

**EFFECTS OF CORPORATE GOVERNANCE ON THE VALUE OF  
SELECTED FIRMS QUOTED AT THE NAIROBI SECURITY  
EXCHANGE KENYA.**

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**A Thesis submitted to the institute of Postgraduate Studies, Kabarak University,  
in Partial Fulfillment for the Requirements for the Degree of Doctor of Philosophy  
Business Administration (Finance)**

**October 2014.**

## DECLARATION

This thesis is my original work and has not wholly or in parts been presented for the award of a degree in any other university

Student

Signature.....



Date.....

24<sup>th</sup> October 2014

Name.....

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**RECOMMENDATION**

To the institute of Postgraduate Studies:

This Thesis entitled “Effects of Corporate Governance On The Value of Selected Firms Quoted at the Nairobi security Exchange Kenya” and written by Charles Yugi Tibbs is presented to the institute of Postgraduate Studies of Kabarak University. We have reviewed the thesis and recommend it be accepted in Partial fulfillment of the Requirements for the degree of **Doctor of philosophy in Business Administration(Finance)**.

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## **ACKNOWLEDGEMENT**

I wish to thank my supervisors Dr Peter Kimutai Cheruiyot and Prof Joseph Benard Ojiambo, Dr Stella Muhanji and Dr Irine Asienga for their technical support, I further thank University of Kabianga for supporting me during the time of writing the thesis. I also thank Kabarak University's Graduate School for guidance throughout the period of research and thesis writing, I also thank my colleagues and friends for their encouragement and support. Finally, I thank Almighty God for keeping me strong through the entire period.

## **DEDICATION**

I dedicate this thesis to my wife Alice Mwazuna and my children Robina Christine Tibbs  
, Lakisha Mugah Tibbs and Jeremy Nelson Tibbs.

## ABSTRACT

In the wake of recent corporate scandals. It is observed that the value of the firm keeps on changing for the worse, the question is; could it be as a result of corporate governance? This study therefore looked at the effects of corporate governance on the value of firms quoted at the Nairobi Security Exchange in Kenya value of the firm. The study adopted diagnostic research design, a sample of 49 quoted companies were selected through stratified and simple sampling designs. Data was analyzed through inferential statistics which involved testing of hypotheses using simple regression model at 95% confidence level, descriptive statistics were also used, which included the use of frequencies and percentage. Data was presented by use of tables and charts. Findings of the study showed that overall level of adoption of the corporate governance stood at 73%. Findings also indicated that individual measures of corporate governance did not affect the value of the firm individually, except board accountability that had an influence on value of the firm measured by ROA, aggregated governance index was had a significant effect ( $p < 0.05$ ), findings also show that size of the firm affected value of the firm, it was concluded that the most implemented measure of corporate governance was shareholders and the least implemented measure of corporate governance is corporate behavior. It was concluded that measures of corporate governance individually did not affect value of the firm but when aggregated they affected value of the firms. The study recommended that board accountability be improved by strengthening the regulatory authority also it is recommended share holders rights to be taken seriously to avoid agency principle conflicts, executive remuneration be moderate for better performance, disclosure and internal control be done effectively, activities relating to take-over's must be sanctioned by investors and corporate behavior must be nurtured in a predictable way for performance.

**Key words:** Corporate governance, Value of the firm, Security exchange.

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## **ABBREVIATIONS/ACCRONYMS**

**AGM** - Annual General Meeting

**CACG** - Commonwealth Association for Corporate Governance

**CBK** - Central Bank of Kenya

**CEO** - Chief Executive Officer

**CGI**-Corporate Governance Index

**CMA** - Capital Markets Authority

**GMI** - Governance Metrics International

**IOSCO** - International Organization of Securities Commission

**NSE** - Nairobi Security Exchange

**OECD** - Organization for Economic Cooperation and Development

**PSCIG** - Private Sector Initiative for Corporate Governance

**PRSCGT** - Private Sector Corporate Governance Trust

**ROA**-Return on Assets

**US** - United States

## **OPERATIONAL DEFINITION OF TERMS**

**Agent** –employees of the quoted companies

**Board Accountability** - duty to ensure that the organization is accountable for its performance to members, funders, stakeholders and the wider community

**Capped Participation** - when the participation rights of the preferred stock are limited so that the preferred stock stops participating in the proceeds of a sale (or other distribution) after it has received back a pre-determined shillings amount (caps typically range from three to five times the original amount invested).

**Corporate behavior** - behavior of an organization influenced by the arrangement of its ownership and control

**Corporate control** – These are general forces that influence the use of corporate resources

**Corporate governance** – board accountability, financial disclosure, shareholder rights, executive remuneration, market for corporate control and corporate behavior

**Principals** – Shareholders/owners of firms quoted at the Nairobi Security Exchange

**Related party transactions** - A business deal or arrangement between two parties who are joined by a special relationship prior to the deal for thi case agents and the companies.

**Shareholders rights**- voting rights

**Value of the firm** - Total assets of the firm plus the market value of the share minus the book value of the shares divided by the total value of the assets also means Return on Assets.

# CHAPTER ONE

## INTRODUCTION

This chapter presents the background of the study, problem statement, objectives of the study, research questions and hypotheses, importance of the study , scope of the study and assumptions of the study.

### 1.1 Background to the Study

Corporations have become powerful and dominant institutions. They have reached every corner of the globe in various sizes, capabilities and influences. Their governance has influenced economies and various aspects of social landscape. Shareholders are seen to be losing trust in management of the firms and market value has been tremendously affected. Moreover with the emergence of globalization, there is greater expansion of territories and less of governmental control, which results in a greater need for accountability (Crane & Matten, 2007). Hence, corporate governance has become an important factor in managing organizations in the current global and complex environment. In order to understand corporate governance, it is important to highlight its definition. Even though, there is no single accepted definition of corporate governance, it can be defined as a set of processes and structures for controlling and directing an organization. It constitutes a set of rules, which governs the relationships between management, shareholders and other stakeholders (Ching, Tan & Chi, 2006). According to Abu-Tapanjeb (2008), the term corporate governance originated from a Greek word, “kyberman” meaning to steer, guide or govern. From this Greek word, it moved over to Latin, where it was known as “gubernare” and the French version of “governor”. Abu-



Tapanjeb (2008) also indicates that it could also mean the process of decision-making and the process by which decisions may be implemented. Hence, corporate governance has much a different meaning to different organizations. In this study, the definition put forward by Abu Tapanjeb applies. Corporate governance extends, to cover economic and non-economic activities. Literature in corporate governance provides some form of meaning on governance, but falls short in its precise meaning of governance. Such ambiguity emerges in words like control, regulate, manage, govern and governance. Owing to such ambiguity, there are many interpretations. It may be important to consider the influences a firm has or is affected by in order to grasp a better understanding of governance. Owing to vast influential factors, proposed models of corporate governance can be flawed as each social scientist is forming their own scope and concerns. Corporate governance theories range from agency theory and expanded into stewardship theory, stakeholder theory, resource dependency theory, transaction cost theory, political theory and ethics related theories such as business ethics theory, virtue ethics theory, feminists ethics theory, discourse theory and postmodernism ethics theory (Tapanjeb,2008).

Prompted by corporate scandals such as Marconi in the United Kingdom in the year 1912 ,Enron in the year 2000, World Com in the United States in 2002 and Royal A hold in Netherlands in 2003, corporate governance has received a lot of attention from the financial community (Bhagat & Black, 2002). Institutional investors have started evaluating which role corporate governance should play in their investment policies. The Mckinsey's (2005) Global corporate governance opinion survey shows that 15% European institutional investors consider corporate governance as more important than a

firm's financial issues, such as profit performance or growth potential. Additionally 22% of European investors' institutions are willing to pay a premium of 19% for a well governed company, although this evidence demonstrates that there is interest in corporate governance. The important question which is whether good corporate governance leads to higher stock returns and consequently to higher firm valuation still remains.

In United States of America, efforts to find correlation between a firm's governance attributes and its value mostly show no or weak correlation, for example the proportion of independent directors on a company's board has no statistically significant effect on performance (Bhagat & Black, 2002). According to Schleifer et al (1988). There are three types of studies that have been done on the association between financial disclosure and value of the firm. These are, relative association studies, incremental association studies, and marginal information content studies. Relative association studies compare the association between stock market values or changes in value and alternative bottom line measures. Incremental studies use regression to investigate whether the accounting number of interest is helpful in explaining value or returns in the long run given other specified variables. Marginal information content studies investigate whether a particular accounting number adds to the information set available to the investors in this study relative association study applies.

In Kenya, corporate governance has gained prominence as is the case in other countries (Ekadah and Mboya, 2011). This has been caused partly by corporate failures or poor performance of public and private companies (Barako, Hancock & Izan, 2006). The (PSCGT) Private Sector Corporate Governance Trust Kenya has been a good advocate of

corporate governance in Kenya . Corporate governance framework in Kenya started in 1999 when the centre for corporate governance Kenya developed a framework which was voluntary for companies to adopt. The framework was further taken up by the Capital Markets Authority (CMA) in 2000 as draft Corporate governance practices for listed companies in Kenya. The CMA made it mandatory for listed companies to adopt those corporate governance practices, these practices mainly dealt with issues of board such as board composition, role of audit committee ,separation of the role of CEO and the chair. In addition they focused on the rights of the shareholders.

According to Manyuru (2005), Nairobi Security Exchange (NSE) market was started in the 1920's by the British as an informal market for Europeans only. The administration of the NSE Limited is located on the 1<sup>st</sup> floor, Nation Centre, Kimathi Street, Nairobi, Kenya.

As a capital market institution, the Security Exchange plays an important role in the process of economic development. It helps mobilize domestic savings thereby bringing about the reallocation of financial resources from dormant to active agents. Long-term investments are made liquid, as the transfer of securities between shareholders is facilitated. The security exchange has also enabled companies to engage local participation in their equity, thereby giving Kenyans a chance to own shares.

The NSE deals in both variable income securities and fixed income securities. Variable income securities are the ordinary shares which have no fixed rate of dividend payable as the dividend is dependent upon both the profitability of the company and what the board

of directors decides (with ratification by the shareholders in an AGM). The fixed income securities include Treasury and Corporate Bonds, preference shares, and debenture stocks, these have a fixed rate of interest/dividend, which is not dependent on profitability. The stock market consists of both the primary and secondary markets. In the primary of new issue market, shares of stock are first brought to the market and sold to investors. In the secondary market, existing shares are traded among investors.

The Nairobi Security Exchange has 58 companies quoted at the market as at December 2012. The quoted companies are classified into ten segments namely: Agriculture, banking, automobiles and accessories, commercial and services, construction and allied, energy and petroleum, insurance, investment, manufacturing and allied, telecommunication and technology ([www.nairobistockexchange.com](http://www.nairobistockexchange.com)) accessed on 20<sup>th</sup> Jan 2012).

## **1.2 Statement of the problem**

Corporate governance has been a recent source of interest to investors, policy makers, and corporations. In the wake of recent corporate scandals for example Enron in the year 2000 and World Com in the year 2002 both in the United States, Royal A hold in Netherlands in 2003, Uchumi and CMC limited in Kenya, investors have asked what must be done to get corporations to maximize wealth of the shareholder. Policy makers have responded by passing legislation requiring corporate governance standards. Corporations have been working, not always without complaint, to meet the demands of the new laws.

According to Muriithi (2009) despite the existence of provisions in company laws,

companies processes have been characterized by scandals where directors have acted illegally or in bad faith towards their shareholders. This has led to establishment of corporate governance codes. In Kenya, a number of problems relating to corporate governance have been identified, the problems range from errors, mistakes to outright fraud, the origins of the problems range from concentrated ownership, weak incentives ,poor protection of minority shareholders to weak information standards(Mwaura,2007).It is observable that market value of equity of listed companies at the Nairobi Security Exchange has been fluctuating therefore affecting the value of the firm, however it is not clear whether the fluctuations are attributable to corporate governance In Kenya, little attention has been paid to determine the relationship between corporate governance and value of the firm, many studies have not paid attention to other measures of corporate governance like, corporate behavior, market for corporate control and financial disclosure and internal control .Mulili(2010) did a study on corporate governance practices in developing countries: the case for Kenya, Ongore and K'bonyo (2011) did a study on effects of selected corporate governance characteristics on firm performance: empirical evidence from Kenya, Manyuru (2005)looked at corporate governance and organization performance, Matengo (2008) looked at the relationship between corporate governance practices and performance in banking industry ,Jebet (2001) did a study of corporate governance practices of firms quoted at the Nairobi Security Exchange ,Muriithi (2005) did the relationship between corporate governance mechanisms and performance of firms quoted at NSE . This study therefore sought to establish the effect of corporate governance on the value the firms quoted at the Nairobi Security Exchange.

### **1.3 Objectives of the study**

#### **1.3.1 General objective**

The general objective of this study was to determine the effects of corporate governance on the value of the firms quoted at NSE.

#### **1.3.2 Specific Objectives**

The following were specific objectives of the study :

- i. To Establish the extent of adoption of corporate governance by the quoted firms trading at the NSE
- ii. To establish the effect of board accountability on value of the firms quoted at NSE
- iii. To examine the effect of financial disclosure on value of firms quoted at NSE
- iv. To determine the effect of shareholders rights on value of the firms quoted at NSE
- v. To establish the effect of Executive remuneration on value of the firms quoted at NSE
- vi. To determine the effect of market for corporate control on value of the firms quoted at NSE
- vii. To find out the effect of corporate behavior on value of the firms quoted at NSE

## **1.4. Research questions and Hypotheses**

### **1.4.1 Research Questions**

This study was guided by the following research question:

- 1) What is the extent of adoption of corporate governance by firms quoted at the NSE?

### **1.4.2 Hypotheses**

**HO<sub>1</sub>:** Board accountability does not affect the value of the firms quoted at NSE

**H<sub>1</sub>:** Board accountability affects value of the firms quoted at NSE

**HO<sub>2</sub>:** Financial disclosure does not affect the value of the firms quoted at NSE

**H<sub>2</sub>:** Financial disclosure affects the value of the firms quoted at NSE

**HO<sub>3</sub>:** Share holder rights does not affect the value of the firms quoted at NSE

**H<sub>3</sub>:** Shareholder rights affects the value of the firm

**HO<sub>4</sub>:** Remuneration does not affect value of the firms quoted at NSE

**H<sub>4</sub>:** Executive remuneration affects value of the firms quoted at NSE

**HO<sub>5</sub>:** Market for corporate control does not affect value of the firms quoted at NSE

**H<sub>5</sub>:** Market for corporate control affects value of the firms quoted at NSE

**HO<sub>6</sub>:** Corporate behavior does not affect the value of the firms quoted at NSE.

**H<sub>6</sub>:** Corporate behavior affects value of the firms quoted at NSE

### **1.5. Significance of the study**

This study is of importance to shareholders and managers since it makes recommendations that reduce the agency principal conflict. It establishes the governance indices mostly practiced and how they affect the value of firms. Which are of paramount importance to shareholders and managers.

Further, this study adds literature to the existing body of knowledge and makes recommendations for areas for further research. This will be significant to scholars.

This study establishes governance index that can be used as a base by policy makers in developing corporate governance policies.

### **1.6. Scope and Limitation of the Study**

This study was conducted between May 2011 and August 2012. The study was conducted on companies that are registered at the NSE which were operational for the last three years. In order to locate these companies, NSE data base was used to get information about the headquarters of these companies. The study covered a sample of 49 companies quoted at the NSE. The respondents targeted were corporate affairs staff of the companies.

The study suffered a limitation of some respondents not returning the questionnaires hence reducing the number of usable response. However, 10% of the NSE listed companies had been added to the sample to cater for non response rate.



## **1.7. Assumptions of the study**

It was assumed that

- i. About 80% of the respondents would return the questionnaires
- ii. All respondents provided honest responses
- iii. All respondents had knowledge about corporate governance

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.0 Introduction**

This chapter presents a detailed review of literature related to the problem area. The chapter also presents the conceptual framework which is a basis of the relationship between variables.

#### **2.1 Theoretical Background**

##### **2.1.1 Fundamental Corporate Governance Theories**

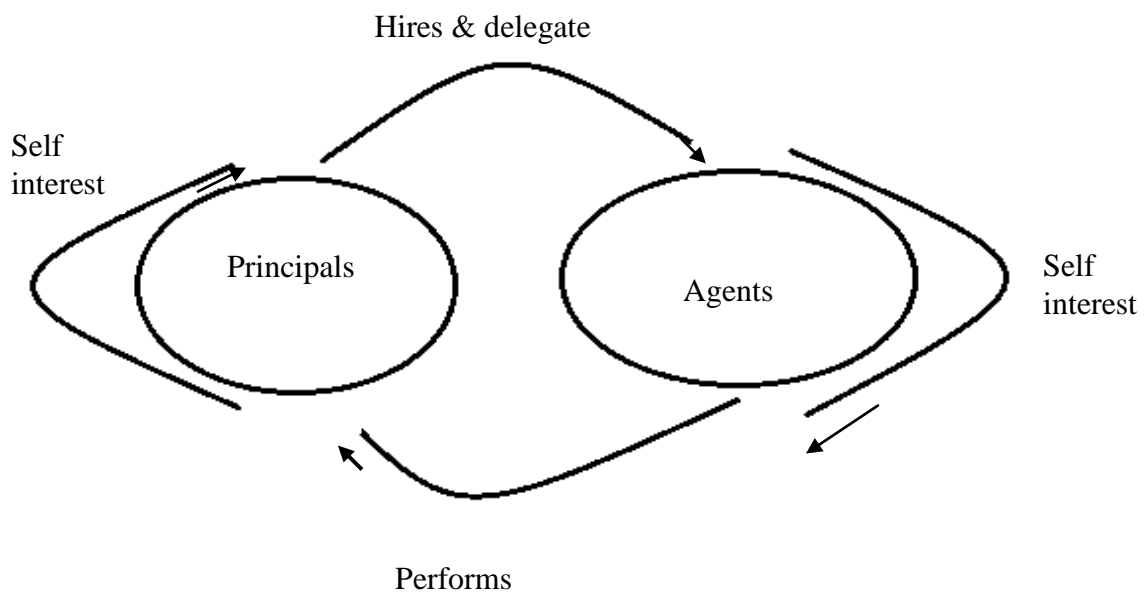
###### **2.1.1.1 Agency Theory**

Agency theory having its roots in economic theory was expounded by Alchian and Demsetz (1972) and further developed by Jensen and Meckling (1976). Agency theory is defined as “the relationship between the principals, such as shareholders and agents such as the company executives and managers”. In this theory, shareholders who are the owners or principals of the company, hire the agents to perform work. Principals delegate the running of business to the directors or managers, who are the shareholder’s agents (Clarke, 2004). Indeed, Daily et al (2003) argued that two factors can influence the prominence of agency theory. First, the theory is a conceptually simple theory that reduces the corporation to two participants of managers and shareholders. Second, agency theory suggests that employees or managers in organizations can be self-interested.

The agency theory shareholders expect the agents to act and make decisions in the principal's interest. On the contrary, the agent may not necessarily make decisions in the best interests of the principals (Padilla, 2002). Such a problem was first highlighted by Adam Smith in the 18<sup>th</sup> century and subsequently explored by Ross (1973). The first detailed description of agency theory was presented by Jensen and Meckling (1976). Indeed, the notion of problems arising from the separation of ownership and control in agency theory has been confirmed by Davis, Schoorman and Donaldson (1997).

In agency theory, the agent may succumbed to selfish, opportunistic behavior and falling short of congruence between the aspirations of the principal and the agent's pursuits. Even the understanding of risk defers in its approach. Although with such setbacks, agency theory was introduced basically as a separation of ownership and control (Bhimani, 2008). Holmstrom and Milgrom (1994) argued that instead of providing fluctuating incentive payments, the agents will only focus on projects that have a high return and have a fixed wage without any incentive component. Although this will provide a fair assessment, but it does not eradicate or even minimize corporate misconduct. Here, the positivist approach is used where the agents are controlled by principal-made rules, with the aim of maximizing shareholders value. Hence, a more individualistic view is applied in this theory (Clarke, 2004). Indeed, agency theory can be employed to explore the relationship between the ownership and management structure. However, where there is a separation, the agency model can be applied to align the goals of the management with that of the owners. Due to the fact that in a family firm, the management comprises of family members, hence the agency cost would be minimal as

any firm's performance does not really affect the firm performance (Eisenhardt, 1989). The model of an employee portrayed in the agency theory is more of a self-interested, individualistic and are bounded rationality where rewards and punishments seem to take priority (Jensen & Meckling, 1976). This theory prescribes that people or employees are held accountable in their tasks and responsibilities. Employees must constitute a good governance structure rather than just providing the need of shareholders, which maybe challenging the governance structure.



**Fig. 2.1: The Agency Model**

**Source –( Jensen & Meckling, 1976)**

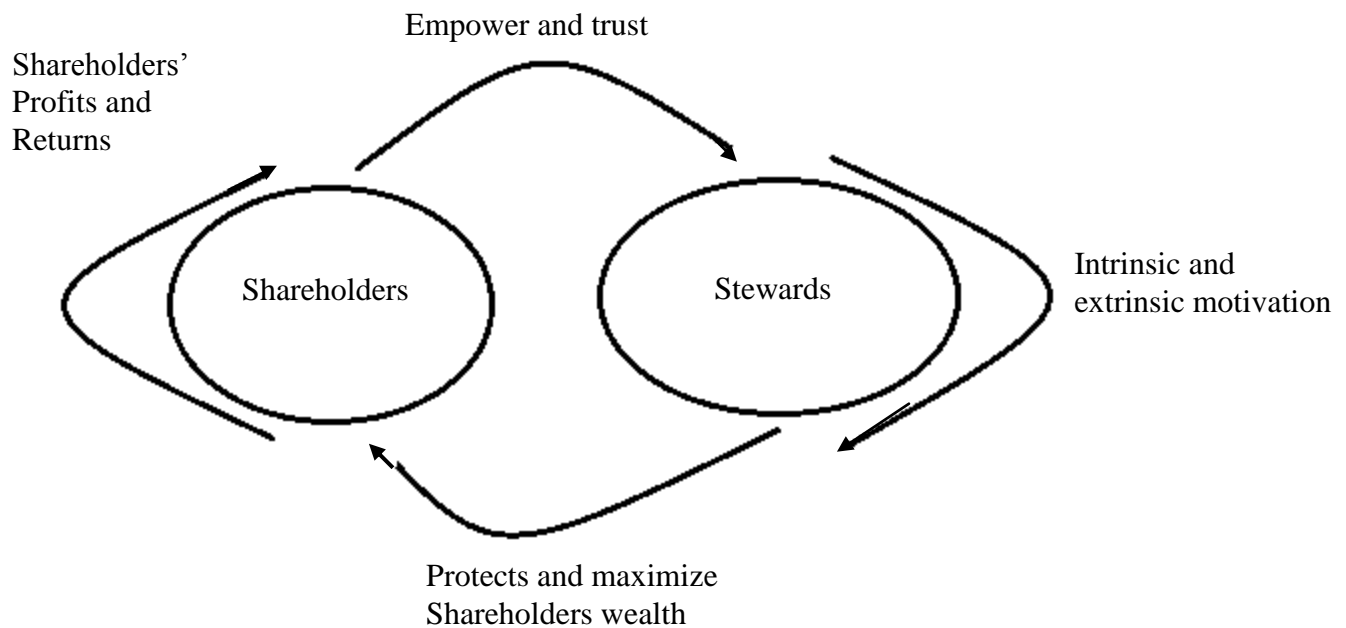
### **2.1.1.2 Stewardship Theory**

Stewardship theory has its roots in psychology and sociology. the word steward is defined by Davis, Schoorman & Donaldson (1997) as one who“ protects and maximizes shareholders wealth through firm performance, because by so doing, the steward's utility functions are maximized”. In this perspective, stewards are company executives and managers working for the shareholders.They protect and make profit for the shareholders.

Unlike agency theory, stewardship theory stresses not on the perspective of individualism (Donaldson & Davis, 1991), but rather on the role of top management as being as stewards and thus integrating their goals as part of the organization. The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained. Agyris (1973) argues that agency theory looks at an employee or people as an economic being, and so suppresses an individual's own aspirations. However, stewardship theory recognizes the importance of structures that empower the steward and offers maximum autonomy built on trust (Donaldson and Davis, 1991) - It stresses on the position of employees or executives to act more autonomously so that the shareholders' returns are maximized. Indeed, this can minimize the costs aimed at monitoring and controlling behaviors (Davis, Schoorman & Donaldson, 1997).

On the other end, Daily et al. (2003) argued that in order to protect their reputations as decision makers in organizations, executives and directors are inclined to operate the firm to maximize financial performance as well as shareholders' profits. In this sense, it is believed that the firm's performance can directly impact perceptions of their individual performance. Indeed, Fama (1980) contends that executives and directors are also managing their careers in order to be seen as effective stewards of their organization, whilst, Shleifer and Vishny (1997) insist that managers return finance to investors to establish a good reputation so that that can re-enter the market for future finance. Stewardship model can have linking or resemblance in countries like Japan, where the Japanese worker assumes the role of stewards and takes ownership of their jobs and work at them diligently.

Moreover, stewardship theory suggests unifying the role of the CEO and the chairman so as to reduce agency costs and to have greater role as stewards in the organization. It was evident that there would be better safeguarding of the interest of the shareholders. It was empirically found that the returns have improved by having both these theories combined rather than separated (Donaldson and Davis, 1991).



Source – (Donaldson and Davis, 1991)

**Fig 2.2: The Stewardship Model**

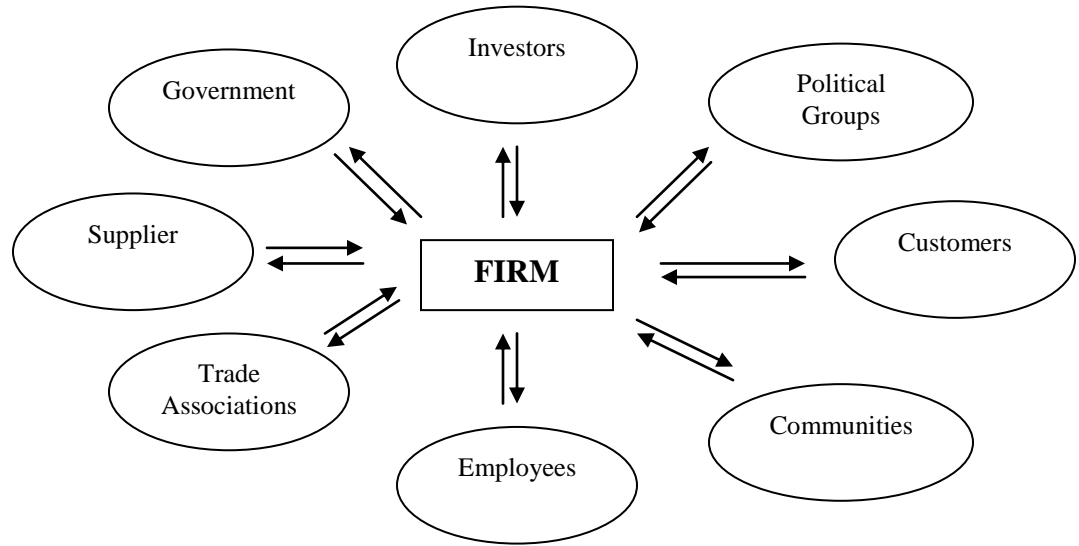
### 2.1.1.3 Stakeholder Theory

Stakeholder theory was embedded in the management discipline in 1970 and gradually developed by Freeman (1984) incorporating corporate accountability to a broad range of stakeholders. Wheeler et al, (2002) argued that stakeholder theory derived from a combination of the sociological and organizational disciplines. Indeed, stakeholder theory

is less of a formal unified theory and more of a broad research tradition, incorporating philosophy, ethics, political theory, economics, law and organizational science.

Stakeholder theory can be defined as “any group or individual who can affect or is affected by the achievement of the organization’s objectives”. Unlike agency theory in which the managers are working and serving for the stakeholders, stakeholder theorists suggest that managers in organizations have a network of relationships to serve - this include the suppliers, employees and business partners. It was argued that this group of network is important other than owner-manager-employee relationship as in agency theory (Freeman, 1999). On the other end, Sundaram and Jnkpen (2004) contend that stakeholder theory attempts to address the group of stakeholder deserving and requiring management’s attention. Whilst, Donaldson and Preston (1995) claimed that all groups participate in a business to obtain benefits. Nevertheless, Clarkson (1995) suggested that the firm is a system, where there are stakeholders and the purpose of the organization is to create wealth for its stakeholders.

Freeman (1984) contends that the network of relationships with many groups can affect decision making processes as stakeholder theory is concerned with the nature of these relationships in terms of both processes and outcomes for the firm and its stakeholders. Donaldson & Preston (1995) argued that this theory focuses on managerial decision making and interests of all stakeholders have intrinsic value, and no sets of interests is assumed to dominate the others.



Source – (Donaldson and Preston, 1995)

**Fig 2.3: The Stakeholder Model**

#### 2.1.1.4 Resource Dependency Theory

Whilst, the stakeholder theory focuses on relationships with many groups for individual benefits, resource dependency theory concentrates on the role of board of directors in providing access to resources needed by the firm. Hillman, Canella and Paetzold (2000) contend that resource dependency theory focuses on the role that directors play in providing or securing essential resources to an organization through their linkages to the external environment. Indeed, Johnson et al, (1996) concurs that resource dependency theorists provide focus on the appointment of representatives of independent organizations as a means for gaining access in resources critical to firm success. For example, outside directors who are partners to a law firm provide legal advice, either in board meetings or in private communication with the firm executives that may otherwise be more costly for the firm to secure.



It has been argued that the provision of resources enhances organizational functioning, firm's performance and its survival (Daily et al, 2003). According to Hillman, Canella and Paetzold (2000) directors bring resources to the firm, such as information, skills, access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy. Directors can be classified into four categories of insiders, business experts, support specialists and community influential. First, the insiders are current and former executives of the firm and they provide expertise in specific areas such as finance and law on the firm itself as well as general strategy and direction. Second, the business experts are current, former senior executives and directors of other large for-profit firms and they provide expertise on business strategy, decision making and problem solving. Third, the support specialists are the lawyers, bankers, insurance company representatives and public relations experts and these specialists provide support in their individual specialized field. Finally, the communities influential are the political leaders, university faculty, members of clergy, leaders of social or community organizations.

#### **2.1.1.5 Transaction Cost Theory**

Transaction cost theory was first initiated by Cyert and March (1963) and later theoretical described and exposed by Williamson (1996). Transaction cost theory was an interdisciplinary alliance of law, economics and organizations. This theory attempts to view the firm as an organization comprising people with different views and objectives. The underlying assumption of transaction theory is that firms have become so large they in effect substitute for the market in determining the allocation of resources, In other words, the organization and structure of a firm can determine price and production. The

unit of analysis in transaction cost theory is the transaction. Therefore, the combination of people with transaction suggests that transaction cost theory managers are opportunists and arrange firms' transactions according to their interests (Williamson, 1996).

#### **2.1.1.6 Political Theory**

Political theory brings the approach of developing voting support from shareholders, rather by purchasing voting power. Hence having a political influence in corporate governance may direct operations within the organization. Public interest is much reserved as the government participates in corporate decision making, taking into consideration cultural challenges (Pound, 1993). The political model highlights the allocation of corporate power, profits and privileges are determined via the governments' favor. The political model of corporate governance can have an immense influence on governance developments. Over the last decades, the government of a country has been seen to have a strong political influence on firms. As a result, there is an entrance of politics into the governance structure or firms' mechanism (Hawley and Williams, 1996).

#### **2.1.1.7 Ethics Theories and Corporate Governance**

Other than the fundamental corporate governance theories of agency theory, stewardship theory, stakeholder theory, resource dependency theory, transaction cost theory and political theory, there are other ethical theories that can be closely associated to corporate governance. These include business ethics theory, virtue ethics theory, feminist ethics theory, discourse ethics theory, postmodern ethics theory.

Business ethics is a study of business activities, decisions and situations where the right and wrongs are addressed. The main reasons for this are the power and influence of business in any given society is stronger than ever before. Businesses have become a major provider to the society, in terms of jobs, products and services. Business collapse has a greater impact on society than ever before and the demands placed by the firm's stakeholders are more complex and challenging. Only a handful of business giants have had any formal education on business ethics but there seems to be more compromises these days. Business ethics helps in identifying benefits and problems associated with ethical issues within the firm. Business ethics is important as it gives a new light into present and traditional view of ethics (Crane and Matten, 2007). In understanding the 'right and wrongs' in business ethics, Crane & Marten, (2007) injected morality that is concerned with the norms, values and beliefs fixed in the social process which helps right and wrong for an individual or social community. Ethics is defined as the study of morality and the application of reason which sheds light on rules and principle, which is called ethical theories that ascertains the right and wrong for a situation.

Whilst business ethics theory focuses on the "rights and wrongs" in business, feminist ethics theory emphasizes on empathy, healthy social relationship, loving care for each other and the avoidance of harm. In an organization, to care for one another is a social concern and not merely a profit centered motive. Ethics has also to be seen in the light of the environment in which it is exercised. This is important as an organization is a network of actions, hence influencing trans-communal levels and interactions (Casey, 2006). On the other end, discourse ethics theory is concerned with peaceful settlement of conflicts. Discourse ethics, also called argumentation ethics, refers to a type of argument that tries

to establish ethical truths by investigating the presuppositions of discourse (Habermas, 1996). Maisenbach (2006) contends that such kind of settlement would be beneficial to promote cultural rationality and cultivate openness.

Virtue ethics theory focuses on moral excellence, goodness, chastity and good character. Virtue is a state to act in a given situation. It is not a habit as a habit can be mindless (Annas, 2003). Aristotle calls it as disposition with choice or decision. For example, if a board member decides to be honest, now that a decision which he makes and thus strengthens his virtue of honesty. Virtue involves two aspects, the affective and intellectual. The concept of affective in virtue theory suggests “doing the right thing and have positive feelings”, whilst, the concept of intellectual suggests “to do virtuous act with the right reason”. Virtues can be instilled with education. Aristotle mentions that knowledge on ethics is just like becoming a builder (Annas, 2003). Through the process of educating and exposure to good virtues, the development of ethical values in a child’s life is evident. Hence, if a person is exposed to good or positive ethical standards, exhibiting honesty, just and fairness, than he would exercise the same and it will be embedded in his will to do the right thing at any given situation. Virtue ethics is eminent to bring about the intangibles into an organization. Virtue ethics highlights the virtuous character towards developing a morally positive behavior (Crane & Matten, 2007). Virtues are a set of traits that helps a person to lead a good life. Virtues are exhibited in a person’s life. Aristotle believed that virtue ethics consists of happiness not on a hedonistic sense, but rather on a broader level. Nevertheless, postmodern ethics theory goes beyond the facial value of morality and addressed the inner feelings and ‘gut

feelings' of a situation. It provides a more holistic approach in which firms may make goals achievement as their priority, foregoing or having a minimal focus on values, hence having a long term detrimental effect. On the other hand, there are firms today who are so value driven that their values become their ultimate goal (Balasubramaniam, 1999).

This review has seen corporate governance from various theoretical perspectives. The emergence of agency theory, stewardship theory, stakeholder theory, transaction cost theory and political theory addresses the cause and effect of variables, such as the configuration of board members, audit committee, independent directors and the role of top management. In addition, ethics in business have been closely associated with corporate governance. This can be seen with the association of business ethics theory, feminist ethics theory, discourse ethics theory, virtue ethics theory and postmodern ethics theory. Hence, it can be argued that corporate governance is more of a social relationships rather than process orientated structure. In addition, these theories focused on the view that the shareholders' aimed to get a return on their investments. In today's business environment, business process should also focus on other critical factors such as legislation, culture and institutional contexts.

Corporate governance is constantly changing and evolving and changes are driven by both internal and external environmental dynamics. The internal environment has a fixed mindset of shareholders' relationship with stakeholders and maximizing profits. Whilst, issues in the external environment such as the breakup of large conglomerates like Enron, mergers and acquisitions of corporation, business collaborations, easier financial funding, human resource diversity, new business start-ups, globalization and business

internationalization, and the advance of communication and information technology have directly and indirectly caused the changes in corporate governance. The current corporate governance theories cannot fully explain the complexity and heterogeneity of corporate business. Governance for different country may vary due to its cultural values, political and social and historical circumstances. In this sense, governance for developed countries and developing countries can vary due to the culture and economic contexts of individual country (Balasubramaniam, 1999)..

Moreover, an effective and good corporate governance cannot be explained by one theory but it is best to combine a variation of theories, addressing not only the social relationships but also emphasize on the rules and legislation and stricter enforcement surrounding good governance practice and going beyond the norms of a mechanical approach towards corporate governance. Literature has proven that even with strict regulations, there have been infringements in corporate governance. Hence it is crucial that a holistic realization be driven across the corporate world that would bring about a different perspective towards corporate governance. The days of cane and bridle are becoming a mere shadow and the need to get to the root of a corporation is essential. Therefore, it is important to re-visit corporate governance in the light of the convergence of these theories and with a fresh angle, which has a holistic view and incorporating subjectivity from the perspective of social sciences.

This study is anchored on four theories that are closely related to the area of study, these include; agency theory, stakeholders theory, resource dependency theory and stewardship theory of governance. These theories are linked to the study in that they are reflecting the basis of governance practices and how this affect the performance or value of the firm as

earlier explained critically in the individual theory. Researcher's opinion is that in Kenya examples of the firms that embrace this theory include Safaricom, Kenya Airways , who undertake activities that give evidence in line with the theories adopted. This include holding of annual general meetings to bring together the agent and the principle to discuss the way forward for the firm, also financial disclosures in terms of annual reports showing how investments have been operating. During the annual general meetings the shareholders are given a chance to elect members to be the board of directors hence determining the board composition.

Corporate governance refers to the broad range of policies and practices that stock holder, executive manager and board of directors use to manage themselves and fulfill their responsibilities to investors and other stakeholders. Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. At first glance, it is not entirely obvious why the suppliers of capital get anything back. After all, they part with their money, and have little to contribute to the enterprise afterwards. The professional managers or entrepreneurs who run the firms might as well abscond with the money. Although they sometimes do, usually they do not. Most advanced market economies have solved the problem of corporate governance at least reasonably well, in that they have assured the flows of enormous amounts of capital to firms, and actual repatriation of profits to the providers of finance. But this does not imply that they have solved the corporate governance problem perfectly, or that the corporate governance mechanisms cannot be improved.

## **2.2 Development in Corporate Governance**

The concept of corporate governance has a long history (Tricker, 1984). In the ancient times, when man was organized in tribes, tribal communities were in existence. The activities of the tribes as well as individual members were supervised by tribal communes to ensure adherence to tribal norms. Over a period of time, the tribal form gave rise to agrarian communities where the concept of family took hold. The family had a structure based on age and experience and the activities of the family members were viewed by the family councils.

According to Tricker (1984), in the Roman Empire, specific corporate bodies, such as municipal bodies were developed to manage public affairs with transparency for common good. In the Middle East, the nomadic tribes had their councils to ensure fair play and justice. The evolution of Christianity and Islam in the Middle East placed the responsibility of governance on religions. The church and the Mulahs were the torchbearers of the concept and practice of governance. In ancient India, the ruling emperors decided the concept and practice of governance. The treatise on economic administration, Arthashastra, written roughly 315 years Before Christ, developed a complete structure of governance in a kingdom with clear demarcation of authority, responsibility and accountability. In the east - Japan and China - also governance was placed in the hands of kings.

According to Tricker (1984), in the post-Christ period, with improved navigation and availability of vessels, the traders from Europe, especially the Portuguese and Dutch



explored the known expanse of the earth and gave rise to global trading entities which reported to the kings. This was the beginning of corporate governance. As the 16<sup>th</sup> century approached, the most powerful trading nation, England, formed a variety of regulations and regulatory authorities such as a joint stock companies and Bank of England to govern all trading activities on a platform of accountability, effectiveness and stakeholders' satisfaction. The concept of corporate governance was the basic platform for these regulations and regulatory authorities and over a period of time the concept and its practice took a firm root for all activities. Commonwealth Association for Corporate Governance defines corporate governance as a defined and promulgated interaction between the directors and management in pursuit of sustained wealth creation for the shareholders and stakeholders.

The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provided the structures through which the company objectives are set, and the means of attaining those objectives and monitoring performance (OECD,2004).

Wymeersch (1994) explained that Belgian companies were generally secretive and unaccountable to the outside world until a process of reform in 1991, when a series of amendments to Belgian company law focused on minority shareholder protection and rights. Also, corporate disclosure has been improved substantially. This is another example of an insider-type system becoming more market-oriented. Institutional

investors in Belgium constitute about 20% of shareholding, with shareholder activism on the increase. However, the market for corporate control through takeover has been viewed as relatively undeveloped. There is a Belgian code of corporate governance, the Cardon Report (1998).

Daniels and Morck (1996), in their study showed that there was an element of outsider-type corporate governance in Canada, as some of Canada's largest companies and all its major chartered banks were widely held by a large number of small shareholders, each of whom had little effective control over managerial decision making. However, they also showed that this type of ownership structure was not common, quoting evidence that only 16% of the 550 largest Canadian companies were placed in this mould (Morck and Stangeland, 1994). Indeed, research has shown that most large Canadian companies were not widely held by investors. Rao and Lee-Sing (1995) found that in more than three-quarters of the Canadian companies they studied, one large shareholder controlled at least 20% or more of the voting shares. Corporate ownership was found to be concentrated significantly in the hands of company management, leading to management control over director appointments and corporate decision making. Although this situation removes the traditional agency problems are introduced, as managerial control can lead to the appointment of board members for reasons of friendship rather than merit. Indeed, Morck and Stangeland (1994) showed that Canadian companies whose dominant shareholders were their founders performed significantly worse than other companies of comparable age and size. Daniels and Morck (1996) stressed that improving corporate governance is to encourage monitoring of company management by institutional investors. Institutional

investors controlled over 38% of Canadian companies in the mid-1990s (Rao and Lee-Sing, 1995), and that proportion has increased gradually. Their influence on corporate governance is likely to increase. Corporate governance reform in Canada was encouraged by the publication of the Dey Report (1994) and by the publication of a series of corporate governance standards by the institutional shareholder representative group, Pensions Investment Association of Canada (PIAC, 1998).

Yasaki (2001) discussed the evolution of corporate governance in Nigeria. The author explained that, before Nigeria became independent, company management was not controlled or monitored by external agents but that in recent years this has changed. Nigerian companies are being increasingly called on to increase accountability. Yasaki (2001) focused specifically on the Nigerian banking industry. The Commonwealth initiatives aimed at improving corporate governance, embodied in their Principles for Corporate Governance in the Commonwealth: Towards Global and Economic Accountability, are having a substantial impact on corporate Nigeria and other Commonwealth countries.

The first King Report (1994) was published in South Africa in order to formalize an ongoing process of corporate governance reform. It was a code of corporate practice and conduct that was based on a broad consensus of the South African business community. One of the most distinguishing aspects of South African corporate governance reform has been its focus on a more stakeholder-oriented approach. The first King Report (1994) included a code of business ethics for companies and their stakeholders, representing one of the most forward-looking codes of corporate governance practice. However, 2002 saw

the publication of an updated report, again taking the title the King Report (2002) from the chair of the Corporate Governance Committee, Mervyn E. King. The 2002 King Report continued in the same vein, by focusing on a stakeholder approach to corporate governance.

Capital Markets Authority (2003) refers to corporate governance as the manner in which the corporation's total portfolio of assets and resources are managed with the objective of maintaining and increasing shareholders' long term value while taking into account the interests of other stakeholders. Thus corporate governance seeks to ensure that the Board of Directors and management act in the best interests of the corporation and its stakeholders.

The World Bank Group and the Organization for Economic Co-operation and Development (OECD 2004) have established the Global Corporate Governance Forum. The forum builds a consensus in favor of appropriate policy, regulatory and corporate reforms, and also co-ordinates and disseminates corporate governance activities. The forum provides corporate development and human capacity building in the associated fields of corporate governance and trains the various professionals and other agents who are essential by building a culture of compliance.

On October 24, 1999, the Global Corporate Governance Forum Secretariat published the 2<sup>nd</sup> Edition of "The Inventory - A survey of Worldwide Corporate Governance Activity". The survey noted that "At a global level, companies in emerging markets traditionally

unwilling to pay for corporate governance-related services now understand the importance of changing their Board and disclosure practices in order to better attract international sources of capital”.

The October 1997 Commonwealth Heads of Government Meeting in Edinburgh, Scotland resolved that “Capacity should be established in all Commonwealth countries to create or reinforce corporations to promote good corporate governance in particular, codes of good practice establishing standards of behavior in public and private sector should be agreed to secure greater transparency and to reduce corruption” (Private Corporate Governance Trust, 2000)

The Commonwealth Association for Corporate Governance (CACG) was subsequently established and developed the CACG Guidelines and Principles for Corporate Governance in the Commonwealth. These were adopted at the November 1999 Commonwealth Head of Government meeting in Durban, South Africa “as guidelines for all Commonwealth countries to develop or enhance their own national corporate governance principles”, (Private Corporate Governance Trust, 2000).

The Africa Capital Markets Forum is undertaking a study on the state of Corporate Governance in Africa. The King’s Committee Report and Code of Practice for Corporate Governance in South Africa published in 1994 continue to stimulate corporate governance in Africa. Training, technical support and awareness raising support has been extended by the World Bank and the Commonwealth Secretariat to various African countries to help them put in place appropriate mechanisms to promote good corporate

governance .

Regional conferences were held in Kampala, Uganda, in June 1998 and September 1999 to create awareness and promote regional co-operation in matters of corporate governance. At the June 1998 Conference, it was resolved that each member state be encouraged to develop both a framework and a code of best practice, to promote national corporate governance, and those efforts be made to harmonize corporate governance in the East African region under the auspices of the East African Co-operation, and through the establishment of a regional apex body to promote corporate governance. (Private Corporate Governance Trust, 2000)

At the September 1999 Conference in South Africa, the earlier resolutions were reaffirmed and recommendations made, encouraging the member states to collaborate with other African initiatives in promoting good corporate governance. Uganda has established the Institute of Corporate Governance of Uganda, and is formulating a national code of best practice for corporate governance. In Kenya, the Private Sector Initiative for Corporate Governance continues to liaise with Uganda and Tanzania towards the establishment of a Regional Center of Excellence in Corporate Governance. (Private Sector Corporate Governance Trust, 2000).

According to Private Corporate Governance Trust (2000), corporate governance has received a wide attention in Kenya due to recognition that improved corporate governance will lead to improved productivity, efficiency, and effectiveness. This will directly impact on the country's economic development especially as the government

withdraws from direct involvement in the economy and leaves the private sector as the main engine for growth.

There have been various suggestions designed to address and enhance Kenya's corporate governance structure. These suggestions or reforms include:

Role of the Government - the government should create an enabling environment, introduce an orderly and well-publicized business procedures and practices that will eliminate corrupt and anti competitive practices, Review of laws and regulations - there is a need to review the laws relating to companies, partnerships, investment and insolvency particularly as they pertain to corporate governance, Central Bank of Kenya (CBK) - the CBK has also reviewed corporate governance in the banking sectors, it has issued guidelines that govern the conduct and responsibility of bank directors. Some of the guidelines include: The directors should be people with impeccable professional qualifications more than the average man so that they can contribute knowledgably and positively to the bank,

The position of the chairman of the board of directors should be separate from that of the chief executive. secondly once appointed directors should receive training and keep informed about development in the .thirdly Banking industry directors should also maintain independence with the bank and ensure that dealings with the bank are at arm's length. The guidelines also recommend that Board of Directors also make use of committee to help in discharging some important function, for example audit committee, lending committee, investment committee among others.

Private sector initiative for corporate governance - in 1999 companies agreed to form the

private sector corporate governance trust (PSCGD). This body has developed a code of best practice to guide companies on issues of corporate governance. The trust also intends to provide training and undertake research in areas of corporate governance.

Capital markets authority - the Capital Markets Authority (CMA) has developed guidelines and regulations on corporate governance practices by listed companies and other public companies as a response to the growing importance of good governance issues in the emerging and developing economies and to promote growth and deepen the domestic and regional capital markets.

These guidelines are comparable to the International Organization of Securities Commission (IOSCO) Principles and Standards. This is an organization that brings together capital markets regulatory bodies worldwide. The authority's view is that listed and other public companies raising capital markets should comply with the prescribed guidelines and where compliance is either not tenable or practical; the reasons for non-compliance should be identified and disclosed in the annual reports. The main provisions in the guidelines are: chairmanship and directorship, audit committee, board obligation, professional membership, shareholders rights, and annual general meetings of listed companies.

The subject of corporate governance is of enormous practical importance. Even in advanced market economies, there is a great deal of disagreement on how good or bad the existing governance mechanisms are. For example, Easterbrook and Fischel (1991) and Romano (1993) make a very optimistic assessment of the United States corporate governance system, whereas Jensen (1989, 1993) believes that it is deeply flawed and a



major move from the current corporate form to a much more highly leveraged organizations, similar to Leverage Buy Out's (LBOs), is in order. There is also constant talk of replacing the Anglo-Saxon corporate governance systems with those patterned after Germany and Japan , the United States, Germany, Japan, and the United Kingdom have some of the best corporate governance systems in the world, and the differences between them are probably small relative to their differences from other countries.

According to Barca , Fabrizio and Zingales (1995), Italian corporate governance mechanisms seemed to be undeveloped as to substantially retard the flow of external capital to firms. In less developed countries, including some of the transition economies, corporate governance mechanisms are practically non-existent. In Russia the weakness of corporate governance mechanisms leads to substantial diversion of assets by managers of many privatized firms, and the virtual non-existence of external capital supply to firms ( Shleifer et al, 1995). Understanding corporate governance not only enlightens the discussion of perhaps marginal improvements in rich economies, but can also stimulate major institutional changes in places where they need to be made.

Corporate governance mechanisms are economic and legal institutions, which can be altered through the political process sometimes for the better. One could take a view that there is no need to worry about governance reform, since, in the long run, product market competition would force firms to minimize costs, and as part of this cost minimization to adopt rules, including corporate governance mechanisms, enabling them to raise external capital at the lowest cost. On this evolutionary theory of economic change (Alchian 1950, Stigler 1958), competition would take care of corporate governance. While it is agreed

that product market competition is probably the most powerful force toward economic efficiency in the world, it is skeptical that it alone can solve the problem of corporate governance. One could imagine a scenario in which entrepreneurs rent labor and capital on the spot market every minute at a competitive price, and hence have no resources left over to divert to their own use. But in actual practice, production capital is highly specific and sunk, and entrepreneurs cannot rent it every minute. As a result, the people who sink the capital need to be assured that they get back the return on this capital. The corporate governance mechanisms provide this assurance. Product market competition may reduce the returns on capital, and hence cut the amount that managers can possibly expropriate, but it does not prevent the managers from expropriating the competitive return after the capital is sunk.

### **2.3 Corporate Governance Practices in Kenya**

The Capital Markets Authority (CMA) developed, and gazetted in May 2002, the guidelines for good corporate governance practices for listed companies in Kenya in response to the growing importance of governance issues both in emerging and developing economies and for promoting growth in domestic and regional capital markets. It is also in recognition of the role of good governance in corporate performance, capital formation and maximization of shareholders values as well as protection of investor's rights.

CMA developed the guidelines by taking into account the work which had been undertaken extensively by several jurisdictions through many task forces and committees

included but not limited to the United Kingdom, Malaysia, South Africa, Organization for Economic Corporation and Development (OECD,2004) and the Commonwealth Association for Corporate Governance. Prior to CMA's promulgation of the guidelines for good corporate governance, the Private Sector Corporate Governance Trust, Kenya, had in November 1999 issued a code of best practice for corporate governance in Kenya and most of the provisions in this code were corporate in the CMA's guidelines.

Manyuru (2005), looked at the extent corporate governance cut across the industries and it was established that all the four sectors scored highly. The results indicated that Agricultural Sector exhibited a high positive correlation between performance and corporate governance. Finance and Investment sector also showed a high correlation. Kihara (2006) found no relationship between ownership structure, governance structure and performance. All ownership variables except foreign ownership

#### **2.4 Board accountability**

Cadbury Report (1992). The primary emphasis of the Cadbury Report was on the need for boards of directors within listed companies to be effective. This was considered by the Cadbury Committee as being a quintessential ingredient determining the UK's competitive position. The Cadbury Report reviewed the structure of the board and the responsibilities of company directors, making recommendations for best practice( Garrat, 1996). Garrat drew on his experiences on company boards as well as his experience as an academic to highlight problems within boards and make recommendations for corporate governance improvements in this essential area. One criticism the author made was that

boards spent too much time ‘managing’ (being professional managers) and insufficient time ‘directing’. Lasfer (2002) tested the hypothesis stating that board structure, as a corporate governance mechanism, and its impact on value is a function of firm’s growth opportunities. The author conducted the study on all companies quoted at the London stock exchange with year end spanning over the period 1996 to 1997. the results showed that ,while low growth firms were less likely to have an independent board , for instance to split the role of the chairman and the CEO, to have a proportion of non-executive directors and to appoint a non-executive as a chairman ,their value is positively related to these board structure variables. In contrast for high growth firms ,the relationship between board structure and firm value is weak ,suggesting that board structure does not always mitigate the agency conflict.

#### **2.4.1 Splitting the role of chairman and chief executive**

splitting the role indeed led to significantly higher financial performance (Peel and O’Donnell, 1995). However, it has been suggested that such improvements may be a case of wishful thinking and that the evidence is not persuasive enough to engender splitting the roles in practice (Daily and Dalton, 1998).

According to Dalton(1998) top management turnover has been used as a proxy for corporate governance quality, as a well-governed company is considered likely to remove ineffectual directors before they can do harm. A company with ‘good’ corporate governance mechanisms, such as split roles or an optimal balance of executive and non-executive directors, is likely to display more effective monitoring of management. However, high turnover of directors may not always involve replacing poor managers

with better ones. There may be ulterior motives behind such replacements, which do not result in better people on the board. Nevertheless, if ‘good’ managers replace ‘bad’ ones, then we would assume that companies with higher top management turnover, better corporate governance mechanisms and more effective board members replace ‘bad’ ones, then it can be assumed that companies with higher top management turnover, better corporate governance mechanisms and more effective board members would display superior financial performance. Basing their analysis on these assumptions, Dahya et al. (2002) found that top management turnover was higher after Cadbury than before, but only in companies that had altered their board structure as a result of Cadbury. They also found that higher turnover of top management was statistically related to poorer financial performance, for an extensive sample of UK companies around the time of the Cadbury Report. They therefore deduced that:

These results indicate that the increase in CEO turnover is not random; rather it is (inversely) correlated with performance: After controlling for performance, the likelihood that the CEO will depart his position is greater once a poorly performing firm comes into compliance with the key provisions of the Code.

#### **2.4.2 The role of non-executive directors**

From an agency theory perspective, non-executive directors may be perceived as playing a monitoring role on the rest of the board. Boards of directors perform an important corporate governance function and that non-executive directors act as necessary monitors

of management (Jensen, 1983). Without the monitoring function of non-executive directors it would be more likely that inside executive directors would be able to manipulate their position by gaining complete control over their own remuneration packages and securing their jobs (Morck et al., 1988).

According to Morck(1988)it was found that non-executive directors have monitored management effectively. An indicator that has been used to proxy for such monitoring efficiency is chief executive turnover, the implication being that more frequent turnover of chief executives leads to better corporate financial performance. Further, this may in turn be related to a greater proportion of non-executive directors on company board. The independent influence non executive directors on the board should lead to the removal of ineffective chief executives. Indeed, Weisbach (1988) found evidence that the turnover of chief executives was more strongly related to company performance in companies characterized by a majority of non-executive directors.

The presence of outsiders on company boards is also thought to be positively related to corporate control activity, as outsiders can facilitate takeovers, thereby activating the takeover constraint that disciplines company management (Agrawal and Knoeber, 1996). In relation to hostile takeover bids, empirical evidence has been provided, showing that boards with a significant independent contingent benefit shareholders in the bidding process (Byrd and Hickman, 1992). Again, this endorses the presence of non-executive, outside directors on boards. Also, in relation to the positive effects for shareholders of non-executive directors' involvement on boards, Rosenstein and Wyatt (1990) found evidence of a positive share price reaction to their appointment.

Boards of directors *per se* are superfluous, as the market provides a natural solution to the notorious agency problem rendering internal mechanisms unnecessary ( Hart, 1983). If boards are superfluous then, from this theoretical viewpoint, non-executive directors are merely another impotent element in an unnecessary structure. Proponents of this view consider that the ‘market’ disciplines company management naturally (e.g., through the threat of hostile takeovers and shareholder voting), thereby aligning managers’ interests with those of shareholders.

In relation to the relevance of non-executive directors versus the relevance of executive directors. Some evidence endorses the position of executives in preference to non-executives on boards. For example, one empirical study investigated the wealth effects of inside, executive director appointments by management (Rosenstein and Wyatt, 1990). Using event study methodology, there was a positive share price reaction to the announcement of inside director appointments. The findings stressed the important role that inside directors played in rectifying material corporate decisions and endorsing corporate strategies. However, the study also highlighted the relevance of the existing board composition to the effect of new appointments on share price, as it was found that the market reacted more favorably to insider appointments, where there was a board imbalance displaying a high proportion of non-executive directors, and less favorably when the balance was skewed more to insiders. It was concluded that the benefits associated with the appointment of a new inside director only outweighed the costs of such an appointment when managerial and shareholder interests were closely aligned (i.e., when there was no significant agency problem).

There is also a perception among some academics and practitioners that the involvement of non-executive, outside directors on boards can damage corporate governance by reducing entrepreneurship in the business and by weakening board unity. This was certainly the view expressed by many board directors in their initial response to the Higgs recommendations to broaden the role and effectiveness of non-executive directors in the UK. Higgs' suggestion to make non-executive directors the champions of shareholder interests met with immediate opposition. Indeed, there is a potential for the appointment of non-executive directors to result in more cronyism and a more comfortable network of close ties and cosy relationships between directors of leading companies. Furthermore, accusations are made that the relatively new level of non-executive directors in UK business provides just more 'jobs for the boys' and the opportunity for an even firmer golden handshake that retiring directors receive already.

There is also evidence suggesting that non-executive directors have a negative, rather than a positive impact on corporate financial performance. The presence of outside directors on US boards represented one of seven mechanisms used to control agency problems examined by Agrawal and Knoeber (1996). They found persistent evidence of a negative relationship between the proportion of outside directors and the companies' financial performance. Their conclusion was that companies had too many outside directors on their boards. This is not encouraging evidence for supporters of the UK Higgs Report. However, the authors were 'puzzled' by this result. One explanation they proffered was that outside directors were often added to boards in companies that were already performing badly, in order to improve performance (a result also presented in Hermalin and Weisbach, 1988). The authors examined their findings and concluded that



the causality ran from board composition to performance, and not in the opposite direction, dispelling this explanation.

They commented that:

One possible rationale is that boards are expanded for political reasons, perhaps to include politicians, environmental activists, or consumer representatives, and that these additional outside directors either reduce firm performance or proxy for the underlying political constraints that led to their receiving board seats.(Agrawal and Knoeber, 1996, p. 394)

Clearly, these authors would be unlikely to support the hypothesis that wider stakeholder accountability improves corporate financial performance. However, their results are interesting and beg further investigation. They emphasized the interdependence of various control mechanisms, such as the non-executive director function, and took account of such interrelationships in their analysis in order to avoid spurious results.

## **2.5 Financial disclosure and internal control**

Disclosure is critical to the functioning of an efficient capital market. The term ‘disclosure’ refers to a whole array of different forms of information produced by companies, such as the annual report which includes the director’s statement, the Operating and Financial Review (OFR), the profit and loss account, balance sheet, cash flow statement and other mandatory items. It also includes all forms of voluntary corporate communications, such as management forecasts, analysts’ presentations, the AGM, press releases, information placed on corporate websites and other corporate

reports, such as stand-alone environmental or social reports (Healy and Palepu, 2001). Voluntary disclosure is defined as any disclosure above the mandated minimum (Core, 2001). Improvements in disclosure result in improvements in transparency, which is one of the most important aims of corporate governance reform worldwide

Research indicates that investors perceive a value to corporate disclosure. There is a theoretical prediction that relevant and reliable disclosure by companies attracts institutional investors (Diamond and Verrecchia, 1991; Kim and Verrecchia, 1994). Indeed, increases in corporate disclosure have been shown to be associated with increases in ownership by institutional investors (Healy et al., 1999). Further, research in accounting has shown that regulated disclosure provides new and relevant information for investors (Kothari, 2001).

one way of reducing agency problems is to establish explicit (and implicit) contracts between company management and their providers of finance. Such contracts require management to disclose relevant information that enables shareholders to monitor their compliance with these contractual agreement, so as to evaluate the extent to which management has utilized the company's resources in the interests of its shareholders (Healy and Palepu, 2001). research has shown that corporate performance measures have been used in evaluating managerial performance and that remuneration contracts depended significantly more on disclosed accounting measures than on share price (Keating, 1997).

As can be seen from these findings, if publicly disclosed financial accounting information is used to determine management remuneration contracts, then it serves as a

means of controlling company management and reducing the agency problem. However, as agency theory states that managers should more logically be determined by share price, not financial accounting information. This is the case to some extent, but research has shown that share price is only one of many factors found to influence remuneration contracts. Principal agent models imply that the shareholders should design a remuneration contract that is based on performance as disclosed in financial accounts, in order to align managerial incentives to their own (Bushman and Smith, 2001). A company's system of internal control represents from an agency theory perspective another corporate governance mechanism that can be used to align the interests of managers and shareholders. Internal control has been defined as:

The whole system of controls, financial and otherwise, established in order to provide reasonable assurance of: effective and efficient operations; internal financial control; and compliance with laws and regulations.

The Turnbull Report (1999) represented the culmination of several years' debate concerning companies' systems of internal control. The report was accompanied by a code of practice and recommendations for listed companies. As with earlier corporate governance codes of practice, The Turnbull Report aimed not to transform companies' systems of internal control but to make explicit the systems of internal control, which many of the top-performing companies had developed, in order to standardize internal control and achieve best practice.

Without an effective system of internal control, companies can undergo substantial financial losses as a result of unanticipated disasters.

## 2.6 Shareholders Rights

The corporate governance literature has burgeoned in recent years, and the evolving role of institutional investors in corporate governance has not been ignored by academic researchers. In relation to voting, Stapledon (1995) shed light on the practical difficulties that can inhibit the exercise of voting rights by institutional investors. Stapledon emphasized that little evidence was available at that time on the voting practices of institutional investors. This was probably a reflection of the fact that institutional investors (inter alia) were not interested in voting their shares. The author provided a summary of empirical evidence on institutional investor voting in the UK as follows:

- (i) Midgley (1974) surveyed an extensive sample of UK companies and found that only about 11% of votes were exercised. However, this included all types of investor (not just institutions).
- (ii) Minns (1980) stated that in the 1970s institutional investors did not generally exercise their voting rights.
- (iii) The ISC performed a study in 1990 and found that on average the total votes received by companies amounted to about 20% (including institutional and other investors). This was similar to, but a little higher than, the findings of Midgley's study from the 1970s. This report was not published and did not appear to break down the voting for institutions.
- (iv) A second survey was conducted by the ISC in 1993. This was published (ISC, 1993), and the findings indicated that 24% of votes were exercised in a sample of

top UK companies. Again, this indicated a rise in the exercise of voting rights over time.

Stapledon performed a series of interviews in order to gather evidence on institutional investors' voting practices. He found that voting practices among UK fund managers were diverse. Some institutional fund managers had always voted all of their shares. Others had only just started to vote on all issues since Cadbury in the early 1990s. Others were continuing to vote on major, contentious issues. The author presented solid evidence that before Cadbury, voting was sparse and disorganized, whereas by 1995 (three years after Cadbury) institutions were beginning to improve and formalize their policies.

An interesting point raised in Stapledon's (1995) paper was whether or not pension fund trustees had a duty to vote. The author argued that under the contemporaneous legal framework, trustees and fund managers did not have any obligation to vote. However, whether they should be obliged through regulation, or a moral responsibility, to employ their voting rights was, he considered, an altogether different issue. Interestingly, a change to pension fund law has since stipulated that pension fund trustees have to (as from July 2000) disclose the extent to which (if at all) their fund managers exercise their voting rights in investee companies. Although this only forces trustees to disclose whether or not they instruct their fund managers to vote and does not make them vote, such disclosure per se can have an effect on voting practices.

Mallin (1996) compared the voting practices of UK institutional investors with those of US institutions. The author carried out an extensive number of personal interviews with institutional fund managers, with the aim of canvassing their attitudes toward voting and

discussing whether or not they had voting policies. Three categories of institutional voting policy emerged from the interview data:

- (i) Fund managers voted on all issues (routine and non-routine);
- (ii) Fund managers voted only on non-routine issues;
- (iii) Fund managers did not vote at all.

It appeared from the interviews that fund managers voted on all issues. However, fund managers who voted on all issues were not necessarily acting responsibly. It appeared that there were two types of fund manager who voted on all issues: 'box tickers' and those who actually considered their votes. The first group voted with the incumbent management on all issues without considering the issues carefully and perhaps voting against the management. In this case, the use of voting rights could hardly be considered effective from a corporate governance perspective. They are called box tickers because they are simply voting for the sake of voting and not reflecting on the impact of their votes. This is the sort of approach the Hampel Report of 1998 warned could result from mandatory voting. Perhaps it is a negative result of recommendations of the Cadbury Committee. The second group did consider their votes carefully and decided in each case whether or not to vote with the incumbent management. This is a more responsible approach from a corporate governance perspective and is likely to result in far more effective monitoring of company management.

Mallin (2001) compared the voting practices of institutional investors across four countries. This study focused on the issue of whether or not voting was a fiduciary duty for institutional investors. Whereas Stapledon (1995) suggested that institutions were not bound to vote as part of their legal and fiduciary responsibilities, Mallin (2001)

considered that they were. Indeed, the researcher provided evidence that in the USA the right to vote was considered to be a fiduciary duty of institutional investors. The paper discussed the focus on encouraging institutional investors to exercise their voting rights. Newbold Committee stated that voting was a fiduciary duty of institutional investors. Indeed, this Committee concluded that regular voting should be one of the first principles of proper conduct by the trustees of pension funds. Mallin (2001) concluded that, although the concept of voting as a fiduciary duty had been accepted in the US, it had only been introduced in the UK relatively recently. There is evidence on whether a package of shareholder rights can predict a higher value of the firm. Cheung, Jiang, Limpaphayom and Lu (2009) found an insignificant relationship between exercising shareholders rights and value of the firms in Hong Kong. Black, Kim, Jang and Park (2009) found an insignificant, negative coefficient on shareholder rights measure in South Korea with value of the firm

## **2.7 Remuneration**

As for the relationship between remuneration and corporate performance, a study found strong statistical evidence linking excessive executive remuneration with 'bad' corporate governance and poor corporate performance in the USA (Core et al, 1999). Indeed a significant negative association was found between remuneration (arising from board and ownership structure) and corporate operating and share price performance, indicating that companies fared less well when their board structure allowed an imbalance of power leading to excessive chief executive remuneration. It was recommended that US boards should split the roles of CEO and chairman, in line with the recommendations of

Cadbury, inter alia. Academic research has also shown a significant relationship between CEO compensation and the manner in which members of the board are appointed. Generally, the more control the CEO has over appointing other board members, the higher their remuneration tends to be (Lambert et al, 1993).

With respect to remuneration committees, Bostock (1995) found that the recommendation to establish remuneration committees comprising relatively few executive directors. Further, Mallin (2000) reported that by 1995, 98% of companies responding to the initial Cadbury recommendations.

In relation to the level of executive remuneration in different countries, another paper examined the progressive globalization of executive remuneration (Cheffins, 2003). The author debated that not only was remuneration harmonizing at an international level but it was also following US levels, which are traditionally higher than in other parts of the world. Cheffins (2003) reviewed the data on the remuneration of US executives, concluding that the pay packages of US chief executives were far more lucrative than those of executives in other countries around the world. With introduction of lucrative executive pay packages, this would advance the 'Americanization' of executive pay. Moreover, shareholders would be able to see the remuneration that incentivizes executives to maximize shareholder value. This would in turn help to reduce the 'agency cost' in those companies. Cheffins (2003) argued that a strong relationship between pay and performance could reduce the costs associated with shareholder monitoring. Nevertheless, it appears that 'Americanization' of pay may become a reality in the Kenya if Cheffins (2003) model holds. Certainly, the remuneration package given to the director of US operations at HSBC in May 2003, which included a multimillion dollar pay-off if



he was ever ousted and totaled 37.5 million over three years, is evidence of American-style remuneration packages crossing the Atlantic (Croft, 12 May 2003). However, unless such appealing packages are offered, it will be impossible to attract talent from the USA, which many world companies are attempting to do (Gimbel, 2003). Indeed, equalization of executive remuneration is likely to occur at a higher, rather than a lower level.

Agency theory, argues that in the modern corporations, where ownership is dispersed and managers have access to superior information, managers typically end up with the residual rights of control, giving them enormous latitude for self-interested behavior. In order to counter such pursuits, one way is to grant a manager a highly contingent, long term incentive contracts ex-ante to align his interests with the interests of investors. Incentive contracts can take a variety of forms, including share ownership, stock options, or a threat of dismissal if income is low (Fama, 1980). The optimal incentive contract is determined by the managers' risk aversion, the importance of his decisions, and his ability to pay for the cash flow ownership upfront (Stiglitz, 1975; Holmstrom, 1979, 1982).

Jensen and Murphy (1990) arrive at a striking number that executive pay rises by about \$3 per every \$1000 change in the wealth of shareholders. Kaplan (1994) shows that the sensitivity of pay (and dismissal) to performance is similar to in the United States, Germany and Japan, although average levels of pay are the highest in the United States. .

Several studies have identified a positive relationship between executive pay and firm performance. Evans and Stromback (1994), and Izan, Sidhu, and Taylor (1998) both supported a positive pay- performance relationship.

## **2.8 Market for corporate control**

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

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

## **2.9 Corporate Behavior**

Black(2001)examined corporate behavior and market value of Russian firms by sampling 21 Russian firms , first in fall 1999 corporate governance ranking was used for

these firms, developed by a Russian investment bank and secondly the “value ratio” of actual market capitalization to potential western market capitalization of these firms ,determined independently by a second Russian investment bank. The correlation between  $\ln(\text{value ratio})$  and governance ranking was striking and statistically strong :Pearson  $r=0.9$  ( $t=8.97$ ). A worst (51 ranking) to best (7 ranking) governance improvement predicted a 700 fold increase in firm value. The results though from a small sample suggested that corporate behavior has a powerful effect on market value of the firm in a country where legal and cultural constraints on corporate behavior are weak

## **2.10 Governance and Firm Value**

From most of the literature, it seems there is a lot of linkage between corporate governance indexes with the value of the firm. Agrawal, Anup and Chadha (2005) studied the effect of board of directors arrangement on accounting earnings restatement and announcements. The authors found that the board size affects value of the firm in that the smaller the board the higher the value of the firm and vice versa. They also found that negative abnormal returns around earnings restatement announcement dates suggest that earnings restatement destroy value of the firm (Palmrose, Richardson, & Scholz 2004).

Chadha (2005) found that there was a lower likelihood of accounting earnings restatement for companies with a financial expert on the board of directors auditing committee, the author also noted that a simple addition of a single governance mechanism for instance a financial expert on the board of directors auditing committee, is found to improve the firm value.

Morck, Shleifer and Vishney (1988) tested Stulz's (1988) theory noting that firm value as approximated by Tobin's Q and changes in board ownership of zero to five percent, decreases in board ownership of five to twenty five percent and increases in board ownership about twenty five percent, were related in that changes in board ownership affected value of the firms hence supporting Stulz's (1988) theory of an optimal level of ownership over most of the ownership level range. The highest levels of ownership reflect close alignment of principal agent interest because of less separation of ownership and control. For firms with the relatively diffused ownership this evidence implies that the marginal benefits of increased incentive alignment must be equal to the marginal cost of increased entrenchment when determining the best ownership level of the firm.

According to Yermack (1996) small boards are associated with greater firm value. According to Jensen (1993) in support Yermack's findings larger boards are ineffective. Demsetz and Lehn (1985) provide support for economic intuition behind the optimality notion. In finding no relationship between board structure and firm performance, it is noted that governance may affect firm value significantly and no relationship can be observed empirically for the following reasons: firstly, a number of governance mechanisms may be close substitutes or complements for each other.

Larcker, Richardson and Tuna (2004) use principal components analysis to construct common governance factors. They found that governance alone explains a small portion

of variation in a number of dependent variables related to the firm value.

Researchers hold a number of views on the effect of corporate governance on firm value which are clarified by nuances of the views. The clearest dichotomy in the views is that either corporate governance affects firm values or it does not. The nuances of each view have received the majority of the attention in the literature.

The view that governance affects firm value considers the costs of agency to be significant. Governance mechanisms should be effective in reducing agency costs. One nuance is that adding a particular governance mechanism improves firm value for all firms in so far as the mechanism can be added. This could be called the no costs nuance. An example is Agrawal and Chadha's (2005) study of the effect of board of directors' arrangements on accounting earnings restatement announcement. Negative abnormal returns around earnings restatement announcement dates suggest that earnings restatements destroy firm value (Palmrose, Richardson and Scholz (2004). Agrawal and Chadha (2005) study legislation from the Sarbanes-Oxley act. The act requires at least one financial expert on the auditing committee of the board of directors. Agrawal and Chadha (2005) find a lower likelihood of accounting earnings restatements for companies with a financial expert on the board of directors auditing committee. The simple addition of a single governance mechanism, a financial expert on the board of directors auditing committee, is found to improve firm value.

Another nuance consistent with governance affecting firm value is that governance mechanisms have costs and benefits. All corporations can trade off the costs and benefits of a governance mechanism to maximize firm value. The costs and benefits nuance is

consistent with Stulz's (1988) model of how the extent of managerial ownership affects takeover premiums and takeover likelihood. As an inside manager's ownership share increases, an outside bidder must offer a higher premium to make a successful bid; however, the gain for a bidder from a takeover decreases with the bid price. If a takeover bid price is too high, no bid will take place. Managers will be entrenched and will have fewer reasons to maximize shareholder wealth. An optimal level of managerial ownership trades off the premium obtained from a higher bid and the value destruction from entrenched management in the case of low takeover probability. Morck, Shleifer, and Vishny (1988) test Stulz's (1988) theory. Firm value, as approximated by Tobin's Q, increases in board ownership of zero to five percent, decreases in board ownership of five to twenty five percent, and increases in board ownership above twenty five percent, Morck, Shleifer, and Vishny (1988) interpret the non-linear relationship between ownership and firm value as supporting Stulz's (1988) theory of an optimal level of ownership over most of the ownership level range. The highest levels of ownership reflect close alignment of principal-agent interests because of less separation of ownership and control. For firms with relatively diffuse ownership, this evidence implies that the marginal benefits of increased incentive alignment must equal the marginal costs of increased entrenchment when determining the best ownership level for the firm.

A few differences can be seen immediately in the implications of the no costs and the costs and benefits nuances. The no costs nuance implies that if the addition of a certain governance mechanism increases firm value, firm value should be improving insofar as one can keep adding that governance mechanism. Jensen and Meckling's (1976) seminal work focuses on the costs of diffuse ownership. They also point out that diffuse

ownership creates value since entrepreneur managers are often wealth constrained. The costs and benefits nuance is at least more realistic than the no costs nuance.

Governance may affect firm value significantly. However, most firms may have optimal governance structures. In this case, a relationship between any single governance mechanism and firm value cannot be detected by a researcher. This could be called the optimality nuance. Demsetz and Lehn (1985) provide some of the economic intuition behind the optimality nuance. In finding no relationship between ownership structure and firm performance, they conclude that no relationship should be expected. When shareholders make conscious decisions about ownership structure, they understand the costs and benefits of a particular ownership structure on firm value. Controlling the other determinants of firm value and accounting for the way ownership concentration varies with firm characteristics, no relationship between ownership concentration and firm value should be expected.

Governance may affect firm value significantly and no relationship can be observed empirically for a number of reasons. First, a number of governance mechanisms may be close substitutes or complements for each other, In this case, no single governance mechanism would be necessary to solve agency conflicts. Any optimal combination of governance mechanisms would be sufficient. After controlling for the interdependence among a number of governance mechanisms, Agrawal and Knoeber (1996) detect only a negative effect of board outsiders on firm performance. Governance mechanisms included in the study are the use of debt, the market for managers, and the market for

corporate control, inside shareholding, institutional shareholding, block shareholding, and board outsiders. A second reason for observing no empirical relationship between governance and firm value may be that amenity potential and severity of agency costs may vary from firm to firm and by industry. In this case, the unique situation that each firm faces plays an important role in choosing governance. There can be no single governance standard improving value for all firms.

Kole and Lehn (1999) argue that firms change their governance structure in response to a change in the underlying firm environment.

Deregulation in the airline industry appears to cause a change in a number of governance mechanisms. Finally, since all firms have incentives to choose the best form of governance, no empirical relationship may be observed between firm value and governance. Shareholders desire the maximization of firm value. If inadequate governance is chosen and high agency costs are unrestrained, investors would move capital to better forms of governance. Firms with high agency costs and poor governance structures may have difficulty surviving competitive product markets with insufficient capital.

Differences and similarities between the costs and benefits nuance and the optimality nuance should be noted. The costs and benefits nuance implies that a relationship between governance and firm value can be observed empirically for all firms. If such a relationship is detected, many firms are not choosing governance optimally. Hermalin and Weisbach (2003) suggest that this is an out-of-equilibrium phenomenon that calls for a particular governance standard to be encouraged or mandated. In this instance, some



firms are not choosing an optimal form of governance. Both nuances fall under the heading of governance affecting firm value. In the case of the optimality nuance, firms are on average choosing the optimal solution to agency problems.

Governance is not ineffective. On the contrary, governance was found to be effective that most firms made sure their governance structures are optimal.

In direct contrast to governance having an important and material effect on firm value is the view that governance has no effect on firm value. Two related nuances are worth mentioning. First, governance may have no effect on firm value because governance is powerless or ineffective in curbing agency costs. This could be called the ineffectiveness nuance. Jensen (1993) could come close to this view in citing the failure or shutdown of a number of governance mechanisms. Jensen's suggestions for reforming governance mechanisms indicate that governance mechanisms could be effective but are not effective currently.

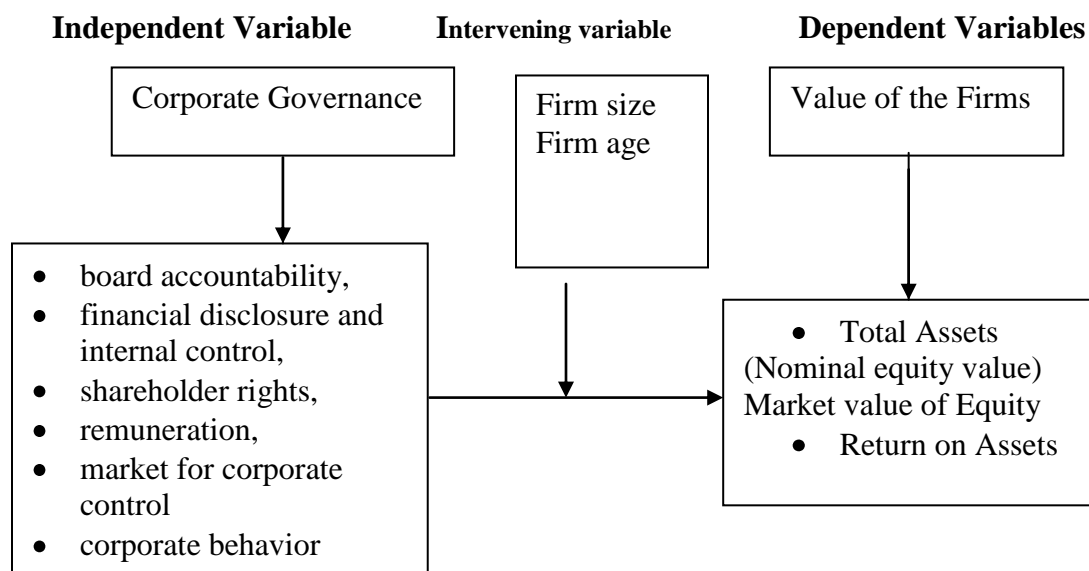
A second nuance to governance having no affect on firm value is that agency costs are minimal at best. This could be called the no agency costs nuance. Literature declaring that no agency costs exist is scant. According to Jensen (1993), with billions of dollars destroyed in the wake of the most recent corporate scandals, agency costs seem to be substantial. Perhaps voicing this view would suggest something counter to what seems obvious about human nature. When humans are given the opportunity to use corporate resources according to their own preferences and without bearing large costs of doing so, they will do so.

Finally, a third view may bridge a gap between views arguing for the effectiveness or

complete ineffectiveness of governance. This could be called the trivial effect view. Governance may affect firm value and agency costs may be real, but the impact of governance on firm value could be viewed as trivial in comparison with other economic factors. A recent paper questions the importance of corporate governance. Larcker, Richardson, and Tuna (2004) use principal components analysis to construct common governance factors. Governance explains only a small portion of the variation in a number of dependent variables related to firm value or firm performance. In addition, many of the governance variables often have unexpected signs. Larcker, Richardson, and Tuna (2004) interpret the relatively weak explanatory power of corporate governance as inconsistent with claims often made by academics and consultants regarding corporate governance, exploitable inefficiencies exist. Academics may probably be interested in the above but, would also like to know the benefits of financial reward equal the costs of financial risk or if an economic free lunch is possible.

Commonly, the efficient markets hypothesis is subdivided into three forms. In a weak form efficient market, current stock prices reflect all information contained in past market trading data. If current stock prices reflect all publicly available information, the market is semi-strong form efficient. Finally, strong form efficient markets reflect all information, public or private. Another definition of efficient markets has probably received more attention in the literature as observed by most tests of the efficient markets hypothesis. Malkiel (2003) defines an efficient market as one in which investors are not allowed to “earn above-average returns without accepting above- average risks”. According to the latter definition, testing market efficiency requires a model of risk and

return. A model of normal returns must be used in order to conclude that some returns are abnormal. Fama (1998) suggests that because an asset pricing model must be used to test the efficient markets hypothesis, tests of the efficient markets hypothesis are subject to a joint hypothesis. When a researcher rejects market efficiency, the asset pricing model being used to test market efficiency may also be rejected. Because of the importance of models of risk and return in testing market efficiency, much of the debate over market efficiency has revolved around the joint hypothesis problem. Fig. 2.4 shows the relationship that is viewed to exist between corporate governance and the value of the firm.



**Fig 2.4: Relationship Between corporate governance and value of the firms (as conceptualized by the researcher)**

Source: Own Conceptualization (2012)

Corporate governance is measured by six indices that include board accountability, financial disclosure, shareholder rights, remuneration, market for corporate control and corporate behavior. These measures or mechanisms affect the value of the firm

depending on other factors such as firm size and age as intervening variables. Value of the firm is measured by the total assets the firm plus the market value of the firm's equity minus the nominal value of equity divide by total assets.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.0 Introduction**

This chapter presents the data collection and analysis procedure. The chapter points out the research design used, the target population, sample and the sampling procedures, data collection, validity and reliability and data analysis methods and presentation.

#### **3.1 Research Design**

Kerlinger (1973) defines research design as an arrangement of conditions for collecting and analyzing of data in a manner that aims to combine relevance to the research purpose with economy in procedure. It is the conceptual structure within which research is conducted; it constitutes the blueprint for the collection, measurement and analysis of data. Orodho(2003) defines research design as the scheme, outline or a plan used to generate answers to research problems.

Diagnostic research design was used in this study. According to Kothari (2008) diagnostic research studies determine the frequency with which a variable occurs or its association with other variables. The design helped in looking at the association between corporate governance variables and value of the firm variables.

### **3.2 Target Population**

Target population refers to the complete group of specific population elements relevant to the research project (Zikmund, 2003)

The target population was all the companies currently quoted at the Nairobi Security Exchange over the study period, the companies are classified into ten segments - agriculture, commercial and services, banking, manufacturing and allied ,Automobiles and Accessories ,Energy and Petroleum, Insurance, Investment, Telecommunication and technology and construction and allied segment as shown in appendix IV. The total numbers of quoted companies from the NSE are 58 as from 2011 (Investors hand book, 2012) .Corporate affairs managers from each company was targeted for the study.

### **3.3 Sampling Design and Techniques**

Sampling is a procedure of using a small number of items or part of the whole population to make conclusions regarding the population. It enables the researcher to estimate some unknown characteristics of the population and make generalization, (Zikmund, 2003)

In selecting a sample, probability methods was used. Probability sampling method is where every item in the population has a known chance, or probability, of being chosen for the sample. The method provides unbiased estimates having measurable precision. This study employed probability sampling design. A stratified sampling design was used to classify the companies participating per segment. Simple random sampling method was used to select corporate affairs managers who were given equal chance of being selected per strata.

A sample of 51 companies operating for the last three years was selected using Yamane'(1967) formulae

$$n = \frac{N}{1 + Ne^2}$$

Where

n = optimum sample size

N = number of registered companies in the stock exchange

e = probability error

In the study, N = 58, e = 5 % (at 95% confidence level). The sample size was 51 firms.

The companies were stratified according to the segments after which purposive sampling technique was used to select the corporate affairs manager, sample in each stratum was determined proportionately. The stratification was as shown in Table 3.1

**Table 3.1: Sample Size Determination**

<b>Segment</b>	<b>Total in the strata</b>	<b>Sample(n)</b>
Agricultural	7	6
Commercial and services	8	7
Investment	4	4
Manufacturing and allied	9	8
Banking	10	9
Construction and Allied	5	4
Energy and Allied	4	4
Insurance	5	4
Telecommunication and Technology	2	1
Automobiles and Accessories	4	4
<b>Total</b>	<b>N=58</b>	<b>n=51</b>

**Source – Field data (2013)**

### **3.4. Data collection Method**

The study used questionnaires to collect data from corporate affairs managers who were either corporate affairs managers or public relations officers in place of the managers depending on different companies. It was used to obtain information and to provide an opportunity for the researcher to capture respondent's views on a whole range of issues. The questionnaire was made up of structured and unstructured questions and was administered to the respondents who were sampled.

This tool was used to collect the primary data for the study. The purpose of structured questions was to get information that would facilitate data analysis and classification in a specific way, while unstructured questions sought an in-depth response. Questionnaires in general were needed to ensure uniformity, cost savings and time savings. The questionnaire schedule



comprised of questions on personal data and questions relating to the attributes of corporate governance. The instrument also contained unstructured items that captured opinion, feeling and suggestions of the respondents in the space provided. All the questions in the questionnaire were related to the objectives of the study.

The study also used schedule to collect secondary data which was obtained from the companies final accounts. The data was a three years panel data as used by Chhaochharia and Laeven (2009) who used a three year panel data set in collecting information about value of the firms .

Tobin's Q was used as a measure of the firms value .Tobin's Q is the sum of total assets less book value of equity plus the market value of equity divide by total assets (Aggarwal et al, 2009).

### **3.5. Data collection procedure**

A list from Nairobi Security Exchange was first established . Corporate affairs staff who included corporate affairs manager or public relations officer were first contacted by telephone to solicit their cooperation. The researcher personally delivered the questionnaires to the informants. The respondents were informed of the confidentiality of their responses and the academic purpose of the research. Informants received a summary report of the survey. A total of 51 questionnaires were delivered to the corporate affairs staff in each company selected in the sample with cover letters explaining the purpose of the study.

### 3.6 Validity and Reliability of Data Collection Instruments

According to Fraenkel and Wallen (2000) validity refers to the appropriateness, meaningfulness and usefulness of any inferences as a researcher draws based on data obtained through the use of the instrument. A high reliability for the questionnaire is necessary but not sufficient criterion for the adequacy of an instrument, it must be valid too. For data collection instrument to be considered valid the content selected and included in the questionnaire must be relevant to the need or gap establishment (Koul 1992). Validity of research instruments was checked by discussing the content and the structure of the instruments with the supervisors and experts in finance and statistics Cronbach alpha statistics was used to measure the validity the coefficient was found to be 80% which is good compared to the standard of 70%. Reliability was checked by piloting the questionnaires with ten none quoted companies and a test-retest process was done for the purpose of confirming consistency in answering the questions.

Kuder-Richardson approaches was used by adopting the following equation

$$KR_{21} = \frac{K}{K-1} \left[ 1 - \frac{M(K-M)}{K(SD)^2} \right]$$

Where

K = number of items on the test

M = mean of the set of test scores

SD = standard deviation of the set of test scores. For research purposes reliability coefficient of 70% and above is desired. (Fraenkel & Wallen et al,2000)

The reliability coefficient value also tested for significance at  $\alpha = 0.05$  using the following *t* test formula.

$$t_{ob} = \frac{r\sqrt{n-2}}{\sqrt{1-r^2}}$$

Where

$n = k$  = number of items in the questionnaire

$r$  = reliability coefficient.

$d.f$  = degrees of freedom

the reliability test was done on the ten private companies and this was found to be over 70% at 82% which indicated that the instrument of data collection was consistent, hence reliable.

### **3.7 Measurement of Variables**

#### **3.7.1 Independent variables**

Corporate governance as an independent variable was measured by the six governance indices which included: board accountability, financial disclosure and internal control, shareholder's rights, remuneration, market control and corporate behavior. The indices were further measured by attributes attached to each index, the adoption of the attribute was denoted by dummy one and none adoption by dummy zero.

#### **3.7.2 Dependent variables**

Key dependent variable is value of the firm. This was measured by using Tobin's Q which is measured by sum of total assets less book value of equity plus the market value of equity divide by total assets also ROA was used to measure value of the firm.

### **3.7.3 Intervening variables**

The intervening variables included the firm size and age of the firm. The firm size is measured by the assets of the firm while age of the firm is measured by the years of listing at the NSE.

### **3.8 Data Analysis and Presentation**

Data responses were first coded, entered, and checked for errors. Data was analyzed using both quantitative and qualitative analysis was used to seek the views for in depth investigation on adoption of the measures of governance, while quantitative data analysis was done through inferential and descriptive statistics which included frequencies and percentages. Attributes of corporate governance adopted was used to construct the governance index which were the measures of governance adoption, the attributes were given a code of one if it is in place indicating good corporate governance and zero otherwise. The corporate governance index was constructed simply by calculating the percentage attributes the company has adopted that is the attributes that have been assigned the value of one.

.multiple regression analysis was used to test the hypotheses on the effect of corporate governance measures on the value of the firm where t statics was used to test the significance of the association. Coefficient of determination,  $R^2$  was used to determine the degree of association between corporate governance and the value of the firm the regression test was done at 5% significance level.

multiple regression equation used was as follows:

$$Q_{it} = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \varepsilon_{it}$$

The second linear regression model will be

$$Q_{it} = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + W + \varepsilon$$

$$Q_{it} = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + Z + \varepsilon$$

Third linear regression was

$$Q_{rt} = \alpha_1 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \varepsilon_{rt}$$

fourth Linear regression was:

$$Q_{rt} = \alpha_1 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + W + \varepsilon$$

$$Q_{rt} = \alpha_1 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + Z + \varepsilon$$

Where

$Q_{it}$  is Tobin's Q of firm ( i) in year( t)

$Q_{rt}$  is Return on Assets (ROA)

$\alpha$  and  $\alpha_1$  is the autonomous variables

$\beta$  Slope or the contribution of governance index to the value of the firm.

$X_1$  is board accountability

$X_2$  is financial disclosure and internal control

$X_3$  is shareholder rights

$X_4$  is remuneration

$X_5$  is market for corporate control

$X_6$  is corporate behavior

Z is the moderating variable which is age of the firm measured by Ln ( age)

W is the moderating variable which is the firm size measured by Ln ( firm size).

$\epsilon_{it}$  and  $\epsilon_{rt}$  is the error terms.

Z and W were treated as covariates during modeling. A covariate is a secondary variable that can affect the relationship between the dependent variable and other independent variables of primary interest

Data is presented by use of tables and charts.

## CHAPTER FOUR

### DATA ANALYSIS AND INTERPRETATION

#### 4.0 Introduction

This chapter presents results based on the research questions and hypothesis derived from the study objectives. Results give the background information ,corporate governance index and the relationship between the corporate governance index measures and the value of the firm.

#### 4.1 Data Analysis and Results

**Table:4.1 Rate of response on duration worked for the company**

<b>Period of service</b>	<b>Frequency</b>	<b>Percent</b>
1-2 years	3	6.8
3-4 years	20	45.4
5-6 years	9	20.5
7 years and above	12	27.3
<b>Total</b>	44	100.0

**Source: Field data (2013)**

It can be observed from Table 4.1 that most of the corporate affairs managers have worked for the companies for between three to four years this is indicated by 20 (45.5%) of the respondents,12 (27.3%) of the respondents indicate having worked for seven years and above, 9 (20.5%) of the respondents indicated having worked for the companies

between five to six years and only 3 (6.8%) of the respondents indicated that they had worked for the company for less than two years.

**Table:4.2 Duration of time that the company has been listed at the NSE**

Duration of listing	Frequency	Percent
1-3 three years	2	4.6
4-5 years	3	6.8
6 years and above	39	88.6
Total	44	100.0

**Source: Field data(2013)**

The results summarized in the Table 4.2 indicates that 2(4.6%) of the companies had been listed between one to three years,3(6.8%) of the companies had been listed for between four to five years. The results also showed that 39(88.6%) of the companies had been listed at the NSE for a period of six years and above.

**Table:4.3 Frequency of participation in the board affairs**

Participation in board affairs	Frequency	Percent
once a month	2	4.5
once in three months	27	61.4
once in six months	7	15.9
once a year	8	18.2
Total	44	100.0

**Source: Field data(2013)**



from the Table 4.3 summary of results showed that 2(4.5%) of the respondents indicated that they participated in the board affairs once a month implying twelve times participation in a year, 27(61.4%) of the respondents indicated having participated in the board activities once in three months that is to say quarterly participation, 7(15.9%) of the respondents indicated that they participated in the boards activities twice a year 8(18.2%) of the respondents indicated that they participated in the boards affairs once a year.

#### **4.1.1 Corporate governance index determination**

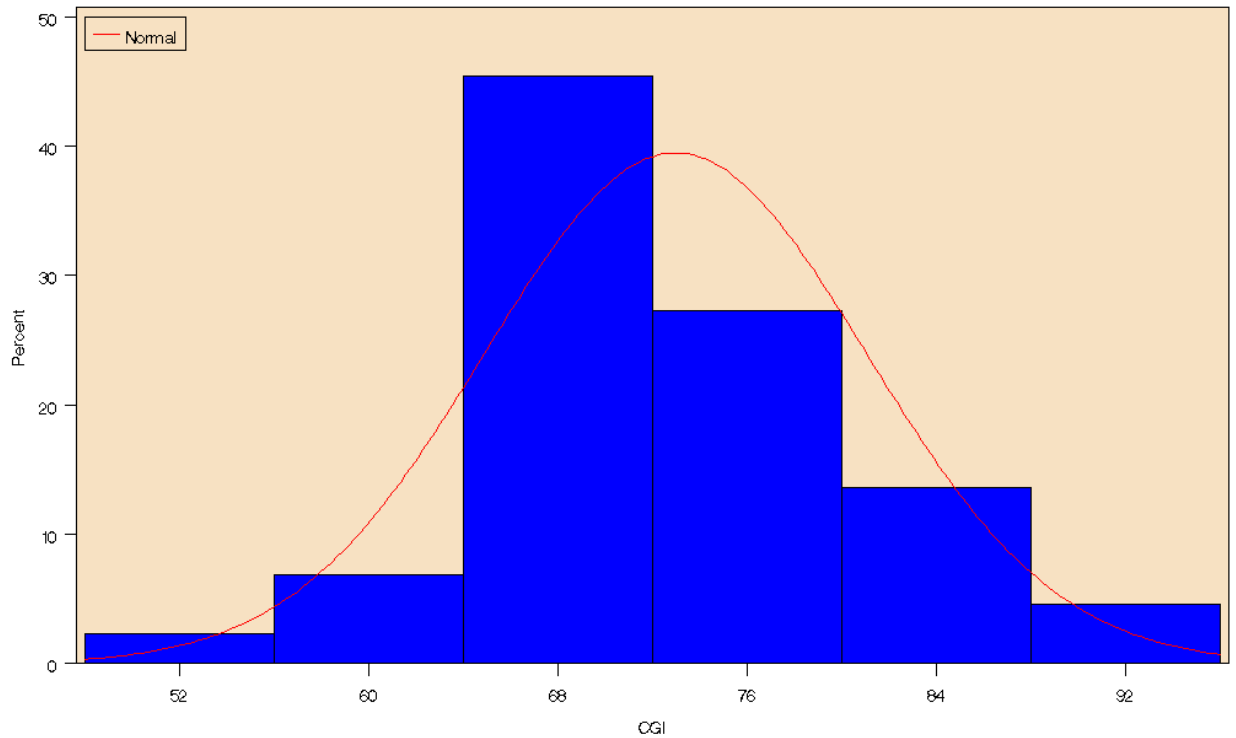
Six sub indices namely; Board Accountability (Sub-Index A), Financial Disclosure and Internal Control(Sub-Index B), Shareholder Rights(Sub-Index C), Remuneration(Sub-Index D), Market for Corporate Control (Sub-Index E), Corporate Behavior (Sub-Index F) were first constructed to have a value between 0 and 1. Each index was arrived at by getting an equivalent of the arithmetic mean for the elements under each category. The sub indices were then standardized to take a value of between 0 and 20. The overall Corporate Governance Index (CGI) was thus computed by summing the six sub indices then dividing by the maximum possible score (120), the results being multiplied by 100 so that the overall CGI had a value between 0 and 100 with the better-governed companies having a higher score.

*CGI*

$$= \left[ \frac{\text{SubindexA} + \text{SubindexB} + \text{SubindexC} + \text{SubindexD} + \text{SubindexE} + \text{SubindexF}}{120} \right] \times 100$$

**Fig 4.1 Distribution of the Corporate Governance Index (CGI)**

The histogram for the overall CGI with a normal distribution curve superimposed on it is shown in figure 4.2. The CGI is almost normally distributed with the skewness being 0.186 and the median being 71.2963.



**Source:** Field data (2013)

**Fig.4.2:** Overall CGI distribution

#### 4.1.2 Adoption of the measures of corporate governance by the quoted firms trading at the NSE

In this study, six measures of corporate governance were considered, namely: Board Accountability, Financial Disclosure and Internal Return, Shareholder Rights, Remuneration, Market for Corporate Control and Corporate Behavior all of which were measured on a scale of 0-20 while the overall corporate governance index was computed on a scale of 0 to 100. Descriptive statistics were utilized in the analysis of the above measures. The results are presented in Table 4.4

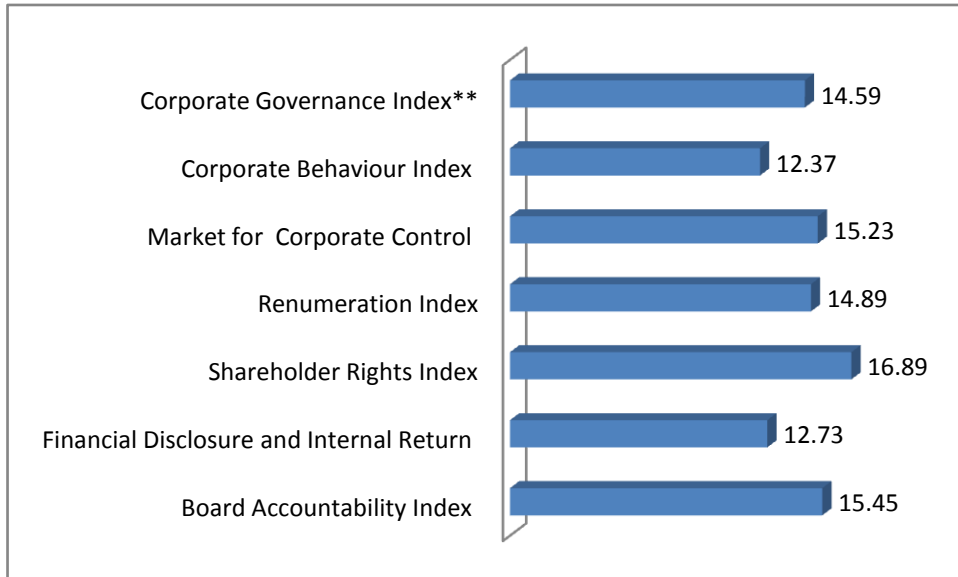
**Table:4.4 Summary Statistics for the Measures of corporate governance**

<b>Index</b>	<b>Minimum</b>	<b>Maximum</b>	<b>Mean</b>	<b>Std. Deviation</b>
Board Accountability Index (Sub Index A)	9.00	19.00	15.4545	2.2870
Financial Disclosure and Internal Return Index (Sub Index B)	5.00	20.00	12.7273	3.9554
Shareholder Rights Index (Sub Index C)	10.00	20.00	16.8939	3.3254
Remuneration Index (Sub Index D)	8.33	18.33	14.8864	2.5006
Market for Corporate Control (Sub Index E)	2.50	17.50	15.2273	3.2268
Corporate Behavior Index (Sub Index F)	4.44	17.78	12.3737	2.6423
Corporate Governance Index (CGI)	51.25	91.99	72.9693	8.08591

**Source: Field data(2013)**

The results showed that the highest implemented measure of corporate governance is the shareholder rights followed by board accountability and market for corporate control. The overall level of adoption of the corporate governance stands at 72.9693 which is

approximately 73% on the scale of 0 to 100. This showed that most of the firms in the NSE have done fairly well with regards to the adoption of corporate governance.



\*\*CGI was transformed to a scale of 0-20

**Fig 4.3: Bar chart for the measures of corporate governance**

**Source: Field data(2013)**

### **4.1.3 Board Accountability**

The measures for board accountability were analyzed using descriptive statistics mainly the mean and frequencies presented in Table 4.5 The results indicate that in general, most firms practiced the given measures of board accountability.

**Table 4.5: Board Accountability**

<b>Board Accountability</b>	<b>No</b>	<b>Yes</b>	<b>Mean</b>
B1. Are Board members subjected to annual election by all shareholders	2 (4.5%)	42 (95.5%)	.95
B2. Do non-executive board members have a formal session without executives	19 (43.2%)	25 (56.8%)	.57
B3. Is board performance evaluated periodically	6 (13.6%)	38 (86.4%)	.86
B4. Does the Company disclose code of ethics for senior executives	3 (6.8%)	41 (93.2%)	.93
B5. Does the Company disclose its corporate governance policies or guidelines	7 (15.9%)	37 (84.1%)	.84
B6. Is the Board or a committee responsible for CEO succession planning	6 (13.6%)	38 (86.4%)	.86
B7. Has the Company complied to adopt the recommendations of a shareholder proposal	10 (22.7%)	34 (77.3%)	.77
B8. Do all executive board members own shares	12 (27.3%)	32 (72.7%)	.73
B9. Do all non-executive board members own shares	18 (40.9%)	26 (59.1%)	.59
B10. Has the Company separated the responsibilities of chairman and CEO	0 (0%)	44 (100.0%)	1.00
B11. Do all members of the board attend at least 75% of the board meetings	1 (2.3%)	43 (97.7%)	.98
B12. Has the Company designated "lead" or senior non-executive board member	9 (20.5%)	35 (79.5%)	.80
B13. Have there been external influence related transactions in the past three years	27 (61.4%)	17 (38.6%)	.39
B14. Is the governance committee composed of independent minded board members	4 (9.1%)	40 (90.9%)	.91
B15. Is there any former CEO in the board	27 (61.4%)	17 (38.6%)	.39
B16. Has the Number of shares held by officers and directors not decreased by 10% or more?	23 (52.3%)	21 (47.7%)	.48
B17. Number of shares held by officers and directors has increased by 10% or more	10 (22.7%)	34 (77.3%)	.77
B18. Does the governance committee have a written charter or terms of reference	0 (0%)	44 (100.0%)	1.00
B19. Is the Board size greater than five but less than 16 members	2 (4.5%)	42 (95.5%)	.95
B20. Is the Board controlled by more than 50% of independent outside directors	14 (31.8%)	30 (68.2%)	.68

**Source: Field data (2013)**

#### 4.1.4 Financial Disclosure And Internal Control

From the results in Table 4.6 it is indicative that most companies practice averagely the attributes of governance sub-index of financial disclosure and internal control with the average score of the respondents agreeing being above 50% and only one attribute having the response rate of 31.8% indicated of companies being under investigation.

**Table:4.6 Financial Disclosure and Internal Control**

<b>Financial Disclosure and Internal Control</b>	No	Yes	Mean
C1. Is the company free from audit query in the past three years	21 (47.7%)	23 (52.3%)	.52
C2. Has the Audit committee got a written charter or terms of reference	3 (6.8%)	41 (93.2%)	.93
C3. Is the Company free from qualified audit opinion within the last two fiscal years	18 (40.9%)	26 (59.1%)	.59
C4. Is the company currently under investigation for accounting irregularities	30 (68.2%)	14 (31.8%)	.32
C5. Is the audit committee wholly composed of independent board members	14 (31.8%)	30 (68.2%)	.68
C6. Do Senior management with sole authority hire outside auditor	12 (27.3%)	32 (72.7%)	.73
C7. Does audit committee with sole authority approve non-audit services from outside auditor	17 (38.6%)	27 (61.4%)	.61
C8. Did the Company the auditor's services as per guided rates	3 (6.8%)	41 (93.2%)	.93

**Source: Field data(2013)**

#### 4.1.5 Shareholder rights

From Table 4.7 results showed that most of the companies practice shareholders right as a measure of corporate governance with average attributes measuring between 0.7 and 0.95.

**Table 4.7 Shareholder Rights**

<b>Shareholder Rights</b>	No	Yes	Mean
D1. Are the Vote results for the last shareholder meeting disclosed within 14 calendar days	2 (4.5%)	42 (95.5%)	.95
D2. Do all ordinary equity shares have one-share, one-vote, with no restrictions	4 (9.1%)	40 (90.9%)	.91
D3. Does the company provide confidential voting with no or with reasonable exceptions	7 (15.9%)	37 (84.1%)	.84
D4. Do the shareholders have a right to convene an AGM with 10% or less of the shareholders	13 (29.5%)	31 (70.5%)	.70
D5. Do the shareowners have a right to act in concert through written communication	6 (13.6%)	38 (86.4%)	.86
D6. Are the voting rights limited at a certain percentage or not	9 (20.5%)	35 (79.5%)	.80

**Source: Field data(2013)**

#### 4.1.6 Remuneration

As pertaining to remuneration as a sub-index results in Table 4.8 show that firms adopt the attributes above average

**Table:4.8 Remuneration**

<b>Remuneration</b>	<b>No</b>	<b>Yes</b>	<b>Mean</b>
E1. Are the non-executive board members paid in cash or in some form of stock-linked compensation	2 (4.5%)	42 (95.5%)	.95
E2. Does the company disclose performance targets for the next fiscal year	5 (11.4%)	39 (88.6%)	.89
E3. Are non executive board members paid entirely in some form of stock linked compensation	22 (50.0%)	22 (50.0%)	.50
E4. Is there CEO without an employment agreement that provides for guaranteed bonus payments	22 (50.0%)	22 (50.0%)	.50
E5. Do the goals used to determine incentive awards aligned with the company's financial goals	4 (9.1%)	40 (90.9%)	.91
E6. Is the CEO/Managing Director restrained to sit on the remuneration committee	18 (40.9%)	26 (59.1%)	.59
E7. Is the remuneration committee wholly composed of independent board members	15 (34.1%)	29 (65.9%)	.66
E8. Is there re-pricing of outstanding stock	7 (15.9%)	37 (84.1%)	.84
E9. Is there expensing of employee stock grants	15 (34.1%)	29 (65.9%)	.66
E10. Does the remuneration committee have a written charter or terms of reference	5 (11.4%)	39 (88.6%)	.89
E11. Is the Potential Dilution from Stock Outstanding below 20%	10 (22.7%)	34 (77.3%)	.77
E12. Is the Potential Dilution from Stock Outstanding plus stock not yet granted below 20%	10 (22.7%)	34 (77.3%)	.77

**Source: Field data(2013)**



#### 4.1.7 Market for Corporate Control

The Table 4.9 showed that market for corporate control has been adopted well with a mean between 0.5 and 0.89

**Table 4.9: Market for corporate control**

<b>Market for Corporate Control</b>	<b>No</b>	<b>Yes</b>	<b>Mean</b>
F1. Has the company adopted a shareholder rights plan ("poison pill")	6 (13.6%)	38 (86.4%)	.86
F2. Does the company have a staggered ("classified") board where directors are placed into different classes and serve overlapping terms	13 (29.5%)	31 (70.5%)	.70
F3. Can the company not issue blank check preferred stock in the event of a hostile tender offer?	22 (50.0%)	22 (50.0%)	.50
F4. Has the company's shareholder rights plan ("poison pill") been ratified by a shareholder vote	11 (25.0%)	33 (75.0%)	.75
F5. Is the fair price provision in place or price protection under applicable law	5 (11.4%)	39 (88.6%)	.89
F6. Does the shareholder rights plan include director's evaluation of poison pill defenses every three years	5 (11.4%)	39 (88.6%)	.89
F7. Does the company require a supermajority vote to approve a merger	5 (11.4%)	39 (88.6%)	.89
F8. Is there any single shareholder or a small group of shareholders with majority voting power	17 (38.6%)	27 (61.4%)	.61
F9. Does the company allow one vote per share multiplied by the number of directors to be elected (cumulative voting) in the election of directors	7 (15.9%)	37 (84.1%)	.84

**Source: Field data(2013)**

#### 4.1.8 Corporate Behavior

Results indicate that most of the firms practice this attribute of the corporate behavior with a mean of between 0.52 and 0.93. These results are given in Table4.10

**Table 4.10 Corporate behavior**

<b>Corporate Behavior</b>	<b>No</b>	<b>Yes</b>	<b>Mean</b>
G1. Does the company have a policy addressing workplace safety	3 (6.8%)	41 (93.2%)	.93
G2. Is the company free from criminal litigation	21 (47.7%)	23 (52.3%)	.52
G3. Is the company free from allegations that the company exposed employees to working for long hours with low wages and bad working conditions in the last three years	17 (38.6%)	27 (61.4%)	.61
G4. Does the Company disclose its environmental performance	5 (11.4%)	39 (88.6%)	.89
G5. Does the Company disclose its workplace safety record	3 (6.8%)	41 (93.2%)	.93
G6. Other than for accounting irregularities is the company free from any other regulatory investigation for material issue	18 (40.9%)	26 (59.1%)	.59
G7. Does the Company disclose its policy regarding corporate level political donations	19 (43.2%)	25 (56.8%)	.57
G8. is the Company free of charges with workplace safety violations within the last two years	13 (29.5%)	31 (70.5%)	.71
G9. Is the company free from allegation by a responsible party that the company misused labor	12 (27.3%)	32 (72.7%)	.73

**Source: Field data(2013)**

#### **4.1.9 OLS Regression Analysis for the Overall Index (CGI) and Sub indices Using Tobin's Q as a measure of firm's value**

The OLS regression was used to analyze the relationship between the Firm's Value (Tobin's Q) as the dependent variable and the various components of Corporate Governance as the explanatory variable. The regression ANOVA is presented in Table 4.11. The results show that there was a significant relationship between the Tobin's Q and the independent variables. That is, the regression is statistically significant at 5% significance level with p value<0.05. The implication of this test is that, the combination of all the components of the corporate governance significantly affects the firm's value.

**Table 4.11 Regression ANOVA**

<b>Source of variation</b>	<b>Sum of Squares</b>	<b>Df</b>	<b>Mean Square</b>	<b>F</b>	<b>p-value</b>
Regression	125.229	6	20.872	22.775	.000
Residual	34.823	38	.916		
Total	160.052	44			

**Source: Field data(2013)**

**Table 4.12 Parameter Estimates**

Variable	Estimate	Std.		
		Error	t	p-value
Board Accountability Index (Sub Index A)	.013	.068	.187	.853
Financial Disclosure and Internal Return Index (Sub Index B)	.027	.047	.573	.570
Shareholder Rights Index (Sub Index C)	-.005	.051	-.095	.925
Remuneration Index (Sub Index D)	.049	.059	.842	.405
Market for Corporate Control (Sub Index E)	.034	.051	.662	.512
Corporate Behavior Index (Sub Index F)	-.002	.063	-.035	.972

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R<sup>2</sup>=78.2%

**Source: Field data(2013)**

From Table 4.12, it is worth noting that none of the estimated parameters for the sub-indices is significant at 1% or 5% levels of significant. Further, it is important to note that the estimates for Shareholder Rights Index (Sub Index C) and Corporate Behavior Index (Sub Index F) all have a negative value. This revealed that the companies that had a lower index for the two issues had a higher firm value. This could imply that lack of practicing of shareholder rights and corporate behavior does not necessarily lead to a lower firm value. The model R-square=78.20% showing a satisfactory fit for the regression model. That is, the regression (combination of the sub indices) explained 78.20% of the Firm's value measured using Tobin's Q.

On the other hand, the p-values for the estimates for all the six sub indices were greater than 0.05 showing that all the sub indices do not individually influence the Firms' value

but they significantly affect the firm's value when combined (i.e since the regression was statistically significant at 5%).

The regression model with firm size as the moderating variable. The moderating variable was treated as the covariate. The results are presented in the Table 4.13 with Model 1 representing a regression of the firm's value (Tobin's Q) as the dependent variable and the covariate (Ln FirmSize) as the explanatory variable. The model summary reveals that the firms' age contributes 76.8% of the Firms value while the firm's value in when combined with the other six dependent variables do account for 78.2% of the variation. The R square change with the introduction of the explanatory variables is not statistically significant at 5% level.

**Table 4.13 Model Summary**

	<b>R</b>	<b>Square</b>				<b>Sig.</b>	<b>F</b>
<b>Model</b>	<b>R Square</b>	<b>Change</b>	<b>F Change</b>	<b>df1</b>	<b>df2</b>	<b>Change</b>	
1	.768	.768	142.703	1	43	.000	
2	.782	.014	.396	6	37	.877	

---

**Source: Field data(2013)**

**Table 4.14 ANOVA Table**

<b>Model</b>		<b>Sum Squares</b>	<b>of Df</b>	<b>Mean Square</b>	<b>F</b>	<b>p-value</b>
1	Regression	122.992	1	122.992	142.703	.000
	Residual	37.060	43	.862		
	Total	160.052 <sup>b</sup>	44			
2	Regression	125.229	7	17.890	19.008	.000
	Residual	34.823	37	.941		
	Total	160.052 <sup>b</sup>	44			

---

**Source: Field data(2013)**

The ANOVA in Table 4.14 reveals that the model 1 (firm size) significantly affects the firm's value at 5% level. It further shows that the model 2 (the combination of the firm size and the six independent variables) is also significant at 5% level.

**Table 4.15 Parameter Estimates for the Regression with Firm Size as Covariate**

Model		Estimate	Std. Error	t	p-value
1	Ln(Firmsize)	.072	.006	11.946	.000
2	Ln(Firmsize)	.001	.056	.012	.990
	Board Accountability	.012	.073	.169	.867
	Financial Disclosure	.027	.048	.564	.576
	and Internal Control				
	Share Holder Rights	-.005	.053	-.094	.926
	Remuneration	.049	.066	.742	.463
	Market for Corporate	.034	.052	.646	.522
	Control				
	Corporate Behavior	-.002	.067	-.037	.971

---

**Source: Field data(2013)**

From table 4.15 results showed that firm size did not significantly affect individual measures of value of the firms' as an intervening variable all the p values with individual relationships was greater than 5%  $p > 0.05$ ,

#### **4.1.10: Age as a covariate**

Age of the firm was also considered as a moderating variable and consequently modeled as a covariate in the regression model. The results are presented in Table 4.15. The model summary showed that the age of firm contributes to the Firm's value at 72.8% and this contribution is statistically significant at 5% level. Also, the combination of the covariate and the independent factors contributes 78.5% to the dependent variable as

indicated by  $R^2=78.5\%$ . However, this contribution is not statistically significant at 5% level.

**Table 4.16 Model summary**

	<b>R</b>	<b>Square</b>					
<b>Model</b>	<b>R</b>	<b>Square<sup>b</sup></b>	<b>Change</b>	<b>F Change</b>	<b>df1</b>	<b>df2</b>	<b>p-value</b>
1	.728	.728		115.335	1	43	.000
2	.785	.057		1.631	6	37	.166

---

**Source: Field data(2013)**

**Table 4.17 ANOVA Table**

<b>Model</b>		<b>Sum</b>	<b>of</b>	<b>Mean</b>		
		<b>Squares</b>	<b>Df</b>	<b>Square</b>	<b>F</b>	<b>p-value</b>
1	Regression	116.586	1	116.586	115.335	.000
	Residual	43.466	43	1.011		
	Total	160.052	44			
2	Regression	125.675	7	17.954	19.324	.000
	Residual	34.377	37	.929		
	Total	160.052	44			

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**Source: Field data(2013)**

The ANOVA in Table 4.17 shows that the covariate (Age of the Firm) has a significant regression at 5% level as a covariate. In addition, the regression for the independent



variables and the covariate is also statistically significant at 5% level. This implies that the combination of the corporate governance in combination with the firm's age significantly affects the firm's value.

**Table 4.18 Parameter Estimates for the Regression with age as Covariate**

<b>Model</b>		<b>Estimate</b>	<b>Std. Error</b>	<b>T</b>	<b>p-value</b>
1	ln(age)	.503	.047	10.739	.000
2	ln(age)	.118	.170	.693	.493
	Board Accountability	.019	.069	.280	.781
	Financial Disclosure and Internal Control	.018	.049	.372	.712
	Share Holder Rights	-.009	.052	-.170	.866
	Remuneration	.038	.061	.624	.536
	Market for Corporate Control	.040	.052	.775	.443
	Corporate Behavior	-.020	.068	-.296	.769

**Source: Field data(2013)**

In Table 4.18 parameter estimates for model 1 for instance the covariate alone as the independent variable is statistically significant. However, for Model 2 which has the corporate governance and the covariate has no significant estimate at 5% level. Other notable features were that the coefficient for Share Holder Rights and Corporate Behavior are negative. This implies that the firm's which had a lower score for the above sub

indices still got a higher firm's value. This indicates that the Share Holder Rights and Corporate Behavior do not positively influence the firm's value.

#### 4.1.11 OLS Regression Analysis for the Overall Index (CGI) and Sub indices Using ROA as a measure of firm's value

Results from regressing corporate governance as an independent variable and value of the firm measured by ROA as a dependent variable show that there was no significant relationship between ROA and CGI the regression was not statistically significant at 5% level of significance where p value was greater than 0.05 at 0.052 as shown in table . The implication is that the combination of all components of corporate governance did not significantly affect the value of the firm measured by ROA. it is also evident from table 4.19 that only 9.6% of the variations was explained showing a very insignificant relationship.

**Table 4.19 Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.310 <sup>a</sup>	.096	.072	9.64514

a. Predictors: (Constant), CGI

**Table 4.20 ANOVA<sup>b</sup>**

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	375.142	1	375.142	4.033	.052 <sup>a</sup>
	Residual	3535.090	38	93.029		
	Total	3910.232	39			

a. Predictors: (Constant), CGI

b. Dependent Variable: ROA

**Table 4.21 Coefficients<sup>a</sup>**

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-24.195	12.974		-1.865	.070
	CGI	7.292	3.631	.310	2.008	.052

a. Dependent Variable: ROA

**Table 4.23 Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.341 <sup>a</sup>	.117	.043	9.79545

a. Predictors: (Constant), Ln( age of listing), firm size Ln( Assets), CGI

The model summary showed that independent variables age of the firm ,size of the firm combined contributed to 12 % to changes in value of the firm as measured by ROA

**Table 4.24 ANOVA<sup>b</sup>**

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	456.002	3	152.001	1.584	.210 <sup>a</sup>
	Residual	3454.230	36	95.951		
	Total	3910.232	39			

a. Predictors: (Constant), Ln( age of listing), firm size Ln( Assets), CGI

b. Dependent Variable: ROA

**Table 4.25 Coefficients<sup>a</sup>**

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	-27.592	13.692		-2.015	.051
	CGI	7.574	3.701	.322	2.047	.048
	firm size Ln( Assets)	-3.265E-13	.000	-.007	-.046	.963
	Ln( age of listing)	.086	.094	.144	.918	.365

a. Dependent Variable: ROA

It can be noted that when corporate governance is combined with the moderating variables which are age of the firm and firm size measured by Assets the relationship between corporate and value of the firm measured by ROA becomes significant as indicated in table 4.25 where  $P < 0.05$  at 0.048 even though firm size alone and age of the firm alone do not have a significant effect on value of the firm as measured by ROA since all their P values are greater than 0.05.

**Table 4.26 Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.396 <sup>a</sup>	.157	.003	9.99708

Predictors: (Constant), corporate behaviour, shareholders rights, market for corporate control, board accountability, financial disclosure, remuneration

Model summary from table 4.26 indicate that corporate be corporate behavior, shareholders rights ,market for corporate control, financial disclosure and executive remuneration contributes 15.7% to value of the firm measured using ROA

**Table 4.27 ANOVA<sup>b</sup>**

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	612.159	6	102.026	1.021	.429 <sup>a</sup>
	Residual	3298.073	33	99.942		
	Total	3910.232	39			

a. Predictors: Predictors: (Constant), corporate behaviour, shareholders rights, market for corporate control, board accountability, financial disclosure, remuneration

b. Dependent Variable: ROA

**Table 4.27 Coefficients<sup>a</sup>**

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	-32.609	15.170		-2.150	.039
	Shareholders rights	9.929	12.933	.162	.768	.448
	Board Accountability	25.375	15.183	.284	1.671	.104
	Market for corporate Control	7.018	9.263	.142	.758	.454
	Financial Disclosure	-.337	11.385	-.006	-.030	.977
	Remuneration	1.012	13.930	.014	.073	.943
	corporate behaviour	1.671	7.781	.036	.215	.831

a. Dependent Variable: ROA

Results from table 4.27 indicate that all individual measures of corporate governance did not have significant effect with value of the firm as measured by ROA. further it can be noted that the estimate financial disclosure had a negative value .this implies that companies that had a lower index for this issue had a higher value of the firm this indicated that even without much practice of disclosure value of the firm was not much affected.

**Table 4.28 Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.508 <sup>a</sup>	.258	.067	9.67249

a. Predictors: (Constant), Ln( age of listing), firm size Ln( Assets), corporate behaviour, shareholders, contol, accountability, remuneration, disclosure

From table 4.28 the model summary shows R square of 25.8% that is to say the contribution of combined measures of corporate governance and the moderating variables which are age of the firm and firm size to value of the firm measured by ROA.this shows that only about 26% of the variation is explained by independent variable in relation to the dependent variable.

**Table 4.29ANOVA<sup>b</sup>**

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1009.964	8	126.245	1.349	.257 <sup>a</sup>
	Residual	2900.268	31	93.557		
	Total	3910.232	39			

a. Predictors: (Constant), Ln( age of listing), firm size Ln( Assets), corporate behaviour, shareholders, contol, accountability, remuneration, disclosure

b. Dependent Variable: ROA

**Table 4.30 Coefficients<sup>a</sup>**

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	-48.322	16.538		-2.922	.006
	Shareholders rights	6.711	12.629	.109	.531	.599
	Board Accountability	40.307	16.395	.452	2.458	.020
	Market for corporate Control	10.471	9.125	.212	1.147	.260
	Financial Disclosure	-6.190	11.461	-.108	-.540	.593
	Remuneration	3.625	13.587	.052	.267	.791
	corporate behaviour	1.255	7.531	.027	.167	.869
	firm size Ln( Assets)	-4.608E-12	.000	-.102	-.632	.532
	Ln( age of listing)	.234	.114	.392	2.046	.049

a. Dependent Variable: ROA

Table 4.30 indicate that combination of corporate governance sub indices/measures with moderating variables affected value of the firm with Board accountability affecting value of the firm with a p value less than 0.05 at 0.02 while the rest of the measures did not have any significant effect on value of the firm as measured by ROA



## **4.2 Discussion of findings**

This chapter discusses the findings in order to achieve the seven objectives that were translated into one research question and six hypotheses in chapter one. It provides some possible explanations as to why the hypotheses were supported or unsupported.

From research question one, which asked about the level of adoption of the measures of corporate governance by companies quoted at the NSE, The results show that the highest implemented measure of corporate governance is the shareholder rights with a mean of 16.89 followed by board accountability with a mean of 15.45 and market for corporate control with a mean of 15.22, remuneration follows with a mean of 14.88, financial disclosure and internal control with a mean of 12.7 and the lowest implemented corporate governance measure is corporate behavior with a mean of 12.7. The overall level of adoption of the corporate governance stands at 73%. This shows that most of the firms in the NSE have done fairly well with regards to the adoption of corporate governance. According to Black and Jang (2003) it was found that on the scale of 0 to 20 score on the measures of corporate governance in Korea board accountability had a mean of 7.75 and shareholders rights a mean of 3.56, disclosure to investors had a mean of 1.17. These are similar measures to the measures used in this study. Other measures used in the Korean corporate governance study include audit committee and internal auditor, outside directors and ownership parity. The governance index in Korea was found to be 86% this is far ahead of the governance index in Kenya by 13%. This difference can be attributed to the level of development in Korea based on the infrastructure and governance structures in place both in politics and business more so in the way their stock market has developed and with reference to the measures of corporate governance, it is notable that the most implemented measure of governance is ownership parity (16.59) followed by

audit committee and internal auditor(10.97) .The third implemented measure is Board accountability(7.75) followed by outside directors(4.29),followed by share holders rights(3.46) while the least implemented measure in Korea is disclosure to investors(1.17).All these measures are rated in a scale of 0-20. It can be seen that from the Korean Governance experience and the Kenyan experience, share holders rights is very important this can be seen from the number one implemented measure of governance which shareholders right in the Kenyan situation but the Korean situation is given less importance since it is second last on the basis of the most implemented measures. The possible reason for it to be number one in Kenya could be because the agents like to please the principles by observing their rights so that the principles do not rebel against them in the Korean situation Business is looked at as an entity and therefore the rights of the shareholders are not so much looked into if they antagonize business strategy implementation.

It is also comparable when looking at the board accountability between the two countries in Korea Board accountability has a score of 7.75 as compared to the Kenyan score of 15.45, the Kenyan score seems to be high implying that most of the board in Kenya are more accountable as compared to those in Korea. This could be as a reason of introducing the best practice of corporate governance in the boards management in Kenya ,also as a result of corporate scandals many board have opted to practice good governance to avoid being associated with scandals .Financial disclosure and internal control measure shows that Korean measure is 1.17 while the Kenyan measure was found to be 12.7 ,this measure is far much better than the Korean one. This could be because it is a legal

requirement of the Kenyan government that any quoted company must disclose to the investors about the status of their investment, this is done through financial statements which are done periodically. In general, the findings of the study show that the measures of corporate governance are adopted to some extent in Kenya and this supports previous studies .

The first hypothesis of the study was  $H_{01}$  : Board accountability does not affect the value of the firm. The results showed that board accountability does not affect the value of the firm individually when you regress value of the firm measured by tobins Q, the findings also revealed that firms that had a higher score in the board accountability still exhibited lower returns. This relationship was not significant since  $p > 0.05$  where  $p = 0.853$  with  $t = 0.187$  the results necessitates that the researcher fail to reject the null hypothesis that board accountability does not affect the value of the firm. The results could imply that most investors exert less pressure on the directors to improve on their performance pertaining to profitability. Black, Kim, Jang and Park (2009) found that board and committee procedures do not affect value of the firm, the authors found an insignificant coefficient on board procedures measures in Korea with firm fixed effects. The findings is in conflict with Yermock (1996) where smaller boards were found to be more accountable than larger boards, it was also found that a smaller board was associated with greater value of the firm and the larger boards with a lower value of the firm. The finding supports the results of Geneen (1984) where the author found that boards did not affect the performance of the firm since 95% of the directors were found not to be doing what they are legally, morally and ethically suppose to do. It is also evident that, the board is a

rubber stamp, the board is dominated by CEO, and the board is plagued with conflicts of interest(Weidenbaum,1986). When value of the firm measured by return on assets was regressed on board accountability including moderating variable the relationship was found to be significant where p value was less than 0.05 with  $p=0.02$ ,using return on asset as the dependent variable and the moderating variables with board accountability as a measure showed improved results necessitating rejection of the null hypothesis. this implied that board accountability does influence value of the firm measured by ROA this findings supports the findings of Yermock(1996) who found a significant influence of board accountability on value of the firm

The second hypothesis of the study was  $H_{02}$ : Financial disclosure does not affect the value of the firm. The results showed that there is no significant cause and effect relationship between financial disclosure and internal control and the value of the firm. This was indicated by  $t=0.573$  and  $p=0.57$  therefore  $p>0.5$  implying that this research fail to reject the null hypothesis this showing that financial disclosure and internal control measures of governance do not individually affect the value of the firm whether the value of the firm is measured by Tobin's Q or ROA. This could be because many investors are not interested so much on disclosures as long as they are earning something from the firm, also some investors tend to invest without financial information. The results are in contrast with the findings that there is a theoretical prediction that relevant and reliable disclosure by companies attracts institutional investors (Diamond & Verrecchia, 1991; Kim and Verrechia, 1994). It has also been found that increases in corporate disclosure

have been shown to be associated with increases in ownership by institutional investors (Healy et al., 1999).

The third hypothesis was  $H_{03}$ : shareholder rights do not affect the value of the firm. The results showed that shareholders rights do not affect the value of the firm individually as a measure of corporate governance whether value of the firm is measured by Tobin's Q or ROA, the value of  $p > 0.05$  which showed statistical insignificance and an estimate value of -0.005 and a  $t = -0.095$  this leads to failure in rejection of the null hypothesis that shareholders rights do not affect the value of the firm. The negative value showed that companies that had a lower governance index for shareholder rights had a higher firm value. This shows that even without proper attention to the shareholders rights, companies still perform by increasing the value of the company. It is notable that companies cannot meet all the demands of the shareholders at the same time even if they are documented.

The fourth hypothesis was  $H_{04}$ : remuneration does not affect value of the firm. Results showed that the relationship is not significant since  $p > .05$  that is to say  $p = 0.405$  and  $t = 0.842$  and the estimate value is 0.49 and this leads to failure in rejection of the null hypothesis that remuneration does not affect value of the firm whether value of the firm is measured by Tobin's Q or ROA. In the study, setting the agency principle conflict is evident for instance taking into account the Uchumi Super market downturn which is one of the examples in Kenya where directors are paid well but the company still went down. This finding is in support of findings that as for the relationship between remuneration and corporate performance, a study found strong statistical evidence linking excessive

executive remuneration with 'bad' corporate governance and poor corporate performance in the USA (Core et al, 1999)

The fifth hypothesis was  $H_{05}$ : market for corporate control does not affect value of the firm. The findings showed that the relationship was not significant since  $p > 0.05$ . Therefore this research fail to reject the null hypothesis that market for corporate control does not affect value of the firm whether value of the firm is measured by Tobin's Q or ROA. This finding is in contrast with the findings given by Jensen (1986, 1988) who argues that takeovers can solve the free-cash flow problem, since they usually lead to distribution of the firm's profit to investors over time. Takeovers are widely interpreted as the critical governance mechanism in the USA, without which managerial discretion cannot be effectively controlled (Easterbrook and Fischel, 1991; Jensen, 1993).

The sixth hypothesis was  $H_{06}$ : corporate behavior does not affect value of the firm. Results showed that the relationship was not significant at 5% level of significance where  $p > 0.05$ ,  $t = -0.035$  and  $p = 0.972$  therefore leading to the rejection of the null hypothesis that corporate behavior does not affect value of the firm whether value of the firm is measured by Tobin's Q or ROA. It can also be noted that corporate behavior index has a negative value.

This reveals that the companies that had a lower index for corporate behavior had a higher firm value. This could imply that lack of practicing of corporate behavior does not necessarily lead to a lower firm value. This finding support results of the study done by Black(2001)found that governance behavior of firms in the United states of America do not affect the value of the firm and this the reason that there was small variation in governance behavior among the firms after all, the minimum quality of the American

corporate governance set by law and by norms so widely accepted that almost no public firm departs from them is quite high. In Kenya there are guidelines to the best practice of corporate governance which to some extent is being implemented by firms quoted at the NSE; Uniformity in requirements for best practice could be the cause of corporate behavior not affecting value of the firm. In Russia the relationship between corporate behavior and value of the firm is contrary to the findings in United States and Kenya, in that corporate behavior affects the value of the firm. This is because legal and cultural constraints were weak. A general finding indicated that , the p-values for the estimates for all the six sub indices were greater than 0.05, showing that all the sub indices do not individually influence the firms value but they significantly affect the firm's value when combined (i.e since the regression was statistically significant at 5%) where  $p < 0.05$ . The  $R^2 = 78.2\%$  indicates that corporate governance variable explains the value of the firm to a very large extent showing a very strong association between corporate governance and the value of the firm. The general finding supports the findings by Abdurrouf (2011). The authors found that there was a positive relationship between corporate and value of the firm in developing countries with a focus on Bangladesh.

Results also showed that regression with firm age as a moderating variable which was treated as a covariate revealed that age contributes 72.8% of the variation the R square change with the introduction of the explanatory variable was not statistically significant at 5% level of significant

where  $p > .05$ . This implies that regardless of the age of the firm, value of the firm is not affected because it depends on other factors and age is one of them as such this is not a determinant of the firm value but alternatively when age is used as a moderating variable

it is found that it affects value of the firm as measured by ROA significantly with a p value equal to  $0.049 < 0.05$ , on the other hand, results of firm size treated as a covariate in the regression model show that firm size significantly affects the firm's value at 5% significant level individually and also when combined with the six independent variables since  $p < 0.05$ . This implies that bigger firms have an opportunity for diversification which leads to reduction of risks ,the fact that risk is low leads to a better value of the firm because of stability provided by a stable environment.



## CHAPTER FIVE

### SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

#### 5.1 Introduction

This chapter summarizes the discussion of objectives investigated during the study and answers the research questions to the purpose of the study.

#### 5.2 Summary of findings

Descriptive statistics was used to analyze data relating to objective one that is to establish the level of adoption of the measures of corporate governance by the quoted firms trading at the NSE, findings showed that the highest implemented measure of corporate governance is the shareholder rights with a mean of 16.8939 followed by board accountability with a mean of 15.4545, followed by market for corporate control with a mean of 15.2273 followed by remuneration with a mean of 14.8864, followed by financial disclosure and internal control with a mean of 12.7273 the least adopted measure was corporate behavior which had a mean of 12.3737. The overall level of adoption of the corporate governance stands at around 73%. This showed that most of the firms in the NSE have adopted corporate governance measures in Kenya

The findings showed that board accountability does not affect the value of the firm individually, and firms that had a higher score in the board accountability still exhibited lower returns this relationship was not significant since  $p > 0.05$  where  $p = 0.853$ . The results imply that most investors exerted less pressure on the directors to improve on

their performance pertaining to profitability. findings also show that board accountability had a significant effect on value of the firm measured by ROA where  $p < 0.05$  where  $p = 0.02$ . The findings supports Yermock (1996) who found that boards expressly influence the performance of a firm.

Findings also showed that financial disclosure does not affect the value of the firm since  $t = 0.573$  and  $p = 0.57$ , therefore  $p > 0.05$  indicating that the relationship was not significant. This could be because many investors are not interested so much on disclosures as long as they are earning something from the firm, also some investors tend to invest without financial information. The results was in contrast with the findings that there is a theoretical prediction that relevant and reliable disclosure by companies attracts institutional investors (Diamond & Verrecchia, 1991; Kim & Verrechia, 1994). It has also been found that increases in corporate disclosure have been shown to be associated with increases in ownership by institutional investors (Healy et al., 1999).

Findings also showed that shareholders rights do not affect the value of the firm individually as a measure of corporate governance, the value of  $p > 0.05$  which shows statistical insignificance and an estimate value of  $-0.005$  and a  $t = -0.095$ , the negative value of the estimate showed that companies that had a lower governance index for shareholder rights had a higher firm value. This showed that even without proper attention to the shareholders rights companies still perform by increasing the value of the company. It is notable that companies cannot meet all the demands of the shareholders since they are so varied and others are quite extreme to meet.

Findings indicate that remuneration does not affect value of the firm the relationship was not significant since  $p > 0.05$  that is to say  $p = 0.405$  and  $t = 0.842$  and the estimate value is 0.49. This finding is not in support of findings that there is a relationship between remuneration and corporate performance, a study found strong statistical evidence linking excessive executive remuneration with 'bad' corporate governance and poor corporate performance in the USA (Core et al, 1999)

Findings also showed that market for corporate control does not affect value of the firm The findings showed that the relationship was not significant since  $p > 0.05$ . This finding is in contrast with the findings given by Jensen (1986, 1988) who argues that takeovers can solve the free-cash flow problem, since they usually lead to distribution of the firm's profit to investors over time. Takeovers are widely interpreted as the critical governance mechanism in the USA, without which managerial discretion cannot be effectively controlled (Easterbrook and Fischel, 1991; Jensen, 1993)

Findings showed that corporate behavior does not affect value of the firm. Results showed that the relationship was not significant at 5% level of significance where  $p > 0.05$ ,  $t = -0.035$  and  $p = 0$ . his finding support results of the study done by Black(2001) who found that governance behavior of firms in the United States of America do not affect the value of the firm .

Findings also showed that aggregated corporate governance measures affect value of the firm  $p > 0.05$  and one of the moderating value, age, also affects the value of the firm where  $p > 0.05$

### 5.3 Conclusions

The study concludes that the most implemented measure of corporate governance is shareholders right followed by board accountability, followed by market for corporate control followed by remuneration followed by financial disclosure and internal control, the least implemented measure of corporate governance is corporate behavior.

Regression results show that board accountability does not influence value of the firm measured by Tobin's Q but when aggregated with moderating variable age the effect of board accountability the effect on value of the firm measure by ROA becomes significant implying that ROA is a better measure of value of the firm in this study, other measures of governance shareholders' rights, market for corporate control, remuneration, disclosure and internal control and corporate behavior individually do not affect value of the firm, the relationship between the individual measure of corporate governance and value of the firm was not significant at 5% level of significance with all the probability values being greater than 0.05 ( $p > 0.05$ ). This results indicated that the value of the firm was only affected when all these measures were aggregated. This was as result of the possible interactions between the measures. It can finally be concluded that a firm's size influence value of the firm.

#### **5.4 Recommendations**

The study recommends that corporate governance index established from the study findings be used by firms listed at the NSE as a yardstick to measure the position of performance on the basis of key measures of corporate governance for example board accountability, financial disclosure and internal control, shareholders rights, remuneration, market for corporate control and corporate behavior.

The study also recommends that boards be held accountable at all levels so as to enhance the performance of the firms this is to be done by the shareholders by the help of capital markets authority, there should also be a legislation that governs the behavior and responsibilities of the board members this can help in moderating how board members conduct themselves while serving the shareholders.

When shareholders rights are taken care of the agency principle conflict eases and as a result more investors are attracted hence improving the value of the firm the study therefore recommends that a policy pertaining to education of shareholders about their rights should be put in place by CMA this is for the purpose of ensuring that shareholders exercise the rights fully in order to achieve their noble objective of wealth maximization which is evident in the value of the firm.

It can be recommended that remunerations to the executive be moderated so that they can have a better performance in their duties this is because when remuneration is not

regulated performance of the executives can not significantly contribute to the value of the firm.

Financial disclosure must be done effectively to attract confidence of the investors this will increase capital base which as a result will stabilize operations and hence performance of the firm also investors need to be educated on the issues relating to disclosure.

It is recommended that activities relating to take-over must be sanctioned by the investors for the firm to perform takeover activities help in reducing the agency principle conflict.

The study recommend that companies listed at the NSE should have a policy on the acceptable corporate behavior elements ,this policy should be made by the controlling body which is CMA, this policy can help companies to improve value of the firm since they will be consisted in practicing acceptable behavior. .

## **5.5 Areas for further research**

Further research can be done in the same area but data be collected for a longer period of more than three years which may be a five year period or a ten year period this is for the purpose of testing if time can bring stability to the governance index.

It is also suggested that further research can be done by looking at the relationship between corporate governance and value of the firm using different ways of measuring value of the firm apart from using Tobin's Q measurement of value of the firm.

It is also suggested that a study can be done to determine firm level corporate governance in predicting the market value of private companies.

Finally a study can be done to compare corporate governance indices between developed and emerging markets.

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## APPENDICES

### APPENDIX I: LETTER OF INTRODUCTION

Charles Yugi Tibbs,

Kabarak University,

Dear respondent,

Private Bag-20157

**Kabarak.**

I am a post graduate student at Kabarak University undertaking a doctor of philosophy degree.

As part of academic requirements for the award of the degree; I am expected to carry out a research. The study is on: *The effect of corporate governance on the value of the firm.*

You have been selected to be among the respondents to fill the questionnaires. I would like you to fill with honesty .all the information you provide will be treated with confidentiality and be used for research purposes only, as such you are asked not to provide your name nor offer any other clue to your identification on the questionnaire.

Your cooperation is highly appreciated.

Thanks in advance,

Yours sincerely,

Charles Y. Tibbs.

## **APPENDIX II : LETTER OF PERMISSION TO CONDUCT RESEARCH**

Charles Yugi Tibbs,

Kabarak University,

Dear respondent,

Private Bag-20157

**Kabarak.**

**National Council of Science and Technology**

**Nairobi.**

### **RE: REQUEST FOR PERMISSION TO CONDUCT RESEARCH**

I am a post graduate student at Kabarak University undertaking a doctor of philosophy degree. As part of academic requirements for the award of the degree; I am expected to carry out a research. The study is on: *The effect of corporate governance on the value of the firm*. With this regard I am humbly requesting your institution to give me permission to conduct research which will target firms quoted at the Nairobi Security Exchange. The research is expected to run from September 2011 to September 2012.

Your consideration is highly appreciated.

Yours faithfully

Charles, Y. Tibbs.

### **APPENDIX III: QUESTIONNAIRE**

This research is purely for academic purpose and any information collected will be treated with high confidentiality. The questionnaire is divided into two sections. Section A is meant to capture background information while section B captures information relating to the attributes of corporate governance which are classified into six indices.

#### **SECTION A**

##### **BACKGROUND INFORMATION**

1) Indicate your position in the company ticking as appropriately

- Chief executive
- Public relation manager
- Financial controller
- Marketing director
- corporate affairs manager

2) How long have you worked for the company?

- one to two years
- Between three to four years
- Between five and six years
- seven years and above

3) How long has the company been listed at the NSE?

- Between one to three years
- Between four and five years
- six years and above

3) How often do you participate in the board affairs?

- Once a month
- Once in three months
- Once in six months
- Once a year

## **SECTION B**

**This section captures information relating to attributes of corporate governance**

### **Board Accountability**

1. a) Are Board members subjected to annual election by all shareholders?

- Yes  No

b) If the answer is no give the reasons why it is so.....

2. Do non-executive board members have a formal session without executives?

- Yes  No

3. Is board performance evaluated periodically? .....

- Yes  No

4. Does the Company disclose code of ethics for senior executives?

- Yes  No

5 Does the Company disclose its corporate governance policies or guidelines?

- Yes  No

6. Is the Board or a committee responsible for CEO succession planning?

- Yes  No

7. a) Has the Company complied to adopt the recommendations of a shareholder proposal?

Yes  No

b) If the answer above is No give possible reasons.....

.....

8. Do all executive board members own shares?

Yes  No

9. Do all non-executive board members own shares?

Yes  No

10. Has the Company separated the responsibilities of chairman and CEO?

Yes  No

11. Do all members of the board attend at least 75% of the board meetings?

Yes  No

12. Has the Company designated “lead” or senior non-executive board member?

Yes  No

13. Have there been external influence related transactions in the past three years?

Yes  No

14. Is the governance committee composed of independent minded board members?

Yes  No

15. Is there any former CEO in the board?

Yes  No

16. Has the Number of shares held by officers and directors not decreased by 10% or more?

Yes  No

17 Has the number of shares held by officers and directors has increased by 10% or more?

Yes  No

18. Does the governance committee have a written charter or terms of reference?

Yes  No

19. Is the Board size greater than five but less than 16 members?

Yes  No

20. Is the Board controlled by more than 50% of independent outside directors?

Yes  No

### **Financial Disclosure and Internal Control**

21. Is the company free from an audit query in the past three years?

Yes  No

22. Has the Audit committee got a written charter or terms of reference?

Yes  No

23. Is the Company from qualified audit opinion within the last two fiscal years?

Yes  No

24. Is the company currently free from investigation for accounting irregularities?

Yes  No

25. Is the audit committee wholly composed of independent board members?

Yes  No

26. Do Senior management with sole authority hire outside auditor?

Yes  No

27. Does audit committee with sole authority approve non-audit services from outside auditor?

Yes  No

28. Did the Company the auditor's services as per guided rates?

Yes  No

### **Shareholder Rights**

29. Are the Vote results for the last shareholder meeting disclosed within 14 calendar days?

Yes  No

30. Do all ordinary equity shares have one-share, one-vote, with no restrictions?

Yes  No

31. Does the company provide confidential voting with no or with reasonable exceptions?

Yes  No

32. Do the shareholders have a right to convene an AGM with 10% or less of the shareholders?

Yes  No

33. Do the shareowners have a right to act in concert through written communication?

Yes  No

34. Are the voting rights limited at a certain percentage ?

Yes  No



## **Remuneration**

35. Are the non-executive board members paid in cash or in some form of stock-linked compensation

Yes  No

36. Does the company disclose performance targets for the next fiscal year?

Yes  No

37 Are non executive board members paid entirely in some form of stock linked compensation?

Yes  No

38 Is there CEO without an employment agreement that provides for guaranteed bonus payments?

Yes  No

39. Do the goals used to determine incentive awards aligned with the company's financial goals?

Yes  No

40. Is the CEO/Managing Director restrained to sit on the remuneration committee?

Yes  No

41. Is the remuneration committee wholly composed of independent board members?

Yes  No

42. Is there re-pricing of outstanding stock?

Yes  No

43. Is there expensing of employee stock grants?

Yes  No

44. Does the remuneration committee have a written charter or terms of reference?

Yes  No

45. Is the Potential Dilution from Stock Outstanding below 20%?

Yes  No

46. Is the Potential Dilution from Stock Outstanding plus stock not yet granted below 20%?

Yes  No

### **Market for Corporate Control**

47. Has the company adopted a shareholder rights plan (“poison pill”)?

Yes  No

48. Does the company have a staggered (“classified”) board where directors are placed into different classes and serve overlapping terms?

Yes  No

49. Can the company not issue blank check preferred stock in the event of a hostile tender offer?

Yes  No

50. Has the company’s shareholder rights plan (“poison pill”) been ratified by a shareholder vote?

Yes  No

51. Is the fair price provision in place or price protection under applicable law?

Yes  No

52. Does the shareholder rights plan include director's evaluation of poison pill defenses every three years?

Yes  No

53. Does the company require a supermajority vote to approve a merger?

Yes  No

54. Is there any single shareholder or a small group of shareholders with majority voting power?

Yes  No

55. Does the company allow one vote per share multiplied by the number of directors to be elected (cumulative voting) in the election of directors?

Yes  No

### **Corporate Behavior**

56. Does the company have a policy addressing workplace safety?

Yes  No

57. Is the company free from pending criminal litigation against it?

Yes  No

58. Is the company free from allegations that the company exposed employees to working for long hours with low wages and bad working conditions in the last three years?

Yes  No

59. Does the Company disclose its environmental performance?

Yes  No

60. Does the Company disclose its workplace safety record?

Yes  No

61. Other than for accounting irregularities is the company free from any other regulatory investigation for material issue?

Yes  No

62. Does the Company disclose its policy regarding corporate level political donations?

Yes  No

63. Is the Company free from charges with workplace safety violations within the last two years?

Yes  No

64. Is the company free from allegation by a responsible party that the company misused labour?

Yes  No

**PART C**

65) In your opinion are the six measures of corporate governance well adopted?

Yes  No

66) if the answer is no in your opinion suggest ways that can be used to help in adopting the six indices measured by the sixty four attributes captured in part B by the questionnaire i.e. (Board accountability ,financial disclosure and internal control, shareholder rights ,market for corporate control and corporate behavior)

.....

**Thank you.**

**-End-**

**APPENDIX IV:SECONDARY DATA COLLECTION SCHEDULE**

FIRM	TOTAL ASSETS	BOOK VALUE OF EQUITY	MARKET VALUE OF EQUITY	TOBINS Q

**APPENDIX V: COMPANIES LISTED AT THE NAIROBI SECURITY EXCHANGE**

<b>NO</b>	<b>MAIN INVESTMENT MARKET</b>
	<b>AGRICULTURAL</b>
1	Eaagards Ltd
2	Kakuzi Ltd
3	Rea Vipingo Plantations Ltd
4	Kapchorua Tea Co. Ltd.
5	Sasini Ltd
6	Williamson Tea Kenya Ltd.
7	The Limuru Tea Co. Ltd .
	<b>COMMERCIAL AND SERVICES</b>
8	Express Kenya Ltd
9	Hutchings Biemer Ltd
10	Kenya Airways Ltd
11	Nation Media Group
12	Scangroup Ltd
13	TPS Eastern Africa (Serena) ltd
14	Uchumi Supermarket Ltd
15	Standard Group Ltd
	<b>BANKING</b>
16	Barclays Bank Ltd
17	CFC Stanbic Holdings Ltd
18	Diamond Trust Bank Kenya Ltd

19	Equity Bank Ltd
20	Housing Finance Co Ltd
21	Kenya Commercial Bank Ltd
22	National Bank of Kenya Ltd
23	NIC Bank Ltd
24	Standard Chartered Bank Ltd
25	The Co-operative Bank of Kenya Ltd
	<b>MANUFACTURING AND ALLIED</b>
26	A. Baumann & Co ltd
27	B.O.C Kenya L
28	British American Tobacco Kenya ltd
29	Carbacid Investments Ltd
30	East African Breweries Ltd
31	Eveready East Africa Ltd
32	Mumias Sugar Co. Ltd
33	Kenya Orchards
34	Unga Group Ltd
	<b>AUTOMOBILES &amp; ACCESSORIES</b>
35	Car & General (K) Ltd
36	CMC Holdings Ltd
37	Marshalls (E.A)Ltd
38	Sameer Africa Ltd
	<b>ENERGY &amp; PETROLEUM</b>

39	KenGen Co. Ltd
40	KenolKobil Ltd
41	Kenya Power & Lighting Co. Ltd
42	Total Kenya Ltd
	<b>INSURANCE</b>
43	British-American Investments Co. Ltd
44	CFC Insurance Holdings Ltd .
45	Jubilee Holdings Ltd .
46	Kenya Re Insurance Corporation Ltd .
47	Pan Africa Insurance Holdings Ltd .
	<b>INVESTMENT</b>
48	Centum Investment Co. Ltd.
49	City Trust Ltd .
50	Olympia Capital Holdings Ltd .
51	Trans-Century Ltd .
	<b>TELECOMMUNICATION &amp; TECHNOLOGY</b>
52	Access Kenya Group Ltd
53	Safaricom Ltd
	<b>CONSTRUCTION AND ALLIED</b>
54	Athi River Mining
55	Bamburi Cement Ltd
56	Crown Berger Kenya Ltd
57	E.A Cables Ltd



58	E.A Portland Cement Co. Ltd
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