CORPORATE GOVERNANCE STRUCTURES AND PERFORMANCE IN FIRMS QUOTED IN THE NAIROBI STOCK EXCHANGE.

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BY

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Declaration

This research project report is my original work and has never been presented for a degree in any other university. No part of this research proposal may be reproduced without prior permission of the author and/or University of Nairobi

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Dedication

This research would not be possible without the loving support of so many people. I find myself overwhelmed in offering them all my thanks in dedicating this research to them. The following is not a hierarchy since each person made their own unique contribution and none could stand above others in that regard.

To my wife, Karen and children, Ronny and Kevin for giving me their unwavering support in countless ways, both direct and indirect. How do I say it, except: ***"Thank you, my love! "***

To my father, mother and stepmother. Dad has always believed that he is the most intelligent in the all family a fact that remain mystery as he can not even spell his name, William. My mom will always want her children to succeed in education. This is one person who mourned the removal of corporal punishment in Kenyan schools. She is a firm believer of "spare the rot and spoil the child. Unlike her boss, at least she can spell her first name, Emily. Even though she can neither write nor read, Alice, my step mom, has always encouraged me to read all what is there to be read.

To Bruno, Charles, Maluzi and Vlwanza for their unconditional assistance. I will not forget their tireless efforts in coordinating and organizing my work.

And last, but certainly not least, my special (but so inadequate) thanks to Riungu, Kijana, his sister and the many friends at NHIF and University of Nairobi who have been so supportive and encouraged the creation and the completion of this research.

Acknowledgement

Abstract

The aim of this research was to see if firms listed on the Nairobi Stock Exchange (NSE) change their corporate governance structures when experiencing performance declines. Several components of corporate governance including Chief Executive Officer (CEO) compensation, board composition, CEO and insider equity holdings, and frequency of board meetings are studied with reference to the financial performance of firms.

The study followed a cross-sectional survey design that sought to identify differences in governance structures between companies facing a decline in value and those with appreciating values, and those with stable values over the calendar years 2000, 2001, 2002, 2003, 2004 and 2005. The study used the four governance structures favoured by companies in sustained financial crises. This study targeted all 47 companies quoted on the NSE for the period of five years from the beginning of 2000 through 2005. The Tobin's Qs (or Book-to-Market ratios), for all listed companies were computed at the end of the calendar years 2000, 2001, 2002, 2003, 2004 and 2005. The Tobin's Q ratios served as the basis of examining the relationship between firms' performance and governance structures.

The findings established that there are positive relationships between listed firms' performance and frequency of board meetings, the ratio of outside directors to total directors, percentage of insider share ownership, and executive compensation. The study concluded that the way forward in examining corporate governance structures for Kenyan firms, perhaps, might be increasing the focus on shareholder interest and concerns, and identification of some widely accepted guiding principles, rather than trying to find some specific structures which are universally applicable, for effective corporate governance.

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List of Abbreviations

ANOVA	:	Analysis of Variance
B/M	:	Book to Market Ratio
CEO	:	Chief Executive Officer
CMA		Capital Markets Authority
DCF	:	Discounted Cash Flow
EVA	:	Economic Value-Added
NSE	:	Nairobi Stock Exchange
R&D	:	Research and Development
TRI	:	Total Shareholder Return Index
WACC	:	Weighted Average Cost of Capital

CHAPTER ONE

1.0 INTRODUCTION

1.1. Background to the Study

Few public policy issues have moved from the wings to centre stage as quickly and decisively as Corporate Governance. The rules of corporate governance specify the rights and obligations of the various claimants on the cash flows of business enterprises. Corporate governance issues arise because of the existence of agency problems that cannot be resolved through contractual solutions due to the high transaction costs (Hart 1995). These agency costs manifest themselves in the form of conflicts between investors and other claim holders on the firm's cash flows, on the one hand, and the managers and directors who have discretion over how the cash flows are used, on the other. This follows from the dominant model of corporate governance in law and economic s which considers a corporation as a compOled web or "nexus" of contractual relationships among the various claimants to the cash flows of the enterprise.

Among the many claimants on a firm's cash flows, equity shareholders have always claimed special attention may be because of the residual nature of their claims. Berle and Means (1932) paradigm of the separation of shareholders ownership and management's control explained that agency problems occur when the principal (shareholders) lacks the necessary power or information to motor and control the agent (Managers) and when the compensation of the principal and agent is not aligned.

Given the existing problems inherent in the corporate form, performance will be function of the quality of the corporate governance structures of the company (Weisbach, 1993). In an efficient capital market, investors will discount the price they are willing to pay for a company's shares by the expected level of managerial agency costs. It is therefore assumed that for a company to prosper it will choose a corporate governance structure that is efficient in minimizing agency costs.

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Virtually every major industrialized country as well as the Organization of Economic Co-operation and Development and the World Bank have made efforts in recent years to refine their views on how large industrial corporations should be organized and governed. Academics in both law and economics have also been intensely focused on corporate governance (Hermalin and Weisbach, 2003).

Corporate governance can be defined as the set of institutional arrangements affecting corporate decision making (Ball, 1998). Evans and Loh (2002, p.l) described corporate governance as "rules governing board structure, managers' and boards' incentive compensation, decision rights by the board and the CEO, succession of the board and CEO, share holding voting, debt/equity finance decisions as well as disclosure during takeovers."

During the last decade, the study of organizational decline and turnaround has been the subject of renewed interest. In their paper on corporate failures, Hambrick and D'Aveni (1988) reported that annual failure rates of large US firms grew from 1% during the 1967 to 1982 period to over 3% since 1985. The statistics indicate that successful turnarounds are difficult to achieve and the probability of failure is high for firms going through decline. Although corporate governance has long been considered an important aspect of corporate control, it is only in recent years that researchers have become directly concerned with the study of alternative governance structures and their impacts on performance. Several aspects of corporate governance including the form of executive pay and their composition of boards have been found to be associated with firs' strategic decisions and performance. An examination of firms in decline provides an ideal forum to analyze governance elements. Firms in decline face greater shareholder scrutiny and, it is speculated, are more likely to respond to this scrutiny with changes to their governance structures.

1.1.1. Corporate Governance Structures

Typical governance structures adopted by firms experiencing declining performance result in changes in; Board meeting frequency (Congen et al 1998); Board composition (Stapledon and Lawrence, 1996; Jense, 1997); insider share ownership (Morck, Shleifer, and Vishny, 1998): and executive compensation (Murphy, 1985; Conyon, 1997). Board meeting frequency potentially caries important governance

implications as it is less costly for a firm to adjust the frequency of its Board meetings to attain better governance of the firm, than to change the composition of its board or ownership structures. Vafeas (1999) found that meeting frequency was influential in improving operating performance in a manner consistent with the agency theory.

Studies on firm performance as a function of Blard composition yield mixed results (Baysinger and Butler, 1985). Bricley and James (1987) for example, found that the proportion of outside directors is significantly lower on boards of banks in states that restrict banking acquisitions, suggesting that outside directors play a role in evaluating takeover proposals. Weisbach reports that CEO turnover is more highly correlated withy firm performance in corporations having a majority of outside directors than in firms that have predominantly insider board. Further, Hermalin and Weisbach (1998) find that outsiders are more likely to join a board after a firm performs poorly or leaves an industry. Once inference may be the need for additional outside guidance in companies undergoing strategic shifts.

Berle and Means (1932) commented that where managers hold little equity in the firm and shareholders are too dispersed to enforce value maximization, corporate assets may be deployed to benefit mangers rather than shareholders. According to Jensen and Meckling (1976) the cots of deviation from value maximization decline as management ownership rises because converging interests. Consistent with the above, McConnel and Servaes (1990) found an inverted U-shaped relationship between Tobin's Q and managerial ownership. Numerous studies have identified a positive relationship between executive compensation and firm performance, although debate continues as to the exact size of this function. Using Australian data Evans and Stromback (1994) for example, found lower (and statistically insignificant) elasticity when compared with US studies.

1.1.2. The Nairobi Stock Exchange

NSE encourages the broader ownership of firms. The opportunity accorded the general public to have ownership rights over listed enterprises helps to reduce large income inequalities through the sharing of profits made by these enterprises, thereby facilitating the redistribution of wealth (Kibuthu, 2005). The Exchange facilitates improved corporate governance. Public companies tend to have better management

records than private companies because of the improvement of management standards and efficiency to meet the demands of shareholders and the NSE under its corporate governance rules (NSE, 2004). About two-thirds of the current listed companies are categorized as local companies, with the majority of shareholders being residents of Kenya or companies incorporated in Kenya under the Companies Act, while a third of the listed companies are categorized as foreign with the majority shareholders being companies incorporated and operating in a foreign country or with shareholders resident in a foreign country (NSE Handbook, 2005).

1.2. State of the Problem

Kenya has experienced a number of corporate failures in the recent past. Corporate failures are usually preceded by financial hardships and declining firm performance. These are the tell-tale signs that should provoke management and boards to take remedial measures to arrest the slide. In Kenya, successful turnarounds are rare, which begs the question whether or not proper and timely responses are employed by the board when the first signs of impending trouble are detected. One such change should target any weaknesses in corporate governance system in the firm. Wambua (2003) documented in general, the actions taken by companies facing rapid performance declines, Although the study did not directly focus on corporate governance, he reported that employee lay-offs was popular and was taken by 60% of the companies sampled.

In a recent study Mululu (2005) found that board activity is related to a number of corporate governance variables such as the board size, the number of executive directors, number of shares held by the largest shareholder, the number of shares held by directors, the number of shares by unaffiliated block holders, and the number of other directorships held by outside directors. More importantly, Mululu reported that boards increase the frequency of their meetings during financial crises. This study differed from Mululu's study in one important respect. While she employed multiple regressions with the attendant multi-collinearity problems the current study employed simple regression to rest the relationship between firm__value and board activity. Secondly, Mululu's study considered variables at same point in time

(contemporaneous), while the current study lags the board activity by one year: this is in order because corrective actions normally come after the advent of the problem.

Other prior research on corporate governance in Kenya focused mainly on compliance with the principles of the best governance practices, and surveys of the state of governance in various sectors, Jebet (2001) documented the corporate governance structures in listed companies; Kitonga (2002) studied the need for corporate governance in Kenya; Mwangi (2002) surveyed the corporate governance practices in the insurance industry; and Mwangi (2003) investigated the determinants of corporate governance practices. The aim of this research was to establish the relationship between performance of firms listed at the Nairobi Stock Exchange (NSE) and their corporate governance structures. Several components of corporate governance including Chief Executive Officer (CEO) compensation, board composition, CEO and insider equity holdings, and frequency of board meetings were studied with reference to the financial performance of firms.

1.3. Objective of the Study

To determine how corporate governance structures change in response to firm performance.

1.4. Hypotheses

To test the relationship of governance related structures to firms and performance, the following hypotheses were employed.

HI: There is a positive relationship between firm performance of preceding year and frequency of board meetings.

H2:   There is a positive relationship between the ration of outside directors to total directors and firm performance in a sample of firms experiencing declining performance.

H3:   There is a positive relationship between percentage of insider share ownership and firm performance

H4:   There is a positive association between executive compensation and firm performance.

1.5. Importance of the Study

The study results stand to inform academicians and researchers. The results of the study serve as a point of departure for further investigation in governance structures and systems. The findings will also stand to benefit regulators of financial markets in identifying the crucial aspects of corporate governance that should be emphasized in the governance matrix. The study is of benefit to the management boards of listing companies by giving guidelines on the key value-adding aspects of corporate governance structures.

CHAPTER TWO

2.0 LITERATURE REVIEW

2.1. Overview of Corporate Governance Structures

According to Tsui and Gul (2000), corporate governance structures including accounting and auditing standards are designed to monitor managers and improve corporate transparency. A number of corporate governance structures have been identified analytically and empirically. According to Agrawal and Knoeber (1996), the structures may be broadly classified as internal structures and external structures as summarized in Figure 1.

Figure1: **Corporate Governance structures** (Source: Adaptation from rendering of Agrawal and Knoeber, 1996 classification)
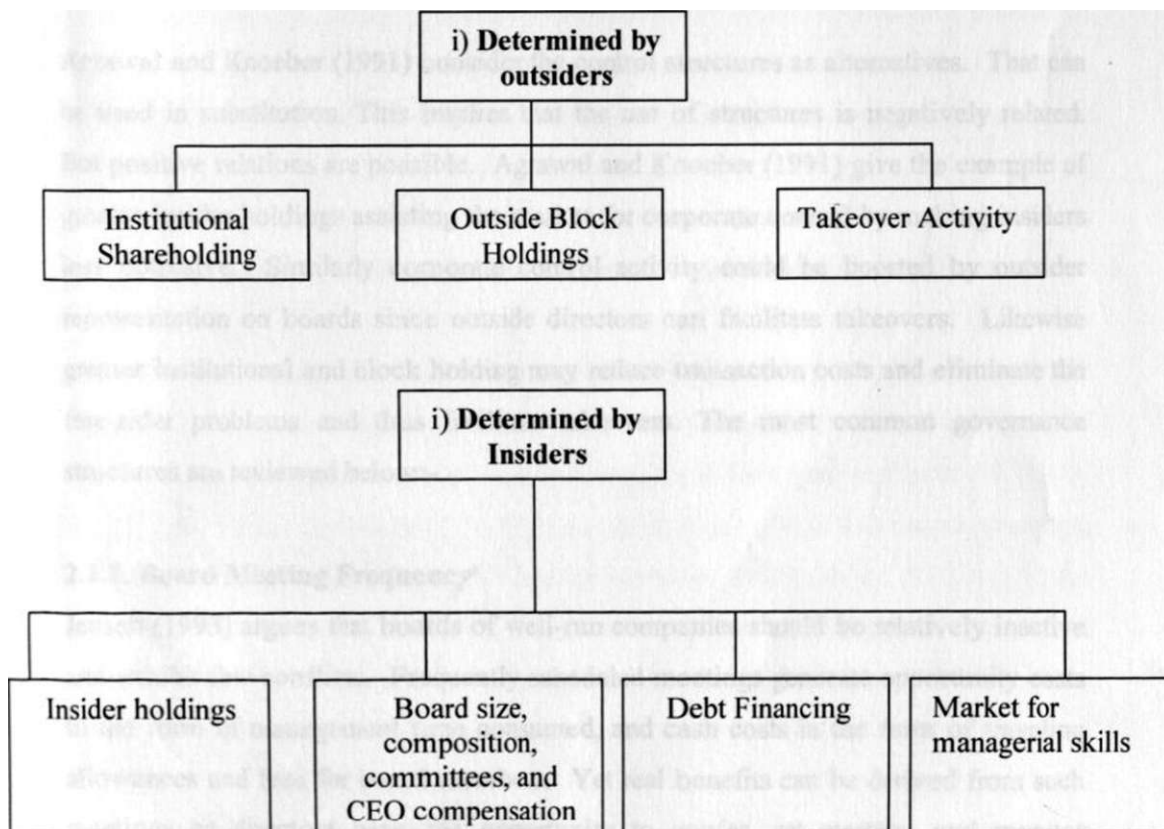
Agrawal and Knoeber (1996) identify seven control structures for the shareholder management agency conflict. Of the seven control structures, the use of four is decided by firm's internal decision makers and the use of three is determined by outsider partners.

Further, the structures can be distinguished by the source of the monitoring that takes place. The use of debt is internally determined and relies on the capital market for monitoring. The market for managers is externally determined and relies on prospective employers; the market for corporate control is determined externally and relied on prospective acquires; Insider shareholdings is determined internally and relies on inside owners; institutional shareholdings in externally determined and rely on institutional owners; block holding relies on large outside shareholders; and use of outside directors and on the board is internally determined and relies on these board members.

Agrawal and Knoeber (1991) consider the control structures as alternatives. That can be used in substitution. This implies that the use of structures is negatively related. But positive relations are possible. Agrawal and Knoeber (1991) give the example of greater insider holdings assisting the market for corporate control by making insiders less obtrusive. Similarly corporate control activity could be boosted by outsider representation on boards since outside directors can facilitate takeovers. Likewise greater institutional and block holding may reduce transaction costs and eliminate the free-rider problems and thus facilitate takeovers. The most common governance structures are reviewed below:-

2.1.1. Board Meeting Frequency'
Jensen (1993) argues that boards of well-run companies should be relatively inactive and exhibit few conflicts. Frequently scheduled meetings generate opportunity costs in the form of management time consumed, and cash costs in the form of traveling allowances and fees for board members. Yet real benefits can be derived from such meetings as directors have the opportunity to confer, set strategy and monitor management. Vafeas (1999), for instance found that meeting frequency was influential in improving operating performance in a manner consistent with agency theory.

Mululu (2005) Shows that boards increase the frequency of their meetings following poor performance and as consequence of such increase the performance of firms improve as captured by the increase in firm value giving support to Jensen (1993) and Vafeas (1999) that the role of boards becomes increasingly important during crises, when shareholders' interests are in visible danger. On the whole however, the association between meetings frequency and firm value remains unclear, and the linkage between board activity and monitoring difficult to establish.

2.1.2. Board Composition   X

For the Board to effectively play it oversight role of monitoring, some scholars argue that it should be composed of a majority of outside directors (Fama 1980). It is argued that outside directors will exhibit considerable independence from top management. There is evidence that supports effectiveness of Board independence. For example, Mace (1971) reports evidence that poor performance or poor proposals will be opposed by outside directors. Weishach (1988) found that outside dominated boards are significantly more likely to respond to poor performance by dismissing the CEO. Briclley et al (1991) also finds evidence suggesting that outside directoOr's act in the shareholders' interest in their decision in the adoption of poison pill provision. Brickley and James (1987), further, found that the proportion of outside directors is significantly lower on boards of banks in states that restrict banking acquisitions.

Hermalin and Weisbach (1998) found that outsiders are more likely to join the board after the firm performs poorly or leaves an industry, reflecting the need to inject new blood or procure expertise in the new industry. Both Coughlan and Schmidt (1985) and Warner, Watts, and Wruck (1988) examine the extent to which boards discipline managers found that poor firm performance increases the likelihood of change in the top management team. However, the relationship between firm performance and CEO turnover has been found to be fairly weak (Jensen and Murphy, 1990; Hermalin and Weisbach, 1998).

2.1.3. Insider Share Ownership

Berle and Means commented that where managers hold little equity in the firm and shareholders are too dispersed to enforce value maximization, corporate assets may be deployed to benefit managers rather than, shareholders. Managers in such situations may shirk, consume large amounts of perquisite, engage in empire building or make suboptimal investment and distribution decisions. To induce management not to engage in opportunistic behavior, measures need to be taken to align their interests with those o shareholders by making them part owners of the firm (Jensen and Meckling, 1976).

Consistent with the above, Morck, Shleifer and Vishny (1988) estimate a piecewise linear relation between board ownership and performance as measured by Tobin's Q and find that Tobin's Q increases with managerial ownership. Klein (1998) finds evidence that equity holdings are positively correlated to firm performance where at least one outside director owns 2% of the firm's equity. Mallete, Middlemist, and Hopkins (1995) argue that 'active defense of shareholders' interests may depend on the existence of directors whose personal interest compels them to actively monitor management activities.

Hermalin and Weisbach (1991) also noted a non-linear effect of insider shareholdings in the course of an analysis of board composition on firm performance. While these findings are mixed, the weight of the evidence implies that firms perform better when managers own a non-trivial fraction of the firm's shares.

2.1.4. Executive Compensation   /

Agency theory, argues that in the modem corporations, where ownership is dispersed and managers have access to superior information, mangers typically end up with the residual rights of control, giving them enormous latitude for self-interested behaviour. In order to counter such pursuits, one way is to grant a manager a highly contingent, long term incentive contracts ex-ante to align his interests with the interest of investors. Incentive contracts can take a variety of forms, including share ownership, stock options, or a threat of dismissal if income is low (Fama, 1980). The optimal incentive contract is determined by the mangers' risk aversion, the importance of his

decisions, and his ability to pay for the cash flow ownership upfront (Stiglitz, 1975; Homstrom, 1979, 1982).

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Jensen and Murphy (1990) arrived at a striking number that executive pay rises by about S3 per every $1000 change in the wealth of shareholders. Kaplan (1994) shows that the sensitivity of pay (and dismissal) to performance is similar to all companies in the United States. Several studies have identified a positive relationship between executive pay and firm performance. Evans and Stromback (1994), and Izan, Sidhu, and Taylor (1998) both supported a positive pay-performance relationship.

2.1.5. Large Block holders^

The most direct way to align cash flow and control rights of outside investors is to concentrate share holdings. This can mean that one or several investors in the firm have substantial minority ownership stakes, such as 10 or 20 percent. A substantial minority shareholder has the incentive to collect information and monitor the management, thereby avoiding the traditional free-rider problem. He also has enough voting control to put pressure on the management in some cases, or perhaps even to oust the management through a proxy fight or a takeover (Shleifer and Vishny, 1986). Large shareholders thus address the agency problem in that they both have a general interest in profit maximization, and control over the assets of the firm to have their interest respected.

The evidence on the role of large shareholders in exercising corporate governance is beginning to accumulate. According to Germany, Franks and Mayer (1994), large shareholders are associated with higher turnover of directors. Japan, Kaplan and Minton (1994) established that firms with large share holders are most likely to replace managers in response to poor performance than firms without them. In United States, Shivdasani (1993) showed that large outside shareholders increase the likelihood that firm is taken over.

2.1.6. **Takeovers (Market for corporate Control)**

Takeovers can be viewed as 'rapid fire mechanisms for ownership concentration' (Shleifer and Vishny, 1997, p. 756). In a typical hostile takeover, a bidder makes a tender offer to the dispersed shareholders of the target firm, and if they accept this offer, acquires control of the target firm and so can replace, or at least control, the management.

Substantial theory and evidence supports the idea that takeovers address governance problems (Jensen 1988; Scarfstein, 1988). Palepu (1985) shows that takeover targets are often poorly performing firms and their managers are removed once the takeover succeeds (Martin and McConnell, 1991). Jensen (1986, 1988) argues takeovers can solve the free-cash flow problem, since they usually lead to distribution of the firm's profit to investors over time. Takeovers are widely interpreted as the critical governance structures in the USA, without which managerial discretion cannot be effectively controlled (Easterbrook and Fischel, 1991; Jensen, 1993).

2.1.7. Large Creditors (debt financing)

Significant creditors, such as banks, have large investments in the firm, and want to see the returns on their investments materialize. Their power comes in part because of a variety of control rights they receive when firms default or violate debt covenants (Smith and Wamer, 1979) and in part because they typically lend short term, so borrowers have to come back at regular short intervals for more funds. As a result, banks and other large creditors are in many ways similar to the large shareholders.

Diamond (1984) presents one of the first models of monitoring by the large creditors. Kaplan and Minton (1994) document the higher incidence of management turnover in response to poor performance in companies that have a principal banking relationship relative to companies that do not. DeLong (1991) points to a significant governance role played by J.P. Morgan partners in the companies J.P. Morgan invested in the early 20[lh] century. Gilson (1990), report that U.S banks play a major governance role in bankruptcies, when they change managers and directors.

Weir, Laing and McKnight (2002) hypothesizes that debt financing is an internal governance structure whereby increased debt reduces free cash flow and so limits

managerial discretion. Debt requires managers to use any excess funds to service company's debts rather than engage in negative net present value projects.

2.2. Measures of Firm Performance

Several metrics are available for measuring the creation or destruction of shareholder value. Four of the most frequently used metrics are Tobin's Q. Total shareholder return index (TRI), Economic Value Added (EVA), and Cash Value Added (CVA).

Tobin's Q: This is the second measure applied in the measurement of a firm's financial performance. Theoretically, if a firm's investment opportunities earn a rate of return, r, equal to its cost of capital, k, (i.e. r=k), Tobin's Q ratio would be 1.0. That is, investors are indifferent in their expectations concerning the firm's growth opportunities. However, if r is greater than k, Tobin's Q would be greater than 1.0 indicating that investors have a positive outlook for the firm's future growth opportunities. The market prices of a firm's shares are based on management's ability to generate sustainable real returns on investments that exceed firm's real discount rate.

Tobin's Q compares the market value of the firm with the replacement cost of the assets implying that the greater the real return on investments the greater the value of Q. In contrast to the Book-to-Market (B/M) ratio, the impact of inflation is mitigated in the Q calculation by the use of the replacement cost of assets measured in constant shillings to measure the value created by the firm. The attractiveness of the Q ratio results from its ability to provide the estimate of a firm's intangible assets such as goodwill, future investment opportunities, market power and quality of management. Ranking firms on their Q values is similar to ranking them on the basis of changes in expected future cash flows.

Total Return Index (TRI): The index is a measure of the combined capital gain and dividend yield to investors. TRI is driven by a firm's free cash flow, asset growth and changes in profitability, all of which are prime determinants of firm's performance. The TRI is constructed using an annualized dividend yield as follows (see Evans, Evans, and Loh, 2002):

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Where:

	=	return index on day t
	=	return index on previous day
pi,	=	price index on day t
	=	price index on previous day
DY_t	=	dividend yield on day t
N	=	number of working days in a year (taken to 260)

Economic Value Added. This model was popularized by Stern Stewart & Company and is based on a company's accounts. Its mechanism which is accounting based simplifies to the following relationship:

EVA = Sales-Operating expenses-Tax-Financial requirements
Where

"Financial requirements" is calculated as defined capital multiplied with a suitable weighted average cost of capital (WACC).

Stewart has identified several errors made in accounting from investors' perspective. He advises that the errors be adjusted to stimulate cash flow. Examples of situations requiring adjustment are inventory costing and valuation, depreciation, revenue recognition, and capitalization and amortization of R&D, marketing, restructuring charges and acquisition premiums.

Cash Value Added (CVA).   Cash value Added represents value creation (destruction) from the shareholders point of view. Weissenrieder (1997) expresses it as an index as follows:

CVA index =   *Operating   cash flows*
Operating cash flows demandm arg in

Weissenrieder splits CVA index into four margins (in relation to sales)

$$\text{CVA Index} = \frac{operating\ surplus\ margin\ -\ Wcmarzin\ -\ nonstatezicinvestment\ arz\ in}{Operatingcashflowdemandm\ arg\ in}$$

These, together with sales, form the CVA's five major value drivers.

$$CVA = Sales\ \left(\frac{operatingsurplus}{Sales}\ -\ \frac{WCM}{Sales}\ -\ \frac{Nonstrategicinvestment}{Sales}\right)$$

(WCM = Working capital movement)

The CVA concept is solely based on cash flows.

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Research Design

This was a cross-sectional survey that sought to identify differences in governance structures between companies facing a decline in value and those with appreciating values, and those with stable values over the calendar years 2000, 2001, 2002, 2003, 2004 and 2005. The study used the four governance structures favoured by companies in sustained financial crises.

3.2 Population and Sample

This study targeted all companies quoted on the NSE for the period of five years from the beginning of 2000 through 2005. The number of companies listed declined from 54 to 47 mainly because of delisting not matched by new listings.

The Tobin's Qs (or Book-to-Market ratios), for all listed companies were computed at the end of the calendar years 2000, 2001, 2002, 2003, 2004 and 2005. Beginning at the end of 2001 all companies listed at the NSE were sorted into three groups based on the movement in their values over the preceding two years. The groups were designated as; (1) LOSERS, which comprised the stocks of companies with negative variation in the performance metric over the previous year; (2) WINNERS, comprising companies with positive variation in the performance metric over the previous year; and (3) MIXED, where the direction of variation over the previous year was not consistent at the end of the year according to their performance. The sorting was repeated at the end of 2002, 2003, and 2004.

For the cohort formed at end of year 2001, corporate governance structures were investigated as evident in 2002; For the cohort formed at end of 2002, relevant governance was documented at end of 2003; for the cohort of 2003 governance was investigated at end of 2004; and lastly for cohort formed at end of 2004, structures at end of 2005 were established. In sum consequences of two consecutive years' performance was studied one year later. The resulting data on the four cohorts were sorted into three categories of WINNERS, LOSERS, and MIXED. The cohorts were

consolidated so that only the three classifications of 'LOSERS', 'WINNERS', and 'MIXED' were left. The purpose of this was to look for companies that have experienced declining performance for a period of time i.e. those firms that had reported negative performance for two consecutive periods. For such firms, the researcher sought to test the probability that a certain corporate governance action was to be taken in the third year.

3.3. Variable Definition

3.3.1. Performance Decline

Several metrics are available for measuring the creation or destruction of shareholder value. The most commonly used metrics include discounted cash flow (DCF), return on invested capital (ROIC), economic value added (EVA), Total shareholder return index (TRI), and Tobin's Q. This study employs one of the above as proxies for financial performance, namely Tobin's Q.

3.3.2. Computation of Tobin's Q

To compute values for Q, where Q is defined as the market value of the firm divided by the replacement cost o the firm's assets, the methodology of Vogt (1994) was formed by first defining the variables as follows:

Market value of firm   =   Market value of ordinary shares +
                                                    Market value of preference shares + book value
                                                    of debt

Replacement cost of assets   =   Replacement value of plant and equipment +
                                                    Replacement value of inventory

3.4. Governance structures

3.4.1. Frequency of Board meetings

A board may appear independent in its structural attributes, but this will have no effect on monitoring if the board is quiescent. Given the difficulties in directly monitoring and measuring board activity, a surrogate measure is used being the regularity with which the board meets (number of board meetings held in the year).

3.4.2. Board size

The Companies Act is silent on the board size (it sets a minimum of 2 directors). The CMA guideline on corporate governance (2002 p. 125) however provides that

> *"The size of the board should not be to large to undermine an interactive discussion during board meetings or too small such that h inclusion of wider expertise and skills to improve the effectiveness of the board is compromised"*

Ultimately the size of the board is a product of the company's relationship with the environment in which it operates. Following Mululu (2005), board size in this study was treated as the number of directors sitting on the board at the annual general meeting as reported in the annual report.

3.4.3. Board composition

The CMA corporate governance guidelines (2002) propose that a balanced board constitutes an effective board. It therefore requires that the independent and non-executive directors should form at least one third of the membership of the board to ensure that no individual or group of individuals dominate the board's decision-making processes. In this study, **outsider directors** (non-executive and independent) were measured by their proportion on the board.

3.4.4. Insider share ownership

Insider ownership refers to the proportion of equity held by insiders. As insider ownership rises insiders have incentives to work diligently to enhance the value of the company. For the purposes of this study, insider ownership was considered as the proportion of common stock beneficially owned by all officers and directors as measured in percentage points.

3.4.5. Executive compensation

Many studies have shown that there is a positive relationship between executive compensation and performance of the firm (Kaplan 1994). Mace (1972) suggests that one reason for the passivity and the lack of involvement by directors is that the relatively modest compensation provides limited monetary incentive to devote time and energy to the company. If compensation pay is sensitive to performance we expect lower pay to CEO of poorly performing firms. In this study executive compensation was associated with the CEO's salary and bonuses.

3.5. Data Analysis

The data collected was analyzed using two approaches.

I.   Descriptive statistics were computed for the WINNERS and LOSERS over the test period for all the governance variables. Tests for significant differences in the means for the two groups were then computed. This sought to provide evidence (or otherwise) to hypothesized relationships between corporate governance structures and decline in firm value. Specifically to establish whether;

        a) Board meetings in distressed firms are more frequent;

        b) Outsider directors make a bigger proportion of distressed firm's boards;

        c) Insider ownership rises for distressed firms;

        d) And whether executive compensation is lower for poorly performing firms.

II.   Regression analysis was then applied to cross-check the conclusion reached in the first approach. A regression model was specified relating each of the four corporate governance structures to the value of the firm as proxied by the Tobin's Q or Book-to-Market ratios.

        a) To test the hypothesized relationship between firm performance the frequency of board meetings (HI), the model as specified below was applied. Following Vafeas (1999) the variable board size, reflecting number of directors on the board was included (See equation 2).

$$Log(Meetings)_{it} \; = \; \alpha_{i,t} \; + \; \beta_1 \pounds ?_{i,t} \; + \; p_2 Log\{Boardsize\}_{it-1} \qquad (2)$$

Where:

$Log\ (Meetings)_{it}$	Logarithm of number of meetings held in year t
Q_{it}	Tobin's Q of firm I for year t
$Log\ (Board\ size)_{it}$	Log of the board size.

b) The firms were classified into three categories. Those where the non-executive directors were less than 40% of the board were considered as insider dominated. Firms were classified as outsider dominated where non-executive directors constitute greater than 60% of the board. Mixed boards are those where non-executive directors constituted between 40-60% of the board. To directly test the relationship between board composition and firm performance **(H2),** the following empirical specification was used (Equation 3).

$$Q^{\wedge}ft + frLogiOutside)^{\wedge} \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots(3)$$

Where:

$Q_{,,}$	=	Tobin's Q of firm i for year t
Log (Outsidej,-,./	=	ratio of outside non-executive directors to the total number of directors lagged one year.

c) To test the relationship between the percentage of insider share ownership and firm performance **(H3),** a stepwise linear regression for each year as described by Morck et al., (1988) was estimated (Equation 4).

$$Q = \qquad fi_iLog(a) + \qquad fi_2Log(b) + fi_3Log(c)\dots\dots\dots\dots(4)$$

Where:

Q= Tobin's Q

P_i = Coefficient that captures the effects of insider ownership <5%

p_2 = Coefficient that captures the effects of insider ownership 5 %< 02 < 25%

p_3 = coefficient that captures the effects of insider ownership >25%

d) Least squares regression was used to test the relationship between executive remuneration and firm performance **(H4).** The model to used was as expressed in equation (5):

$$\{CEOREMl = \qquad + {}^{\wedge}(REVENUE),.,\dots\dots\dots\dots\dots\dots\dots(5)$$

Where:

(CEOREM)j,	=	log of executive remuneration (salary + bonus)
$Q_{i,.i}$	=	Tobin's Q lagged one year.
(REVENUE)jt-**i**	=	log of annual revenue lagged one year.

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CHAPTER FOUR

4.0 DATA ANALYSIS AND PRESENTATION

4.1. Introduction

This chapter presents the data analysis, interpretation, and discussion of the research findings. The chapter is organized as follows: section 4.2 presents descriptive statistics on the governance structures of the firms listed at NSE (2000-2005) which also entails the tests of hypotheses on the relationship between the governance structures and performance of firms listed at the NSE.

4.2. Governance structures of the NSE listed firms

Beginning at the end of 2001 all companies listed at the NSE were sorted into three groups based on the movement in their values over the preceding two years. The groups were designated as; (1) LOSERS, which comprised the stocks of companies with negative variation in the performance metric over the previous year; (2) WINNERS, comprising companies with positive variation in the performance metric over the previous year; and (3) MIXED, where the direction of variation over the previous year was not consistent at the end of the year according to their performance over the preceding two years. The sorting was repeated at the end of 2002, 2003, and 2004.

The findings on Table 4.1 indicate that in the year 2000, majority of the firms (93%) displayed 'mixed' performance metrics in the stocks when compared to the values in the years 1999, and 1998. Only one firm had improved performance in 2000. In the year 2001, majority of the firms (72.7%) were 'losers', which is evidenced by the declined performance metrics in their stocks as compared to the year 2000. Ten of the firms (representing 22.7%) were 'winners' in 2001 with only two firms manifesting 'mixed' performance in stocks. In 2002, the level of performance amongst firms increased considerably with the number of 'winning' firms increasing from 22.7% in 2001 to 53.3% in 2002, and further hitting the all time high of 81.4% in 2003. The proportion of 'losing' firms also decreased from 33.3% in 2002 to 11.6% in 2003. The number of 'winning' firms decreased to 72.7% in 2004 while the number of 'losing' firms rose to 25% in 2004 up from 11.6% in 2003.

Table 4.1: Performance characteristics of the listed firms (2000-2004)

YEAR	Performance	Descriptive Statistics	
		n	**%**
2000	Winner	1	2.3%
	Loser	2	4.7%
	Mixed	40	93.0%
	Total	**43**	**100.0%**
2001	Winner	10	22.7%
	Loser	32	72.7%
	Mixed	2	4.5%
	Total	**44**	**100.0%**
2002	Winner	24	53.3%
	Loser	15	33.3%
	Mixed	6	13.3%
	Total	**45**	**100.0%**
2003	Winner	35	81.4%
	Loser	5	11.6%
	Mixed	3	7.0%
	Total	**43**	**100.0%**
2004	Winner	32	72.7%
	Loser	11	25.0%
	Mixed	1	2.3%
	Total	**44**	**100.0%**

The One-Way ANOVA procedure produces a one-way analysis of variance for a quantitative dependent variable by a single factor (independent) variable. Analysis of variance is used to test the hypothesis that several means are equal. One-way analysis of variance (One-way ANOVA) was used to establish the relationship between board meetings and performance; proportion of outsider directors and performance; insider ownership and performance; and the relationship between executive compensation and performance. This was based on the test of the following hypotheses respectively: Board meetings in distressed firms are more frequent; Outsider directors make a bigger proportion of distressed firm's boards; Insider ownership rises for distressed firms; and whether executive compensation is lower for poorly performing firms. 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 the critical levels of significance of the test (usually fixed at 5%). The findings of Table 4.2 indicate that the p-values were greater than 0.05 for all four categories thus leading to the conclusion that there are no significance differences in the mean values of each of the

four variables and performance of the listed firms (factored between 'WINNERS' and 'LOSERS').

Table 4.2: One-way ANOVA tests for Governance structures Amongst Listed Firms

		Sum of Squares	d.f.	Mean Square	F	Sig.
No. of board meeting held in a year	Between Groups	7.951	1	7.951	1.287	0.258*
	Within Groups	1019.127	165	6.177		
	Total	1027.078	166			
No. of non-executive directors	Between Groups	0.165	1	0.165	0.068	0.794*
	Within Groups	397.740	165	2.411		
	Total	397.904	166			
Percentage of shareholding held by directors and other officials	Between Groups	82.933	1	82.933	0.294	0.588*
	Within Groups	46550.079	165	282.122		
	Total	46633.012	166			
Salaries and bonuses to the CEO	Between Groups	74453927735077.4	1	74453927735077.4	2.001	0.159*
	Within Groups	6138859443052030	165	37205208745769.930		
	Total	6213313370787110	166			

Notes: * P-value > 0.05

Regression analysis was then applied to cross-check the conclusion reached in the One-way ANOVA approach. A regression model was specified relating each of the four corporate governance structures to the value of the firm as proxied by the Tobin's Q or Book-to-Market ratios. To test the hypothesized relationship between firms' performance and the frequency of board meetings (HI), the model of equation (2) was applied with the variable board size, reflecting number of directors on the board was included (Vafeas, 1999). The findings are presented in Table 4.3 below. The findings indicate that the test statistics obtained led to acceptance of the null hypothesis hence there is a positive relationship between firm performance of preceding year and frequency of board meetings.

Table 4.3: Relationship between performance and frequency of board meetings

Model: $Log(Meetings)_{it} = a_{,,\_,} + /?,(?_{,,\_,} + P_l Log\{Boardsize)_{i,\_x}$			
Variable	**T-statistic**	**P-Values (5%)**	**Decision**
Constant	29.419	0.000	Reject **Ho**
Q_it-1	-0.492	0.623	Accept **Ho**
LN_(Boardsize)_it-l	0.486	0.628	Accept **Ho**

Notes: Dependent Variable: Natural Log of Board Meetings;
H_0: There is a positive relationship between firm performance of preceding year and frequency of board meetings.

To test the relationship between board composition and firm performance **(H2),** the empirical specification of equation (3) was used. The firms were first classified into three categories. Those where the non-executive directors were less than 40% of the board were considered as insider dominated. Mixed boards were considered as those where non-executive directors constituted between 40-60% of the board. Firms were classified as outsider dominated where non-executive directors constituted greater than 60% of the board. The proportions of the insider-dominated and mixed boards were eliminated during the regression procedures of equation (3). The findings are documented in Table 4.4 below. The findings indicate that the test statistics obtained led to acceptance of the null hypothesis that there is a positive relationship between the ration of outside directors to total directors and firm performance in a sample of firms experiencing declining performance.

Table 4.4: Relationship between firm performance and ration of outside domination

Model: $Q_{it} = $ $+ p_2 Log\{Outside)_{it\_x}$			
Variable	**T-statistic**	**P-Values (5%)**	**Decision**
Constant	-0.324	0.750	Accept Ho
LN_(outside)_it-l	0.689	0.499	Accept Ho

Notes: Dependent Variable: Tobin's Q (Q_it);
H_0: There is a positive relationship between the ration of outside directors to total Directors and firm performance in a sample of firms experiencing declining performance.

To test the relationship between the percentage of insider share ownership and firm performance **(H3),** a stepwise linear regression for each year as described by Morck et al., (1988) was estimated using the empirical model of Equation (4). The findings established that there were only two categories of insider ownership namely: firms with insider ownership of between 5% and 25%; and firms with insider ownership of above 25%. The findings are documented in Table 4.5 below. The findings indicate that the test statistics obtained led to acceptance of the null hypotheses for the two categories of insider ownership in the years 2000 to 2004. This leads to the conclusion that there is a positive relationship between the percentage of insider share ownership and firm performance.

Table 4.5: Relationship between firm performance and Percentage of Insider ownership

$$\text{Model: } Q = 0_l Log\{a\} + /3_2 Log\{b\} + faLog\{c\}$$

YEAR	% of Insider ownership	t-Statistics	P-values (5%)	Decision
2000	5%-25% *(Ji₂)*	-0.275	0.787	Accept Ho
	Above 25 %*{J1ⱼ)*	-1.433	0.165	
2001	5%-25% *(Jh)*	0.486	0.634	Accept **Ho**
	Above 25%*(flⱼ)*	-0.297	0.769	
2002	*5%-25%(/h)*	0.878	0.393	Accept **Ho**
	Above 25 %*(/Jⱼ)*	-1.021	0.317	
2003	5%-25%(/ty	-0.059	0.954	Accept **Ho**
	Above 25%(/7j)	-1.830	0.079	
2004	5%-25 %*{/h)*	0.312	0.759	Accept **Ho**
	Above 25%(//j)	-1.309	0.203	

Notes: Dependent Variable: Tobin's Q (Q„)
Ho: There is a positive relationship between the percentage of insider ownership and Firm performance
P1 = Coefficient that captures the effects of insider ownership <5%
(32 = Coefficient that captures the effects of insider ownership 5 %< P2 < 25%
P3 = coefficient that captures the effects of insider ownership >25%

Least squares regression was used to test the relationship between executive remuneration and firm performance **(H4).** The empirical model used was as expressed in equation (5). The findings are documented in Table 4.6 below. The findings indicate that the test statistics obtained led to acceptance of the null hypothesis that there is a positive relationship between executive compensation and firm performance.

Table 4.6: Relationship between firms' performance and Executive Compensation _ _

Model: {CEOREM)„ = /?,£>,,_, + {REVENUE) ^			
Variable	**T-statistic**	**P-Values (5%)**	**Decision**
Constant	34.990	0.000	Reject Ho
Qit-i	-1.954	0.054	Accept Ho
(REVENUE)it-i	8.018	0.000	Reject Ho

Notes: Dependent Variable: salaries and bonuses to the CEO (CEOREM);
Ho: There is a positive relationship between executive compensation and firm performance.

CHAPTER FIVE

5.0 CONCLUSIONS AND RECOMMENDATIONS

5.1. Introduction

This chapter presents the summary and description of findings derived from the study. The chapter also details the conclusions and recommendations as well as recommendations for further research.

5.2. Conclusions

The findings of the study have established that there are positive relationships between listed firms' performance and frequency of board meetings, the ration of outside directors to total directors, percentage of insider share ownership, and executive compensation. This implies the following: Firstly, firms where the boards meet more frequently exhibit improved performance than firms where the boards meet rarely; Secondly, firms that are outsider-dominated (where the ratio of non-executive directors is greater than 60%) exhibit improved performance than firms with mixed boards (40-60% domination) and insider-dominated (up to 40% domination); Thirdly, firms with insider shareholding levels of greater than 5% exhibit improved performance over the years; and fourthly, listed firms that pay high salaries and bonuses to the executive exhibit improved performance. Therefore, good board practices are important catalysts of financial performance for corporations. Good corporate governance practices on the other hand are of utmost importance in contributing to investor confidence in the companies. Adoption of sound corporate governance practices is therefore significant for the continued success of businesses.

While there is increasing evidence of the failure of certain governance structures to control and motivate managers to increase firm performance, the empirical evidence gathered from this study is mixed and gives little coherent evidence for the shape of an optimal governance structure. One explanation is that existing theories have not been sufficiently complete to include all major determinants of good corporate governance. Perhaps there will never be one optimal governance structure because no two firms, two markets, two legal-regimes or two cultures are exactly the same, resulting in highly complex issue of corporate governance. Ultimately governance structures are determined by a combination of the above factors and their dynamics.

The way forward in examining corporate governance structures for Kenyan firms, perhaps, might be increasing the focus on shareholder interest and concerns, and identification of some widely accepted guiding principles, rather than trying to find some specific mechanisms which are universally applicable, for effective corporate governance.

5.3. Recommendations

5.3.1. To the Management Boards of Listed Firms

Institutional investors typically view a well-governed company as one that has a majority of outside directors with no management ties to its board, undertakes formal evaluations of directors, and is responsive to requests from investors for information on governance issues. To ensure improved performance of firms, the study recommends that the boards should seek to achieve the following: Improve on executive compensation; Meet more regularly; ensure that the directors hold significant shareholdings in the company, and a large part of their pay should come in the form of stock options; and increase the existing ration of outsider-domination.

5.3.2. For Further Research

Given the findings of the study, further research may be conducted to establish the firms' corporate governance needs. This study focused on firms listed at the NSE. However, there are other non-listed firms which are family-owned or owned by groups of persons. More in-depth empirical study on the merits and demerits of family ownership structure and how it impacts on firm value should be conducted. May be the resource dependency theory can better explain the success of such companies. There is also a need to establish how corporate governance may evolve in these companies and what can be done to better align the interest of controlling family ownership and other shareholders.

The study also focused on the pool of listed firms irrespective of the segment of listing at the NSE. In comparison amongst different listing sectors, further empirical research may be conducted to establish the effects of governance structures on corporate performance for firms in the main investments segment, financial and inyestment^gmcnts, agricultural segments, and industrial & allied segments. This

will shed more light on the effect of the governance structures on firms in each of these categories. This study used only four variables: frequency of board meetings, executive compensation, insider/outsider domination, and insider shareholding levels. Future research studies may seek to incorporate other corporate governance issues such as corporate financial policies, blockholders and institutional investors.

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Appendix I: Firms Listed at NSE

J.   ABaumann & Co.Ltd
2. Athi River Mining
3. B.O.C Kenya Ltd
4. Bamburi Cement Ltd
5. Barclays Bank Ltd
6. British American Tobacco Kenya Ltd
7. C.F.C Bank Ltd
8. Car & General (K) Ltd
9. Carbacid Investments Ltd
10. City Trust Ltd
11. CMC Holdings Ltd
12. Crown Berger Ltd
13. Diamond Trust Bank Kenya Ltd
14. E.A.Cables Ltd
15. E.A.Portland Cement Ltd
16. Eaagads Ltd
17. Equity Bank Ltd
18. Express Ltd
19. Housing Finance Co Ltd
20. Hutchings Biemer Ltd
21. I.C.D.C Investments Co Ltd
22. Jubilee Holdings Ltd
23. Kakuzi
24. Kapchorua Tea Co. Ltd
25. Kenya Airways Ltd
26. Kenya Commercial Bank Ltd
27. Kenya Oil Co Ltd
28. Kenya Orchards Ltd
29. Kenya Power & Lighting Ltd
30. Limuru Tea Co. Ltd
31. Marshalls (E.A.) Ltd
32. Nation Media Group
33. National Bank of Kenya Ltd
34. NIC Bank Ltd Ord
35. Olympia Capital Holdings ltd
36. Pan Africa Insurance Holdings Ltd
37. Rea Vipingo Plantations Ltd
38. Sameer Africa Ltd
39. Sasini Tea & Coffee Ltd
40. Scangroup Ltd
41. Standard Chartered Bank Ltd
42. Standard Group Ltd
43. Total Kenya Ltd
44. TPS Eastern Africa (Serena) Ltd
45. Uchumi Supermarket Ltd
46. Unga Group Ltd
47. Unilever Tea Kenya Ltd
48. Williamson Tea Kenya Ltd
49. East African Breweries Ltd
50. KenGen Ltd.
51. Mumias Sugar Co. Ltd

Source: NSE/CMA Research Departments (2006)