THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND FIRM PERFORMANCE IN THE CASE OF NAIROBI STOCK MARKET

BY

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OCTOBER 2012
DECLARATION

I declare that this is my original work and to the best of my knowledge has not been submitted for a degree award in any other university or institution of higher learning.

Signature................................................ Date........................................

Wilson Kipng’eno Chirchir
D61/P/8454/2003

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

Signature................................................ Date........................................

Supervisor: Dr. Josiah O. Aduda
DEDICATION

I dedicate this work to my late Grandmother Mrs. Tapranyei Sang who, despite not having gone to School, ensured that I completed my High School. Her ideals continue to inspire me each day of my life.
ACKNOWLEDGEMENT

My first gratitude and acknowledgement goes to the Almighty God from Whom all good things come.

This work is a synergistic outcome of many minds. It began in 2004 when I bumped into a Mr. Samuel Kipngetich Rotich of the Communications Commission of Kenya (CCK) who introduced me to the MBA Programme at the University of Nairobi. I am indeed grateful to the inspiration and wisdom of many thinkers for the trans-generational sources and root of wisdom, among them my Supervisor Dr. Josiah O. Aduda.

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I thank the Board, Management and the staff of the Capital Markets Authority and Nairobi Securities Exchange for assisting me with access to data.

For the development and production of this Research Project itself, I feel a deep sense of gratitude to Ednah and each of our five children: Chepngetich, Kipkorir, Kipng’etich, Chemutai, and Kiplang’at.

To all involved in this Project, I give a big “Thank You”. May God bless you.
ABSTRACT

This study analyzed the performance of firms listed on the Nairobi Securities Exchange (NSE) and active for the years 2006 to 2010. A total of 232 observations were taken for firms whose data was available. Performance was measured using the accounting Return on Assets and the market-based Tobin’s Q ratio. Data was analyzed using dynamic panel data with Ordinary Least Squares estimation applied to investigate the significance of the overall models for relationship between performance and the corporate governance. ANOVA results generated from the OLS estimation were used to test the overall significance of the model while correlation analysis was done for the relationship between performance and the individual corporate governance variables.

The study found that firms sampled had a high level of board independence (72.25%). Firms had a mean size of 6.62 for independent directors and 2.41 for non-independent directors. The mean size for directors was 8.29 with standard deviation of 3.41 representing a wide variation in size of boards. The study also found a wide variation in corporate performance as measured by both the ROA and the Tobin’s Q.

The study found a positive, though low correlation between firm performance and board independence. The overall quality of the boards was also found to be low (30.71%). However, the study found a positive and statistically significant relationship between the quality of the board and board independence. This implies that the effectiveness of corporate governance appears to increase with an increase in board independence.

Overall, however, the study did not find any significant relationship between performance and corporate governance variables. It was suspected that the lack of the expected significant relationship may have been caused by the confounding impact of the unexpected turmoil that affected the macroeconomic and political environment in the country and which negatively affected Kenyan industry during the period under study. This arose from the significant impact of violence in the period 2007-2008 arising from political violence and which had wide (and negative) ramifications on corporate performance for subsequent years up to 2010.
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<td>CEO</td>
<td>Chief Executive Officer</td>
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<tr>
<td>CFO</td>
<td>Chief Finance Officer</td>
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<td>CGI</td>
<td>Corporate Governance Index</td>
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<td>CMA</td>
<td>Capital Markets Authority</td>
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<td>G- Index</td>
<td>Governance index</td>
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<td>GOK</td>
<td>Government of Kenya</td>
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<td>IRRC</td>
<td>Investor Responsibility Research Center</td>
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<td>NED</td>
<td>Non-Executive Directors</td>
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<td>NSE</td>
<td>Nairobi Securities Exchange</td>
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<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
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<td>OLS</td>
<td>Ordinary Least Squares</td>
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<td>PRSCG</td>
<td>Private Sector Corporate Governance Trust, Kenya</td>
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<td>ROI</td>
<td>Return on investment</td>
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<td>ROE</td>
<td>Return on equity</td>
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CHAPTER ONE: INTRODUCTION

1.1 Background to the Study

Firm performance is a subjective measure of how well a firm can use assets from its primary mode of business to generate revenues. There are many different ways to measure firms’ performance, but all measures should be taken in aggregation. Line items such as revenue from operations, operating income or cash flow from operations can be used, as well as total unit sales. Furthermore, the analyst or investor may wish to look deeper into financial statements and seek out margin growth rates or any declining debt.

Quantitative measures of firm performance include profitability measures such as gross margin, net margin for example return on sales, return on equity, economic value added, return on equity less cost of equity, return on capital employed, cash flow measures such as free cash flow over sales, and growth measures such as 1-, 3-, 5- and 10-year historical revenue growth. Ideally, forward-looking measures such as expected profitability, cash flow and growth should be used to measure a firm’s performance because the current operating conditions (such as number of hierarchical levels or organization form) will influence future performance (Kumar, 2003).


The Nairobi’s Securities Exchange is licensed and regulated by the Capital Market Authority (CMA). It has the mandate of providing a trading platform for listed securities and overseeing its member firms. It is a market for shares and stocks.
At the moment there are fifty eight (58) companies listed on the Nairobi Securities Exchange. Prices quoted for Stocks and Shares of the listed companies of the Nairobi Securities Exchange gives an indication of the financial soundness of the listed firms. Nairobi Securities Exchange is a very vibrant Market in the East African Region.

Effective corporate governance is critical to firm performance and by extension shareholder value and especially so after the high profile corporate collapses and scandals such as Enron, WorldCom and others in the US, serving as an impetus to such recent U.S. regulations as the Sarbanes-Oxley Act of 2002, considered the most sweeping corporate governance regulation in the past 70 years (Byrnes et al., 2003), the main object of the Act being to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws and other purposes. Others are Parmalat in Italy, Marcos10b & Fortune and Baby Doc of Haiti. Back in Kenya, the collapse of Uchumi Supermarkets, Kenya-United Insurance, Lake Star Insurance, Goldenberg, Kenren and Anglo-Leasing scandal clearly point out on the need for good corporate governance. Corporate governance has succeeded in attracting a good deal of public interest because of its apparent importance for the economic health of corporations and society in general. Corporate governance is about the exercise of power over corporate entities. It has become one of the central issues in the running and regulating of modern enterprise today. However, the underlying ideas and concepts of corporate governance have been surprisingly slow to evolve.

In its broadest sense, corporate governance refers to a complementary set of legal, economic, and social institutions that protect the interests of a corporation's owners. According to La Porta et al. (2000), corporate governance is to a certain extent a set of mechanisms through which outside investors protect themselves.

Corporate governance can influence a firm's performance whenever a conflict of interest arises between management and shareholders and/or between controlling and minority shareholders. In the management-shareholder conflict, the agency problem manifests itself in management’s low effort and unproductive investments, usually known as
perquisites. In the controlling-minority shareholder conflict, controlling shareholders use their power to benefit themselves at the expense of the minority shareholders, in what is called expropriation or private benefits of control. The root of both conflicts is the fact that the manager in the first case, and the controlling shareholders in the second case, receives only a portion of the firm's net revenue, while they fully appropriate the resources diverted.

Thus, it is conceivable that, in light of this incentive structure, insiders will maximize their (pecuniary and non-pecuniary) utility even when the firm as a whole will not. Of course, the ability to fulfill these goals is conditioned on the power insiders have in the company's decision-making process. Managers will enjoy more power as they are part of the board or act in connivance with the board and the controlling shareholders.

In turn, the power of controlling shareholders relies on how effectively they can manipulate board decisions by way of voting majorities and other means; distortionary policies will then increase as the ratio of voting to cash flow rights is higher (see La Porta et al., 1999, and Valdes, 1997).

Outsiders have two main instruments to counterbalance this power: the enforcement of adequate corporate governance standards and the quality of the regulatory and legal environment, which should discourage detrimental actions by insiders and, once committed, allow affected stakeholders to challenge them through corporate and judicial channels. According to Cremers & Nair, 2005, the principal-agent relationship may be reflected in management pursuing activities which may be detrimental to the interest of the shareholders of the firm.

Corporate governance exists as a mechanism for dealing with the separation of ownership and control, and the agency problems and conflicts of interests it creates. At the center of corporate governance functionality is the monitoring function of the board of directors on behalf of shareholders as the latter themselves would find it difficult to exercise control due to wide dispersion of ownership of common stock. This problem in monitoring is
endemic to most large corporations with diffuse ownership, because an individual shareholder lacks sufficient stake in the firm to justify spending resources to closely monitor managers. This leads to a free rider problem, as shareholders, individually, attempt to free ride on others to monitor managers.

To address this market failure, governments create oversight authorities to regulate the financial market. For the particular case of Kenya, the Capital Markets Authority embraced international trend in corporate governance reform and issued corporate governance guidelines and principles for best practice for which listed companies are required to comply. It was also in recognition of the role of good governance in corporate performance, capital formation and maximization of shareholders value as well as protection of investors’ rights (CMA Act, 2002).

International evidence on the subject has greatly increased in the last few years. La Porta et al. (2002) are prominent efforts in proving the nexus between corporate governance and performance using cross-country data, while other studies look at individual countries, such as the United States, South Korea and Germany (Factor, 1996). By aiming to analyze the relationship between corporate governance and firm performance (as measured by the return on assets and Tobin’s Q) in Kenya in 2006-2010 the present study forms part of the latter country-level line of research. Corporate governance lacks any form of coherence, either empirically, methodologically or theoretically with only piece meal attempts to try understand and explain how the modern corporation is run.

1.2 Problem Statement
It is widely acclaimed that stronger and more explicit corporate governance systems are associated with increased firm value and performance, as well as low levels of capital expenditure and institutional shareholdings. While overall corporate governance is important, not all governance characteristics of the firm have the same effect. Whereas ownership and remuneration policies improve corporate performance, the quality of disclosure and audit is a more important driver of corporate value and capital expenditure. Board structure, which is the most frequent topic of research in corporate
governance, is shown to have no impact on performance value, investment or institutional ownership.

Several explanations have been given to account for these apparent inconsistencies. Some have argued that the problem lies in the use of either publicly available data or survey data which are generally restricted in scope. It has also been pointed out that the nature of performance measures (that is, the restrictive use of accounting based measures such as return on assets (ROA), return on equity (ROE), return on capital employed (ROCE) or restrictive use of market based measures (such as market value of equities) could also contribute to this inconsistency (Cadbury, 1992).

Furthermore, it has been argued that the "theoretical and empirical literature in corporate governance considers the relationship between corporate performance and ownership or structure of boards of directors mostly using only two of these variables at a time" (Shirley & Nellis, 1992). For instance, Buchholtz, Young, & Powell, (1998) studied the correlation between board composition and performance, whilst Burke & Mattis (2000) studied the relationship between managerial ownership and firm performance.

Mang’unyi (2011) in his study explored ownership structure and corporate governance and its effects on performance of firms in Kenya with reference to banks. Ongore & K’Obonyo (2011) dealt with the effects of selected corporate governance characteristics on firm performance, empirical evidence of firms in Kenya. Kyereboah-Coleman (2007) carried out a study that examined the effect of corporate governance on the performance of firms in Africa, Kenya being among those countries considered using both market and accounting based performance measures. Okiro (2006) carried a study on the relationship between board size and board composition on firm performance, a study of quoted companies at the NSE. This study just like all the previous studies about Nairobi Securities Exchange actually dealt with the stock exchange which has since changed to the Nairobi Securities Exchange. This study shall therefore include aspects of the new look securities Exchange. Also, the above researches have not been able to cover all the firms listed at the Nairobi Stock Market. This leaves a knowledge gap that needs to be
addressed. This is the reason why this study is necessary to shed more light on what relationship exist between corporate governance and firm performance for firms in the Nairobi Stock Market, due to recent and frequent economic turbulence and technological changes, it is important for the present study to be carried out since time has elapsed and the economic factors have also changed significantly.

It is notable that despite the volume of empirical evidence on this subject, there has been no consensus on how to resolve the problem. These problems lend credence to the following pertinent questions: Do better corporate governance practices lead to greater firm performance? What is the optimal corporate governance structure that firms need to comply with in order to maximize firm performance?

The present study adds to the literature by employing both market based and accounting based performance measures such as return on assets and Tobin’s Q and test the relationship between corporate governance and performance of firms quoted on the Nairobi Securities Exchange.

In order to study this problem, the following hypothesis will be tested:

\[ H_0: \text{There is no relationship between firm-level corporate governance and firm performance} \]

\[ H_A: \text{There is a relationship between firm-level corporate governance and firm performance.} \]

1.3 Importance of the Study

The findings and deductions of this study will be of interest to the following groups: firstly the Capital Markets Authority will benefit from the findings of this study in relations to its corporate governance oversight role of listed companies and act adequately on the facts of the study.

The findings will help unravel the fact that corporate governance plays a key role in firm performance and hopefully build a strong case for NSE to closely monitor the activities
of the firm Boards for effective firm performance. Secondly, the shareholders/ investors will use the findings of this study in making informed investment decisions and thus identify firms that comply with corporate governance principles and are more likely to offer fair return on capital invested. Shareholders will be more informed on the specific characteristics to look for when appointing Board directors.

Equally, the management of publicly quoted companies will make use of the study findings to determine the optimal corporate governance standards that are likely to maximize firm performance. The financial consultants will also be able to offer proper advice to clients on the possible effects of reported losses or gains on the companies covered by this study and will be able to base their advice on the findings of the study. Lastly, scholars may also wish to use the findings of this study as a basis for further research especially on issues of methodology and literature review.
2.1 Introduction

This chapter covers among other topics and subtopics, the theories examined such as the agency theory, stakeholder theory, stewardship theory and resource dependency theory. It also looks at the corporate governance constructs, the empirical literature on the relationship between corporate governance and firm performance, governance principles and guidelines, firm performance and chapter summary.

2.1.1 Agency Theory

A fundamental challenge underlying all corporate governance is not new. The directors of companies, being managers of other peoples ‘money cannot be expected to watch over it with the same vigilance with which they watch over their own’ (Smith 1776). Agency theory looks at corporate governance practices and behaviour through the lens of the agency dilemma. In essence, the theory perceives the governance relationship as a contract between the shareholder (the principal) and the director (the agent). Directors, it is argued, seeking to maximise their own personal benefit, take actions that are advantageous to themselves but detrimental to the shareholders.

Essentially, trust involves an agreement between parties with asymmetrical access to information. In companies, of course, the directors know far more about the enterprise than the shareholders, who must trust them. This is the underpinning concept of the joint stock limited liability company. The shareholders trust the directors to be stewards of their funds.

The agency theory of corporate governance takes a less sanguine view of directors. As the early proponents of agency theory Jensen and Meckling (1976), explained: agency theory involves a contract under which one or more persons (the shareholders) engage another person (the directors) to perform some service on their behalf which includes delegating some decision making authority to the agent. If both parties to the relationship
are utility maximizers there is good reason to believe the agent will not always act in the best interests of the principal. Anecdotal evidence of such behaviour is not hard to find.

There are myriad cases in which directors treat a listed public company as though it was their own property, exploiting their position, receiving unsanctioned benefits, and taking remuneration unrelated to their performance to the shareholders' detriment. Bob Monks (2008), a shareholder activist, reckons that trillions of dollars of shareholders' wealth have been wrongly extracted from US corporations over the years by directors abusing their power.

Directors may also take a different view to that of their shareholders on corporate risk. After all, it is not their money they are risking. Of course, successful management involves taking controlled risks. But directors might hazard corporate funds on riskier venture, a hostile takeover bid for example, than many of their shareholders would expect.

Agency theory has been developed within the discipline of financial economics. Jensen elaborated his original work in Fama and Jensen (1983). Most scholarly research in corporate governance has used his theoretical approach. Looking at corporate governance through the agency lens enables researchers to explore relationships between governance processes and corporate performance.

Agency theory offers a statistically rigorous insight into corporate governance processes. Because of its simplicity and the availability of both reliable data and statistical tests, agency theory has provided a powerful approach to corporate governance theory building.

2.1.2 Stakeholder Theory

Stakeholder theory is concerned with value and beliefs about the appropriate relationships between the individual, the enterprise, and the state. It involves a discourse on the balance of responsibility, accountability, and power throughout society. It is not a
predictive theory that can be researched. Consequently, this societal view of corporate
governance is probably better thought as a philosophy rather than a theory.

Companies, stakeholder advocates argue, should recognize a responsibility to all those
affected by the companies’ decisions, including customers, employees, and managers,
partners in the supply chain, bankers, shareholders, the local community, broader societal
interests for the environment and the state.

Companies owe a duty to all those affected by their behaviour, they argue. Some
advocates go further and call for directors to be accountable and responsible to a wide
range of stakeholders far beyond companies’ current company law responsibility to
shareholders.

Such responsible behaviour, the stakeholder advocates argue, should be the price society
demands from companies for the privilege of incorporation, granting shareholders limited
liability for the company’s debts.

Jones & Wicks, (1999) critique the Stakeholders theory for assuming a single-valued
objective (gains that accrue to a firm’s constituencies). The argument of (Valdes, 1997)
suggests that the performance of a firm is not and should not be measured only by gains
to its stakeholders. Other key issues such as flow of information from senior management
to lower ranks, inter-personal relations, working environment, etc are all critical issues
that should be considered. Some of these other issues provided a platform for other
arguments as discussed later. An extension of the theory called an enlightened
stakeholder theory was proposed. However, problems relating to empirical testing of the
extension have limited its relevance (Jones, & Wicks, 1999).

2.1.3 Stewardship Theory
Stewardship theory is rooted in the belief that directors, accept fiduciary duty to act in the
best interest of the owners who have entrusted their funds to them.
Stewardship theory reflects the classical ideas of corporate governance. Directors' legal duty is to their shareholders not themselves, or to other groups. Contrary to the agency theory, stewardship theory believes that directors do not always act in a way that maxims their personal interests, they can and do act responsibly with independence and integrity. As Lord Cairns said in the London High court in 1874, 'no man, acting as an agent, can be allowed to put himself in a position in which his interest and his duty will be in conflict'. Stewardship theorists argue that, clearly, this is what most directors actually do. Of course, some fail but this does not invalidate the basic concept.

The underpinning disciplines in stewardship theory are legal and organizational studies. By reflecting the legal model, stewardship theory provides precise boundaries for the company, clearly identifying its assets and liabilities, its shareholders and its directors. It facilitates the description of complex pyramids, chains, and networks of corporate groups.

### 2.1.4 Resource Dependency Theory

Resource dependency theory takes a strategic view of corporate governance. It sees the governing body of a corporate entity as the lynchpin between a company and the resources it needs to achieve its objective. These resources could include, for example, links to relevant markets including potential customers and competitors, access to capital and other sources of finance, provision of know-how and technology, and relationships with business, political, and other societal networks and elites.

The directors are viewed as boundary-spanning nodes of networks able to connect to its strategic environment. Studies from this perspective focus on the interdependence of companies in a market and can serve to reduce uncertainties in corporate decisions. This theory finds its roots in organization theories, for example Pfeffer (1972).

The theory of social networks recognizes that those involved in corporate governance processes are often linked through networks. Individuals at the nodes may have things in common including, perhaps, social standing, class, income, education, institutional or
corporate links, and so on. Lifestyle theory, focusing on the backgrounds of key players, has also been used. Some individuals in the network, such as chairman or CEO, may be pivotal nodes in a number of networks, increasing their communication leverage. Such social networks can enhance or adversely interfere with independent and objective governance activities. Identifying such networks and monitoring their activities provides another insight into governance processes and powers.

2.2 Corporate Governance Constructs

2.2.1 Board size

There is a view that larger boards are better for corporate performance because they have a range of expertise to help make better decisions, and are harder for a powerful CEO to dominate. However, recent thinking has leaned towards smaller boards. Jensen (1976) and (Scheshinski & Lopez-Calva, 2000) argue that large boards are less effective and are easier for a CEO to control. When a board gets too big, it becomes difficult to co-ordinate and process problems. Smaller boards also reduce the possibility of free riding by individual directors, and increase their decision making processes. Empirical research supports this. For example, (Shirley & Nellis, 1992) documents that for large U.S. industrial corporations, the market values firms with smaller boards more highly. (Tricker, 1997b) also find negative correlation between board size and profitability when using sample of small and midsized Finnish firms. In Ghana, it has been identified that small board sizes enhances the performance of microfinance institutions.

Van den Berghe & De Ridder, (1999,). Wallis, (2000) echo the above findings in firms listed in Singapore and Malaysia when they found that firm valuation is highest when board has five directors, a number considered relatively small in those markets. In a Nigerian study, Van den Berghe & De Ridder, (1999,) found that, firm performance is positively related with small, as opposed to large boards. Jensen (1976) has indicated that a value-relevant attribute of corporate boards is its size. Organizational theory presupposes that larger groups take relatively longer time to make decisions and, therefore, more input time (Hermalin, Weisbach, 1991).
What should a board size be? This has been a difficult question to answer because it seems to sit in the realms of relativity and subjectivity against the backdrop of unbiased objective measure. However, (Francis, 1997) suggest an optimal board size between seven and nine directors. In this respect, empirical studies have shown that the market values firms with relatively small board sizes (Francis, 1997; Leighton, 2000). Hence, as board size increases board activity is expected to increase to compensate for increasing process losses (La Porta et al, 2000). The argument is that large boards are less effective and are easier for a CEO to control. The cost of coordination and processing problems is also high in large boards and this makes decision making difficult.

On the other hand, smaller boards reduce the possibility of free-riding and therefore have the tendency of enhancing firm performance. We measure the size of the board by the number of directors serving on such boards and expect this to have a negative relationship with firm performance.

2.2.2 Board Independence

Though the issue of whether directors should be employees of or affiliated with the firm (inside directors) or outsiders has been well researched, yet no clear conclusion is reached. On the one hand, inside directors are more familiar with the firm’s activities and they can act as monitors to top management if they perceive the opportunity to advance into positions held by incompetent executives.

On the other hand, outside directors may act as “professional referees” to ensure that competition among insiders stimulates actions consistent with shareholder value maximization (Wymeersch, 1998). Turnbull, (1997a), argue that boards of directors are more independent as the proportion of their outside directors increases.

Hermalin, Weisbach,(1991), argue that a board is more independent if it has more non-executive directors (NEDs). Sir Adrian Cadbury’s report (1992) proposals and its code of practice emphasized the importance of independent non-executive directors, with independence defined as ‘independent of management and free from any business or
other relationship which could materially interfere with exercise of independent judgment a part from their fees and shareholding'. As to how this relates to firm performance, empirical results have been inconclusive. In one breadth, it is asserted that executive (inside) directors are more familiar with a firm's activities and, therefore, are in a better position to monitor top management.

On the other hand, it is contended that NEDs may act as "professional referees" to ensure that competition among insiders stimulates actions consistent with shareholder value maximization Jackson, (1998). Jones & Wicks, (1999), and Lanoo, (1995) support this view underscoring the important role of outside directors in protecting shareholders' interest through effective decision control.

Some authors have also found that there is no significant relationship between proportion of NEDs and firm performance. It has been shown that the effectiveness of a board depends on the optimal mix of inside and outside directors (Fama and Jensen, 1983; Jackson, 1998). However, available theory is scanty on the determinants of optimal board composition (Baxt, 2002). We measure the independence of the board by finding the ratio of NEDs to board size and we expect this to have a positive relationship with firm performance.

2.2.3 Board Activity Intensity

In this study, I introduce another variable namely the intensity of board activity as an important value-relevant board attribute in tandem with (Baxt, 2002). A priori, the nature of the association between board activity intensity and firm performance is not clear. Some contend that board meetings are beneficial to shareholders. For instance (Donaldson & Preston, 1995) suggest that "the most widely shared problem directors face is lack of time to carry out their duties".

In a similar argument, (Fama & Jensen, 1983) suggest that board meeting time is an important resource for improving the effectiveness of a corporate board. The implication
is that when boards of directors meet frequently, they are likely to enhance firm performance and thus perform their duties in accordance with shareholders’ interests.

On the contrary, some have argued that board meetings are not necessarily useful in that the limited time NEDs spend together is not used for meaningful exchange of ideas among themselves or with management (Gomez-Mejia & Balkin, 1992). This position has been recognized as a natural consequence of the fact that agenda setting for such meetings is done by chief executive officers (Jensen, 1976).

In addition, it is believed that routine tasks absorb much of the meetings and this limits opportunities for NEDs to exercise meaningful control over management and therefore boards should be relatively inactive, and rather being more active when there are corporate crises (Jensen, 1976). In view of the debate surrounding board meetings and its relationship with firm performance, the significance of board activity intensity is an open question. We measure the intensity of board activity by the frequency of meetings annually.

2.2.4 Chief Executive Officer Duality

The role of chairman and chief executive continue to be one of the contentious and unresolved dilemmas in corporate governance. The guidelines prescribe a clear separation of the role and responsibilities of the chairman and chief executive officer (CEO) to ensure a balance of power of authority and to provide for checks and balances so that no individual has unfettered powers of decision-making. In the event that the role of the chairman and CEO are combined, disclosure of the same is required to the shareholders in the company’s annual report. A chairman is precluded from holding a similar position in more than two listed companies at any one time to ensure effective participation in the board. Garet (2011), however while reporting on international corporate governance argued that the dual role of CEO acting as chairman also places too much power into the hands of an individual and makes the full board unable to fulfil its fiduciary duties to its shareholders effectively. This was more pronounced in the recent
case of News Corporation CEO Murdoch who also doubled as chairman, thereby complicating corporate governance of the firm.

Considerable degree of attention has been devoted to the critical role of boards' ability in monitoring managers and removing non-performing CEOs. Jensen (1976) shows a deep concern that a lack of independent leadership creates a difficulty for boards to respond to failure in top management. In this regard, Fama and Jensen (1983) also argue that concentration of decision management and decision control in one individual hinders boards' effectiveness in monitoring top management. It is argued that there is conflict of interest and higher agency costs when a CEO doubles as board chair (Charkham, 1995) and this leads to the suggestion that the two positions should be occupied by two persons.

Nonetheless, there is also the argument that when a CEO doubles as board chair, it affords the CEO the opportunity to carry out decisions and projects without undue influence of bureaucratic structures and in this regard it is expected that CEO duality should have a positive relationship with performance (Conger, Finegold, Lawler, 1998). However, empirical evidence is not conclusive. (Charan, 1998) show a positive relationship between firm performance and separating the functions of the CEO and board chair, while (Drucker, 1986) find no relationship between CEO duality and firm performance. We measure CEO duality as a dummy (equals unity when a CEO doubles as board chair and 0 otherwise) and expect a negative coefficient.

2.2.5 Chief Executive Officer Tenure
It has been advanced that the tenure of the CEO constitutes another governance mechanism. How long should a CEO serve? In this study, I argue that when a CEO serves longer in a firm, it serves as an added incentive to promote the interest of shareholders due, essentially to the fact that apart from job security, the CEO is afforded the opportunity to witness results of decisions taken and retain institutional memory. In this regard, longer tenure is expected to have a positive influence on performance, though some have indicated that a longer tenure enables CEOs to resort to empire-building with
less focus on productive activities. We measure the tenure of the CEO by using the number of years a CEO serves in that capacity.

2.2.6 Audit Committee and its Characteristics
The independent, external auditor plays a fundamentally important role in corporate governance reporting to the members that the information by the directors to the shareholders give a true and fair view.

The argument has been advanced that perhaps the audit committee is the most reliable entity to safeguard public interest. The Cadbury Commission (1992) recommended that audit committees should have minimum size of three members and should consist of solely Non-Executive Directors (NEDs). This feeds into the independence of such committees. Thus, it is posited that in an ideal case a strictly independent audit committee should consist solely of NEDs and non-affiliates of the company (directors who have previously worked in the company).

Audit committees thus, represent another internal governance mechanism whose impact is to improve the quality of financial management of a company and hence its performance. However, very little empirical work has been done on the impact of audit committees on firm performance. (Nowak & McCabe, 2001) shows that markets are able to react favorably to earning reports after the establishment of audit committees. In this study, we consider the size of audit committee (measured by number of members), its independence (measured by the ratio of non-executives directors/affiliates to size of audit committee), and also audit committee activity intensity (measured by the number of meetings per year). While we expect the size of audit committee to have a negative relationship with firm performance, we expect that both audit committee independence and number of meetings per year should have a positive correlation with firm performance.
2.2.7 Institutional Ownership

It has been argued that the nature of ownership of a firm also constitutes a dimension of its governance structure and should, therefore, influence performance. It is known that for places such as Australia, Belgium, Germany, and Italy, more than half of listed industrial companies have large block holders who own at least 50% of such companies (Charan, 1998). When there are large block holders, mechanism are put in place to ensure equitable treatment of all shareholders. In this study, I consider institutional shareholding measured by the percentage volume of shares held by institutions. Institutions under such circumstances serve as extra monitoring device on the operations of the firm. It is, therefore, expected that institutional ownership should have a positive relationship with firm performance.

2.3 Empirical literature on the relationship between corporate governance and firm performance

Previous empirical studies have provided the nexus between corporate governance and firm performance (AIMA, 1995, Claessens et al., 1999; Brown and Caylor, 2006), with inconclusive results. Ian Clacher, Elirehema Doriye, and David Hillier in their study (2008) found that stronger and more explicit corporate governance systems are associated with increased firm value and performance, as well as lower levels of capital expenditure and institutional shareholdings.

Others, Carver, 1990; Charkham, 1992 & Charkham, 1995 have shown that well governed firms have higher firm performance. The main characteristic of corporate governance identified in these studies include board size, board composition, and whether the CEO is also the board chairman.

Studies by Monks & Minow, 1996; Norburn, Boyd, Fox, & Muth, 2000, found no relationship between the proportion of outside directors and Tobin’s Q. Pollak, (2000) found an inverse relation between board size and Tobin’s Q. The study by Claessens et al. (1997) found a positive relationship between management participation in the director selection process and Tobin’s Q.
A number of empirical studies on outside directors support the beneficial monitoring and advisory functions to firm shareholders (see Francis, 1997; Mwanthi, 2003). (Monks & Minow, 1996) showed that the market rewards firms for appointing outside directors. Selby (2000) found a positive relation between proportion of outside directors and stock-market reactions to poisons pill adoptions. Also (Cadbury, 1992) found a positive relationship between proportion of outside board members and performance of MFIs in Ghana. However, (Charkman, 1992) found no relationship between proportion of outside directors and various performance measures. (Cadbury, 1993) and (Chomika, 1997) found no significant relationship between board composition and performance. (Cadbury, 1996) also showed that, the percentage of outside directors does not significantly affect firm performance.

This was also confirmed (Carver, 1990), when studying export firms in Ghana. (Charan, 1998, Charkham, 1995) suggest that boards expanded for political reasons often result in too many outsiders on board which does not help performance. Thus, the literature reveals a board structure typology, the one-tier system and the two-tier system. In the one-tier system the Chief Executive Officer (CEO) is also chairman of the board, whilst the two-tier system has a different person as the board chairman and is separate from the CEO.

It has been noted though that the one-tier board structure type leads to leadership facing conflict of interest and agency problems (Donaldson, 1993, Factor, 1996,) thus giving preference for the two-tier system. The study by (Leighton, 2000) shows that staggered boards have a negative impact on the value of the firm. (Leighton, 2000) show that a six-factor firm entrenchment index fully drives the relation between G-Index and firm value.

Luoma & Goodstein (1999) have shown that a three-factor external governance index impedes firm valuation. They argue that effective corporate governance requires both internal and external measures so they include shareholder activism, their proxy for internal governance. (Mace, 1971), add to this literature by re-examining the links between corporate governance and firm valuation, using a far more extensive database.
They create simple summary governance index using fifty one (51) data items. Similar to Gompers, et al, they show that their new Gov-Score increases in firm value. They also show that a small subset of factors fully drives the relation between corporate governance data and firm value. Similar to (Turnbull, 1997b), they show that links between governance and firm value are not confined to anti-takeover measures.

Brown and Caylor regress Tobin’s Q on Gov-Score show that Tobin’s Q is positively related to Gov-Score. They use three econometric techniques to conduct this investigation. First, they regress Tobin’s Q on all fifty one (51) firm-specific factors. Second, they regress Tobin’s Q on each of the fifty one (51) factors plus the remaining fifty (50), defined as Gov-Score minus the factor in question. Third, they use stepwise regression to identify which of the fifty one (51) factors enter the valuation model. Subsequently, Brown and Caylor identified seven factors that are significant in determining firm valuation, and these include: (1) board members are elected annually; (2) company either has no poison pill or a pill that was shareholder approved; (3) option re-pricing did not occur within the last three years; (4) average options granted in the past three years as a percent of basic shares outstanding did not exceed 3%; (5) all directors attended at least 75% of board meetings or had a valid excuse for non-attendance; (6) board guidelines are in each proxy statement; and (7) directors are subject to stock ownership guidelines. They create a summary index based on these seven factors, and show that a small subset of the data (seven of 51 factors) fully drives the relation between Gov-Score and firm valuation.

2.4 Governance Principles and Guidelines

Corporate governance principles and guidelines are established by several organizations to provide best practices or benchmarks against which to assess the appropriateness and the quality of the corporate governance system (Heracleous, 2001, Hilmer, 1993). Over the years a number of organizations have been involved in preparing various guidelines and principles of corporate governance.
All of these advocate the common threads of core corporate governance perspectives owing to the emergent corporate governance challenge; financial scandals and corporate collapses and has generally been motivated by a desire for more transparency, accountability, integrity and efficiency and a desire to increase investor confidence (Renton, 1994). The guidelines recognize the fact that corporate governance is not merely compliance, as it works best when it is flexible. In all the codes, it is recognized that directors should act in good faith, exercise due care, possess some skills, and exercise due diligence.

2.4.1 Corporate Governance in Kenya
Sections 11(3) and 12 of the Capital Markets Authority (CMA) Act CAP, 485A empower the Capital Markets Authority to make rules and regulations to govern capital markets in Kenya. Pursuant to this authority, the Capital Markets Authority developed guidelines on corporate governance practices by public companies in Kenya (GoK, 2002) and incorporated them as a schedule in the Capital Markets Act. The guidelines were developed in recognition of the role of good governance in corporate performance, capital formation and maximization of shareholders' value and protection of investors' rights.

The main objective of these rules is to strengthen corporate governance practices in public listed companies in Kenya and to promote the standards of self-regulation so as to bring the level of governance in line with international standards. Some of the standards taken into account by the Authority while formulating the guidelines include those in the United Kingdom, Malaysia, South Africa, Organization for Economic Cooperation and Development (OECD) and the Commonwealth Association for Corporate Governance.

The code of best practice for corporate governance in Kenya issued by the Private Sector Corporate Governance Trust, Kenya, (PRSCG) in 1999 was also useful in the development of the guidelines. This code has also been incorporated into the Act as recommended best practices in corporate governance by public listed companies. The Authority identified a number of principles as essential and critical foundations for good
corporate governance practices. These are the minimum standards that public listed companies are expected to adhere to and they relate to directors, shareholders, auditors, public disclosure, chairman and chief executives as explained below:

2.4.2 Board of Directors

Every public listed company is to be headed by a board of directors made up of both executive and non-executive directors with a specific requirement that at least one third of the directors should be independent and non-executive.

The Authority justifies this requirement with the need to ensure that no individual or group of individuals can dominate the board’s decision-making processes. The procedure for appointment to the board should be formal and transparent, and prospective directors are required to disclose potential areas of conflict that may undermine their position as director. The Authority restricts any person from being a director in more than five listed companies at any one time to ensure effective participation in the board. In addition, election of all directors, except the managing director, is to be conducted at regular intervals or at least every three years with present directors presenting themselves for re-election. Executive directors should have a fixed service contract not exceeding five years with a provision to renew subject to regular performance appraisal and shareholder approval.

The procedure for remuneration of directors and the remuneration package is to be approved by the shareholders. The executive directors’ remuneration should be competitively structured and linked to performance while that of non-executive directors should be in line with that of other directors in competing sectors. Directors are expected to be accountable to shareholders and to offer strategic advice, lead and control the company. In addition, they are to establish an audit and nominating committee and delegate specific mandate to these and other committees.

In addition, they are to present an objective and understandable assessment of the Company’s operating position and prospects, and ensure that accounts are presented in
line with international Accounting standards and International Financial Reporting Standards.

2.4.3 Auditors
The Authority requires that auditors of public listed companies be members of the Institute of Certified Public Accountants of Kenya and comply with the International Auditing Standards. Independent auditors are to be appointed by the shareholders at each annual general meeting.

2.4.4 Chief Finance Officers
The chief finance officers and persons heading the accounting department of a listed company are required to be members of the Institute of Certified Public Accountants of Kenya.

2.4.5 Disclosure
The board is required to disclose in its annual report, its policies, incentives, quantum and components of remuneration for directors as well as the share options and other forms of executive compensation that have been made or are to be made during the financial year. Other forms of disclosure include the ten major shareholders of the company, the aggregate loans held by directors and any management or business agreements entered into by the company and its related companies that may result in a conflict of interest. The system of corporate governance required by the Authority relies on the board of directors rather than the shareholder instruments of corporate governance. The focus on directors has been attributed to the fact that corporations need quality and effective leadership which is responsive, transparent and accountable in order to achieve their objectives, effectively discharge their responsibilities, create wealth and be sustainable in the long term (Jones, 1995).

In addition to the provisions described above that are considered minimum standards of corporate governance in public listed companies, the Authority recommends best
practices that every public listed company should endeavor to achieve. They are designed as a basis to assist individual companies formulates their own specific and detailed codes.

The best practices have been modeled after the code of best practice for corporate governance in Kenya that was issued by the Private Sector Corporate Governance Trust, Kenya, in 1999. Reference was also made to international standards such as those in the United Kingdom, Malaysia, South Africa, Organization for Economic Cooperation and Development (OECD) and the Commonwealth Association for Corporate Governance.

2.4.6 Role and Responsibilities of the Board of Directors

Given their various attributes and different competencies, directors inevitably make a variety of contributions to their board and can play a number of roles. Some of these roles contribute to the performance aspects of the board’s work (strategy formulation and policy making) others conformance aspects (executive supervision and accountability).

Some of the boards’ roles are as below:

Appoint a nominating committee consisting mainly of independent and non-executive directors to propose new nominees for the board and consider candidates for directorship proposed by the chief executive and shareholders.

The proposed candidates should only be considered if they are persons of caliber, credibility and who have necessary skills and expertise to exercise independent judgment on issues necessary to promote the company’s objectives and performance; appoint a remuneration committee or assign mandate to a nominating committee made up of independent and non-executive directors to recommend to the board the remuneration of the executive directors and the structure of their compensation package; the whole board should determine the remuneration of non-executive and independent directors. The consolidated total remuneration of the directors should be disclosed to the shareholders in the annual report; the structure of the board should reflect the company’s shareholding structure without being biased towards representation by a substantial shareholding (not less than fifteen per cent of the voting shares) structure and provide a mechanism for
representation of the minority shareholders without undermining the collective responsibility of the directors.

2.4.7 Chairman and Chief Executive Officer
The role of the chairman and CEO should be separated, however where it is combined a clear rationale and justification must be for a limited period, be approved by shareholders, include measures to ensure no one individual person has unfettered powers of decision in the company and include a plan for separation in the future; the chairman should be an independent and non-executive director; a clear succession plan for the chairman and CEO should be put in place to avoid unplanned and sudden departures which could undermine the company’s and shareholders’ interest; the CEO is obliged to provide necessary information to the board in the discharge of the board’s business.

2.4.8 Audit Committee
It should consist of at least three independent and non-executive directors who report to the board; the chairman of this committee should also be an independent and non-executive director; the board should disclose whether it has an audit committee and the committee’s mandate in its annual report; the committee should obtain professional advice and invite or consult with outsiders with relevant experience; review the quarterly, half-yearly and year-end financial statements of the company.

2.5 Firm Performance
Management researchers prefer accounting variables as performance measures such as return on equity (ROE), return on investment (ROI), and return on assets (ROA), along with their variability as measures of risk. Earlier studies typically measure accounting rates of return. These include: Return on Investment (ROI), return on capital (ROC), return on assets (ROA) and return on sales (ROS). The idea behind these measures is perhaps to evaluate managerial performance-how well is a firm's management using the assets to generate accounting returns per unit of investment, assets or sales. The problems with these measures are well known. Accounting returns include depreciation and
inventory costs and affect the accurate reporting of earnings. Asset values are also recorded historically.

Return on equity (ROE) is a frequently used variable in judging top management performance, and for making executive compensation decisions. ROE is defined as net income (income available to common stockholders) divided by stockholders equity. On the other hand, ROA is the most frequently used performance measure in previous studies. It is defined as net income (income available to common stockholders), divided by the book value of total assets.

2.6 Chapter Summary
Although there has been a worldwide paradigm shift in the management of corporations, corporate governance is a new phenomenon in Kenya and a number of legal safeguards have been put in place to ensure transparency and accountability in the execution of the companies / corporations. Legal safeguards appear disjointed and they seem to address corporate governance weakness in a duplicity manner.

As a result, this study seeks to unveil the main corporate governance weaknesses in public institutions and recommended appropriate means of how to synchronize the approach to ensure adherence to good corporate governance practices in Kenya.
CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction
This chapter details the approach that was used in this research method. This includes sources of data, population, description of the sample, type of data collected, method of data collection, and data procedures that were employed.

3.2 Population and Sample
The population consisted of all firms quoted at the Nairobi Securities Exchange. There are fifty eight (58) companies presently listed at the Nairobi Securities Exchange. However, 44 companies which submitted their returns to the Capital Markets Authority in the period 2006-2010 were picked. These firms submitted their returns on principles of good corporate governance and role of Board of Directors to the financial regulatory agency, as required by the Capital Markets Authority (CMA Act, 485A). These firms also adhered to the public listing requirements of the Nairobi Securities Exchange. Given their listing, therefore, their financial data was readily available at the Nairobi Securities Exchange. The sample of the study was, therefore, a census study of all the listed companies of Nairobi Securities Exchange.

3.3 Data Collection
For the purpose of this study, both primary and secondary data were used. The former were collected from CEOs of the listed companies while the latter were collected from annual financial statements of the target firms that were quoted at the Nairobi Securities Exchange. The latter information was available from the Nairobi Securities Exchange, the Capital Markets Authority and the Company Registry.

The researcher used a validated structured questionnaire for primary data collection. The questions were closed and were structured in both yes/ no basis. A pilot survey of 10 respondents was conducted through pre-testing the questionnaires for validity and practicality. The lessons from the survey formed the basis for the review of the questionnaire administration for the main survey.
The final questionnaire was self-administered. The questionnaires were dropped and later picked from the respondents. Response rates were continuously and closely monitored by making follow up reminder calls to the respondents after the survey was distributed. To ensure quality of responses the respondents were urged to be as honest as possible in filling the questionnaire. Participation was voluntary, anonymous and confidential. Further, to complement the questionnaire, reduce errors and response bias, questions where answers were also in published accounts were checked and validated from the returns at the CMA.

The dependent variables of Return on Assets (ROA) and Tobin’s Q were measured, respectively, by the net income of each of the surveyed firms divided by the book value of the total assets and the ratio of market value of assets over book value of assets. The independent variables of director independence, non-independent directors, and quality of audit committee were obtained as per the following descriptions: Board independence was determined using Weisbach’s (1991) definition where a board is considered to be more independent if it has more non-executive directors. The Cadbury Report defines board independence as one which is characterized by “independence of management and free from any business or other relationship which could materially interfere with exercise of independent judgment apart from their fees and shareholding.”

Board quality was measured by assessing whether the audit committee was independent, determining the experience and qualifications of the members of the audit committee, the composition of the audit committee (that is, whether it consisted solely of independent directors), and whether the company has a formal policy on auditor rotation.

3.4 Data Analysis

The Tobin Q and CGI were constructed and average taken out for these five years. Estimation of the basic model was done using Ordinary Least Squares (OLS). Panel data analysis was employed because it is more suited for this study. For the purposes of the empirical analysis, the following models were estimated:
Model 1:

\[ Q_{it} = a + b \text{ CGI}_{it} + \varepsilon_{it} \]

Model 2:

\[ \text{ROA}_{it} = a + b \text{ CGI}_{it} + \varepsilon_{it} \]

Where:

i. The firm performance measures, \( Q_{it} \) and \( \text{ROA}_{it} \) are respectively Tobin's Q and return on assets for firm i at time t, \( i = 1,2,3..., 47; t=1,2,3,4,5 \)

ii. \( \text{CGI}_{ij} \) a vector of governance index

iii. \( \varepsilon_{ij} \) is the error term

**Tobin's Q and ROA**

Tobin's Q, is defined as the ratio of market value of assets (calculated as book value of assets minus book value of equity plus market value of equity) over book value of assets. As an approximation, the market value of assets is normally computed as market value of equity plus book value of assets, minus book value of equity. This is then divided by the book value of assets to obtain Tobin’s Q. This ratio is expected to be greater than unity as an indication that management has done well in its investment decisions.

The study used Return on Assets (ROA) and Tobin’s Q as the relevant measures for corporate performance considered most appropriate. Several researchers among them Clacher et al (2008) and Kyereboah-Coleman (2007) have used the same approach in similar studies. The two measures of performance used with the same data and at the same time are in line with arguments that suggest that using only one or the other performance measure is responsible for the inconsistencies in establishing a clear relationship between corporate governance and corporate performance. ROA was measured as the ratio of Earnings Before Interest and Taxes to Total Assets (EBIT/TA) and Tobin’s Q was defined as the ratio of market value of equity plus book value of assets, minus book value of equity. This is then divided by the book value of assets. The
ratio is expected to be greater than unity as an indication that management has done well in its investments.

**Construction of CGI**

In order to construct Corporate Governance Index for the firms listed on the NSE, a broad, multifactor corporate governance rating is done which is based on the data obtained from the annual reports of the firms that submitted their returns to CMA and corroborated with the questionnaire. The index construction is as follows: for every firm, there are 44 governance proxies or indicators which are selected; these indicators are categorized into three themes. The three categories or sub-indices consist of indicators: seven factors each for the Board, ownership and shareholdings and for transparency, disclosure and audit.
CHAPTER FOUR: SUMMARY AND INTERPRETATION OF THE STUDY

4.1 Introduction
This study was conducted on a sample of 44 firms that were listed on the Nairobi Securities Exchange and which were consistently active for a period of five years from 2006 to 2010 (both years inclusive). Data was obtained from company annual returns filed with the Capital Markets Authority (CMA), the statutory body responsible for overseeing regulation of firms trading on the country's stock exchange.

Panel data was obtained for active firms for the years mentioned above. This period was chosen because of data availability and completeness of statutory returns. A total of two hundred and thirty two (N= 232) observations were made. The firms sampled were operational in industrial, manufacturing, mining, agriculture and services sectors.

4.2 Description of the Model
The study employed the panel data framework for analysis due to the advantage it gives in allowing for more data points (N = 232 for this study). The basic panel data model is of the form: \( Y = a + bCGI_t + \varepsilon_{it} \) where \( a \) is a constant, \( b \) is a vector of independent variables, and \( \varepsilon_{it} \) is the error term. \( Y \) is the dependent variable and is the measure for corporate performance represented by ROA and Tobin's Q. The estimation of the basic model is done by means of the Ordinary Least Squares (OLS).

Hsiao (2003) and Klevmarken (1989) have highlighted the following as the merits of panel data: Use of the panel data controls for individual heterogeneity. The underlying principle of panel data is the assumption that firms are heterogeneous. Using panel data gives more informative data, more variability, less collinearity among the variables, more degrees of freedom and more efficiency. Panel data also has the ability to study the dynamics of adjustment because a cross-sectional distribution that looks relatively stable conceals a lot of changes.
This study used as the vector proxy for Corporate Governance Index (CGI) the variables of board quality (a proxy for audit committee measured by members’ qualifications), board independence, and the ratio of independent directors and also that of non-independent (that is, executive) directors in the board. In addition to these descriptions, the study assumes that the basic assumptions of the OLS model hold true for all the data considerations.

4.3 General Description of the Study

The major objective of this study was to test the hypothesis regarding the relationship between firm-level corporate governance and firm performance. This was tested by means of the ANOVA model and results are discussed in the subsequent sections of this chapter. The study also explored the nature of the correlations between firm performance (as measured by both ROA and Tobin’s Q) and the proxies for the Corporate Governance Index (CGI) vector and also investigated the statistical significance of the correlations identified.

The study made further hypothesis tests for the relationship between performance and the individual variables of independent directors, non-independent directors, board independence, and board quality. Board independence was determined by finding the ratio of non-executive directors to board size. It was expected that there would be a positive relationship with firm performance. Accordingly, the following hypothesis was tested:

Ho: Independent directors do not have a positive relationship on firm performance.
Ha: Independent directors have a positive relationship on firm performance

Board quality (proxy for audit committee) is another element in the construction of the corporate governance index. The more effective an audit committee is, the more likely it is that good firm performance would result. The Cadbury Commission has, in fact, recommended that audit committees should be established and that they should have a minimum of three members and should consist solely of non-executive directors and non-affiliates of the company. Audit committees, thus, represent another internal governance
mechanism whose impact is to improve the quality of financial management of a company and hence its performance. Audit committee quality was measured by reference to the independence of the audit committee, if the chairman was independent, the experience and qualifications possessed by members of the audit committee, the extent to which the audit committee consisted of independent outside directors, and whether the company had a formal policy on auditor rotation. This study hypothesized that:

$H_0$: The quality of audit committee does not have a positive relationship on firm performance.

$H_a$: The quality of audit committee has a positive relationship on firm performance.

4.4 Descriptive Statistics of the Performance and Governance Indicators

The descriptive statistics for the performance and governance variables are represented in the next table:
From the table of summary statistics above, the study found a wide variation in the performance of the firms with some doing well while others did not. For example, the mean ROA is 0.069 with the maximum and minimum being, respectively, 0.318 and -0.140. The standard deviation in ROA was 0.065 giving a relative variation of 94.2%. This shows that the performance among the sampled firms varies very widely and this can be attributed to a number of factors among them: nature of industry, prevailing economic climate, quality of management, and so on. The performance of the firms appears to be better when measured by the market-based Tobin’s Q compared to the accounting measure of ROA.

### 4.4.1 Governance Characteristics

The mean board size is 8.29 with a maximum of 18 directors. The standard deviation of 3.407 (coefficient of variation is 41.1%) suggests that there is a reasonably wide dispersion among the firms with respect to the size of their boards. The dispersion in the number of directors may be influenced by the size of the firms (with larger firms having larger boards and vice versa). The dispersion may also reflect the specific corporate governance mechanisms that may have been put together by the shareholders. The mean size of the independent directors (that is, non-executive directors) was 6.62 with the
maximum being 16 and a minimum of 1 (standard deviation is 2.827). The corresponding figures for the non-independent directors (that is, executive directors) were: mean, 2.41, maximum, 13, minimum, 1, and standard deviation of 1.933.

The overall sample indicates existence of an independent board (mean board independence = 72.25%). The dispersion in board independence is modest (standard deviation = 21.492 and coefficient of variation of 29.7%). This means that the boards are dominated by independent directors as the summary statistics show. The board independence of 72.25% indicates that only about 30% of the board comprises executive directors.

The board quality (which, in this study, is a proxy for audit committees) was relatively poor. The quality was only 30.71%. This indicates that firms sampled did not have access to well-qualified persons sitting on the audit committee. Qualification was measured by possession of a business or legal background.

4.5 Correlation Analysis of Performance and Governance Indicators

The study investigated the correlations between corporate performance and the selected governance indicators in order to understand how these are related. The results of the correlations are shown in the next table:

Table 2: Correlations between performance and corporate governance indicators

<table>
<thead>
<tr>
<th>Performance measure (ROA)</th>
<th>Board quality</th>
<th>Independent directors</th>
<th>Non-independent directors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pearson correlation,</td>
<td>0.125</td>
<td>0.033</td>
<td>0.012</td>
</tr>
<tr>
<td>(p-value)</td>
<td>(0.067)</td>
<td>(0.627)</td>
<td>(0.861)</td>
</tr>
</tbody>
</table>

The table shows that there is only low correlation between corporate performance as measured by the accounting ROA and board quality, independent directors, and non-
independent directors. The correlation is positive in all the cases, which means that good performance is positively correlated with good corporate governance practices. However, the correlation between performance and corporate governance is not statistically significant.

The next table shows the correlations between performance as measured by Tobin's Q and corporate governance:

Table 3: Correlations between performance and corporate governance indicators

<table>
<thead>
<tr>
<th>Performance measure (Tobin's Q)</th>
<th>Board quality</th>
<th>Independent directors</th>
<th>Non-independent directors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pearson's correlation</td>
<td>0.127</td>
<td>-0.080</td>
<td>0.060</td>
</tr>
<tr>
<td>(p-value)</td>
<td>(0.063)</td>
<td>(0.246)</td>
<td>(0.391)</td>
</tr>
</tbody>
</table>

From the table, there is low correlation between corporate performance as measured by Tobin's Q and board quality, independent directors, and non-independent directors. While correlation between board quality and non-independent directors is positive, that between performance and independent directors is negative. This means that good performance is positively correlated with the existence of good boards and a high percentage of non-independent directors but is negatively correlated with independent directors. The results also show that the correlation between performance and corporate governance is not statistically significant.

The study, however, found that there was a statistically significant correlation between some of the corporate governance indicators, namely: between board quality and independent directors and between independent directors and non-independent directors. This information is presented in the next table as shown:
Table 4: Correlations across corporate governance variables

<table>
<thead>
<tr>
<th>Variable</th>
<th>Independent directors</th>
<th>Non-independent directors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board quality</td>
<td>0.149*</td>
<td>0.130</td>
</tr>
<tr>
<td></td>
<td>(0.030)</td>
<td>(0.062)</td>
</tr>
<tr>
<td>Independent</td>
<td>-0.470**</td>
<td>-0.470**</td>
</tr>
<tr>
<td>directors</td>
<td>(0.000)</td>
<td>(0.000)</td>
</tr>
</tbody>
</table>

* Correlation significant at the 0.05 level (two-tailed)

** Correlation significant at the 0.001 level (two-tailed)

The table shows that there is a statistically significant correlation between board quality and independent directors. Furthermore, this correlation is positive. This means that board quality appears to improve with the increase in the percentage of independent directors. Similarly, the table shows that there is a statistically significant correlation between independent directors and non-independent directors. This correlation is negative and implies that the higher the percentage of independent directors on the board, the lower will be the percentage of non-independent directors on the same board. This is to be expected since the firm’s board must, of a necessity, have a certain fixed number of director positions.

4.6 Discussion of the Regression Model

The corporate performance model for ROA is summarized as $R = 0.101$ and $R^2 = 0.010$. The ANOVA summary is shown in the next table:

Table 5: ANOVA statistics for ROA

<table>
<thead>
<tr>
<th>Statistic variable</th>
<th>Sum of Squares (SS)</th>
<th>Degrees of freedom (df)</th>
<th>Mean Square</th>
<th>$F$</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>0.008</td>
<td>4</td>
<td>0.002</td>
<td>0.518</td>
<td>0.723</td>
</tr>
<tr>
<td>Residual</td>
<td>0.757</td>
<td>200</td>
<td>0.004</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td><strong>0.765</strong></td>
<td><strong>204</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
(The dependent variable is Return on Assets while the independent variables are: board quality, board independence, independent directors, and non-independent directors.)

From the table, it is seen that the regression model for the ROA is not statistically significant (F= 0.518). A test of the hypothesis as follows:

\(H_0: \text{There is no significant relationship between firm performance and corporate governance (as measured by ROA)}\)

\(H_a: \text{There is a significant relationship between firm performance and corporate governance (as measured by ROA)}\)

The overall model for ROA has an F statistic of 0.518 and a p-value of 0.723 (which is higher than the critical p-value of 0.05). Thus, we fail to reject the null-hypothesis and conclude that available data does not appear to support the supposition that there is a significant relationship between firm performance as measured by ROA and corporate governance.

The corporate performance of sampled firms was also tested for Tobin's Q and the following summary statistics obtained: \(R = 0.259\) and \(R\) square = 0.067. The ANOVA results are summarized in the next table:
Table 6: ANOVA statistics for Tobin’s Q

<table>
<thead>
<tr>
<th>Statistic variable</th>
<th>Sum of Squares (SS)</th>
<th>Degrees of freedom (df)</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>18941520</td>
<td>4</td>
<td>4735380</td>
<td>3.593</td>
<td>0.007</td>
</tr>
<tr>
<td>Residual</td>
<td>2.64E+08</td>
<td>200</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>2.83E+08</td>
<td>204</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(The dependent variable is Tobin’s Q while the independent variables are: board quality, board independence, independent directors, and non-independent directors.)

From the table, the overall model is not statistically significant (F = 3.593). Testing the hypothesis stated as follows:

**Ho**: There is no significant relationship between firm performance and corporate governance (as measured by Tobin’s Q)

**Ha**: There is a significant relationship between firm performance and corporate governance (as measured by Tobin’s Q)

The results show that the model is not statistically significant (F = 3.593, p-value = 0.007). Thus, available results do not seem to provide enough evidence to reject the null hypothesis. It is, therefore, concluded that there does not seem to be enough evidence to support the conclusion that firm performance as measured by Tobin’s Q is influenced by the corporate governance indicators studied.

4.6.1 Testing of the Hypothesis of Relationships between Performance and Governance Indicators

The study sought to test two sets of hypotheses as follows:

**Ho**: Independent directors do not have a positive relationship on firm performance.

**Ha**: Independent directors have a positive relationship on firm performance

And;
Ho: The quality of audit committee does not have a positive relationship on firm performance.

Ha: The quality of audit committee has a positive relationship on firm performance.

The p-values for the individual governance variables are shown in the next table:

Table 7: Significance of Hypothesis Tests for Governance Indicators (using ROA)

<table>
<thead>
<tr>
<th>Governance variable</th>
<th>p-value</th>
<th>Significant?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent directors</td>
<td>0.627</td>
<td>No</td>
</tr>
<tr>
<td>Non-independent directors</td>
<td>0.704</td>
<td>No</td>
</tr>
<tr>
<td>Board independence</td>
<td>0.642</td>
<td>No</td>
</tr>
<tr>
<td>Board quality</td>
<td>0.213</td>
<td>No</td>
</tr>
</tbody>
</table>

From this table, all the governance indicators are not statistically significant when measured using the Return on Assets. This means that we are not able to reject the null hypotheses stated above. We conclude that existence of independent directors and audit committees do not have a significant relationship with performance.

The hypotheses were further tested using Tobin’s Q performance measure. The results are shown in the next table:

Table 8: Significance of Hypothesis Tests for Governance Indicators (using Tobin’s Q)

<table>
<thead>
<tr>
<th>Governance variable</th>
<th>p-value</th>
<th>Significant?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent directors</td>
<td>0.126</td>
<td>No</td>
</tr>
<tr>
<td>Non-independent directors</td>
<td>0.009</td>
<td>Yes</td>
</tr>
<tr>
<td>Board independence</td>
<td>0.004</td>
<td>Yes</td>
</tr>
<tr>
<td>Board quality</td>
<td>0.045</td>
<td>Yes</td>
</tr>
</tbody>
</table>

From the Tobin’s Q, three of the governance indicators have a significant relationship with performance. These are the percentage of non-independent directors, the percentage
of board independence, and board quality. Thus, Tobin’s Q ratio brings out significant relationships which the ROA does not.

4.7 Summary and Conclusion of the Study

Corporate governance is now recognized as an important management tool of for major business organizations. The role of corporate governance has continued to rise with the increase in reported cases of corporate scandals. Since the introduction of the Cadbury Report (1992), corporate governance in the United Kingdom (U.K.) has undergone a number of major developments mostly affected by the scandals that have affected that country. The wave of scandals in the USA starkly represented by the collapse of the energy giant Enron has led to stringent demands for putting in place effective boards. The USA has enacted the Sarbanes-Oxley Act to regulate corporate governance. In the UK, the corporate governance regime is more flexible compared to that in the USA and operates on the principle of “Comply or Explain”. According to this principle, firms are required to comply with codes of good governance practice or explain if they do not wish to follow the recommendations. The UK has realized that it is better to encourage voluntary governance rather than to force compliance out of the understanding that mandatory systems of governance can hinder business prosperity, as well as limit growth and risk taking (Short, Keasey and Wright, 2005).

Researchers have found a link between robust corporate governance and firm competitiveness (Kyereboah-Coleman, 1997). There is also available a growing literature which suggests that corporate governance is related to higher firm value. Klapper and Love (2004) and Durnev and Kim (2005) have demonstrated that, across countries, companies with better governance and disclosure have higher measures of performance as measured by Tobin’s Q. Other studies such as by Beiner et al (2006) have also confirmed that there exists a significant and positive relationship between the quality of the firm corporate performance and equity market valuation.

Findings established that corporate governance is positively correlated with better firm performance, however, the relationship is weak. There is still a lot of debate on the exact
nature of the relationship between governance and the interaction of internal and external governance mechanisms. This study, just like that of Weir, Laing and McNight (2002) did not find a significant relationship between internal corporate governance structures and performance.

This study, however, found a low correlation between corporate performance and individual corporate governance items of board independence and board quality. The study also found a statistically significant correlation between board quality and board independence which implies that board quality appears to improve with the increase in the percentage of independent directors. Overall, however, the study did not find a statistically significant relationship between corporate performance and the corporate governance indicators as represented by the corporate governance index.

This chapter has provided a summary of the key governance indicators of board independence, non-independent directors, independent directors, and board quality. It has attempted to explore the relationship between firm performance as measured by the accounting Return on Assets and also using the market-based Tobin's Q. The chapter also discussed the results of the overall models of firm performance using the two measures. Available data does not seem to support the existence of a statistically significant relationship between firm performance and corporate governance practices.
CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Overall Summary
This study intended to investigate the relationship between firm performance and corporate governance. The study was motivated by the findings of various researchers which tend to suggest that there is a positive relationship between the adoption of an effective corporate governance regime and firm performance as measured by accounting and market-based measures of performance. The researcher did not find a statistically significant relationship between performance and corporate governance in the overall model, although performance was found to be positively correlated to some aspects of corporate governance of board independence.

A review of literature shows that there exists varying levels of agreement on the extent of the impact of corporate governance regime on corporate performance. While some researchers argue that various corporate governance mechanisms have a positive relationship with firm performance, other researchers argue that the opposite is the case. A brief review of some of these arguments, for example, shows that John and Senbet (1998) argued that a board is more independent if it has more non-executive directors. However, according to Bhagat and Black (2002), there is no significant relationship between the proportion of non-executive directors and firm performance.

5.2 Conclusions
This study did not find any significant relationship between the individual corporate governance indicators and firm performance as measured by the ROA. However, the study found that the percentage of non-independent directors, the extent of board independence, and the board quality had a significant impact on firm performance as measured by Tobin’s Q. Because Tobin’s Q is a market based measure, it is possible to hypothesize that investors are more apt to recognize the role of corporate governance in safeguarding the interests of shareholders. Accordingly, these investors reward such firms through buying of their shares and it is this which market actions which translate
into positive and significant relationships in the case of Tobin’s Q as opposed to the ROA. Kyereboah –Coleman (2007) also makes the same observation.

A more detailed analysis of the corporate governance characteristics of firms shows that, while overall corporate governance is important, individual aspects of governance have a differential impact. That is, while ownership and remuneration policies improve corporate performance, the quality of disclosure and audit is a more important driver of corporate value. Similarly, corporate disclosure has the strongest impact on capital expenditure. In the presence of other governance characteristics, board structure, which is the most frequent topic of research in corporate governance, is shown to have no impact on performance, value, investment or institutional ownership. Overall, corporate disclosure and audit committee quality appear to be the most important component of governance in a firm.

In the overall sample, however, the study did not find any significance between firm performance and the corporate governance index. This was the case for both the Return on Assets and the Tobin’s Q measures of performance. This probably suggests that the corporate governance regime in the sampled firms may not have been strong enough to have an impact on the firms’ performance. It may also be attributed to the effect of other non-performance variables such as macro-economic forces which may have rendered irrelevant any impact corporate governance mechanisms may have had. It should also be realized that the period within which the study referred was marked by many changes in the external operational environment of the sampled firms, a situation which may have confounded the financial and market performance of the firms under study.

5.3 Policy Recommendations
This study recommends that, at the policy level, regulatory bodies such as CMA and industry bodies such as NSE insist that companies must increase the percentage of independent directors on their boards. This is because this study has shown that there exists a positive correlation between board quality and the percentage of independent directors. These regulatory bodies could consider setting a certain threshold percentage
for the representation by independent directors for all firms listed on the stock exchange. For smaller firms, the threshold percentage of independent directors could be recommended but not mandatory.

Because the overall model does not find a significant relationship between corporate performance and corporate governance, this study recommends that firms be advised to adopt the UK's "Comply or Explain" governance systems. This is out of the realization that it can be expensive putting in place stringent requirements for corporate governance yet available results regarding performance and corporate governance are not always conclusive. Mandatory systems for corporate governance hinder business prosperity, as well as limit growth and impede risk taking.

Policies should attempt to account for interactions between corporate governance and the institutional framework in Kenya. The search for good practice should be based on identification of what works in our economic environment, to discern what broad principles can be derived from current experience. As this document has demonstrated, not only well different improvements be called for in different systems but these improvements will also depend upon the factors determining effectiveness of different systems in a particular industry. For example, some systems and circumstances in other areas such as strengthening product competition or removing distortions in corporate governance mechanisms created by other regulations (e.g Central Bank recent rules on composition directorships).

5.4 Limitations of the Study
This study suffered a number of limitations. Firstly, the study did not manage to obtain data for frequency of meetings of directors. The number of meetings conducted by the board has been identified by some researchers (such as Jensen, 1993) as being a useful corporate governance indicator and is a proxy for board intensity. It is felt, however, that the omission of this variable does not compromise the quality of the results discussed here. This is because even in the study conducted by Kyereboah-Coleman (1997), the frequency of board meetings as a measure of board activity intensity had a very weak
relationship with Tobin's Q in the overall sample. This researcher further argues that the number of meetings does not necessarily imply good corporate practices and, instead, may be indicative of the corporate crisis. Jensen (1993) has also argued that board meetings do not necessarily enhance firm performance and that board meeting frequency increases when there are problems.

The study may also have been affected by the fact that it concentrated on a time frame (2006-2010) that was unusual in the sense that it coincided with a wholly-changed macro-economic and political environments in the country occasioned by political violence which wiped out the gains companies may have made. This may explain why the models of performance were not found to be statistically significant and can be considered a limitation of this study.

Most of the data obtained is accounting data which does not capture the qualitative characteristics of the Board and top management. It does not also show the possible influence of powerful shareholders.

The Nairobi Stock Securities Exchange is a developing market and unlike in developed countries, a lot of market information may not be explicit. Capital market dynamism the world over has an impact in Kenyan local market though at a slower pace. Today businesses that hope to succeed in the global market place must incorporate newer and strict legal requirements and also take into account growing social expectations. This realization can be considered a major limitation to the study conclusions.

5.5 Suggestions for Further Studies

It is suggested that future studies of the relationship between performance and corporate performance include the role of board diversity on performance. This is because various writers are now hypothesizing that boards should reflect the diversity of the community in which the companies operate. This means that boards should have representations from members of minority communities and women (these are the two major components of diversity).
Future studies should investigate how performance differs between companies whose boards are diversified from those that are less diversified. According to Hamel and Prahalad (1994), unless a company did something to dramatically increase genetic variety, it would find it very difficult to compete with new, nontraditional competitors. Companies without genetic diversity have been associated with a downward spiral of customer expectations, where ever poorer service begets ever lower expectations and ever more price sensitivity. According to these researchers, one way to introduce more genetic variety into a population is to bring in new members who cross-breed with the old. The corporate equivalent to cross-breeding is hiring managers from outside and may take the form of bringing in a new CEO or raiding a competitor for key divisional vice president (ibid.).

Future studies should also investigate the impact of the board’s time frame (that is, does the board take a long term view or short term view of its work?) on corporate performance. The hypothesis here is that boards which take a long term time frame are more likely to return higher performance than those which take a short term time frame. According to Lorsch and Clark (2008), boards must assume leadership of their companies’ long term destiny. Boards must push management to address the company’s future through a process of deliberate engagement with senior managers about critical future concerns and to signal that those issues are priorities. A long-term view of the future must start with a common understanding between directors and managers about how far out the long term goes.

It is also recommended that future studies consider the impact of large institutional-shareholding on firm governance and performance. In Kenya, institutions such as the National Social Security Fund (NSSF) hold a large percentage of shares in private companies and have representations on the boards of these companies. It would be useful for future studies to compare the performance of private companies with large institutional shareholding to that of companies without. The test should be whether
boards of these two types of companies differ in their effectiveness and the impact on performance.

Last but not least, the role of independent directors should be studied in more depth in future studies given the input such directors bring to the various influential committees of the board such as remuneration, nomination, and audit.
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