

**THE EFFECT OF CORPORATE GOVERNANCE PRACTICES ON THE
FINANCIAL PERFORMANCE OF DEPOSIT TAKING MICROFINANCE
INSTITUTIONS IN KENYA**

BY

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DECLARATION

This project is my original work and has not been presented for an award of a degree, diploma or certificate at any University or College.

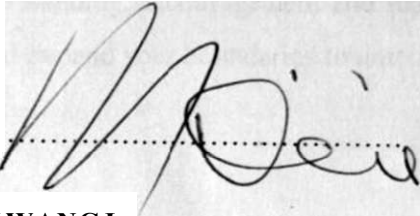
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Supervisors' Approval

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

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ABSTRACT

MFIs have been providing financial services to their members with little competition from other players in the financial market. However, the entry of other players in the financial market, targeting the same clientele that had been traditionally considered as the territory of MFIs and introducing services and products especially tailor-made to out-compete MFI's products, coupled with the liberalization of the financial market and the economy at large, all have strained the performance of the MFIs. In light of this, many MFIs have implemented corporate governance measures and practices in an effort to improve their performance and make them more relevant in their business and better able to compete in the financial markets in which they operate. This study sought to analyze the effect of the adoption of these corporate governance practices on the financial performance of deposit taking MFIs. The research was based on deposit taking MFIs in Kenya. The target population was the 6 MFIs registered with the Central Bank of Kenya as at 30 June, 2011. A survey of 6 respondents drawn from the 6 MFIs registered with the CBK was taken for the study. Data was collected using a structured questionnaire method. The responses from cross-functional sample group were analyzed using descriptive statistical techniques in form of frequency distribution tables, percentages, pareto, and computer packages. The expected output was to establish whether the adoption of corporate governance practices has any relationship with the financial performance MFIs, and therefore come up with recommendations that will help in the enforcement of these practices by the relevant regulatory authorities. The findings were that corporate governance influences the financial performance of the deposit taking MFIs. Transparency and disclosure measures were found to have a greater influence on the financial performance of the deposit taking MFIs.

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ABBREVIATIONS

AGM	- Annual General Meeting
CBK	- Central Bank of Kenya
CG	- Corporate governance
CMA	- Capital Markets Authority
DT.MFI	- Deposit taking Microfinance Institution
ICPAK	- Institute of Certified Public Accountants of Kenya
ICPSK	- Institute of Certified Public Secretaries of Kenya
KNBS	- Kenya National Bureau of Statistics
MFIs	- Micro Finance Institutions
MSEs	- Micro and Small Scale Enterprises
OECD	- Organization for Economic Co-operation and Development
ROE	- Return on equity

CHAPTER ONE

INTRODUCTION

1.1 Background to the study

Microfinance has been used as a tool for poverty reduction in developing countries at least since the 1930s, where governments and international institutions around the world began to sponsor development finance institutions or rural development institutions (Hulme and Mosley, 1996; Woller et al., 1999). These institutions were heavily subsidized and did not perform well either socially in terms of reaching their target group, nor financially in terms of recovering a reasonable part of their funds (Adams, 1984; Hulme and Mosley, 1996; Zeller and Meyer, 2002). In the 1970s new methods for doing microfinance appeared, in particular group lending, frequent loan monitoring and focus on women. This has led to high repayment rates and high self-sustainability in many cases - something that clearly distinguishes these models from the old microfinance (Morduch, 1999). The subsequent very rapid growth of microfinance led to the formulation of "the microfinance promise": Providing poverty reduction and financial sustainability at the same time (Morduch, 1999). Microfinance started as a small non-collateral credit to rural poor in South Asia and Latin America in the 1970s, and initially it was implemented by microfinance institutions (MFIs) mainly through grants and donations from development agencies.

Since the mid 1990s, however, some leading MFIs facing the necessity of raising more capital due to rapid loan growth have sought to transform into commercial organizations in order to attract the money they need. Meanwhile, international private investors have increasingly focused on microfinance because of its high repayment rates and stable returns, and they have significantly increased investment in MFIs, especially large-scale MFIs. Foreign capital investment in microfinance is estimated at US\$12 billion as of 2009, and more than half of it is managed by the investment funds that invest primarily in microfinance (Reille et al., 2009, p.1; Glisovic-Mezieres and Reille, 2010, p.1). For almost 35 years microfinance has been the golden child of development policy, offering the

simple idea that lending very small amounts of money to very poor people can help them to help themselves get out of poverty (Bunting, 2011). However, in the last six months, a series of scandals have hit the sector. Nobel Peace prize-winner and founding father of microfinance, Muhammad Yunus, has been removed from his position as head of the Grameen Bank, and faces accusations of corruption. And in Andhra Pradesh in India, there have been a series of suicides by indebted borrowers, provoking concerns about the coercive methods of some private sector microfinance lenders.

According to the microfinance Act (2006), MFIs in Kenya are classified and registered into three tiers: deposit taking institutions (Tier 1), credit only non deposit taking institutions (Tier 2) and informal organizations supervised by an external agency other than the government (Tier 3). The Act enables Deposit taking Microfinance Institutions licensed by the Central Bank of Kenya to mobilise savings from the general public, thus promoting competition, efficiency and access. It is, therefore, expected that the microfinance industry will play a pivotal role in deepening financial markets and enhancing access to financial services and products by majority of the Kenyans.

Issues of corporate governance have been raised with regard to the manner in which countries and public corporations are managed. Corporate governance can be defined as a set of principles concerning the governing of companies and how these principles are disclosed or communicated externally. It is therefore an institutional attempt to create a structured dialogue between companies and their shareholders and with the aim of ensuring that the organizational goals are understood and the critical factors necessary for their achievement (Parum, 2005). In a similar manner, Yener (2001) sees corporate governance as a set of relationships and networks between a company's management, its board of directors, its shareholders and the stakeholders. In broader terms therefore, corporate governance refers to the processes by which organizations are directed, controlled and held accountable. It therefore encompasses issues concerning authority, accountability, stewardship, leadership, direction and control exercised in corporations or cooperative societies for that matter. The system by which business corporations are directed and controlled is referred to as corporate governance (Hodgetts et al. 2006).

Robbins et al (2005) defines corporate governance as a system used to govern a corporation so that the interests of the corporate owners are protected

The subject of corporate governance, especially in MFIs has gained considerable attention due to the huge amounts of money they handle, the liberalization of the world economy as well as the competition in the financial markets in which they operate. According to the CBK (2007), MFIs had 841 outlets, 2,073,363 and 493,682 active savers and borrowers with KSh.16,589 million loans (US \$ 260,000) disbursed and outstanding loan portfolio of KSh. 16,007 million (US \$ 250,000). Since the enactment of the Microfinance act in 2008, the microfinance sector has grown as a new frontier of financial reach through mobilisation and intermediation of public deposits. The CBK has expressed confidence that the financial inclusion gap, which shows that 32.7 percent of Kenyans lack access to financial services, will be bridged.

The boards of directors of MFIs are required to govern these enterprises in a manner that ensures that their growth and sustainability is achieved. Shareholders expect to see performance of these entities in terms of a better return on their investments. Stakeholders will use various measures to evaluate the performance of the MFIs including return on equity, earnings per share and even participation in social responsibility activities. An organization will only perform to the expectations of the stakeholders and remain competitive and viable in the market if it embraces good corporate governance practices. It is in view of this that this study sought to examine the corporate governance practices adopted by the deposit taking MFIs and analyse the effect of corporate governance practices on their financial performance.

1.2 Statement of the problem

While the recent high profile corporate governance failures in both developed and developing countries have brought the subject of corporate governance to media attention, the issue has always been central to finance and economics (Chia et al. 2008). Studies done on corporate governance in organizations point to the conclusion that corporations that embrace good corporate governance practices perform better than those

which do not (Miring'u 2008). Several researchers have studied the area of microfinance but none has done any study on (the corporate governance in MFIs). The few researches done on corporate governance have only concentrated on the specific practices and measures of corporate governance adopted by various organisations, e.g, Ojiambo (2008). Ademba (2006) and Muriithi (2004). Those studies which have been done on MFIs have primarily centered on the impact of MFIs on poverty reduction (Rasmussen 2010). There is lack of evidence on research done on corporate governance in MFIs or the effect of adopting corporate governance measures and practices on the performance of MFIs. A study done by Ojiambo (2008) found that most SACCOs have instituted corporate governance practices in an effort to gain a competitive edge in the market and remain relevant and viable in their business in the ever changing global economy but pointed that further research needs to be done to examine the effect of adopting corporate governance measures and practices on the performance of corporations. According to Miring'u (2008), research needs to be carried out to examine whether different financial institutions had instituted corporate governance measures and determine whether the adoption of corporate governance practices had any effect on the performance of other organizations other than commercial state corporations. This study therefore sought to investigate the various corporate governance practices adopted by the deposit taking MFIs in Kenya and evaluate the effect of corporate governance on their financial performance.

1.3 Research objectives

J.3.1 General Objective

The general objective of the study was to establish the relationship between corporate governance practices and the financial performance of MFIs in Kenya.

1.3.2 Specific Objectives

- a) To ascertain the influence of the composition of board members on financial performance:

- b) To examine whether the size of the board affects financial performance of MFIs;
- c) To investigate the relationship between transparency and disclosure and financial performance of MFIs;
- d) To examine whether or not the separation of the posts of CEO and Board Chair is of **any** value in the promotion of firm financial performance;

1.4 Significance of the study

The results of this study will be of great importance to several parties including;

The managements of different MFIs will find the study useful in that it will help them to recognize and appreciate the importance of adopting corporate governance practices in the management of their organizations in order to improve their performance as well as their relative position in the market in terms of competitiveness.

The findings of the study will serve as a pointer to the government to institute more stringent rules and policies on MFIs which will compel them to implement corporate governance practices in the management of their affairs.

The study findings will add to the knowledge pool for future researchers interested in the same area of study as well as other related areas of study.

CHAPTER TWO

LITERATURE REVIEW

2.0 INTRODUCTION

In this section, previous studies related to the link of corporate governance and performance are reviewed in line with the research problem and objectives. The historical development of cooperatives, the concept of corporate governance, the governance structure of cooperatives as well as the prominence of corporate governance are discussed. Also in discussion is the importance of corporate governance, pillars of good corporate governance, the international credit union governance principles and the theories of corporate governance. The section also deals with the performance indicators for measuring performance, various governance practices as well as a critical review of major issues and lastly a summary and gaps to be filled by the study.

2.1 Historical Development of Microfinance Institutions

Microfinance is the provision of financial services like savings, credit and insurance with a social goal. One of the earlier and longer lived microcredit organizations providing small loans to rural poor with no collateral was the Irish loan fund system, initiated in the early 1700s by author and nationalist Jonathan Swift. The 1990s saw growing enthusiasm for promoting microfinance as a strategy for poverty alleviation. The microfinance sector blossomed in many countries leading to multiple financial services firms serving the needs of micro entrepreneurs and poor households. Microfinance has been used as a tool for poverty reduction in developing countries at least since the 1930s, where governments and international institutions around the world began to sponsor development finance institutions or rural development institutions (Hulme and Mosley, 1996; Woiler et al 1999). These institutions were heavily subsidized and did perform well neither socially in terms of reaching their target group, nor financially in terms of recovering a reasonable part of their funds (Adams, 1984; Hulme and Mosley, 1996; Zeller and Meyer, 2002). In the 1970s new methods for doing microfinance appeared, in particular group lending, frequent loan monitoring and focus on women. This has led to high repayment rates and

high self-sustainability in many cases - something that clearly distinguishes these models from the old microfinance (Morduch, 1999). The subsequent very rapid growth of microfinance led to the formulation of "the microfinance promise": Providing poverty reduction and financial sustainability at the same time (Morduch, 1999). Microfinance started as a small non-collateral credit to rural poor in South Asia and Latin America in the 1970s, and initially it was implemented by microfinance institutions (MFIs) mainly through grants and donations from development agencies. Since the mid 1990s, however, some leading MFIs facing the necessity of raising more capital due to rapid loan growth have sought to transform into commercial organizations in order to attract the money they need. Meanwhile, international private investors have increasingly focused on microfinance because of its high repayment rates and stable returns, and they have significantly increased investment in MFIs, especially large - scale MFIs. Foreign capital investment in microfinance is estimated at US\$12 billion as of 2009, and more than half of it is managed by the investment funds that invest primarily in microfinance (Reille et al., 2009; Mezieres. G. and Reille , 2010). For almost 35 years microfinance has been the golden child of development policy, offering the simple idea that lending very small amounts of money to very poor people can help them to help themselves get out of poverty (Bunting, 2011). However, in the recent past, a series of scandals have hit the sector. Nobel Peace prize-winner and founding father of microfinance, Muhammad Yunus, has been removed from his position as head of the Grameen Bank, and faces accusations of corruption; and in Andhra Pradesh in India, there have been a series of suicides by indebted borrowers, provoking concerns about the coercive methods of some private sector microfinance lenders.

2.2 The Concept of Corporate Governance

"The proper governance of companies will become as crucial to the world economy as the proper governance of countries" as stated by James D. Wolfensohn. former President of the World Bank (Gataniah. 2004). Corporate governance has emerged as a major policy concern for many developing countries following the financial crisis in Asia, Russia, and Latin America. The collapse of Enron suggests that even the highly industrialized countries such as the U.S. are not immune to the disastrous effects of bad corporate

governance. Studies have shown that low corporate governance standards raise the cost of capital, lower the operating performance of industry, and impede the flow of investment (Agrawal and Knoeber; Daily and Dalton; Lippman et al). Following the corporate scandals of Enron, WorldCom, and Tyco, more and more countries have embarked on corporate governance reforms to better protect the interests of investors.

In Africa, significant study has been done on corporate governance, the King's Committee Report and Code of Practice for Corporate Governance in South Africa published in 1994 continues to stimulate corporate governance in Africa (Rossouw, 2000). Training, technical and awareness raising support has also been extended by the World Bank and the Commonwealth Secretariat to various African countries such as Botswana, Senegal, Tunisia, Mali, Mauritania, Cameroon, Gambia, Mozambique, Mauritius, Sierra Leone and Zambia to help them put in place appropriate mechanisms to promote good corporate governance (Private Sector Initiative for Corporate Governance, 2009). East African Regional conferences were held in Kampala, Uganda, in June 1998 and September 1999 to create awareness and promote regional co-operation in matters of corporate governance. At the June 1998 Conference, it was resolved that each member state of East Africa be encouraged to develop both a framework and a code of best practice, to promote national corporate governance (Private Sector Initiative for Corporate Governance, 2009). Efforts are also under way to harmonize corporate governance in the East African region under the auspices of the East African Cooperation, and through the establishment of a regional apex body to promote corporate governance. In Kenya, the Private Sector Initiative for Corporate Governance continues to liaise with Uganda and Tanzania towards the establishment of a Regional Center of Excellence in Corporate Governance. On October 8, 1999, the Corporate Sector at a seminar organized by the Private Sector Initiative for Corporate Governance formally adopted a national code of best practice for Corporate Governance to guide corporate governance in Kenya, and mandated the Private Sector Initiative to establish the Corporate Sector foundation (Private Sector Initiative for Corporate Governance, 2009). Although corporate governance is now rather popular, in 1990 it was not a major concern

for firms, therefore, within this context, research work in the area of corporate governance was only underway in Kenya in 1998.

According to Ferrell et al (2008), corporate governance is the formal system of accountability, oversight, and control aimed at removing the opportunity of employees to make unethical decisions; where accountability is how closely workplace decisions are aligned with a firm's strategic direction and its compliance with ethical and legal considerations, oversight provides a system of checks and balances that limit employees and managers' opportunities to deviate from policies and strategies and that prevent unethical and illegal activities, while control is the process of auditing and improving organizational decisions and actions (Fraedrich and Ferrell. 2008). A more inclusive approach to corporate governance has been preferred, one that creates governance systems that consider stakeholders welfare in tandem with corporate needs and interests thus promoting the development of long-term relationships. The Capital Markets Authority identifies this in their definition of corporate governance for the purpose of their guidelines. "The process and structure used to direct and manage business affairs of the company towards enhancing prosperity and corporate accounting with the ultimate objective of realizing shareholders long-term value while taking into account the interest of other stakeholders" (Capital Markets Authority, 2002).

Therefore, at the core of Corporate Governance is the manner in which the power of a corporation is exercised in the running of the corporation's total portfolio of assets and resources with the objective of maintaining and increasing shareholder value and satisfaction of other stakeholders in the context of its corporate mission. It is concerned with creating a balance between economic and social goals and between individual and communal goals while encouraging efficient use of resources, accountability in the use of power and stewardship and as far as possible to align the interests of individuals, corporations and society (Private Sector Initiative for Corporate Governance, 2009). Integrity is highly emphasized in good corporate governance. It creates a compliance and ethics culture so that employees see that integrity is at the core of competitiveness while providing mechanisms for identifying risks and for planning for recovery when mistakes or problems occur (Fraedrich and Ferrell. 2008).

According to Mudibo (2005), the inability of corporations in meeting the requirements of good corporate governance results in corporate governance irregularities. Good Corporate Governance seeks to promote responsive and accountable corporations, legitimate corporations that are managed with integrity, probity and transparency and the recognition and protection of stakeholder rights. These ideals are necessary for any country in order to attract investors- both local and foreign and assuring efficient management and security of their investments in a transparent and accountable process. It also promotes competitive and efficient companies and business enterprises by enhancing the accountability and performance of those entrusted to manage corporations. It is imperative to note that with efficient companies or business enterprises, the country is able to create employment and wealth. The lack of investment in companies leads to stagnation and collapse. If business enterprises do not prosper, employment declines, tax revenue falls and invariably economic growth hindered. The country needs well-governed and managed business enterprises that can attract investments, create jobs and wealth and remain viable, sustainable and competitive in the global market place. Good corporate governance, therefore, becomes a prerequisite for national economic development.

The financial crises of Enron, WorldCom and Parmalat have intensified the discussion about the adequacy of good governance of various institutions and companies. In corporate governance a lot of issues are borne by the separation of ownership and control (Chia et al, 2008).

Corporate governance in the academic literature seems to have been first used by Richard Eells (1960) to denote "the structure and functioning of the corporate policy". But how to manage companies and the question for the best structure to achieve an optimal allocation of resources is as old as the history of companies. Nevertheless, the term corporate governance is inescapably connected with (listed) corporations, as here the separation of ownership and control and the therefore arising agency conflicts are obvious. Therefore it is instructive for the further work to begin with a brief historical origin of the corporation.

The Private Sector Corporate Governance Trust (1999) defines corporate governance as the manner in which, the power of a corporate entity is exercised in the stewardship of the entity's total portfolio of assets and resources with the objective of maintaining and increasing shareholder value and satisfying other stakeholders. According to the OFCD, "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

In Anglo-Saxon countries like the US and UK, good corporate governance involves firms pursuing the interests of shareholders. In other countries like Japan, Germany and France corporate governance involves pursuing the interests of all stakeholders. The Centre for Corporate Governance in Kenya (2005) broadly defined corporate governance as the process by which corporate entities are directed, controlled and held accountable. The Economist Intelligence Unit Limited (2002) defines corporate governance as a system by which business corporations are directed and controlled.

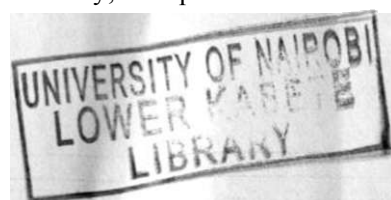
The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders, and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this it also provides the structure through which the company's objectives are set, and the means of attaining those objectives and monitoring performance.

2.3 Prominence of Corporate Governance

Becht et al. (2002) identified five reasons why corporate governance became so prominent in the past two decades:

2.3.1 The World-Wide Privatization Wave

Privatization has been an important phenomenon not only in Western Europe and Asia but especially in former communist countries. Inevitably, the privatization wave has



raised the issue of how the newly privatized corporations should be owned and controlled.

2.3.2 Pension Fund Reforms and Growth of Private Savings

The growth in defined contribution pension plans has channeled an increasing fraction of household savings through mutual and pension funds and has created a constituency of investors that is large and powerful enough to be able to influence corporate governance. These funds are playing an increasingly active role in global corporate governance.

2.3.3 The Takeover Wave of the 1980's

The hostile takeover wave in the U.S. in the 1980s and in Europe in the 1990s, in addition to the recent merger wave (e.g. AOL-Time Warner, DaimlerChrysler, or AcelorMittal Steel recently), has influenced the public debate on corporate governance.

2.3.4 Deregulation and Integration of Capital Markets

Corporate governance rules have been promoted in part as a way of protecting and encouraging foreign investment in emerging markets. The greater integration of world capital markets (in particular in the European Union following the introduction of the Euro) and the growth in equity capital throughout the 1990s have also been a significant factor in rekindling interest in corporate governance issues.

2.3.5 Economic Crises

The East Asia economic crises 1998 highlighted the weak corporate governance practices in emerging countries and led to a reassessment of the Asian model characterized by centralized and hierarchical industrial groups controlled by management and large investors.

2.4 Importance of Corporate Governance

In today's world, shareholders are demanding more say and better transparency and disclosure of information from their directors. The quality of governance at all levels is

increasingly becoming the most important factor for the success of corporations. The occurrence of major scandals leading to the collapse of big corporations with disastrous social and economic consequences has made the wider society to start questioning the running and management of corporations. With the globalization of the economies and privatization of public enterprises, corporate governance is increasingly taking centre stage in the board room (Miring'u, 2009).

The Society has greater expectation that corporate organizations and especially those in the private sector will take a more leading role in growing and developing the economy. Good corporate governance aims at achieving; increased profitability and efficiency of business enterprises; enhanced ability to create wealth for shareholders; increased employment opportunities with better terms of workers; enhanced separation of ownership from control; viability in corporations for investment in a competitive global market; enhanced legitimacy, responsibility and responsiveness of the business enterprise and transparency, accountability and probity of business enterprises. Mudibo (2005).

Mudibo (2005) further posits that, good corporate governance practices facilitate achievement of the following in organisations: strategic thinking and strategy setting; balance of power and control; efficiency and effectiveness; transparency and probity; productivity and responsiveness; responsibility and respectiveness; creativity and innovativeness and competitiveness and sustainability.

2.5 Pillars of Good Corporate Governance

Good governance is based upon the attitudes, ethics and values of the society regarding accountability, democracy, sense of right or wrong, attitude towards accumulation of wealth through hard work and maintenance of essential order and security, efficiency and effective use of resources for production of goods and services (Gatamah et al,2000)

New Zealand Manauerrert (2007) states that there are four "generally accepted pillars on which good governance is grounded upon. First, there must be an efficient body responsible for corporate governance, which should be separate and independent from management, and responsible for promoting accountability, efficiency and effectiveness.

probity and integrity and responsibility. Secondly, transparent and open leadership with accurate and timely disclosure of information relating to all economic and other activities of the corporation. Thirdly, there must be an all inclusive approach to governance that recognizes and protects the rights of members and all stakeholders both internal and external. Lastly the institution must be governed and managed with accordance with the mandate granted to it by its founders and society.

2.6 Theories of Corporate Governance

There are basically three theories on corporate governance; that is the agency theory, stewardship theory and the stakeholder theory. However, this study will be based on the stakeholder theory of corporate governance.

2.6.1 Stakeholder Theory

The stakeholder theory argues that managers should make decisions so as to take account of the interests of all stakeholders in a firm (including not only financial claimants, but also employees, customers, communities, governmental officials). Because the advocates of stakeholder theory refuse to specify how to make the necessary tradeoffs among these competing interests they leave managers with a theory that makes it impossible for them to make purposeful decisions. With no way to keep score, stakeholder theory makes managers unaccountable for their actions. It seems clear that such a theory can be attractive to the self interest of managers and directors (Jensen and Meckling 1976).

Creating value in terms of corporate performance takes more than acceptance of value maximization as the organizational objective. As a statement of corporate purpose or vision, value maximization is not likely to tap into the energy and enthusiasm of employees and managers to create value. Seen in this light, change in long-term market value becomes the scorecard that managers, directors, and others use to assess success or failure of the organization. The choice of value maximization as the corporate scorecard must be complemented by a corporate vision, strategy and tactics that unite participants in the organization in its struggle for dominance in its competitive arena. Therefore a firm cannot maximize value if it ignores the interest of its stakeholders.

Enlightened value maximization utilizes much of the structure of stakeholder theory but accepts maximization of the long run value of the firm as the criterion for making the requisite tradeoffs among its stakeholders. Managers, directors, strategists, and management scientists can benefit from enlightened stakeholder theory.

2.7 Performance Indicators

Performance indicators are at the heart of a performing organisation's monitoring system (Miring'u, 2009). They define the data to be collected to measure progress and enable actual results achieved over time to be compared with the planned results (Xu and Wang, 1997). There are various measures of performance to determine financial and non-financial performance. The researcher intends to use Return on Equity (RoE) and Earnings per Share (EPS) performance indicators to determine the financial performance of the MFIs. Financial measures of performance analyse the financial statements of a business enterprise. There are three statutory financial statements, i.e., the income statement, the balance sheet and the cash flow statement. Financial statement analysis seeks to evaluate management's performance in several areas including profitability, risk and efficiency.

2.7.1 Return on Equity (RoE)

RoE or "return on net worth" (RONW) is the most significant profitability measure to investors. To the investor, the measure reports the returns on dollar invested to permit comparisons across firms. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. The ROE is useful for comparing the profitability of a company to that of other firms in the same industry. ROE encompasses the three pillars of corporate management; profitability, asset management, and financial leverage. To the management, the ratio is vital because it can be dissected to reveal sources of financial performance. 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). RoE is calculated by dividing total profit after tax and interest payments by total equity.

$$\text{Return on Equity (RoE)} = \frac{\text{Net profit after tax}}{\text{Equity share capital}} \times 100 \%$$

Equity share capital

2.8 Governance practices

Measures of good governance structure include CEO duality, composition and size of the board, transparency and disclosure, board member's professional membership and audit committee among others that the researcher may not examine in this study.

2.8.1 Board Composition

This is the ratio of outside directors to the total number of directors, i.e, the number of outside directors divided by the total number of directors. It also encompasses the professional qualifications and education levels of the board members (Miring'u, 2009).

2.8.2 Board Size

This is the number of board members serving in the board of the MFI.

2.8.3 CEO Duality

This refers to whether the CEO equally doubles as the board chairman or the two roles are performed by different professionals. It is a dummy variable which takes the value 1 if the CEO doubles as the board chairman and 2 if there are different people occupying the two positions of CEO and board chairman.

2.8.4 Transparency and Disclosure

This is the timely and adequate disclosure of the operating and financial performance of the firm and its corporate governance practices related to its ownership, board, and management structures and processes.

2.1) PAST STUDIES ON CORPORATE GOVERNANCE

2.9.1 Corporate governance and firm performance

Most of the studies done in the area of corporate governance and firm performance in the past have dwelt predominantly on companies, parastatals and cooperatives, while ignoring the MFIs, which are key players in the financial system of our country as well as the entire world. Previous studies on corporate governance and performance of firms, e.g. Bebchuk & Cohen (2004), Bebchuk et al (2002) have shown that well governed firms have higher performance

The main characteristics of corporate governance identified in these studies include board size, board composition and whether the CEO is the board chairman. The question is whether corporate governance has any impact on the financial performance of MFIs.

2.9.2 Board size and firm performance

The question that has always remained in the minds of scholars and managements of businesses enterprises is whether corporate governance really affects firm performance. According to Miringu (2009). there is a view that larger boards are better for corporate performance because they have a wide range of expertise to help make better decisions, and are harder for a powerful CEO to dominate.

In recent times however, emphasis has been on smaller boards. Jensen (1993) and Lipton & Lorsch (1992) articulate that large boards are less effective and easier for a CEO to control, the reason being that when the board grows too large, it becomes difficult to coordinate and poses problems. Smaller boards are also said to reduce the possibility of free riding by individual directors and increases their participation in the decision - making process. Smaller boards have been supported by several empirical researches, for example, Yermack (1996) postulates that for large US industrial corporations, the market value firms with smaller boards are highly managed.

Conversely, Eisenberg et al (1998) finds negative correlation between board size and profitability when using sample of small and medium size Finnish firms. Mark and Yuanto (2003). while studying firms in Singapore and Malaysia found that firm valuation is highest when a board has five directors, a number considered relatively small in those markets. Sanda et al (2003) in a Nigerian study found that firm performance is positively related with small, as opposed to large firms.

2.9.3 Board composition and firm performance

Likewise, according to Miring'u (2009). although the issue of whether directors should be employees of or affiliated with the firm (inside directors) or outside directors has been well researched, no clear conclusion has been reached.

Fama (1980) affirms that although on one hand inside directors are more familiar with the firm's activities and that they can act as monitors to top management especially if they perceive the opportunity to advance into positions held by incompetent executives, outside directors may on the other hand act as 'professional referees' to ensure that competition among insiders stimulates actions consistent with shareholder value maximization. Klein (1998) found little association between firm performance and overall board composition. However, by going into the inner workings of the board via board committee composition, he was able to find significant links between firm performance and how boards are structured. First, a positive relation was found between the percentage of inside directors on finance and investment committees and accounting and stock market performance measures. Next, firms significantly increasing inside director representation on these two committees experienced significantly higher contemporaneous stock returns and return on investments than firms decreasing the percentage of inside directors on these committees. These findings were consistent with Fama and Jensen's assertion that inside directors provide valuable information to boards about the firms' long-term investment decisions.

John & Senbet (1998) established that boards of directors are more independent as the proportion of their outside directors increases. Kihara (2006) however notes that unlike

inside directors, outside directors are better able to challenge the CEO. This could probably be the rationale behind the requirement that a board consists of a minimum of three outside directors.

Several empirical studies done on outside directors support the beneficial monitoring and advisory functions of firm shareholders, Brickley et al, (1994).Rosenstein and Wyatt (1990) showed that the market rewards firms for appointing outside directors. Brickley et al (1994) found a positive relationship between the proportion of outside directors and stock market reactions poison pill adoptions.

However, Forsberg (1989) found no relationship between the proportion of outside directors and various performance measures. Hermalin and Weisbach (1991) found no significant relationship between board composition and firm performance. Yermack (1996) also showed that the percentage of outside directors does not significantly affect firm performance. Agrawal and Knocher (1996) suggest that boards expanded for political reasons often result in too many outsiders on the board, which does not help in performance. Considerable attention has been given to the role of boards in monitoring managers and in removing non-performing CEOs. Jensen (1993) voices his concern that a lack of independent leadership makes it difficult for boards to respond to failure in top management.

2.9.4 CEO Duality and firm performance

In the period 1999-2003, hundreds of firms converted from dual CEO leadership structure to non dual CEO structure, while a smaller number of firms converted in the opposite direction (Chia. et al. 2008).The recent trend is partly due to several high profile cases where powerful dual CEOs were found to abuse their tremendous power at the expenses of the company and shareholders.

However, empirical evidence is scant and inconclusive on whether non-dual, as versus dual. CEO leadership structure is associated with better firm performance. Theoretical studies provide no consensus as to whether firms with split titles (CEO and chairman of the board) outperform firms with combined titles. Fama and Jensen (1983) and Jensen

(1993) suggest that CEO duality may hinder board's ability to monitor management and thereby increase the agency cost. As a result, splitting the titles of CEO and Chairman of the Board will improve firm performance. In contrast, Stoeberl and Sherony (1985) and Anderson and Anthony (1986) argue that CEO duality provides clear-cut leadership in strategy formulation and implementation and will therefore lead to better firm performance. Splitting titles may create information sharing costs, conflicts between CEO and non-CEO chairman and inefficiency: It will be costly to communicate firm-specific information to others in a timely manner: decision making process and execution may both be less efficient when there are two versus one key leader; it may be more difficult to assign blame for bad company performance.

Whether combining or separating the leadership is beneficial to the firm is then an empirical question. However, the empirical evidence is mixed and inconclusive. Pi and Timme (1993) find that there is negative relationship between CEO duality and accounting performance measures in banking industry. Baliga, Mover, and R. Rao (1996) found no evidence of performance changes surrounding changes in the duality status. Another study they conducted in 2001 suggested that: (1) the market is indifferent to changes in a firm's duality status; (2) there is little evidence of operating performance changes around changes in duality status; and (3) there is only weak evidence that duality status affects long-term performance, after controlling for other factors that might impact that performance. Daily and Dalton (1997) find that there is no significant difference in performance between dual CEO and non-dual CEO firms. Dahya and Travlos (2000) document a positive association between CEO duality and firm performance. Dahya (2005) show that splitting the titles of CEO and Chair of the Board among U.K. companies is not associated with performance improvement. Faleve (2007) find that CEO duality is positively related to organizational complexity, CEO reputation and managerial ownership. His results suggest that firms do consider the costs and benefits of alternative leadership structure.

Both theoretical and empirical studies are inconclusive as to which might be better: vesting both CEO and Chair of the Board positions into one person, or splitting the titles.

However, in many countries including the U.S., regulators and investors have become more and more strongly recommending separation of CEO and chairman duties.

Chia et al (2008), in their study "CEO Duality and firm performance-An endogenous issue", found significant differences in firm characteristics between dual and non-dual CEO firms. However, they found no evidence that CEO duality has a significant effect on firm performance. They found the existence of endogeneity in CEO duality, indicating that the corporate leadership structure is endogenously and optimally determined, given firm characteristic and ownership structure. Their evidence casted doubt on the notion that firms changing from dual to non-dual leadership structure would improve performance. Miring'u (2009) while studying corporate governance in commercial state corporations in Kenya found that most of them displayed a relatively positive significance to performance in relation to Return on Equity.

What measures should therefore be put in place to mitigate against costs associated with the agency theory? Miring'u (2009) documents that to induce managers to behave efficiently and to reduce agency problem, incentive contracts, which tie manager's compensation to measures of corporate performance have been proposed. This is accomplished through performance related bonuses, stock grants and stock options. However, executive incentive pay has been criticized as being manipulated or controlled by the executives themselves. Jensen and Murphy (1990) examined the relationship between pay and performance by CEOs in the USA. They advanced the argument that the conflict of interest between the shareholders and CEO represents a classic case of principal - agency problem. Agency theory predicts that compensation policy will be designed to give managers incentives to select and execute actions that increase shareholder's wealth. They find that in small firms, CEO pay is more sensitive to performance (due to more option - more ownership). However for large firms, pay - performance sensitivity is low. This low sensitivity is linked to several hypotheses, such as: maybe CEOs do not matter much, or "their actions may be easily monitored" or "political forces in the contracting process may be limiting the pay"

2.9.5 Transparency and Disclosure and Firm Performance

Full disclosure and transparency (T&D) of financial information are vital components of the CG framework (OECD, 1999) and are regarded as an important indicator of CG quality. Indeed, Beeks and Brown (2005) find that firms with higher CG quality make more informative disclosures. Transparency is integral to corporate governance, higher transparency reduces the information asymmetry between a firm's management and financial stakeholder's (equity and bondholders), mitigating the agency problem in corporate governance (Sandeep et al, 2002).Sadka (2004) provides both theoretical and empirical evidence that the public sharing of financial and analyst reports (market transparency) has enhanced factor productivity and economic growth in 30 countries.

Understandable, relevant, transparent, reliable, timely, and full disclosure of the results of economic activities and the structure and processes used in its organizational units entrusted to operate in shareholders' interests, gives the stakeholders a true and fair view of the firm and the quality of the CG standards it follows. In this sense, good T&D mechanisms are set in place to essentially protect the rights of the minority shareholders and creditors and other outsiders who do not have first hand knowledge about the firm and its prospects, from extraction of private benefits by insiders based on their superior information. This, in turn, is expected to minimize the informational asymmetry in the firm and the probability of fraud, also enhancing its easier detection, leading to lower cost of capital and hence higher firm value. A related informational advantage of good T&D practices is that it increases investor awareness and trust which will reduce the uncertainty of the returns to the capital suppliers which, again, is expected to reduce the firm's cost of external capital and hence increase its value (Berglof and Pajuste, 2005). A third advantage is that compliance with good T&D practices mitigates the political costs of non-compliance and hence reduces the risk of higher taxes, litigation and too much regulation. Transparency, disclosure and trust, which constitute the integral part of corporate governance, can provide pressure for improved financial performance, financial performance, present and prospective is a benchmark for investment. The McKinsey Quarterly surveys suggest that institutional investors will pay as much as 28% more for the shares of well governed companies in emerging markets (Mark, 2000).

According to the corporate governance survey 2002, carried out by the Kuala Lumpur stock exchange and accounting firm Price Water House Coopers (PWC), the majority of investors in Malaysia are prepared to pay 20% premium for companies with superior corporate governance practices.

Greater information provision (disclosure) on the company's capital and control structures - can be an important means to achieve public trust on business leaders. High quality and relevant information is crucial for exercise of governance powers. Full disclosure seeks to avoid financial statements fraud (Beasley, 1996; Beasley et al, 2000). Prior studies have concentrated on disclosure of items such as management earnings forecasts (Johnson et al, 2001; Lev and Penman 1990) or interim earnings (Leftwich and Zimmerman 1981), or have examined a very general disclosure index of financial and/or non - financial items (Chow and Wong - Borren. 1987). The CIFAR Index (i.e. a disclosure index created by the Center for Intentional Financial Analysis and Research (CIFAR) rates annual reports on the inclusion or omission of about 90 (rather traditional and mandatory financial) items from the following categories; general information, income statements, balance sheet, funds flow statement, accounting standards, stock data and special items (Laporta et al, 1998).

2.10 Critical Review of Major Issues

The major issues here are the board composition, board size, transparency and disclosure and CEO duality. Sometimes when the organisation has least interference from outsiders (appointment of outside directors) they seem to perform better since those in management have a sense of ownership at heart. Hence the board ought to compose of more inside directors than outside directors.

However. John and Senbet (1998) argue that boards of directors are more independent as the proportion of their outside directors increases. Kihara (2006) also notes that unlike inside directors, outside directors are better able to challenge the CEO. It is perhaps in recognition of the role of outside directors that a minimum of three directors is required

on the board. The study sought to find out which of these arguments is the case with MFIs in Kenya.

2.11 Summary and Gaps to be filled

Much of the literature quoted in the study relates to research work done on firms operating in developed western countries. There is quite little literature relating to corporate governance on the African continent and especially in Kenya. Worse still, information relating to corporate governance of the Kenyan MFIs is quite scanty. Most of the information on corporate governance and MFIs is found in newspaper articles, magazines and journals and annual reports and accounts published by the MFIs.

Those who have researched in the area of corporate governance in Kenya like Naibo (2006) who researched on Corporate governance structures and practices in insurance underwriting sector in Kenya, Ademba (2006) on Corporate governance system in SACCOs' front office savings entities (FOSAs), Muriithi (2004) who studied the relationship between corporate governance mechanisms and performance of firms quoted on the NSE, Ojiambo (2008) who did an analysis of the corporate governance practices of selected Kenyan SACCOs and Miring'u (2009) studying the analysis of corporate governance on the performance of commercial state corporations in Kenya have not fully exhausted the area of corporate governance.

The said sources have still left out quite a number of areas unresearched on, leaving a gap to be filled in terms of conducting more researches on the area of corporate governance and its effect on the performance of various firms in Kenya .which has of late gained considerable attention. It is on this basis that the researcher conducted this research so as to investigate and report on the effect of corporate governance practices on the financial performance of MFIs in Kenya.

2.12 The Model

In order to capture the relationship between financial performance (dependent variable) and the independent variables, the following model is suggested;

$$P_i = f(C, S, D, T, E) \dots \dots \dots (1)$$

Where,

P_i = financial performance of the MFI, which is measured using ROE

C = board composition

S = board size

D = CEO duality

T - Transparency and disclosure

E = Error term

Equation (1) can be specified as a regression model as follows:

$$P_F = a_0 + a_1C + a_2S + a_3D + a_4T + E \dots \dots \dots (2)$$

The coefficients a_0 to a_4 can be estimated in order to determine the direction and magnitude of the independent variables on the dependent variable, as follows:

$$ROE = 0.096600 - 0.118800C - 0.064000S - 0.079200D + 0.049880T \dots \dots \dots (3)$$

Transparency and disclosure strongly influences the financial performance of the DTMFIs.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1. INTRODUCTION

This chapter describes the research methodology that will be used in carrying out the study. The chapter has been categorized into research design, target population, location of the study, sampling technique and sampling size and the expected output.

3.2. Research Design

This study is a descriptive research design, which is a method of collecting information by administering a questionnaire to a sample of individuals (Orodho, 2003). Mugenda and Mugenda (1999) define descriptive research as a process of collecting data in order to test hypothesis or to answer questions concerning the current status of the subject in the study. The study was a survey and hence all the DTMFIs were be studied. The study employed die causal comparative or ex post facto research design, which attempts to explore cause and affect relationships where causes already exist and cannot be manipulated. It uses what already exists and looks backward to explain why.

3.3. Target Population

The target population of this study was the 6 deposit taking DTMFIs in Kenya registered with the CBK as at 30th June, 2011.

3.4 Sample Size and Sampling technique

The researcher randomly sampled 1 respondent from each of the 6 deposit taking DTMFIs, making a total of 6 respondents. The respondents were sampled from the top managers of the DTMFIs.

3.5 Data Collection

Data was collected using the questionnaire method. A questionnaire with a set of questions, both open-ended and closed-ended was administered to each respondent. The close ended questions were accompanied by a list of all possible alternatives from which the respondents selected the answers that best describes their situation, while the open ended questions allowed them freedom of response. The questionnaires were used to collect primary data on the corporate governance measures instituted by their organizations as well as secondary data on their financial performance using the financial indicator selected by the researcher, i.e, ROE. The questionnaires were administered by drop and pick method so as to allow the respondents time to provide the necessary information.

3.6 Ethical issues

As data collection instruments were developed, the researcher ensured that the research procedures did not cause any harm or emotional distress to the respondents. The researcher also ensured that the respondents' human rights were observed and not infringed upon. As a result, in carrying out the study, the researcher endeavoured to obtain consent from the respondent before distribution of the questionnaires. The respondents were assured of confidentiality of the information they provided beforehand. In order to protect herself, the researcher obtained consent from the university in order to be allowed to collect data. Additionally, honesty and integrity were observed and maintained through out the study period.

3.7 Data Analysis

The primary data obtained using the questionnaires was analyzed using descriptive statistics. This enabled the researcher to meaningfully describe a distribution of scores or measurements using a few indicators or statistics. The closed ended Questions were coded for analysis using statistical instruments. These will include frequency distribution tables, percentages, pie charts, bar charts, pareto and related diagrams, computer packages especially the statistical packages for social scientists (SPSS version 11.5) and excel

software to help draw conclusions and make recommendations from the research findings.

CHAPTER FOUR
DATA ANALYSIS AND PRESENTATION OF FINDINGS

4.0 Introduction

The chapter contains summaries of data findings and their interpretations. The analysis has been computed from the 6 deposit taking DTMFIs registered with the CftK. The researcher distributed questionnaires to the 6 deposit taking DTMFIs and the response rate was 100% which was favourable for the study.

4.1 General information

The general information considered in this study included the length of employment of the respondent in the DTMFI and position held in the DTMFI. The length of service in the DTMFI and the position held has a significant bearing on the ability of the respondents to understand the systems and structures of operation of the organization as well as the subject matter of the study. Those respondents with a long duration of service and holding senior positions in the DTMFI are better able to understand the systems of operations of the organization as well as the subject of corporate governance issues (Naifco, 2006).

4.2 Corporate governance practices

The researcher examined the various corporate governance practices implemented by the various DTMFIs and found the following results.

Table 4.1 No of board members

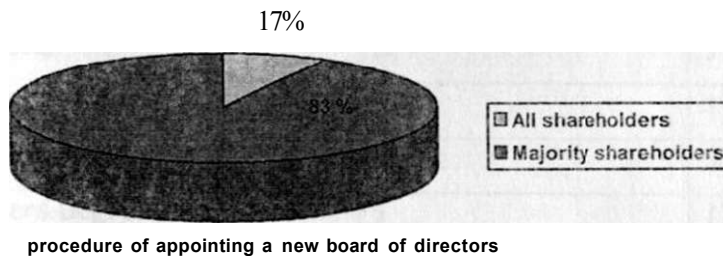
Number of members of board of directors	Frequency	Percentage
7	1	17
9	3	55
11	2	33
Total	6	100

The above table 4.1 indicates that 1 DTMFI (17 %) had a board consisting of 7 directors, 3 (55 %) consisted of 9 directors while 2 (33%) had 11 directors.

In terms of the proportion of external directors as compared to the internal directors, the researcher found that 3 DTMFIs (50%) had less external directors as compared to the internal directors, 2 (33 %) had their external directors being equal to the internal directors while 1 (17%) reported that their boards had more external as compared to the internal directors.

The researcher equally found out that out of the 6 DTMFIs 2 (33%) reported that their boards had more executive as compared to the non-executive directors with 4 (67%) having more non-executive as compared to the executive directors.

Fig 4.1 Appointment of the board



As shown in Fig. 4.1 above, the researcher found that 83% of the DTMFs appointed their boards by a vote of majority shareholders while only 17% appointed by a vote of all shareholders.

Table 4.2 Professional composition of the board

Profession	Frequency	Percentage
Legal officers	2	
Accountants/Finance specialists	1	17
Auditors	2	33
Others	1	17
Total	6	100

From the table 4.2 above, 2 out of the 6 DTMFIs (33%) boards had legal officers in their boards and auditors respectively, with 1 (17 %) having accounts/finance specialists and

others respectively. Some of the other professions identified include economists, engineers and business men.

The researcher was also interested in the professional qualifications of directors and found out that, out of the 6 DTMFIs, 1 (17 %) had economists sitting on the board, 2 (33%) being legal officers, 3 (50 %) being audit specialists and finance specialists while 1 (17%) were accounts specialists and other business specialists. This implies that most DTMFIs have various professionals serving as directors and therefore the decisions made by the boards are quite sound and informed.

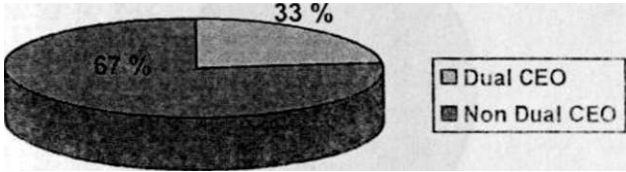
Table 4.3 Academic qualifications of board members

Qualification Level	Frequency	Percentage
O' Level	2	33
Diploma	1	17
Bachelor's Degree	2	33
Masters Degree	1	17

According to table 4.3 above, 2 (33 %) of the respondents reported that their directors had bachelors degree and O-level certificates while 1 (17%). had diplomas and masters degree certificates. This shows that majority of the DTMFIs were being managed by directors who had attained high levels of education, hence being well informed and exposed to make sound management decisions.

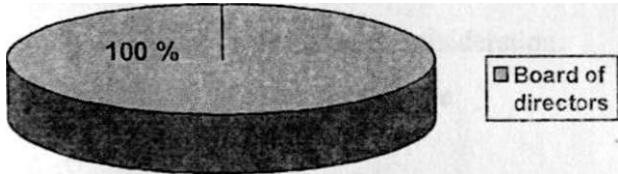
The researcher equally examined the membership of board members to professional bodies and found out that 67% of the DTMFIs had directors who belonged to ICPAK while 33% of the DTMFIs having directors belonging to ICPSK. This is to imply that majority of the DTMFIs are being managed by board members who understand the proper way of keeping books of accounts and the prudential reporting standards and requirements.

Fig 4.2 CEO Duality



According to Fig 4.2 above, 2 (33 %) of the DTMITs had their CEOs doubling as the board chairmen while 4 (67 %) had separated the roles of the CEO from that of the board chairman, with both roles being performed by different persons.

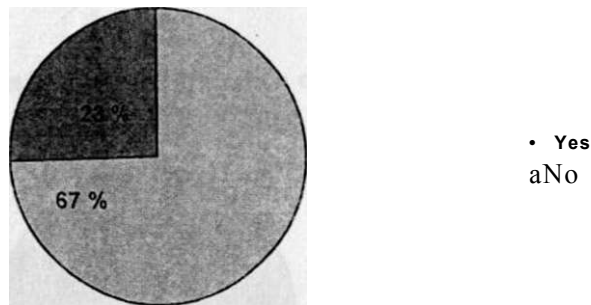
Fig.4.3 Who drafts CEO Remuneration



who drafts the CEO remuneration

The researcher found that in all the DTMFIs, the CEO remuneration was drafted by the board of directors as shown in Fig.4.3 above. This implies that the CEO was not involved at all in the drafting or determination of his remuneration.

Fig 4.4 Availability of CEO recruitment committee



As shown in Fig 4.4 above, the researcher found that 67% of the DTMFJs had in place a CEO recruitment committee while 23% did not have in place a CEO recruitment committee. Additionally, the researcher found that among the respondents who had CEO recruitment committees, the chairman of the committee was also the board chairman. Equally, only 50% of the chairmen belonged to ICPAK and none belonged to ICPSK.

When asked to state how their DTMFJs came up with the directors' remuneration, all respondents (100%) stated that the board of directors made proposals to the shareholders during the AGM for discussion and consideration.

Fig 4.5 Availability of audit committee

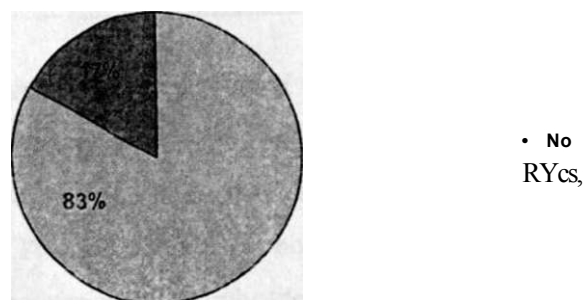


Fig.4.5 above shows that 83% of the DTMFJs had an audit committee in place with 17% not having formed the same. Out of the DTMFJs which had audit committees in place, 50% had more outside directors compared to the inside directors, 33% had an equal number of inside and outside directors while 17% had more inside directors compared to the outside directors. Additionally, 67% of the DTMFJs had more non-executive

not compared

directors compared to the executive directors while 33% had more executive as compared to the non-executive directors.

Fig 4.6 Implementation of performance contracting

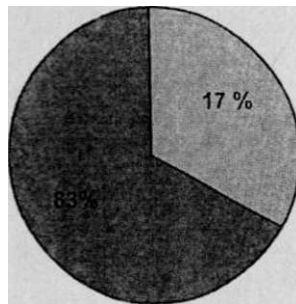


Fig 4.6 above shows that majority of the DTMFIs (83 %) had not implemented performance contracting while only 17% had implemented performance contracting in their operations.

Table 4.4 Parties involved in performance contracting

Party	Frequency	Percentage
Between Board and Management	2	100
Between Board and Shareholders	0	0

As indicated in table 4.4 above, out of the 17% of DTMFIs which had implemented performance contracting, all of them had implemented the contracts between board and management while none had implemented performance contracts between board and shareholders. This means that the boards were not willing to commit themselves to the scrutiny and evaluation by shareholders and were only keen to have the management enter into performance contracts and be evaluated.

directors compared to the executive directors while 33% had more executive as compared to the non-executive directors.

Fig 4.6 Implementation of performance contracting

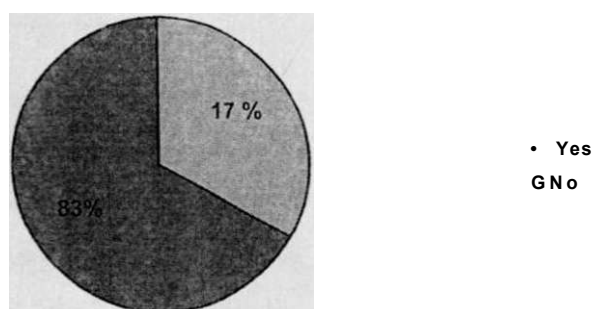


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Table 4.5 Availability of standardized code of conduct for management and Board

Management	Response	Frequency	%	Board	Response	Frequency	%
	Yes	5	83		Yes	2	33
	No	1	17		No	4	67
1	Total	6	100		Total	6	100

Table 4.5 above shows that 10 respondents (83%) reported that their DTMFIs had a standardized code of regulations for the management while 2 (17%) did not have it. Similarly, 4 respondents (33%) reported that their DTMFIs had a standardized code of regulations for the board members while 8 (67%) did not have the same. This again shows that the boards of most DTMFIs were less willing to regulate their conduct but more interested in regulating that of the management.

4.6 Financial performance of the MFIs

Trend	Frequency	Percentage
MFIs with consistent increase in ROE	2	33
MFIs with consistent decrease in ROE	1	17
MFIs with erratic ROE		50
Total	6	100

The table 4.6 above indicates that 33% of the DTMFIs showed a consistent increase in ROE. 17% showed a consistent decrease in ROE while 50% exhibited an erratic/inconsistent ROE over the 3-year period

4.4 What needs to be done to improve the performance of the MFI

When asked what they thought needed to be done to improve the performance of their DTMFIs, the respondents gave various suggestions, including, avoiding laxity, providing various categories of loans, strict adherence to prudent financial management, embracing ICT in DTMF1 operations, creation of more value added products board should concentrate on policy matters and leave the day to day management of the MFIs to the management staff.

CHAPTER FIVE
SUMMARY OF MAJOR FINDINGS, CONCLUSIONS AND
RECOMMENDATIONS

5.0 INTRODUCTION

This research was aimed at determining the effect of corporate governance practices on the financial performance of deposit taking MFIs. The study was carried out based on its objectives. The target population of 6 deposit taking MFIs was taken for the study. Data relating to the objectives of study was collected and analysed and the findings are presented in chapter four.

This chapter therefore presents a summary of the major findings of the study conclusions and recommendations.

5.1 SUMMARY OF MAJOR FINDINGS

The following are the results of major findings of the study.

5.1.1 Board size

The study found out that majority of the DTMFIs had the right number of board members, that is, between 5 and 9 as recommended by CMA. However, some 25% still had large boards consisting of more than 9 members. This implies that majority of the DTMFIs are in agreement Jensen (1993), Limpson & Lorch (1992), Yermack (1996), Yuanto (2003) and Sanda et al (2003) that large boards are less effective and easier for a CEO to control, the reason being that when the board grows too large, it becomes difficult to co-ordinate and poses problems. Smaller boards are also said to reduce the possibility of free riding by individual directors and increases their participation in the decision - making process. However, some DTMFIs still maintained large boards, probably because large boards have a wide range of expertise to help make better decisions, and are harder for a powerful CEO to dominate, as postulated by Miringu (2009).

5.1.2 Board composition

The researcher found out that majority of the MFIs (67%) had a higher proportion of non-executive directors as compared to the executive directors, with only 33% having a higher number of executive directors as compared to the non-executive directors. A

higher number of non-executive directors ensures a check on the powers of the executive directors and prevents them from domineering in the decisions of the board.

Similarly, in terms of the composition of external versus internal directors, the researcher found that 50 % of the DTMFIs more internal directors compared to the external, 33% had an equal number of external and internal directors while 17 % of the DTMFIs had a higher proportion of external directors compared to the internal directors. The CMA recommends that at least one third of the directors be external directors.

Majority of the DTMFIs had directors belonging to professional bodies with 75% belonging to ICPAK and 25% to ICPSK. Similarly, 67% of the DTMFIs had their directors having diplomas, bachelors and masters degree certificates with only 33% having O-level certificates. This means that majority of the DTMFIs were being managed by directors who understand the proper way of keeping books of accounts as well as the prudential reporting standards and requirements.

5.1.3 CEO Duality

In terms of CEO duality, the researcher found out that 67% of the DTMFIs had their CEO and board chairman roles being performed by different persons (non-dual CEO) while only 33% had a dual CEO structure. This means that decision making and power is not controlled by one individual.

5.1.4 Transparency and disclosure

The researcher found out that in all the DTMFIs, the board drafts the CEO's remuneration. In terms of performance contracting, 67% of the respondents indicated that their MFIs had implemented performance contracts compared to 33% which had not. Performance contracting provides an effective tool for performance evaluation. However, out of the DTMFIs which had implemented performance contracting, all of them had implemented performance contracts between the board and management, while none had implemented performance contracts between the board and the shaieholders, implying that most of the boards were less willing to be evaluated by the shareholders but they were keen to evaluate the performance of the management

The researcher similarly found out that 17% of the DTMFIs had in place an audit committee compared to an overwhelming majority of 83% which did not have an audit committee in place. Additionally, majority of the DTMFIs (83%) had standardized code of regulations for the management while 17% didn't have any. However a lesser number of DTMFIs (33%) had a standardized code of regulations for the board while 67% didn't have the same. This again shows that the board was keen to regulate the conduct of the management but the board was itself less willing to be regulated.

5.2 Conclusions

The research findings indicate that most DTMFIs have implemented some corporate governance measures though not all. It was clear from the research that the boards of directors of some DTMFIs, though at a slow pace, have put in place measures of transparency and disclosure including implementation of performance contracting and standardized code of regulation, formation of CEO remuneration and audit committees among other things. Most DTMFIs have separated the roles of board chair and CEO and are equally well composed in terms of the proportion of executive compared to the non-executive directors as well as the internal and external directors.

The researcher found out that majority of the DTMFIs had more non-executive compared to the executive directors, while majority had more external compared to the internal directors. The CMA recommends that boards be composed of an odd number and should constitute of at least one third of its directors being external directors. The researcher found that the DTMFIs which composed of more non - executive as compared to executive directors had a consistent increase in ROE hence a better performance than those with more executive relative to the non-executive directors. This is due to the fact that when the board is composed of more non-executive directors as compared to the executive directors, the board will better play its monitoring role on the CEO since it will be more independent than when it composes of relatively more executive members. This is in agreement with the findings of Jensen (1993) who voices his concern that a lack of independent leadership makes it difficult for boards to respond to failure in top management.

Based on the board size of the DTMFIs, the researcher found that majority of the DTMFIs had small boards as compared to those with large boards. According to Miring'u (2009), there is a view that larger boards are better for corporate performance because they have a wide range of expertise to help make better decisions, and are harder for a powerful CEO to dominate. In recent times however, emphasis has been on smaller boards. Jensen (1993) and Lipton & Lorsch (1992) articulate that large boards are less effective and easier for a CEO to control, the reason being that when the board grows too large, it becomes difficult to co-ordinate and poses problems. Smaller boards are also said to reduce the possibility of free riding by individual directors and increases their participation in the decision - making process.

Concerning CEO duality, the researcher found out that majority of the DTMFIs had separated the roles of CEO and board chair, it is expected that DTMFIs with non- dual CEO structures would have better firm performance as compared to those with a dual CEO structure, according to Fama and Jensen (1983) and Jensen (1993) who suggested that CEO duality may hinder board's ability to monitor management and thereby increase the agency cost. As a result, splitting the titles of CEO and Chairman of the Board will improve firm performance. On the contrary however, Stoeberl and Shrony (1985) and Anderson and Anthony (1986) argue that CEO duality provides clear-cut leadership in strategy formulation and implementation and will therefore lead to better firm performance. Splitting titles may create information sharing costs, conflicts between CEO and non-CEO chairman and inefficiency: It will be costly to communicate firm-specific information to others in a timely manner; decision making process and execution may both be less efficient when there are two versus one key leader; it may be more difficult to assign blame for bad company performance.

Transparency and disclosure was also found to strongly influence the financial performance of DTMFIs in that firms which had shown high levels of transparency and disclosure practices were found to have a consistent increase in ROE. Transparency disclosure was measured in terms of implementation of performance contracting and availability of a standardized code of conduct for board members and management. Majority of the DTMFIs had not implemented performance contracts in their operations,

but quite a number had a standardized code of conduct in place for the management and the board.

5.3 Recommendations

The researcher recommends to CI3K to ensure that all DTMFIs implement performance contracting in their operations which is a better monitoring tool for the performance of both the board and management and between the board and shareholders. This will ensure that the performance of these parties is well monitored and evaluated in line with the set objectives for better overall performance of the DTMFIs. Additionally, all MFIs should have a standardized code of conduct for management staff and the board, which will ensure that the interests of the DTMFI supersede those of the individual members. Similarly, DTMFIs should put in place CFO recruitment committees as well as audit committees to ensure that proper internal controls are maintained.

5.4 Suggestions for further research

The researcher recommends that further studies be done to determine whether other financial institutions in Kenya like mortgage institutions and pension funds have put in place corporate governance practices and if so, whether the adoption of the corporate governance practices had an effect on their performance. A similar study needs to be conducted among other MFIs other than the DTMFIs in Kenya and in other countries to establish whether the findings shall tally with those of this study.

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APPENDIX I: LETTER OF INTRODUCTION

UNIVERSITY OF NAIROBI

SCHOOL OF BUSINESS

To: All Respondents,

Dear Sir/Madam

**RE: THE EFFECT OF ADOPTION OF CORPORATE GOVERNANCE
PRACTICES ON THE FINANCIAL PERFORMANCE OF YOUR MLFI**

I am a postgraduate student at the University of Nairobi, pursuing Master of Business Administration degree in Finance. I am carrying out a survey for a study as referenced above, among the deposit taking MFIs in partial fulfillment of the requirements for the award of the degree.

You have been selected to provide information on the performance in relation to the implementation of corporate governance practices in the MF1. The information provided for this study will be treated with the confidentiality it deserves and used purely and exclusively for academic purposes. Thank you for your cooperation and participation towards making this academic work a success.

KITETEI EUNICE MBITHE,

REG.NO. D61/73087/2009

MBA STUDENT.

APPENDIX 2: LIST OF DEPOSIT TAKING MFIs

Faulu Kenya DTM Limited

Postal Address: P. O. Box 60240 - 00200, Nairobi

Email: info@faulkenya.com. custoiviercare@fa'jlukenva.com

Website: [www.faulkenya .co.ke](http://www.faulkenya.co.ke)

Physical Address: Faulu Kenya House, Ngong Lane -Off Ngong Road

Peer Group: Small

Branches: 26

Kenya Women Finance Trust DTM Limited

Postal Address: P.O.Box 4179-00506, Nairobi

Email: info@kwftdtm.com

Website: www.kwftdtm.com

Physical Address: Woodlands Business Park. Kiambere Road. Upper Mill,

Peer Group: Large

Branches: 11

Remu DTM Limited

Postal Address: P. O. Box 20833-00100 Nairobi

Email: info@remuhd.co.ke

Physical Address: Finance House, 14th Floor, Loita Street

Branches: 2

SMEP Deposit Taking Microfinance Limited

Postal Address: P. O. Box 64063-00620 Nairobi

Email: info@srnep.co.ke

Website: www.smep.co.ke

Physical Address: SMEP Building - Kirichwa Road. Off Argwings Kodhek Road

Branches: 6

UWEZO Deposit Taking Microfinance Limited

Postal Address: 1654-00100 Nairobi

Email: info@uwezodtm.com

Website: www.uwezodtm.com

Physical Address: Park Plaza Building, Ground Floor, **Moktar Daddah Street**

Branches: 2

Rafiki Deposit Taking Microfinance Ltd

Central Office. Riverside

P.O BOX 66049 - 00800

ir.fo <ftchasebank.co.ke

APPENDIX 3: QUESTIONNAIRE

INTRODUCTION

Dear respondent, the purpose of this questionnaire is to get the actual scenario of your MFI a^ pertains the topic addressed purely for academic purpose. Please read the statements and give the response that represents your most honest opinion. The information so given will be accorded the confidentiality it deserves and not used for any other purpose other than for this research. Your name should not appear on this questionnaire. Kindly respond to all the items.

PART A: GENERAL INFORMATION

1. Name of your MFI
2. For how long have you been an employee of the MFIs ?
3. What position do you hold in your MFI?

PART B: CORPORATE GOVERNANCE PRACTICES

4. (a) How many members does the board of directors have?

- (b) How many are:
- | | |
|----------------------------|-----|
| Inside directors | [] |
| Outside/external directors | [] |
| Executive directors | [] |
| Non-executive directors | [] |

- 5 How is the board appointed?

By vote of majority shareholders

By vote of all shareholders []

A head hunt by the chairman I]

Any other process (please describe)

6. What is the composition of the board in terms profession? (Specify number)

Legal officers []

Accountants Finance specialists []

Auditors []

Others (specify **specialization** and numbers)

7. (a) What is the board composition in terms of their highest academic qualification:;?

(Specify how-many per level)

O'Level []

A' Level []

Diploma []

Bachelors Degree []

Masters Degree f]

b) How many board members belong to: ICPAK [] ICPSK. []

8. (a) Does the CEO double as the board chairman ? Yes [] No []

9. Who drafts CEO remuneration?_

10. (a) Do you have a CEO recruitment committee? Yes [] No []

(b) Who chairs it? _

(c) Which body does he belong to? (Tick appropriately) ICPAlt [] ICPSK []

11. How do you come up with the directors' remuneration?

12. (a) Do you have an audit committee? Yes [] No []

(b) Give the number of members of the audit committee in terms of:

Outside directors []

Inside directors []

Executive directors []

"Nonexecutive directors []

13. (a) Has the MF1 implemented performance contracting? YES [] NO []

(b) If YES, which parties are involved in performance contracting? (Tick where appropriate)

Between the Board and the Shareholders []

Between the Board and the Management []

14. Does the MF1 have a standardized code of conduct for:

(a) Management? YES [] NO []

(b) Board members YES [] NO []

PART C: FINANCIAL PERFORMANCE

15. Kindly provide the following information about the Mi 1 for the last 3 years.

	2008	2019	2010
Net Profit After Tax(Ksh.)			
Ordinaryy Share Capital(Ksh-)			
ROE			

16. In your own opinion, what do you think led to the above performance!?

17. What else do you think should be dene to improve the performance of the MF1 ?

Thank you for taking your precious time to fill in ibis questionnaire.

APPENDIX 4 : ADJUSTED PANEL RESULTS

Dependent Variable: ROE

Method: Panel Least Squares

Dale: 10/25/11 Time: 12:22

Sample: 2008 2010

Periods included: 3

Cross-sections included: 3

Total panel (unbalanced) observations: 7

Variable	Coefficient	Std. Error	t-Statistic	Prob.
BOCOMP	-0.118800	0.154812	0.767380	0.0231
BOSIZE	0.064000	0.122390	0.522919	0.0332
CEODUA	-0.079200	0.280875	0.281975	0.0045
TRANSP	0.049880	0.077664	0.642256	0.0165
C	0.096600	0.266274	0.362784	0.0115
R-squared	0.769260	Mean dependent var		0.094557
Adjusted R-squared	0.732221	S.D. dependent var		0.248643
S.E. of regression	0.282647	Akaike info criterion		0.486576
Sum squared resid	0.159779	Schwarz criterion		0.447940
Log likelihood	3.296984	Hannan-Quinn criter.		0.009047
F-statistic	0.660792	Durbin-Watson stat		1.242929
Prob(F-statistic)	0.675943			