

**THE RELATIONSHIP BETWEEN AGENCY COSTS AND
FINANCIAL PERFORMANCE OF FIRMS LISTED IN NAIROBI
SECURITIES EXCHANGE**

By:

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DECLARATION

I, the undersigned declare that this research project is my original work and has not been presented for the award of a degree in this or any other University.

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This research project report has been submitted for examination with my approval as the University Supervisor.

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God bless you all.

DEDICATION

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LIST OF ABBREVIATIONS AND ACRONYMS

ANOVA	Analysis of Variance
FCF	Free Cash flow
KCB	Kenya Commercial Bank
NBK	National Bank of Kenya
NPV	Net Present Value
NSE	Nairobi Securities Exchange
ROA	Return on Asset
ROE	Return on Equity
ROI	Return on Investment
SPSS	Statistical Package for Social Sciences
VIF	Variance Inflation Factor

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ABSTRACT

The purpose of this study was to establish the relationship between agency costs and financial performance of firms listed at the Nairobi Securities Exchange.

Descriptive study was applied; the target population was all the companies in the NSE that traded continuously within the period of 5 years for the year 2008 to 2012. A census was used for the firms. 52 companies were analyzed since the rest were suspended from trading at the NSE.

The study was a research which utilized secondary data from companies listed in Nairobi Securities Exchange. Multiple regression analysis and correlation analysis was used to determine relationship between agency costs and financial performance at the NSE. Statistical Package for Social Sciences (SPSS) was used in the data analysis.

The results of the study indicated that there is a positive relationship between agency costs and financial performance, when agency costs increases by one unit, financial performance increases by 0.02 units.

The study also found that there was no multicollinearity and autocorrelation among all the variables tested. Finally a positive slope graph was obtained showing a positive relationship between financial performance and agency costs.

This study concluded that the relationship between financial performance and agency costs was significant at the 5% level. The study recommended that since agency costs and financial performance are significantly related, decisions should take into account the implications of agency costs for the firms listed in NSE when taking financial decisions.

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

The agency problem was originally raised by Berle and Means (1932) who argued that agency costs might be incurred in the separation of ownership and control due to inconsistent interests of management and stockholders. Jensen and Meckling (1976) suggested that the incomplete contractual relationship between the principal and the agent might cause the agency problem.

Separation of ownership and management does not come without costs. Berle and Means (1932) introduced the canonical agency problem by suggesting that dispersed ownership leads to less corporate monitoring. Jensen and Meckling (1976) further spurred the interest in the theoretical and empirical aspects of the modern theory of corporate finance by formalizing agency costs as a conflict of interest between managers and shareholders.

Denis et al. (1999) state the reasons for why a firm's diversification strategy is likely to reduce firm value. They find that diversified firms trade at a discount as against their single-segment peers and further prior studies find significant positive relation between greater shareholder wealth and focused strategy for many leading US firms. Given that diversification can lead to value reduction, Denis et al. (1999) examine why managers resort to corporate diversifications. They argue that managers do so as their private benefits related with diversified portfolio.

Incorporated in 1954, the Nairobi Securities Exchange (NSE) is the leading securities exchange in East and Central Africa. The products traded at the NSE are shares and bonds which are financial instruments that are jointly referred to as securities. NSE facilitates investments and savings by bringing together borrowers and lenders. Currently, a total of 62 firms categorized into 12 sectors are listed (NSE, 2013). The NSE plays an important role in economic development in Kenya, by providing a medium for the transfer of funds from surplus spending units to deficit spending units.

1.1.1 Agency Costs

Jensen and Meckling (1976) identify agency costs derived from conflicts between equity holders and owner-managers as residual loss which means agent consumes various pecuniary and non-pecuniary benefits from the firm to maximize his own utility. According to the Pavlik et al. (1993) analysis, agency theory suggests that compensation should be contingent on more than one performance measure and further predicts that the relative importance of alternative performance measures should be a function of their precision and sensitivity to the manager's performance. Ang et al. (2000) and Fleming et al. (2005) shows that agency costs generated from the conflicts between outside equity holders and owner manager could be reduced by increasing the owner-managers proportion in equity, that is agency costs vary inversely with the manager's ownership

Jensen and Meckling (1976) define the agency relationship as a contract under which the principal engages the agent to perform some service on their behalf. These agency problems arise because of the impossibility of perfectly contracting for every possible action of an agent whose decisions affect both his own welfare and the welfare of the

principal (Brennan 1995b). Arising from this problem is how to induce the agent to act in the best interests of the principal. They defined agency costs as the sum of monitoring costs, bonding costs, and residual loss.

The significance of agency cost is that it helps mitigate the effects of the agency problem. Baker and Powell (2005) defined agency problem as referring to the difficulties faced by financiers in ensuring that their funds are not expropriated or wasted on unattractive projects. With this framework, shareholders are assumed to derive purely financial benefits from ownership of their equity investments (Baker & Anderson, 2010).

1.1.2 Financial Performance

Chakravathy (1986) observed that financial performance is a multidimensional construct and thus, any single index may not be able to provide a comprehensive understanding of the performance relationship relative to the constructs of interest. Therefore, it is important to use multiple indicators of performance. Studies that have considered performance as a dependent variable have sought to identify other variables that produce variations in performance. March and Sutton (1997) pointed out that researchers who study organizational performance in this way typically devote little attention to the complications of using such a formulation to characterize the causal structure of performance phenomena.

The important role of organizational performance in strategic management warrants close attention to the conceptualization and measurement of business performance (Venkatraman & Ramanujam, 1986). Measuring firm performance has been a major

challenge for scholars and practitioners as well (Simerly & Mingfang, 2000). Ang et al. (2000) describes financial measures of performance as financial ratios, stock market returns, gross profit, total assets, revenue growth, earnings per share and return on asset.

1.1.3 Relationship Between Agency Costs and Financial Performance

Agency theory suggests that compensation should be contingent on more than one performance measure and further predicts that the relative importance of alternative performance measures should be a function of their precision and sensitivity to the manager's performance (Pavlik et al.,1993). They further pointed out that stock returns are affected by many economic factors and thus may be too noisy and insensitive to link to a manager's actions. Accounting measures, on the other hand, can be created and tailored to capture different aspects of a firm's circumstances and appear to capture both short-term and long-term aspects of performance not adequately captured by either general or relative measures of stock return.

Agency costs can be reduced through the presence of large-block shareholders, also known as block holders. With a large stake in the firm and hence significant voting rights, block holders can directly and indirectly influence the decision making process of the firm. On one hand, as block holder ownership increases block holders have a greater incentive to increase firm value through better monitoring. Consequently agency costs would be reduced and firm value increased (Shleifer and Vishny, 1986). They found that block holders play an active role in monitoring management. Agrawal and Mandelker (1990, 1992) find evidence suggesting better monitoring at firms with higher institutional

ownership. Similarly, Denis, Denis and Sarin (1997) document that executive turnover is positively related with the presence of outside block holders. Moreover, firms with large block holders tend to outperform their peers with relatively fewer outside block holders (Denis and Serrano, 1996; Bhagat, Black and Blair, 2001). The findings suggest that block holders are effective monitors in the firm and the benefits are shared along with other shareholders.

1.1.4 Nairobi Securities Exchange

The Nairobi Securities Exchange formerly Nairobi Stock Exchange was constituted as a voluntary association of stock brokers under the society act. In 1990, a trading floor and secretariat was set up at the IPS building, before moving to the Nation Centre Nairobi in 1994. The securities exchange has witnessed numerous changes, automating its trading in September 2006 and in 2007 making it possible for stockbrokers to trade remotely from their offices, doing away with the need for dealers to be physically present on the trading floor. Trading hours were also increased from two to six. Moving to Westlands in the surroundings of Nairobi symbolically marked the end of an era where the market was owned and run by stockbrokers (NSE, 2013).

Nairobi Securities Exchange aims at supporting trading clearing settlement of equities debt derivatives and other associated instruments. It is mandated to list companies on the securities exchange and enables investors to trade in securities of companies thus its charged with the strength of Securities Exchange. There are 61 listed companies as at 2013 categorized in 11 different sectors namely: Agricultural, Commercial and Service, Telecommunication and Technology, Automobiles and Accessories, Banking, Insurance,

Investment, Manufacturing and Allied, Construction and Allied, Energy and Petroleum and lastly Growth Enterprise Market Segment (NSE, 2013).

1.2 Research Problem

Jensen and Meckling (1976) suggests that costs arise from conflicts of interest between stakeholders, which are borne by the shareholder in order to keep managers focused on pursuing shareholders interest, with the hope that wealth will increase. However, do increased spending in agency costs necessarily lead to a decrease in firm performance? There is indeed destruction of value from some agency costs behavior of managers (Jensen, 2003). Ross (1973) suggests that when a firm has debt, management is tempted to pursue selfish strategies, imposing agency costs on the firm. These strategies are costly, because they lower the market value of the firm. They include: incentives to take large risks and incentive toward underinvestment.

Locally, there are several examples of NSE listed companies that have previously either been delisted, liquidated or placed under receivership on account of the agency problem mismanagement.

Uchumi started to experience financial and operational difficulties occasioned by a sub-optimal expansion strategy coupled with weak internal control systems. As a result, on 31st May 2006, the board of directors resolved that the company ceases operations and on 2nd June 2006, the debenture holders placed the company under receivership. Simultaneously, the CMA suspended the company's listing on the NSE. (NSE, 2013).

In 19th Sept 2013, CMC was acquired by Al Futtaim. It acquired all of the shares and has no present intention of disposing of them and intends to continue trading as a subsidiary. The reasons for suspension ranged from revelations of fraud within the companies, lack of disclosure in published financial statements, conflicts of interest amongst board members and non-compliance to the reporting obligations, corporate governance structure issue, Insider trading, board wars causing panic in the capital market.

Existence of agency problems issues leads to corporate governance that cannot be resolved through contractual solutions due to high transaction cost.(Hart,1995).These agency costs manifest themselves in the form of conflicts between investors and other claim holders on the firms cash flows.

Two government dominant banks KCB and NBK disposed of in the NSE, have consequently landed in massive liquidity fix leading to market capital loss of between one-third and two-thirds as their real bad debt situations unraveled in 1995.

Studies usually examine the relationship of agency costs and different variables such as Nyamboga (2008) determined whether there exists a relationship between capital structure and agency costs for firms listed in the Nairobi Stock Exchange, while Mwisywa (2007) focused on the relationship between agency costs and the prices of stock public companies quoted at Nairobi Securities Exchange. Asuke (2009) established whether dividend policies have a relationship with the amount of agency related cost from a sample of companies quoted in the Nairobi Securities Exchange.

Many studies have been done in different contexts, the question is, is agency costs in form of audit costs, emoluments and compensations to external directors really necessary to affect firm performance, or are they just another example of misdirected resources by the shareholders? Hence there is not yet study thoroughly analyzing the relationship between agency costs and financial performance. Hence the study answers the following question; what is the relationship between agency costs and financial performance of the firm?

1.3 Objective of the Study

To establish the relationship between agency costs and financial performance of firms listed at the Nairobi Securities Exchange.

1.4 Value of the Study

The importance of the study comes from its theoretical and practical sides. Theoretical importance comes from highlighting an important subject related to agency theory, namely the problem of agency cost in firm performance, its most important measures and its relatedness with some variables.

The practical importance lies in presenting evidence about agency problem for performance in the Kenyan companies for guidance to reduce agency cost and improve some of financial policies having significant impact on and upgrade the financial performance in such a way that increases the value of the company in the Kenyan financial market, particularly the Kenyan business environment lacks such frameworks in addition to having the phenomenon of managerial opportunism.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

The purpose of this literature review is to gain insight into the relationship of agency costs and firm performance. It has discussed the theoretical framework which includes: agency theory, stakeholder theory, free cash flow theory and pecking order theory. It has also covered the empirical evidence and the summary of literature review.

2.2 Theoretical Review

Various theories have attempted to explain the relationship between agency costs and performance in the literature.

2.2.1 Agency Theory

Agency theory has been pointed out that separation of control from ownership implies that professional managers manage a firm on behalf of the firm's owners (Kiel & Nicholson, 2003). Conflicts arise when a firm's owners perceive the professional managers not to be managing the firm in the best interests of the owners. According to Eisenhardt (1989) stated that the agency theory is concerned with analyzing and resolving problems that occur in the relationship between principals and their agents or top management. The theory rests on the assumption that the role of organizations is to maximize the wealth of their owners or shareholders (Blair, 1995).

Agency theory (Jensen and Meckling, 1976; Fama and Jensen, 1983; Fama, 1980) states that agency costs arise from the conflict of interest between a principal and an agent. This conflict results, for example, when managers, who are responsible for important decisions of the firm, are not the primary claimants of the firm's net assets, and thus do not bear a major share of the wealth effects of their decisions. Pavlik et al. (1993) suggests that compensation should be contingent on more than one performance measure and further predicts that the relative importance of alternative performance measures should be a function of their precision and sensitivity to the manager's performance.

2.2.2 Stakeholders Theory

Ansoff (1960) derived the stakeholder concept. The traditional definition of a stakeholder is any group or individual who can affect or is affected by the achievement of the organization's objectives (Freeman 1984). Friedman (2006) states that the organization itself should be thought of as grouping of stakeholders and the purpose of the organization should be to manage their interests, needs and viewpoints.

The father of the stakeholder concept changed his definition over the time. In one of his latest definitions Freeman (2004) defines stakeholders as those groups who are vital to the survival and success of the corporation. In one of his latest publications Freeman (2004) adds a new principle, which reflects a new trend in stakeholder theory. In this principle in his opinion the consideration of the perspective of the stakeholders themselves and their activities is also very important to be taken into the management of companies. He states the principle of stakeholder recourse. Stakeholders may bring an action against the directors for failure to perform the required duty of care (Freeman 2004).

Stakeholders theory claims that developing strategies by considering a broader stakeholder network and interaction will produce more successful results than focusing merely on direct profit maximization attempts (Jamali, 2008). Long-term sustainability of enterprises requires a management approach more sensitive towards the interests and the benefits of all stakeholders (Sarikaya, 2009). Stakeholder theory also asserts that stakeholders do not have the incentives to become as well informed as investors in the company.

2.2.3 Free Cash Flow Theory

Although the first complete study regarding the agency theory was conducted by Jensen and Meckling (1986), yet the idea of free cash flow (FCF) was originally proposed by Jensen (1976), in which FCF is defined as net cash flows after deducting the needs of positive NPV projects. Since FCF is financial resources at the management's discretion to allocate, it is also called idle cash flows. Jensen (1976) argued that too much FCF would result in internal insufficiency and the waste of corporate resources, thus leading to agency costs as a burden of stockholder's wealth. Jensen (1993) empirically examined the agency problem and thus asserted that FCF was accused of the main reason why the investment return in the US companies fell below the required rate of return in 1980s.

In addition to FCF, Jensen (1991) argued that the self-interest motive of management was an important factor leading to agency costs. This was especially obvious when stockholder's and management's interests were in conflict, and consequently stockholder's interest was always dominated by management's. Brush et al. (2000) asserted that weak corporate governance caused the inefficiency in the allocation of free

cash flows since the corporate board of directors was directed at the policies in favor of management's interest at the expense of stockholder's wealth.

2.2.4 The Pecking Order Theory

The pecking order theory stems from Myers (1984) who in turn was influenced by the earlier institutional literature including the book by Donaldson (1961). Myers (1984) argues that adverse selection implies that retained earnings are better than debt and debt is better than equity. This ranking was motivated with reference to the Myers and Majluf (1984) adverse selection model. Pecking order models can be derived based on adverse selection considerations, agency considerations, or other factors.

The most common motivation for the pecking order is adverse selection developed by Myers and Majluf (1984) and Myers (1984). The key idea is that the owner manager of the firm knows the true value of the firm's assets and growth opportunities. Outside investors can only guess these values. If the manager offers to sell equity, then the outside investor must ask why the manager is willing to do so. In many cases the manager of an overvalued firm will be happy to sell equity, while the manager of an undervalued firm will not.

Myers (1984) points out that some versions of agency theory imply a financing hierarchy. Agency costs of equity, for example, could result in a pecking order. Halov and Heider (2004) argue that the standard pecking order is a special case of adverse selection. When there is adverse selection about firm value, firms prefer to issue debt over outside equity and standard pecking order models apply. However, when there is asymmetric

information about risk, adverse selection arguments for debt apply and firms prefer to issue external equity over debt. Thus, adverse selection can lead to a preference for external debt or external equity depending on whether asymmetric information problems concern value or risk. They concluded that adverse selection models can be a bit delicate. It is possible to construct equilibrium with a pecking order favor. But adverse selection does not imply that pecking order as the general situation.

2.3 Determinants of Firm Performance

Researchers have offered a variety of models for analyzing financial performance. However, little consensus has emerged on what constitutes a valid set of performance criteria (Cameron, 1981).

Studies on financial performance should include multiple criteria analysis. Thus different models or patterns of relationship between financial performance and its determinants should be used to demonstrate the various sets of relationships between the dependent and the independent variables in the estimated models (Schmidt, 1993).

Nickell et al.(1997), have identified the following factors as the drivers of performance, namely firm size, competition, leverage, corporate control, and corporate demographic issues.

2.3.1 Size

The effects of firm size on corporate performance have gained important attentions in the research of the firm. According to common intuition, the size of the firm has an important

role in firm performance for many reasons. In a certain perspective of studies, size can be a proxy of firm resource. Since larger firms have more organizational resources, they give larger firms the better equipment to achieve their goals (Penrose, 1959). Sizes can also proxy for the probability of default and the volatility of firm assets hence higher much agency costs.

2.3.2 Demographic Characteristics

Majumdar (1997) pointed out that larger firms generate superior performance relative to smaller firms. A firm's demographic characteristic such as number of outlets and the age or life stage of the firm as well as board size are seen by some researchers as driver of financial performance. If there are economies of scale, a larger number of outlets mean a better performance due to the incurring of agency costs such as monitoring costs, if not, more outlets lead to a worse performance. In a study on retail banks, Barnett et al. (1994) find single unit banks performing better. They argue that a firm's emphasis on market positioning retards organizational learning.

2.3.3 Age

Again the age of a firm is said to have a consequence for financial performance. Firms have a cycle of growth and decline. Newly established firms generally have an enthusiastic and energetic crew, which should enhance performance. On the other hand young firms are confronted with start-up problems (Cromie, 1991). Older firms have overcome these problems, and can rely on experience and a network of existing suppliers

and customers, which enhances efficiency. Birley (1990) find mature firms performing better.

2.4 Empirical Evidence

Several studies validate agency theory predictions in different contexts.

2.4.1 International Evidence

Rechner and Dalton (1991) examined the relation between CEO duality and organizational performance. Their study supports agency theory expectations about inferior shareholder returns from CEO duality. They studied a random sample of corporations from the Fortune 500. Rechner and Dalton (1991) identified corporations which had remained as either dual or independent chair CEO structures for each year of a six-year period (1978–1983). They found that corporations which had independent chair-CEO structures had higher return on equity (ROE), return on investment (ROI) and profit margins. But Rechner and Dalton (1991) made no control for industry in their study, so the extent of any confounding of structure effects by industry effects is unknown. It is thus desirable to assess effects of structure on shareholder returns controlling for industry effects.

Schulze et al (2001) set out to establish that a positive relationship exists between agency costs incurred by family firms and performance. The research design was a cross-sectional survey which targeted a total of 37, 3011 chief executives of privately held U.S.A family businesses of which a sample of 1376 firms was selected. The firms selected as the sample had average annual sales of \$36million, with 195 employees and

had been in businesses for 49 years. The data indicated a positive relationship existed between performance for non-family pay incentives but not for family pay incentives. The data also showed that strategic planning was positively related to performance and CEO tenure was negatively associated with firm performance, average board tenure and outside directors.

Iran Pouraghajan (2012) studied the effect of free cash flows and agency costs on the performance of listed companies in Tehran Stock Exchange. A sample of 140 companies were selected during the time span from 2006-2011. Efficiency ratios were used as measures of agency cost and Len and Paulsen model issued to measure free cash flows. F-Limer and Hausman tests were used to appropriate estimate of models for selecting among one of methods of the common effects, fixed effects and random effects. Results from research hypotheses testing have shown that there is no significant relationship between free cash flows and firm performance. While, there is significant and positive relationship between total asset turnovers with measures of firm performance. Negative and significant relationship is observed between operating income volatility with measures of firm performance.

2.4.2 Local Evidence

Wasike (2007) investigated and assessed the nature and identify salient aspects of agency relationship between the government as the principal and public universities in Kenya as agents for the provision of higher education. All the six commissioned public universities were selected and five agents, semi structured questionnaires send to each university. The

data was analyzed using tables, percentages and proportions. Results indicated that agency relations between the government and public universities are direct and are expressed in form of parliamentary legislations, financing higher education, policy, establishment, research and collaboration.

Mwisywa (2007) focused on the relationship between agency costs and the prices of stock public companies quoted at Nairobi Stock Exchange. The data used in this paper was extracted from annual financial reports of companies listed at the Nairobi stock exchange and from Authorized Data Vendors by the Nairobi Stock Exchange Council. Descriptive statistics were used to present data and quantitative analysis was conducted to give meaning to the results. However there was evidence that all companies studied incur some form of agency costs and that the increase in the stock prices may have been influenced by that spending. It also became clear that, there is a strong positive correlation between the agency costs incurred by public companies and the prices of their stocks.

Alfadhl (2007) aimed to investigate the relationship between some determinants of managerial behavior and agency cost from one hand, and the impact of this relationship on firm performance from the other. A data of a sample of 27 firms distributed to three economic sectors: banks, industry and services. The findings in relation to ownership variable confirm there is a significant and non-linear correlation between managerial ownership and agency cost of ownership; and such relationship is affected by firm

performance. As for the other two variables, the findings show there is no relationship between them and agency cost and no impact of performance on this relationship.

Nyamboga (2008) determined whether there exists a relationship between capital structure and agency costs for firms listed in the Nairobi Stock Exchange. The study investigated whether the use of debt in capital structure can reduce conflict between shareholders and managers. The population of the study included all companies listed in the Nairobi Stock Exchange between 2000 and 2007. Data analysis was done using statistical power for Excel. The findings indicated mixed results. Overall, a weak relationship exist between capital structure and agency cost firms in Nairobi Stock Exchange. It was concluded that, the use of debt decreases expenses in high growth firms but increases asset utilization in low growth firms.

Asuke (2009) sought to establish whether dividend policies have a relationship with the amount of agency related cost from a sample of companies quoted in the Nairobi Stock Exchange. Descriptive research design was used and targeted all 54 companies quoted at the Nairobi Stock Exchange. Stratified random sampling was used to select data of which a sample of 20 companies out the population of 54 companies was picked for a period of 8 years, 1999 to 2006 to ensure that information obtained was current and relevance. The findings showed that the dividend policies of the firm in the various sectors do not seem to be designed to mitigate the agency costs.

2.5 Summary of Literature Review

The theoretical framework has explained various theories that have attempted to explain the relationship between agency costs and firm performance in the literature. Agency theory, stakeholders' theory, free cash flow theory and pecking order theory (Jensen, 1976; Freeman, 2004; Myers and Majluf, 1984). These theories explain how agency costs affect different determinants of firm performance.

Some studies have been conducted on agency cost both internationally and locally. Alfadhil (2007) found a significant and non-linear correlation between managerial ownership and agency cost of ownership; and such relationship is affected by firm performance. Mwisywa (2007) strong positive correlation between the agency costs incurred by public companies and the prices of their stocks. Schulze et al (2001) a positive relationship exists between agency costs incurred by family firms and performance. Nyamboga (2008) a weak relationship exist between capital structure and agency cost. Pouraghajan (2012) found there is no significant relationship between free cash flows and firm performance.

From the recent studies done there exists a research gap which needs to be thoroughly analyzed by examining the relationship between agency costs and firm performance. Hence the study will seek to find the relationship between agency costs and performance of the firm.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter discusses the research design, population of the study, data collection, data analysis, analytical model, operationalization of variables, measurement of agency costs, measurement of financial performance, and lastly tests of significance.

3.2 Research Design

Dooley (2007) a research design is an outline that is used to give answers to research problems. Descriptive study was applied in the study which is concerned with describing the characteristics of a particular individual or group (Ross, 2005). The design is appropriate because the study will aim at exploring whether a relationship between the variables exists.

3.3 Population of the Study

The target population was all the companies in the NSE that traded continuously within the period of 5years for the year 2008 to 2012. A census was used for the firms. (Appendix 1)

3.4 Data Collection

The study was a research which utilized secondary data from companies listed in Nairobi Securities Exchange. An audited financial statements for the companies selected was used, thus increasing the reliability and validity of the findings and conclusion. The data

that was collected was in the form of total net income, value of equity, total fixed assets, total assets, revenue, and total debts.

3.5 Data Analysis

Multiple regression analysis and correlation analysis was used to determine relationship between agency costs and financial performance at the NSE. Statistical Package for Social Sciences (SPSS) was used in the data analysis.

3.5.1 Analytical Model

The model that was used is similar to one used by Zhang (2009). The model is as stated below;

$$Y_i = \beta_0 + \beta_1 X_{1i} + \beta_2 X_{2i} + \beta_3 X_{3i} + \beta_4 X_{4i} + \varepsilon_i$$

Where,

Y_i = Performance of firm i.

X_{1i} = Agency costs of firm i.

X_{2i} = Asset structure of firm i.

X_{3i} = Advertising Expenditure of firm i.

X_{4i} = Debt Structure of firm i.

ε_i = Error term.

β_0 is a constant and $\beta_1, \beta_2, \beta_3,$ and β_4 are coefficients of regression equation.

$X_{1i}, X_{2i}, X_{3i},$ and X_{4i} are the control variables.

3.6 Operationalization of the Study Variables

The dependent variable of the study is financial performance, while independent variable is agency costs.

3.6.1 Measurement of Agency Costs

One major way of measuring agency costs, is computing the asset utilization ratio used by Ang, Cole and Lin (2000) and Singh and Davidson (2003). It was computed as the ratio of sales to total assets. A higher asset utilization ratio indicates that companies are making investment decisions which are non-optimal or a second interpretation was that companies are investing their funds in projects which are unproductive. The equation that was used to calculate agency costs was :

$$X = \frac{\text{Sales for the year}}{\text{Total assets for the year}}$$

3.6.2 Measurement of Firm Performance

Performance is a difficult concept, in terms of both definition and measurement. It has been defined as the result of activity, and the appropriate measure selected to assess corporate performance is considered to depend on the type of organization to be evaluated, and the objectives to be achieved through that evaluation. (Hunger et al. 1997)

In this study return on assets was used to measure financial performance.

Return on Assets (ROA) as an accounting based measure and is computed as follows

ROA = Profits after Tax (Net Income)

Book Value Total Assets

The essence of the control variables is to give recognition to the fact that the performance of a firm may be influenced by several factors. For example, Audit costs and degree of leverage use are two determinants of Firm performance (Dalton et al; 1999; De Jong et al; 2002). The control variable utilized were advertising expenditure, asset structure and the level of leverage (debt structure).

3.6.2.1 The Advertising Expenditure

Grullon, Kanatas and Weston (2004) find that advertising improves firm visibility in the market and Easterbrook (1984) argues that agency costs are lower for firms with higher visibility because they will be under greater scrutiny from investors and regulators. Hence, a manager who expends effort to make her firm more visible is simultaneously attracting more attention from potential monitors.

Advertising expenses = Total advertising expenses

sales revenue.

The advertising-to-sales ratio is designed to show whether the resources a firm spends on an advertising campaign helped to generate new sales. A high advertising-to-sales ratio indicates that high advertising expenses resulted in low sales revenue; this could mean the campaign was not successful. A low ratio may indicate that the advertising campaign generated sales.

3.6.2.2 The Asset Structure

It is the ratio of fixed assets to total assets, it measures how much of the asset base represents fixed assets and for that matter, structure and equipment.

Asset Structure = $\frac{\text{Fixed assets}}{\text{Total assets}}$

3.6.2.3 Debt Structure

It is the percentage of debt to total assets, it was given as :

Debt Structure = $\frac{\text{Total Debts (both long-term and short – term)}}{\text{Book Value of Total Assets.}}$

3.7 Tests of Significance

Inferential statistics was used to analyze data collected in the research. A One-Way ANOVA procedure was conducted, which produces a one- way analysis of variance for a quantitative independent variable by a single factor of dependent variable. Analysis of variance was used to test the hypothesis that several means are equal.

One-way ANOVA was used to establish the relationship between agency costs and firm size, agency costs and asset structure, and the relationship between agency costs and debt structure . The decision rule for the one-way ANOVA test is to reject the null hypotheses that the group means are equal when the p-values are less than critical levels of significance of the test (usually fixed at 5%).

Coefficient of determination (r^2) was used. It measures the proportion of the variation in a dependent variable that can be explained statistically by the independent variable.

Autocorrelation and multicollinearity were tested too using Durbin – Watson and Variance Inflation Factor respectively.

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND FINDINGS

4.1 Introduction

The chapter details nature and strength of the relationship, regression analysis, the data analysis, findings and interpretation of the research study, and tests of significance.

4.2 Nature and Strength of the Relationship

Table 4.1 below shows that there is a positive relationship between financial performance and agency costs since $r = 0.192$. It also indicates a positive relationship between financial performance and advertising expenditure with $r = 0.369$. There is a negative relationship between financial performance and asset structure and debt structure with the value of $r = -0.010$ and $r = -0.542$ respectively.

Correlation analysis was conducted in table 4.1 below, to trace the mutual influence of the variables on one another.

Table 4.1: Correlation – Pearson correlation

		Financial Performance	Agency Costs	Asset Structure	Advertising Expenditure	Debt Structure
Pearson Correlation	Financial Performance	1	0.192	-0.010	0.369	-0.542
	Agency Costs	0.192	1	-0.006	-0.041	-0.185
	Asset Structure	-0.010	-0.006	1	-0.042	-0.452
	Advertising Expenditure	0.369	-0.041	-0.042	1	0.141
	Debt Structure	-0.542	-0.185	-0.452	0.141	1

Source : Research Findings

Table 4.2 : Correlation – P-value

		Financial Performance	Agency Costs	Asset Structure	Advertising Expenditure	Debt Structure
Pearson Correlation	Financial Performance	.	0.258	0.471	0.204	0.004
	Agency Costs	0.258	.	0.483	0.386	0.095
	Asset Structure	0.471	0.483	.	0.384	0.004
	Advertising Expenditure	0.204	0.386	0.384	.	0.159
	Debt Structure	0.004	0.095	0.004	0.159	.

Source : Research Findings

Figure 4.2 above shows the correlation between financial performance and Agency costs is not significant since its p-value is 0.258 which was less than 0.05. Similarly the correlations between financial performance and asset structure and advertising expenditure was since the p-values were 0.471 and 0.204 respectively as shown in figure 4.2 above. However the correlation between financial performance and debt structure was significant since its p-value was 0.004 which was less than 0.05.

4.3 Regression Analysis

A regression analysis was conducted on financial performance against agency cost, which was proxied by asset utilization and control variables: asset structure, advertising expenditure and debt structure. The regression equation was as follows:

$$Y_i = \beta_0 + \beta_1 X_{1i} + \beta_2 X_{2i} + \beta_3 X_{3i} + \beta_4 X_{4i} + \epsilon_i$$

Data for the variables above was generated for 52 companies trading continuously within the period of 5years for the year 2008 to 2012, listed in the NSE (Appendix i).

The data was subjected to regression analysis and the findings are discussed below :

Table 4.3 : Coefficients of the model

	Coefficients	Standard Error	Beta	t statistics	P-value	VIF
Intercept	0.230	0.037	.	6.300	0.002	
Agency Costs	0.020	0.011	-0.017	-0.150	0.882	1.043
Asset Structure	-0.061	0.026	-0.288	-2.332	0.024	1.148
Advertising Expenditure	0.051	0.003	0.266	2.401	0.020	1.121
Debt Structure	-0.219	0.044	-0.638	-5.026	0.001	1.304

Source : Research Findings

Table 4.3 above shows the numerical relationship between the independent variable and the controls variables in the following equation :

$$\text{Financial Performance} = 0.230 + 0.020 X_{1i} - 0.061 X_{2i} + 0.051 X_{3i} - 0.219 X_{4i}$$

The above equation indicates that when agency costs increases by one unit, financial performance increases by 0.02 units. When asset structure increase by one unit, financial performance decreases by 0.061 units. Whereas when advertising expenditure increases by one unit, financial performance increases by 0.051 units. When debt structure increases by one unit, financial performance decreases by 0.219 units.

4.4 Test of Significance

Coefficient of determination was used to determine the goodness of fit of the model, Durbin – Watson was computed to detect the presence of autocorrelation, Variance

Inflation Factor was calculated to quantify the severity of multicollinearity and Analysis of variance to test where or not the means are equal.

Table 4.4 : Model of summary of agency cost on financial performance

Regression Statistics	
Multiple R	0.668
R square	0.446
Adjusted R square	0.625
Standard Error	0.058
Durbin- Watson	1.623

Source : Research Findings

R^2 between the observed and modeled data values of the financial performance as seen in table 4.4 above, which indicated that predictor variables influenced 62.5% of variation in financial performance as indicated by the adjusted R square statistics 0.625. This meant that sixty two point five percent of the variation in the response variable can be explained by the explanatory variables. The remaining thirty seven point five percent can be attributed to unknown, lurking variables or inherent variability.

Autocorrelation was tested using Durbin- Watson value. From table 4.4 above, the value of Durbin- Watson was 1.623 hence there was no existence of autocorrelation since the statistics ranges in value zero to four, hence a value 1.623 indicates no autocorrelation.

Multicollinearity of the predictor variables was tested using variance inflation factor (VIF). It is the undesirable situation where the correlations among the independent variables are strong. It exists in the model if $VIF \geq 10$. From table 4.3 above, the VIF for agency costs, asset structure, advertisement expenditure and debt structure were 1.043, 1.148, 1.121 and 1.304 respectively. Multicollinearity was not in existence since all the VIF were less than 10.

Table 4.5 ANOVA for agency cost on financial performance

Model	Sum of Squares	Df	Mean Square	F	Significance F
Regression	0.181	4	0.033	6.447	0.005
Residual	0.113	47	0.003		
Total	0.294	51			

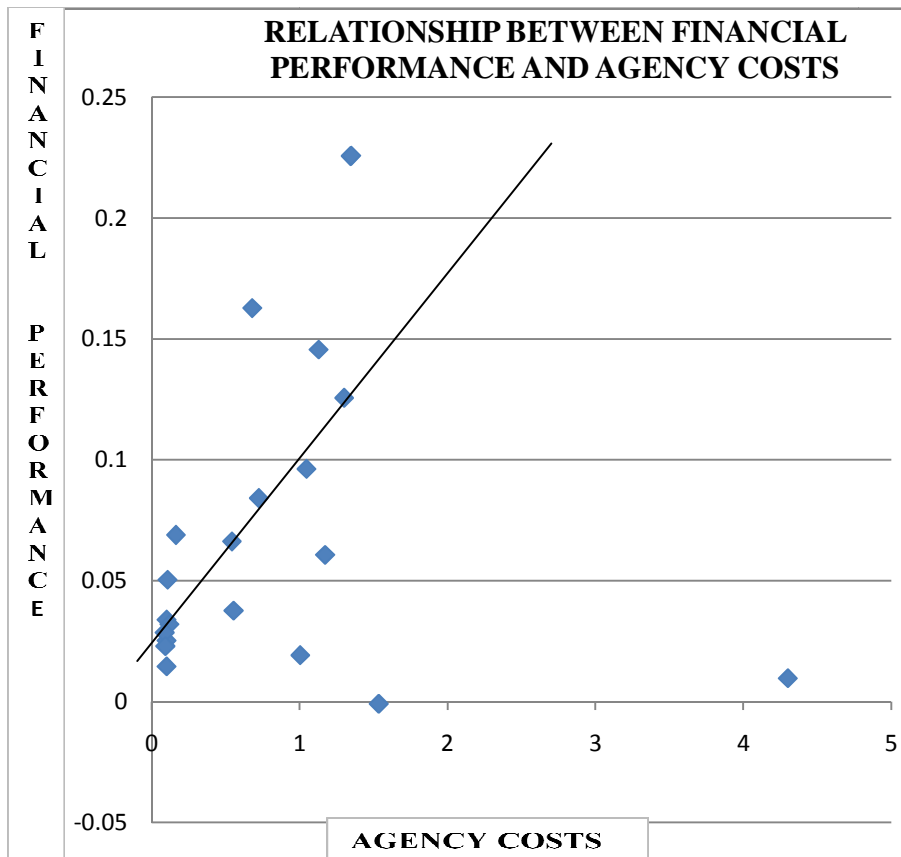
Source : Research Findings

Significance F from table 4.5 above indicates the usefulness of the overall regression model at 5% level of significance. Since the p-value of the F test is less than alpha that is $0.005 < 0.05$ it was concluded that there was a significant relationship between the dependent and independent variables used in the study.

Table 4.5 above clearly shows that the regression only accounted for 61.56%, which was the most dominant number of variations in agency costs, of 0.181 out of 0.294, and the rest, less dominant number of the variations being accounted for by other external factors which was 0.113 out of 0.294 accounting for 38.44%.

Graphically, the relationship between Financial Performance and Agency Costs was shown by figure 4.1 below. The figure indicates that the slope of the graph is positive hence there is a positive relationship between Financial Performance and Agency Costs.

Figure 4.1 : Relationship Between Financial Performance and Agency Costs



Source : Research Findings

4.5 Interpretation of Findings

The results indicated that there is a positive relationship between agency costs and financial performance, when agency costs increases by one unit, financial performance increases by 0.02 units. It is indicated that the predictor variables influenced a higher percentage of the variation in financial performance.

Durbin – Watson value was used to test autocorrelation between the variables, but since the range was between zero to four, it was concluded that there was no existence of autocorrelation. Variance inflation factor was used to test multicollinearity of the predictor variables. Since the value of VIF was less than 10, then it was concluded that there was no existence of multicollinearity among the predictor variables.

Significance F indicated that there was a significant relationship between the dependent and independent variables that were used in the study.

CHAPTER FIVE : SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter consists of summary of findings, conclusions of the study, limitation, recommendation and suggestions for further studies.

5.2 Summary

The objective of the study was to establish the relationship between agency costs and financial performance of firms listed at the Nairobi Securities Exchange that traded continuously within the period of 5years for the year 2008 to 2012. To achieve this objective, a regression analysis was conducted whereby financial performance was regressed against control variables which were: advertising expenditure, asset structure and the debt structure. NSE was the source of obtaining the raw data for both dependent and control variables.

The study found that in the model, agency cost influenced a significant variation of 61.56% in firm's financial performance as depicted by the adjusted R square of 0.181 out of 0.294. Hence the study found that agency costs to be significantly related to financial performance.

The study also found that there was no multicollinearity and autocorrelation among all the variables tested. Finally a positive slope graph was obtained showing a positive relationship between financial performance and agency costs.

5.3 Conclusion

The results indicated that agency costs significantly influenced financial performance of the firms listed in NSE.

5.4 Recommendations for Policy

This study concluded that the relationship between financial performance and agency costs was significant at the 5% level. The study recommended that since agency costs and financial performance are significantly related, decisions should take into account the implications of agency costs for the firms listed in NSE when taking financial decisions.

5.5 Limitations of the Study

The study was unable to obtain data from all the 60 companies listed in NSE, since only 52 firms were trading continuously within the period of 2008 to 2012. This study also used only four proxies of agency costs, whereas there are other possible agency cost surrogates which the study did not factor in.

This study is based on the findings and analysis of five years from 2008 to 2012, thus interpretations deviating from the findings of this research may occur if the period is outside the study period, or when a different research methodology is implemented.

5.6 Suggestions for Further Studies

Further investigation may be done to establish the effect of other agency costs surrogates on financial performance. In addition a study may be done to establish the effect of agency costs on other variables. There is need for future researcher to consider extending

the duration of observation for companies listed in the NSE. Further study in this area needs to include more independent variables such as those relating to management structures and consider including the Nairobi all share index (NASI).

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APPENDICES

Appendix i: Firms listed at the NSE that traded continuously within the period of 5years for the year 2008 to 2012

1. Athi River Mining
2. Bamburi Cement Ltd
3. Barclays Bank Ltd
4. Car and General (K) Ltd
5. Diamond Trust Bank Kenya Ltd
6. E.A.Cables Ltd
7. Equity Bank Ltd
8. Eveready East Africa Ltd
9. Housing Finance Co Ltd
10. KenGen Ltd
11. KenolKobil Ltd
12. Kenya Airways Ltd
13. Kenya Power & Lighting Co Ltd
14. Mumias Sugar Co. Ltd
15. Nation Media Group
16. NIC Bank Ltd
17. Pan Africa Insurance Holdings Ltd
18. Rea Vipingo Plantations Ltd
19. Scangroup Ltd

20. The Co-operative Bank of Kenya Ltd
21. TPS Eastern Africa (Serena) Ltd
22. Kakuzi Limited
23. Kapchorua Tea Company Limited
24. Limuru Tea Company Limited
25. Sasini Tea And Coffee Limited
26. Williamson Tea Kenya Limited
27. CMC Holdings Limited
28. Marshalls (EA) Limited
29. Sameer Africa Limited
30. CFC Stanbic Bank
31. Kenya Commercial Bank Limited
32. National Bank Of Kenya Limited
33. Standard Chartered Bank Kenya
34. Express Kenya Limited
35. Longhorn Kenya Limited
36. Standard Group Limited
37. Crown Paints Kenya Limited
38. East African Portland Cement
39. Total Kenya Limited
40. CIC Insurance Limited
41. Jubilee Holdings Limited
42. Kenya Reinsurance Corporation

43. Pan Africa Insurance Company Limited
44. Centum Investment Company (ICDCI)
45. Transcentury Limited
46. Boc Kenya Limited
47. British American Tobacco Kenya
48. Carbacid Investments Limited
49. East African Breweries Limited
50. Unga Group Limited
51. Accesskenya Group
52. Safaricom Limited