general macroeconomic environment amongst others.

Conclusion

As is evident from the above literature, academic research on corporate governance continues to occupy the minds of many scholars due to the perceived importance on corporate growth and social economic improvement. The academic literature and corporate governance regulators

acknowledge the impact of corporate governance attributes on the performance of firms. A number of propositions emerge from the discussion in this chapter. The propositions relate to the links among corporate governance attributes and earnings. The evidence relating corporate governance and firm performance varies. It is certain that there is a positive relationship between size of Board and corporate performance; it is however less certain of the optimal size. Ownership structure, and in particular presence of block equity holders has been demonstrated to have a positive relationship to corporate performance. This follows from the fact that they do have sufficient interest and resources to closely monitor management performance. Independence of the Board has also been studied with the more studies finding a direct relationship between this attribute and performance. It is also acknowledged that separation of the CEO role from that of the Chair of the Board increases performance.

In Kenya, corporate governance studies have been few and those few have tended to be focused on either specific sectors like Banking and Cooperatives or limited to one corporate Governance attribute. Studies have been conducted relating privatization, ethics, voluntary corporate disclosure and Corporate Governance. Mucuvi (2002) reviewed corporate Governance practices in the Motor Vehicle industry, Musikali (2008) evaluated the adequacy of laws governing Corporate Governance, Mwangi (2002) looked at the Corporate Governance practices adopted by Insurers while Njuguna (2006) checked the level of compliance with the CMA guidelines by listed companies.

This study fills the gap in having current research findings (after close to 10 years of promulgation of CMA guidelines) linking corporate governance to performance and to have an across the sectors study by looking at all the listed companies.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlines the methods, tools and sources of research data, targeted groups and sample from which data was collected in order to attain the objective of the study which is to map the value of corporate governance in Kenya by surveying well-managed companies. It further discusses how the data will be processed and tools to be used in data analysis and presentation.

3.2 Research Design

This study took a causal research design approach. Causal Research explores the effect of one thing on another and more specifically, the effect of one variable on another, that is, concerned with cause-and-effect relationships between two or more variables. Being that the study sought to find out the effect of corporate governance on performance, a causal research design was deemed appropriate.

3.3 Target Population and Sample

Target population in statistics is the specific population about which information is desired. For the purpose of this study and to avoid ambiguity, the target population of the study was all the 44 companies listed at the Nairobi Stock Exchange, under the main segment. This built a more cross sector evaluation contrary to prior studies that have concentrated on specific segments. The information/data on the sample will be obtained from the Capital Market Authority (CMA).

3.4 Data Collection Procedure

The study solely used secondary data sources available at the companies' financial statements at the NSE or Capital Market Authority offices. The Secondary data sources are chosen owing to the fact that they are cheaper and more quickly available than primary data and help clarify and

answer research question. Every listed company is required to report the extent to which they complied with the Corporate Governance Principles in their annual reports, information about corporate governance will be readily accessible at the CMA data on performance will be collected on return on equity while data on corporate governance will be collected on board size, board composition, chief executive status and audit committee.

Profitability as a financial goal of every firm is used to expand the firm, and or to provide a cushion for future slow periods. Profitability helps a firm to ensure, its solvency, for owners to invest in the future. A firm can go out of business, if it incurs losses and become insolvent (Rogers, 1996). Profit is generally created only when a company operates effectively. Management's operating effectiveness is proven if the company can prosper, obtain funding, and reward the suppliers of its funds (Friedlob and Plewa, 1996). Accounting earnings are deemed value relevant due to the association between share returns and accounting earnings (Easton and Harris, 1991). The association is based on shareholders' reaction to accounting earnings, which is dependent on shareholders' perception of earnings usefulness and reliability. There has been significant range of studies, since Ball and Brown (1968), showing earnings to be modestly informative in explaining movements in share prices (e.g. Ramakrishnan and Thomas, 1998).

Measure of performance used

Return on Equity (ROE)

ROE is a percentage determined by dividing profit to equity i.e. pretax profits from the profit and loss statement and equity or net worth from statement of financial position. The result represents the return you have made on the dollars that you invested in your business. Over several years, if your return on equity is lower than a certain minimum industry requirement over several years, you may consider selling your business and investigating the proceeds in bonds. As a consequence your return would be similar, your risk and the work much less (Tyson and Schell, 2008).

ROE ratio tells us how much profit a business earned in comparison to the book value of its shareholder's equity. It is useful especially for privately owned business, which is hard to determine the market value of owners' equity. Public corporations also use ROE just like book value per share, it generally plays a secondary role and is not the dominant factor driving market prices (Tracy, 2008, p.286). Return on equity is the most appropriate profitability and potential growth indicators and it is the return obtained by the owners of the firm in exchange for providing equity. A business that has a high return on equity is more likely to be one that is capable of generating cash internally. For the most part, when return on equity of the company is higher as compared to its industry, the better the company is doing (Holz, 2003, p 35-36).

3.6 Data Analysis

The study will use multiple linear regression equation and the method of estimation will be Ordinary Least Squares (OLS) so as to establish the relationship between corporate governance and performance.

Model Specification

The study uses regression to estimate the model with earnings as the dependent variable and corporate governance as the independent variables. The objective of the model is to provide an assessment of the impact of corporate governance on earnings.

The economic model to be used in the study is given as:

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

Where, Y is the dependent variable, β_0 is constant, $\beta_{1,2,3,4}$ is the coefficient of the explanatory variable (corporate governance attributes), and ε_{it} is the error term assumed to have zero mean and independent across time period. From the economic model in the equation above, equation below will evolve:

$$PERF = \beta_0 + \beta_1 BSIZE + \beta_2 BCOMP + \beta_3 CEO + \beta_4 AUDCOM + \varepsilon_{it}$$

Variable Description

The table below shows the variables and their descriptions as used in this study. The chosen corporate governance attributes were picked by Njuguna (2006) as representing higher compliance areas by listed companies of the CMA Guidelines.

Variable	Description/ Measurement
Dependent Variable Description	
ROE = Return on Equity Total	Profit after tax/Total equity shares in issue

Independent Variable Description

Corporate Governance attributes

Operationalisation

BSIZE = Board size

Number of directors on the board

BCOMP = Board composition

Proportion of outside directors sitting on the board;
Number of independent directors divided by the
total number of directors on the board

CEO = Chief executive status /CEO dominance

Value zero (0) if the same person occupies the post
of the chairman and the chief executive and one (1)
if otherwise.

AUDCOM = Audit committee

Number of independent directors on the audit
committee divided by the total number of directors
on the audit committee

CHAPTER FOUR: DATA ANALYSIS AND PRESENTATION

4.1 Introduction

The purpose of this study was to determine the relationship between corporate governance and performance of firms listed on the Nairobi stock exchange. The study specifically sought to examine the relationship between Return on Equity as a measure of firm performance and corporate governance attributes which were board size, board composition, the status of the CEO and the composition of the audit committee.

The study relied solely on secondary data which was extracted from the companies' annual financial statements for the year ending December 2009. The populations of companies under study were all the 46 companies listed in the Nairobi stock exchange (NSE). The annual financial reports available at the Capital Markets Authority offices were however for 23 companies. This therefore constituted a response rate of 50%. Data was captured in Ms Excel and SPSS for analysis Regression analysis was used to drive the model in order to determine the relationship between performance and aspects of corporate governance.

4.2 Descriptive Statistics for corporate governance

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

Table 4.1: Descriptive Statistics

Variable	Mean	Std. Deviation	N
ROE	13.1916	9.69087	23
Board size	9.2609	2.43492	23
Board composition	.7715	.19831	23
CEO status	.9565	.20851	23
Audit composition	.9526	.13081	23

Of the firms studied, the mean board size was 9.2609 suggesting that the firms in the Nairobi Stock Exchange have relatively moderate board sizes. With a maximum of 14 and a standard deviation of 2.434, the implication is that firms at the NSE have relatively similar board sizes. This is essentially good for firm performance according to researchers such as Jensen (1993).

As far as Board composition was concerned the difference is statistically significant in that the majority of the firm in the stock exchange having a ratio of 0.7715 with a standard deviation of 0.19831 meaning that on average most companies had more external independent directors.

The descriptive statistics for corporate governance indicates that the status of the Chief executive officers (CEO) had a mean of 0.9565 and a standard deviation of 0.20851. From these findings most chief executives did not perform dual roles of chief executive and CEO at the same time. On the other hand the ratio of independent directors to those from within the firms had a mean of 0.9526 with a standard deviation of 0.13081. From this analysis, most of the firms in the stock exchange embraced the idea of more external members in the audit committee than insider ones.

On the average most of the firms appear not to be doing well with regards to the mean of the performance variable ROE at 13.1916 and a standard deviation of 9.69087, by implication most of the firms do not even on this front especially those that had posted negative results in their performance. While the maximum performance is about 36.16 the minimum performance is 0.

4.3 Correlation analysis

This study was guided by the aim of establishing the relationship between ROE and corporate governance attributes, **Correlation analysis** was used to determine whether a change in one variable is accompanied by a change in another variable. Pearson's correlation coefficient, were computed between the measure of liquidity (illiquidity) and each of the independent variables. Table 2 shows the results.

Table 4.2: Correlations

		ROE	Board size	Board comp	CEO status	Audit com
Pearson Correlation	ROE	1.000	.023	-.150	-.169	-.126
	Board size	.023	1.000	-.134	-.066	.387
	Board comp	-.150	-.134	1.000	.079	.310
	CEO status	-.169	-.066	.079	1.000	.338
	Audit com	-.126	.387	.310	.338	1.000
Sig. (1-tailed)	ROE	.	.459	.248	.220	.283
	Board size	.459	.	.271	.382	.034
	Board comp	.248	.271	.	.361	.075
	CEO status	.220	.382	.361	.	.058
	Audit com	.283	.034	.075	.058	.
N	ROE	23	23	23	23	23
	Board size	23	23	23	23	23
	Board comp	23	23	23	23	23
	CEO status	23	23	23	23	23
	Audit com	23	23	23	23	23

From the **Correlations matrix**, the findings show a miniature correlation between ROE and board size ($r=0.023$) of a quoted company. There is a negative correlation ($r= -0.150$) between ROE and board composition while the relationship between ROE and CEO status is also negative ($r= -169$) and the relationship between ROE and the audit composition is also negative at ($r= -0.126$)

The findings generally showed a weak correlation between the Board size and other corporate governance variables. Between Board size and Board composition, the coefficient of correlation was ($r = -0.134$) while Between Board size and the CEO status was ($r = -0.066$) while Between Board size and Audit composition was positive at ($r = 0.387$)

4.4 Regression Analysis

Linear regression was used to derive a linear model describing the relationship between each of the independent variables and the Return on Equity. The model summary table below reports the strength of the relationship between the model and the dependent variable.

Table 4.3: Model summary

model	R	R square	std error	R square	F change
1	0.220a	0.049	10.45007	0.049	0.230

As shown in Table 4.3, the significance value of the F statistic is less than 0.230 (98% confidence interval). This implies that the variation explained by the model is not due to chance. This signals the models' efficiency in estimating the relationship between the dependent and the independent variables.

Table 4.3 further shows that R, the correlation coefficients has a value of 0.220 this signify a linear correlation between the observed and model-predicted values of the dependent variable. R square, the coefficient of determination yielded a value of 0.049. This implies that 49% of the variation in ROE is explained by the model or that the model is 49 % efficient in estimating the relationship.

The contribution of each independent variable in the model is shown by the size of the coefficient. Table 4 shows the coefficients of the independent variables in the model.

4.4 Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	26.843	18.298		1.467	.160
	Board size	.056	1.070	.014	.052	.959
	Board comp	-5.983	12.413	-.122	-.482	.636
	CEO status	-6.675	11.717	-.144	-.570	.576
	Audit com	-3.328	21.961	-.045	-.152	.881

This suggests that amongst all the other variables only Board size was positively related to ROE. In summation the linear model for estimating the effect of corporate governance on company performance in terms of other variables can be expressed thus: $X = 26.843 + 0.065 \text{ Board size} - 5.983 \text{ Board comp} - 6.675 \text{ CEO} - 3.328 \text{ Auditcomp} + \varepsilon_{it}$

4.5 Test of Hypothesis

This study was guided by the following hypotheses:

1. *H₀*: there is no significant relationship between the corporate governance and the performance of the firm.
2. *H₁* there is a significant relationship between corporate governance and the performance of the firm.

From the study findings there is not significant relationship between corporate governance and the performance of the firm. The null hypothesis is therefore accepted.

CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary and Conclusions

The objective of the study was to investigate the relationship between corporate governance and company performance of firms listed in the Nairobi stock exchange. In order to attain this objective, statistical analysis was done for 23 companies out of a population of 46 companies quoted in the period ending December 2009.

This chapter gives a summary of the study findings. It also presents the limitations and recommendations for further research. The data were analyzed by use of SPSS package to produce the correlation as well as regression analysis. Tables were used to describe the data and draw conclusions on the findings.

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

The study examined the relationship between some measures of corporate governance such as board size, board composition, and CEO duality and firm performance of listed in the NSE.

According to the findings presented in the previous chapter, the following summaries can be drawn:

- The findings have shown that the correlation coefficient between ROE and the board Size factor was ($r=0.023$) this by extension implies that ROE was positively affected by the board independence as measured by the board independence factor.

- The correlation between ROE and the board composition was a negative correlation ($r = -0.150$) implying that there was a corresponding poor performance of ROE where the board composition was composed of internal non independent directors.
- The findings also showed a miniature negative correlation between the relationship between ROE and CEO status is also negative ($r = -0.169$) the findings and analysis implied that in cases where the CEO was also the Board chairman conflict of interest will almost certainly affect the performance of the firm in terms of ROE.
- A weak correlation was observed between the relationship between ROE and the Audit composition negative at ($r = -0.126$) the implication here was that the independence of the audit committee positively affected the performance of the firms in terms of ROE.
- The findings generally showed a weak correlation between the Board size and other corporate governance variables. Between Board size and Board composition, the coefficient of correlation was ($r = -0.134$) while Between Board size and the CEO status was ($r = -0.066$) while Between Board size and Audit composition was positive at ($r = 0.387$)

The linear model for estimating illiquidity in terms of other variables can be expressed thus: $X = 26.843 + 0.065 \text{ Board size} - 5.983 \text{ Board comp} - 6.675 \text{ CEO} - 3.328 \text{ Auditcomp} + \varepsilon_{it}$

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

Corporate governance embraces a broader set of variables, such as economic and legal environment, progressive practices, existence of internal control measures, ownership and compensation structure within an institution, the nature and quality of information flow and the level of involvement in staff in the day today decision of corporate entity. The mean board size for the sample was found to be 9.2609 and the maximum of fifteen and a deviation of 2.43492. This is a consistent with the study of Mwangi [2004] who found out that the average board size was eight members and the outside representation constitute about 71.23%. With regard to the board composition, the mean ratio of about 63% implies the use of more outside directors on the board in the overall sample.

Since the wave of corporate scandals began, a consensus has developed around the importance of good corporate governance to individual companies and to the global economy as a whole. Companies are under more pressure than ever before to adopt governance best practices and to convince investors that their governance is responsible. The easy course may be simply to adopt a one-size-fits-all model, and there are features-such as independent board committees-that make sense across the board. But as the academic research shows, there is no governance "magic bullet," and no substitute for thoughtful, contextual analysis.

5.2 Limitations of the Study

One of the major limitations encountered is that data financial performance on companies quoted on the NSE was not readily available which resulted in the use of time in locating individual financial statements from the CMA. Also the number of listed firms at the NSE is rather small as compared to other stock exchanges in the world.

Return on Equity is a measure of how profitably a company employs its equity, that is, the money raised from shareholders. Everything else being equal, a higher ROE is better as it means that the company is efficient about using its equity.

Due to the unique nature of each industry and variances in accounting methodologies among them, ROE should normally be used for comparisons within the same industry. For example: The

ROE for service-oriented industries, such as the software industry, is significantly higher than that of capital-intensive industries such as the construction industry.

Comparisons of ROE within the same industry can also be misleading as ROE ignores the effect of debt. If a company can issue debt at a lower interest rate than the rate of return on its investments, it could increase its ROE. However, higher debt also increases the risk of failure for the company. Generally, companies with higher debt, as measured by the debt to equity ratio, will have better ROE. An investor could get a better sense of the investment by considering the Return on Assets, which mitigates the influence of debt, along with ROE.

5.3 Recommendations for further Study

The study focused on the relationship between corporate governance and performance

Of companies quoted in the NSE. Other mechanisms can be used as a proxy for corporate governance e.g. legal/regulatory environments, markets for corporate control, product/labor markets, managerial compensation, and bylaw/charter provisions among others. Also the study focused mainly on the relationship between board attributes & processes of corporate governance and Return on Equity. Studies should be carried out to investigate board decision making process and stock market liquidity. With regard to stock market liquidity, studies could be carried out to investigate the effect of capital structure, dividend policy, insider trading, market power, stock splits on liquidity of stocks.

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

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Appendix 1: Population-Companies listed at the NSE (main segment)

AGRICULTURAL

- 1 Kakuzi
- 2 Rea Vipingo Plantations Ltd
- 3 Sasini Ltd

COMMERCIAL AND SERVICES

- 4 AccessKenya Group Ltd
- 5 Car & General (K) Ltd
- 6 CMC Holdings Ltd
- 7 Hutchings Biemer Ltd
- 8 Kenya Airways Ltd
- 9 Marshalls (E.A.) Ltd
- 10 Nation Media Group
- 11 Safaricom Ltd
- 12 Scangroup Ltd
- 13 Standard Group Ltd
- 14 TPS Eastern Africa (Serena) Ltd

FINANCE AND INVESTMENT

- 15 Barclays Bank Ltd
- 16 Centum Investment Co Ltd
- 17 CFC Stanbic Holdings Ltd
- 18 Diamond Trust Bank Kenya Ltd
- 19 Equity Bank Ltd
- 20 Housing Finance Co Ltd
- 21 Jubilee Holdings Ltd
- 22 Kenya Commercial Bank Ltd
- 23 Kenya Re-Insurance Corporation Ltd
- 24 National Bank of Kenya Ltd
- 25 NIC Bank Ltd
- 26 Olympia Capital Holdings Ltd
- 27 Pan Africa Insurance Holdings Ltd
- 28 Standard Chartered Bank Ltd
- 29 The Co-operative Bank of Kenya Ltd

INDUSTRIAL AND ALLIED

- 30 Athi River Mining
- 31 B.O.C Kenya Ltd
- 32 Bamburi Cement Ltd
- 33 British American Tobacco K Ltd
- 34 Carbacid Investments Ltd
- 35 Crown Berger Ltd Ord
- 36 E.A.Cables Ltd Ord
- 37 E.A.Portland Cement Ltd
- 38 East African Breweries Ltd
- 39 Eveready East Africa Ltd
- 40 KenGen Ltd .
- 41 KenolKobil Ltd
- 42 Kenya Power & Lighting Co Ltd
- 43 Mumias Sugar Co. Ltd
- 44 Sameer Africa Ltd
- 45 Total Kenya Ltd
- 46 Unga Group Ltd