EFFECT OF FIRM PERFORMANCE ON CORPORATE GOVERNANCE PRACTICES OF FIRMS LISTED AT NAIROBI SECURITIES EXCHANGE

BY

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DECLARATION

I declare that this dissertation is my original work and has not been previously published or submitted elsewhere for award of a degree. I also declare that this contains no material written or published by other people except where due reference is made and author duly acknowledged.

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ABSTRACT

With the heightened sensitivity of shareholders towards corporate governance practices, the study sought to establish the effect of firm performance (ROA) on corporate governance practices of firms listed at Nairobi Securities Exchange. The corporate governance practices studied were board size, number of outside directors, frequency of board meetings and CEO replacement. The study adopted the descriptive study design and the sample consisted of all the firms listed at Nairobi Securities Exchange for a period of 7 years from 2007 to 2013 which ranged between 42 and 61 firms. After calculating firm performance (ROA), the listed firms were classified into declining, improving or mixed firms based on their performance for two consecutive years and corporate governance practices were observed a year later for all the declining and improving firms. Data was analyzed using descriptive statistics (frequencies, means and percentages) as well as inferential statistics (Pearson correlation and simple regression). Pearson correlation was useful in depicting the correlation between the dependent and independent variables whereas simple regression was useful in ascertaining the sensitivity of corporate governance practices to firm performance as measure by ROA. Findings from the study indicated that for declining firms, firm performance had a significant positive effect on the board size as well as the number of outside directors but no significant effect on the frequency of board meetings and on CEO replacement. For improving firms, the findings indicated that firm performance had no significant effect on all the four corporate governance practices. The study recommended that declining firms need to evaluate their corporate governance practices and adopt sound corporate governance practices like improving the number of outside board members who may bring in a wealth of industry knowledge that may assist in successful turnarounds and avoid failure.

Key words: Corporate governance, firm performance, shareholders

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DEDICATION

I dedicate this project to my late dad Francis Nyachae who not only taught me how to walk in the right path but he showed me how.

TABLE OF CONTENTS

ABSTRACT**..........iii**

ACKNOWLEDGEMENT **..........iv**

DEDICATION**..........v**

TABLE OF CONTENTS**..........vi**

LIST OF FIGURES**..........ix**

ABBREVIATIONS AND ACRONYMS**..........x**

CHAPTER ONE**..........1**

INTRODUCTION**..........1**

1.1 Background of the Study..........1

1.2 Statement of the Problem..........7

1.3 Objective of the Study..........9

1.4 Hypotheses..........10

1.5 Significance of the Study..........10

1.6 Limitations of the study..........11

CHAPTER TWO**..........12**

LITERATURE REVIEW**..........12**

2.1 Introduction..........12

2.2 Theoretical Review..........12

2.3 Empirical Review..........17

2.4 Corporate Governance Mechanisms..........18

2.5 Conceptual Framework..........23

CHAPTER THREE**..........24**

RESEARCH METHODOLOGY...24

3.1. Introduction...24

3.2. Research Design...24

3.3. Target Population...25

3.4. Sample Size and Sampling Technique...25

3.5 Data Collection...26

3.6 Data Analysis...26

CHAPTER FOUR...29

FINDINGS AND DISCUSSIONS...29

4.1 Introduction...29

4.2 Financial Performance of Firms Listed at Nairobi Securities Exchange...29

4.3 Effect of Firm Performance on Corporate Governance Practices...30

4.4 Regression Analysis...37

CHAPTER FIVE...42

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS...42

5.1 Introduction...42

5.2 Summary of Research Findings...42

5.3 Discussion of Findings...43

5.4 Conclusions...46

5.5 Recommendations...46

5.6 Areas of Further Research...47

REFERENCES...48

APPENDICES...52

APPENDIX I..52

APPENDIX II...54

LIST OF TABLES

***TABLE 1*..28**

***TABLE 2*..29**

***TABLE 3*..31**

***TABLE 4*..32**

***TABLE 5*..34**

***TABLE 6*..35**

***TABLE 7*..35**

***TABLE 8*..38**

***TABLE 9*..39**

***TABLE 10*..40**

LIST OF FIGURES

FIGURE 1...23

ABBREVIATIONS AND ACRONYMS

ASX	Australian Stock Exchange
CEO	Chief Executive Officer
NSE	Nairobi Securities Exchange
CMA	Capital Markets Authority
ICPAK	Institute of Certified Public Accountants of Kenya
EVA	Economic Value Add
OECD	Organization for Economic Cooperation and Development
ROA	Return on Asset

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

With the increased trend in corporate failure both globally and locally there is a heightened sensitivity of shareholders towards corporate governance structures and practices. In the presence of an efficient capital market, institutional investors would be willing to offer a premium to invest in firms with sound corporate governance structures implying that investors are more discerning and hunger for firms that maximize the value of their wealth. Locally, globalization has exposed Kenyan corporate sectors to the world market and with the advent of the multinational firms; competition on the domestic front has been intensified. In such light, the quality of corporate governance practices cannot be undermined as a factor for the survival of businesses, a source of competitive advantage as well as an influencing factor in the sourcing of funds from the capital markets.

Although corporate governance has gained international interest due to the globalization of businesses, various countries have adopted different approaches to corporate governance depending on their political, cultural, technological, economic as well as legal inclinations .In similar light literature on the Australian Stock Exchange (ASX) Corporate Governance Council (2007) points out that even within a country various corporations employ different governance practices. This indicates that corporate governance is situational and what has worked in developing countries may not be directly applicable in developing economies because of

political, economic, technological and cultural differences. The differing dynamics therefore call for different governance structures.

According to Kiel & Nicholson, (2003) corporate governance is concentrated at the board level because the board is entrusted with investors' capital which they are required to invest for the benefit and interest of the investors. Similarly, the current study will focus on the corporate governance aspects related to the board. Among the various corporate governance theories developed by various scholars the study will focus on four main theories namely agency theory, stewardship theory, stakeholder theory and resource dependence theory. Of particular interest to the current study will be the reaction of corporate governance practices to prior year firm performance and it will be based on firms listed at the Nairobi Securities Exchange (NSE) between December 2007 and December 2013.

1.1.1 Nairobi Securities Exchange

The NSE was constituted in 1954 as a voluntary association of stock brokers in the European community registered under the Societies Act. It provides services to stock brokers and traders to trade stocks, bonds and other securities.

The NSE provides firms with the platform to raise capital for expansion through selling shares and securities to the general public. It plays a key role in the economy by facilitating the meeting of borrowers and lenders at relatively low costs. Kobonyo & Ongore (2011) assert that typical ownership identities at the NSE are by government, foreigners, institutions, individuals and diverse ownership form. In 2014 NSE received approval from the Capital Markets Authority to list its shares on the main investment market segment. To measure performance of firms at NSE three indices are used which are NSE 20 Share Index, NSE All Share Index, and

the FTSE NSE Index. There are 61 listed companies which are classified into 11 broad economic sectors namely agriculture, commercial and services, auto mobiles and accessories, telecommunications and technology, banking, insurance, investment, manufacturing and allied, construction and allied, energy and petroleum and finally growth enterprise market segment. In each of the listed companies, capital structure overrides company specific activities like capital budgeting and dividend policy. Similarly accounting procedures apply to all the listed companies and management prudence is observed by all the quoted companies as it is a major requirement of the capital markets.

1.1.2 Firm Performance

The performance measurement system utilized by a firm has far reaching implications on the strategic plans of the organization, affects the evaluation of achievement of objectives and has a bearing on the rewarding of managers. Although accounting based performance measures have been popular in the past, there has been a shift in focus towards adoption of shareholder value as the long term objective of the organization. Venanzi (2012) notes that the inadequacies of accounting based performance measures, has encouraged the uptake of value based metrics which explicitly incorporate the cost of capital into the performance calculation. Examples of some of the commonly used measures are Economic Value Add (EVA), Cash Flow Return on Investment (ROI), Shareholder Value Added and Cash Flow Value Added. BPP (2010) identified 10 observable symptoms of corporate decline as follows: declining profitability, decreasing sales volume, improving gearing, decreasing liquidity, restrictions in dividend policy, changes in accounting policies, frequent changes in senior management, top management fear, falling market share and evidence of lack of planning.

The presence any of the above indicators does not necessarily imply imminent crisis however if one of these emerges and the others follow, then trouble is likely to surface. BPP (2010) further explains the four stages of internal wrangles within the management of a firm. The first stage is crisis denial whereby the managers are complacent and ignore warning signs. This may result from poor control systems or poor monitoring. Prompt action may reverse the trend. The second stage is referred to as the hidden crisis characterized by management explaining the signs of crisis away as they believe that by accepting there is a problem, they shall be blamed. More severe corrective action may reverse this trend. The third stage is disintegration or faulty action whereby the managers decide that things are amiss and pre-empt some action. Such action is usually faulty and mostly autocratic, it may not be enough. The final stage is referred to as crisis and collapse/dissolution where action is impossible and the expectation of failure increases. The most able managers leave and a power vacuum is created and eventually the receiver is called in.

From the foregoing, it is important for the board to provoke timely and appropriate remedial action whenever they spot any alarm signals. Although firms are impacted by external factors such as recession, movements in interest rates, changes in government policy, inflation, new competition into the markets as well as industry or product obsolescence, such factors are rarely the sole reason for failure. Most failures are therefore attributed to management because although all companies in an industry will be subject to similar external shocks, not all of them will fail others survive and prosper.

In Kenya, various firms have been put in receivership and some have even been declared bankrupt. The governing bodies of declining firms usually employ various restructuring activities

with the hope of turning around the firms and rapidly recovering from financial decline. According to Lishenga (2006) it is difficult for declining firms to achieve successful turnarounds and the probability of failure for declining firms is high. Barker and Mone (1994) have attributed corporate failure after the onset of performance decline to managerial inaction, poor timing, and poor implementation of turnaround strategies. This suggests that success of managerial responses to performance decline is conditioned by their timing, intensity and effective implementation.

1.1.3 Corporate Governance

Bhagat and Black (2002) assert that, sound corporate governance shields firms from vulnerability to future financial distress. Since the governance structure of a corporate entity contributes to the firm's ability to respond to external factors, it can be argued that, well governed firms generally have more impressive performance. Shleifer and Vishny (1997) described corporate governance as dealing with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. They argued that ownership concentration as well as the legal protection of investor rights played a key role in controlling the discretion of management hence enabling the shareholders to get returns on their investment. Denis (2001) stated that corporate governance encompasses the set of institutional and market mechanisms that induce self-interested managers to maximize the value of the residual cash flows of the firm on behalf of its shareholders.

A sound corporate governance framework is beneficial to a firm as it secures cheaper financing options, ensures more favorable treatment of stakeholders and ultimately leads to better financial performance. Other literature in corporate governance has outlined various reasons for firms adopting sound corporate governance practices key among them being; the

emergence of more discerning and better informed investors who are aware of their rights and demand value for their investments. The increased alertness of shareholders has majorly been triggered by the collapse of high profile corporations like Enron, WorldCom and Parmalat which resulted in great losses to investors and subsequently renewed interest in the subject of corporate governance. Locally in Kenya, various corporations have experienced similar challenges as demonstrated by Uchumi Supermarkets Limited, Trust Bank, Euro Bank, Kenya Finance Trust, KCC and CMC Motors .Such collapses led to the emergence of a class of discerning and well informed investors who understand their rights and demand value for their money. They are more cautious as to where they invest their money and place great importance on sound corporate governance.

Second is the globalization of businesses which has facilitated the deployment of capital by investors internationally. Before committing their funds, such investors seek comfort in firms which have established sound corporate governance mechanisms which may influence the level of investor protection thus encouraging investment. Companies keen on growing and expanding must match the expectations of their investors to ensure sustained growth and avoid the possibility of stagnation especially amidst the fierce competition in the business world.

Third is the growing acknowledgement that sound corporate governance is a prerequisite for national economic development. The growth and expansion of various corporations directly impact on the economy in terms of increased levels of employment, increased revenue from taxes, and enhanced quality of life. Some of the organizations that have spear headed the implementation of sound corporate governance principles include Organization for Economic Cooperation and Development, International Finance Corporation and the World Bank.

In Kenya there are a number of institutions championing the corporate governance agenda. They include: Capital Markets Authority (CMA),Nairobi Securities Exchange, Center for Corporate Governance ,Central Bank of Kenya as well as Institute of Certified Public Accountants of Kenya(ICPAK)which requires its members to report the corporate governance practices of the firms they audit.

1.2 Statement of the Problem

The year 2002 saw the introduction of the Sarbanes Oxley Act in the United States of America with the aim of restoring public confidence in companies and financial markets after accounting fraud caused the fall of high profile corporations such as Enron and WorldCom. The move further propelled the subject of corporate governance from the wings to the centre. As more corporate entities in various parts of the world collapsed in the 1980s, a change of attitude was observed with a much higher performance expectation being placed on management boards to ensure firms were run effectively.

In Shleifer and Vishny (1997) survey, corporate governance is defined as the ways in which the suppliers of finance to corporations guarantee themselves of receiving a return on their investment. Based on this definition it is paramount for firms to evaluate their corporate governance practices and align them appropriately in order to ensure value to their shareholders. Although there is no 'straight jacket' that fits all corporate governance decisions, declining firms may portray similar distress signals and the response strategies applied may result into successful turnarounds for such firms.

Corporate governance issues are pertinent in developing economies due to their infant financial infrastructure, weaker capital markets and the fact that few organizations deal with corporate governance issues. In Kenya a company that has experienced significant losses in

shareholder value is Mumias Sugar Company which is a listed firm in the Nairobi Securities Exchange. The sales of Mumias plunged by almost 23% in 2013 when they recorded sales of 11.9 billion shillings down from 15.5 billion shillings recorded in 2012. With the approval of senior management, Mumias would import cheap sugar, repackage it and sell it under the listed firm's brand name. (Ciuru, 2014).When the board realized what was happening they suspended the CEO together with the Commercial Director to pave way for investigations of interest would be the corporate governance actions undertaken by Mumias post the declaration of its financial performance.

A review of literature revealed that some studies established a strong relationship between the performance of firms and the governance practices of their boards (Valenti, Luce and Mayfield, 2011; Kiel & Nicholson, 2002) while others found no systematic relationship between board composition and firm performance (Bhagat and Black, 2002). Delving into the specific elements of corporate governance, some studies have shown that independent boards help enhance shareholder value while others have associated such boards with no improvement in corporate performance and perhaps even worse overall corporate performance. Perry and Shivdasani (2005) conducted a research to study if boards affected the performance of declining firms and from their study which analyzed 94 declining firms they established that changes in firm performance were often accompanied by changes in board composition.

In Kenya, previous research related to the current study includes the work of Lishenga (2006) who noted that declining firms face more scrutiny from stakeholders and normally respond to such scrutiny by changing their corporate governance practices. Kavulya (2011) studied the relationship of corporate governance and financial performance of deposit taking SACCOs and concluded that board size and board composition did not affect financial

performance in SACCOs. Muturi (2013) on his study of the effects of corporate governance on financial performance of large manufacturing firms established that there is a positive significant relationship between independent directors, board committees, board size and CEO’s dual role as chairman of the board and the financial performance.

Such mixed results obtained from studies related to the impact of firm performance on corporate governance practices coupled with the little research done on the area in the Kenyan context begs the question, does firm performance affect corporate governance practices of firms listed at Nairobi Securities Exchange?

1.3 Objective of the Study

The general objective of the study is to investigate the effect of firm performance on the corporate governance practices of firms listed at Nairobi Securities Exchange. From this, the specific objectives are derived as follows:

i. To establish the effect of firm performance on board size of firms listed at Nairobi Securities Exchange.

ii. To establish the effect of firm performance on the number of outside directors of firms listed at Nairobi Securities Exchange.

iii. To determine the effect of firm performance on the frequency of board meetings of firms listed at Nairobi Securities Exchange.

iv. To determine the effect of firm performance on CEO replacement of firms listed at Nairobi Securities Exchange.

1.4 Hypotheses

In order to test the relationship of firm performance to governance related practices, the following hypotheses were employed

***H_{01}*:** *Firm performance has no significant effect on the board size of firms listed at Nairobi Securities Exchange*

***H_{02}*:** *Firm performance has no significant effect on the number of outside directors of firms listed at Nairobi Securities Exchange*

***H_{03}*:** *Firm performance has no significant effect on the frequency of board meetings of firms listed at Nairobi Securities Exchange*

***H_{04}*:** *Firm performance has no significant effect on the CEO replacement of firms* listed at *Nairobi Securities Exchange*

1.5 Significance of the Study

The study will be useful to strategic decision makers in companies facing declining performance as it will shed light on the appropriate corporate governance practices that may result into turnaround for such declining firms. This is critical since declining firms face plenty of scrutiny from various stakeholders including shareholders, creditors, suppliers as well as competitors.

Secondly the study will inform investors on the value of investing in firms which up hold sound corporate governance practices and finally , the study will contribute to existing literature in the field of corporate governance and shall subsequently serve as a source of reference material for future researchers interested in related topics.

1.6 Limitations of the study

Time and resources were a constraint which restricted the sample of the study; this limited the sample as the researcher only focused on firms listed at Nairobi Securities Exchange. There was also a limitation on the sources of data collected whereby the researcher only made use of secondary data due to the difficulty of obtaining primary information on corporate governance mechanisms employed by listed firms.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This section of the study will seek to review academic research carried out on the subject of corporate governance structures and firm performance. It will focus on theoretical review composed of the general corporate governance theories as well as empirical review which will focus on the components of corporate governance and their interaction with corporate performance.

2.2 Theoretical Review

This section shall focus on the major corporate governance theories namely agency theory, stewardship theory, stakeholder theory and resource dependence theory.

2.2.1 Agency Theory

Shankman (1999) contends that the agency relationship is a contractual link between principles who are the providers of capital and the agents who run the companies. Principles usually have the knack for accumulation of capital but since they may lack the time, expertise or motivation to run their companies they hand over the capital to the agents who usually possess a surplus of ideas on how to utilize the capital. The agents would be in charge of the day to day operations.

Considering the growth in shareholder numbers and the complexity of organizational operations, the management team who are equipped with the relevant knowledge and expertise gain greater control placing them in compromising positions where they may be tempted to pursue their own interest at the expense of the shareholders. The separation of ownership of

capital from its management marked the beginning of the agency problem and hence the need for corporate governance.

Literature on agency theory has identified three major challenges that could be triggered by the separation of ownership and management which may subsequently impact negatively on firm value .The first is the effort problem which questions whether or not managers offer their best delivery in managing corporations so as to maximize shareholder wealth. The challenge arises whenever principals are unable to determine the performance of managers considering the fact that managers may not apply the same effort levels required for shareholder wealth maximization as they would if they were owners of the firms. The second challenge is the use of assets problems which concerns managers controlling corporate assets. Agents may abuse corporate assets by engaging in diverse schemes to enhance their personal wealth. Examples of such schemes include: diversion of various business assets, claiming extreme remuneration and deploying transfer prices of assets with other entities they control (Vishny and Schleifer 1997).The third problem is the differential risk preference problem which arises due to the divergent views of the principal and agent on risk taking. The differences in risk appetites between principals and agents may influence managers to undertake suboptimal investment decisions which may not maximize shareholders wealth. An example is where the managers are too cautious and risk averse, hence opting out of high-risk, high-return investments which may maximize shareholder value in the long run.

From the foregoing, agency theorists have recommended various corporate governance mechanisms aimed at addressing agency conflicts. A possible option that may be explored is devising an incentive scheme aimed at rewarding managers with cash bonuses for maximizing

shareholder wealth. Specific examples are developing an employee share ownership scheme where senior executives own a portion of the firm thus aligning financial interests of executives with those of shareholders. Other mechanisms include fixing executive compensation and levels of benefits to shareholders returns and having part of executive compensation deferred to the future to reward long-run value maximization of the corporation. Finally the organization may consider increasing the number of independent directors sitting at their boards to ensure more objective oversight on the managers hence driving down agency costs.

2.2.2 Stewardship Theory

This theory is based on the assumption that managers are stewards whose behaviors are aligned to the objectives of the principals. It implies that managers have an intrinsic satisfaction when firm performance improves and organizational success is attained. The dominant motive which directs managers to accomplish their job is the desire to perform excellently (Davis et al, 1997).

The theory asserts that managers are also motivated by non-financial factors like challenging work, the opportunity to exercise responsibility and authority as well as gaining recognition from peers and their managers. Davis et al (1997) further portends that it is critical for the organization to build a structure which allows for symphony between principles and agents. With regards to the firm’s leadership, the structure proposed is where there is CEO duality. In such a scenario the powers of the chairman of the board (responsible for board processes) and CEO (responsible for operational issues of the organization) are vested in one

office. Such a structure allows unambiguity in the CEO role as power and authority over lower ranking managers and other board members is vested in one office (Donaldson and Davis, 1991).

The organization will enjoy the benefits of consistency in leadership style, unity of direction as well as command. Abdulla and Valentine (2009) contend that amalgamating the role of CEO and board chairman drives down the cost of agency while enhancing performance. Apart from supporting CEO duality, proponents of stakeholder theory favor majority of insider directors and argue that they have superior knowledge of the organization thus take a shorter time to make decisions; they are more effective at evaluating the performance of top manages and utilize their expertise to ensure high quality information is presented to the board for discussions. According to Letting et al., (2012) the inclusion of more executive directors in the boards of companies would lead to more effective and efficient decision making resulting to wealth maximization.

Lishenga (2006) further portends that the stewardship theory is centered on the assumption that managers are trust worthy and capable of meeting their responsibility hence removing the need for external independent directors to bolster the monitoring and control of a firm's executives.

2.2.3 Stakeholder Theory

This theory is based on the proposition that the success of a firm is a function of successful management of the various relationships that a firm has with its stakeholders considering without the stakeholders, the organization would cease to exist. 2004 saw the

revision of the Organization for Economic Cooperation and Development (OECD) principles which shifted the principles from their narrow focus on the traditional shareholder centered corporate governance practice to a wider once which is accommodative of the interests of different stakeholders of a firm.

The success of the firm is not entirely dependent on maximization of shareholders wealth but rather on its interaction with its various stakeholders which include: shareholders, government, political groups, suppliers, investors, employees, customers, trade associations as well as the community around which the firm operates. Each of listed stakeholders has a distinct interest in the firm. The shareholder is interested in future returns on investment, suppliers and financiers are interested in timely repayments, employees are concerned about job security and good remuneration, customers are interested in quality products and variety in the product range, government is interested in legislative compliance and tax collection while the community is interested in employment opportunities, social facilities and non-degradation of the environment.

Stakeholder theory purports that regardless of the ultimate goal of the corporation, the broad interests of the various stakeholders who may impact or be impacted by the firms' activities should be given consideration (Donaldson and Preston 1995).

2.2.4 Resource Dependence Theory

The theory is based on the need for the firm to establish linkages with outside resources. The inequitable distribution of needed resources results in inter-dependent organizational relationships. Several factors would appear to enhance the character of this dependence, e.g. the

significance of the resource(s), the demand of the resource(s) and the concentration of the resource (s) in the environment (Donaldson and Davis, 1991).Organizations engage in transactions with others in a quest to obtain essential resources and directors serve as a critical connection between external resources and the firm.

2.3 Empirical Review

This section will focus on various corporate governance practices and their relationship with firm performance. It will discuss corporate governance and firm performance, market for corporate control and firm performance and wrap up with corporate governance mechanisms.

2.3.1 Corporate Governance and Performance

Policy makers show interest in corporate governance due to the impact it is purported to have on performance. A review of literature on corporate governance supports the hypothesis that large shareholders are keen monitors on managers and their monitoring activity has a bearing on a firms' profitability. (Frank and Mayer 1994) establish a larger turnover of directors when large shareholders are present indicating supporting the above view. According to Maher and Andersson (1999) the degree of monitoring and control exercised by shareholders not only influences firm performance but also provides incentives for investment, innovation and entrepreneurial activity.

Maher and Andersson (1999) find that policy makers are faced with the challenge of designing a corporate governance framework that balances the advantages of large shareholders as effective monitors of management while at the same time preventing them from extracting excessive benefits of control.

2.3.2 Market for Corporate Control and Firm Performance

A well-known disciplining tool in the market for corporate control is a takeover. It is used by investors who identify underperforming firms, buy controlling interest with the expectation of reaping gains associated with effective management control. In developed economies especially where the predominant corporate governance system is the outsider system, the market for corporate control is an effective disciplinary devise for managers of declining firms. According to Maher and Anderson (1999) failure of a firm's management to maximize shareholder value exposes the firm to the threat of a takeover bid which may result in the retrenchment of incompetent management teams.

In Kenya we have not experienced many hostile takeovers hence little reliance can be placed on the market for corporate control as an effective disciplining devise. Some researchers have questioned the effectiveness of takeovers especially in scenarios where such takeovers have resulted in reduction in firm value. It is however important to note that the objective of every take over may not necessarily be disciplining management, it may range from the desire to change the corporate strategy to pure rent seeking behavior e.g. in the case of acquiring an entity in a convenient tax jurisdiction with the motive of reducing tax liability by engaging in transfer pricing schemes between parent and subsidiary.

2.4 Corporate Governance Mechanisms

Corporate governance guidelines specify the rights and obligations of the various stakeholders of an enterprise and the choice of corporate governance structures should be aimed at lowering agency costs. The structure of corporate governance defines the distribution of power in the corporate board and determines best practice.

2.4.1 Board Size

Among the duties of a director is the fiduciary duty to protect shareholder's interest (Ongore and K'obonyo, 2011). Although there is no ideal board size, for purposes of avoiding a stale mate during voting, it should be an odd number (Haniffa and Hudaib, 2006). While Eisenberg, Sundgren and Wells (1998) suggest that large boards offer relevant networking, are more diverse, experienced, better exposed and execute more objectivity in decision making, Lipton and Lorsch (1992) argue that larger boards are more likely to become dysfunctional because as board size increases, there is greater productivity losses resulting from greater coordination problems, slower decision making and more director free riding. Some of the determinants of board size should be the company's financial strength, industry, shareholder groups, need for institutional memory as well as the skills mix needed to move the organization forward.

Empirical evidence on the correlation between board size and performance appears to be mixed and the paper shall discuss three prominent views. One strand of research (Dalton et al., 1998; Pearce and Zahra, 1992, Kumudini and Anona, 2010) suggests that board size has a positive relationship with firm performance. The arguments brought forward by the supporters of this strand of research revolve around the assumption that board size is associated with the

breadth of perspectives in the decision making process considering larger boards will have directors from diverse backgrounds.

The second strand of research has established a negative relationship between board size and corporate performance (Yermack, 1996; Eisenberg et al., 1998; Van- Ees and Postma, 2002). Proponents of this school of thought suggest that the challenges experienced by larger boards are based on group dynamics. They argue that in the presence of a large number of directors, there may be lack of ownership, lack of accountability as well as delayed decision making due to poor coordination of member contributions.

The final strand of research (Goilden and Zajac, 2001; Vefeas, 1999) has established the relationship between corporate performance and board size to be an inverted “U” shaped, with an ideal board size existing mid-way. The assumption is that board should neither be too big to impede decision making nor too small to deny the organization synergistic benefits that arise from a diversified board.

2.4.2 Mix of Directors (Insider/ Outsider domination)

Fich and Slezak (2007) note that in distressed firms, executive directors are more likely to have a keen interest in the future turn-around of the firm due to the higher risk they face in case the firm fails. This is in comparison to the non-executive directors who face a lower risk of losing their seats on the board and face reduced probability of being appointed to other boards. Pearce and Zara (1992) support the assumption that an effective board comprising of a greater proportion of outside directors is significant to firm performance .A preference for outsider dominated boards is based on the premise of the agency theory which argues that more insider control leads to self interest by those in control of the company. Outside directors are more

vigilant as they mainly focus on the firm's financial performance, they may easily dismiss the CEO following poor performance to maintain their personal reputation as directors.

Since non- executive directors provide impartial assessment which is usually stock holder oriented, they are an ideal check and balance on top management. This makes non executive directors a vital asset to any board as they usually posses significant industry knowledge with regards to capital markets, legislation and technology which complements insider information. Such board appointments can be used to expand linkages to outside business circles and the wider community thus broadening learning and business opportunities. Non executive directors are also more objective in the role of arbitration in case of conflicts between the insiders. A balanced board should be constituted of at least one third of independent directors (Brickley, Cole and Terry, 1994).On the other end of the spectrum; Krishnan (2005) argues that there is little evidence to support the relationship between board independence and firm performance. In similar light, Agrawal and Knoeber (1996) report that more outside directors negatively impact on firm performance.

It is important for the board to possess a good mix of executive and non executive directors. Considering the boards of directors constitute the highest level of control mechanism in corporations and they are endowed with the authority to reward or punish the decisions made by top management.

2.4.3 Frequency of Board Meetings

Amongst the key responsibilities of the directors is attending board meetings. It is in these meetings that they exercise the right to vote key decisions (Ronen and Yaari,

2008).Various researchers have suggested that the effectiveness of boards may be enhanced by more frequent board meetings. Ronen and Yaari (2008) argue that effective boards meet more frequently and they are more likely to engage in activities that are aligned to shareholder wealth maximization. They further portent that the frequency of board meetings is an ideal proxy for board operations.

Vafeas (1999) in his study of board meeting frequency and firm performance established that a higher meeting frequency is a reaction to failing performance while Stile (1993) attributes corporate failure to a weak board which is unable to effectively exercise their mandate. Chen, Shang and Cheng (2014) in their study of firm risk and performance conclude that shareholder interests are taken care of by allowing shareholders to actively participate in board meetings which facilitate enhanced communication levels between shareholders and management.

2.4.4 Chief Executive Officer Replacement

Evidence from Jensen and Murphy's 1990 study indicates a weak correlation between firm performance and CEO turnover. Hermalin and Weisbach (1998) develop a model illustrating that the relative bargaining power between the CEOs and outside directors determines board decisions. The CEOs bargaining power is expected to diminish after a drop in performance and hence CEO turn over becomes more likely. The model demonstrates that whenever there is increased monitoring pressure; the CEOs tend to work 'harder' which may be interpreted as taking less perquisites which if coupled with the perception that their jobs are less secure may cause for them to demand greater compensation. A possible consequence of instituting more independent boards over a period of time could be an upward pressure on CEO remuneration.

Perry and Shivdasani (2005) observed that the probability of a forced CEO departure rises significantly when the firm is in the bottom decile of stock return performance a trend which they attributed to either the reactive nature of boards which is only triggered to action by extreme performance decline or the unpopularity of CEO retrenchment as a strategy of improving declining firm performance.

2.5 Conceptual Framework

The study seeks to explore the effect of firm performance on the corporate governance practices instituted by firms listed at NSE. The independent variable is firm performance measured by return on assets while the corporate governance practices specifically board size, number of outside directors, frequency of board meetings and CEO replacement were the dependent variables. The conceptual frame work is summarized in Figure 1 below.

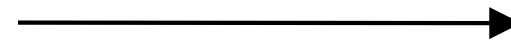
FIGURE 1

Conceptual Framework

Independent Variable **Dependent Variables**

Firm Performance

- Return on Assets



Corporate Governance Practices

- Board size
- Number of outside directors
- Frequency of board meetings
- CEO replacement

CHAPTER THREE

RESEARCH METHODOLOGY

3.1. Introduction

This chapter discusses the research methods used in conducting the study. It will focus on the research design, the population of study, the sample as well as the procedures used in data collection.

3.2. Research Design

The research design can be defined as a plan of action aimed at obtaining answers to the research questions asked. It constitutes the measurement of variables, the sample selection data collection, hypothesis testing as well as analysis of results (Kumar, 2011).

The study is a descriptive study that aimed at establishing the effect of firm performance on corporate governance practices of firms listed at the NSE. According to Neuman (2010) a descriptive study provides a significantly accurate picture, locates new data, clarifies a sequence of steps or stages and documents a causal process. A descriptive study seek to answer 'who' 'what' 'when' 'where' and 'how' questions and its findings help a researcher to understand the characteristics of an individual or group in a given situation.(Sekaran 2009: Zikmund 2010). A descriptive study was deemed most suitable for answering the 'what' 'when' and 'how' questions that will be asked by the researcher with regards to how firm performance affects the corporate governance practices of firms listed at Nairobi Securities Exchange.

3.3. Target Population

According to Cooper et al, (2000) a population comprises of the total collection of elements about which the researcher desires to construct some inference. For purposes of the study, the target population comprised of the 61 firms listed at the Nairobi Securities Exchange as at December 2013.The listing is attached at the appendix I

3.4. Sample Size and Sampling Technique

According to Kumar (2011) a sample is a subgroup of the population which is the focus of the research enquiry. Whenever selecting a sample, the researcher should ensure it is representative of the study population. For quantitative research a sample needs to be selected in such a way that it is unbiased and represents the target population since the purpose of such sampling is to draw inference about the total population (Kumar, 2011).

The population comprised of all firms listed at the NSE between 2007 and 2013.Which ranged between 42 firms in 2007 and 61 firms in 2013.The Return on Assets of all the firms in the target population was calculated at the end of each calendar year starting from 2007 to the year 2012. 2007 was the base year and was useful in classification of the firms according to performance. E.g. the ROA calculated at the end of 2008 and 2009 was compared to the 2007 ROA and at the end of 2009; the firm was classified. Sorting of performance based on ROA was done beginning at the end of the year 2009 through to the end of 2012 where the firms were sorted into declining firms, improving firms or mixed firms. Declining firms, comprised of companies with persistent decline in the performance over the previous two years; improving firms, comprised of companies with persistent appreciation in their performance over the previous two years while mixed firms comprised of firms which experienced improving performance followed by decreasing performance or vice versa for a period of two consecutive years.The study specifically focused on 34 declining firms and 38 improving firms and examined the response of their corporate governance structures one year after reporting their performance.

3.5 Data Collection

The study made use of secondary data from the desk top review of audited financial statements, financial journals and management reports. It covered a 7 year period between 2007 and 2013. The period was considered sufficient for calculation of ROA, classification of the firms into declining, improving or mixed and measurement of the corporate governance practices in place a year after the classification.

3.6 Data Analysis

According to Walliman (2011) data analysis is an essential part of the research and should be carried out in relation to the research problem and specific aims of the research project. Descriptive statistics as well as inferential statistics (Pearson correlation and Simple Regression) analysis were employed in analyzing the data. Statistical Package for Social Sciences (SPSS) was used to solve the regression equations. The independent variable was firm performance measured by Return on Assets value while the dependent variables were: board size, number of outside directors, frequency of board meetings and CEO replacement. Return on Assets (ROA) is a widely used measure of financial performance and it measures the efficiency of assets in producing income. Various corporate governance researchers have used it as a proxy for firm performance (Muturi, 2013). The correlation coefficient (R) was calculated to establish the strength and direction of association between the independent variable and the independent variables while the coefficient of determination (R^2) was used to determine how much variations in the dependent variable could be explained by the independent variable. The result of data analysis was presented in tables.

The below simple regression equations shall be used:

$Y_1 = \alpha + B_1X_1 + \mu$ ***(Equation i)*** $Y_3 = \alpha + B_1X_1 + \mu$ ***(Equation ii)***

$Y_2 = \alpha + B_1X_1 + \mu$ ***(Equation iii)*** $Y_4 = \alpha + B_1X_1 + \mu$ ***(Equation iv)***

B_1= Beta coefficient measuring sensitivity of the dependent variable to a unit change in the independent variable

α = Constant term

X_1=Firm Performance (Measured by ROA)

μ= Error term which captures the unexplained variations in the model.

Y_1 to Y_4 have been defined in table 1 below;

TABLE 1

Definition of Dependent and Independent Variables

Variable	**Definition**	**Surrogate Measure**
Y_1	Board Size	Number of directors sitting at the board at the AGM as per the annual report
Y_2	Number of outside directors	Number of outside directors (independent)
Y_3	Frequency of board meetings	Number of board meetings held in the year
Y_4	CEO replacement	CEO’s departure from firm in the year
X	Firm Performance	Return on Assets

CHAPTER FOUR

FINDINGS AND DISCUSSIONS

4.1 Introduction

This chapter contains the findings and interpretations of the study. The findings were analyzed and interpreted in line with the objective of the study which was to investigate the effect of firm performance on the corporate governance practices of firms listed at Nairobi Securities Exchange.

4.2 Financial Performance of Firms Listed at Nairobi Securities Exchange

After calculating Return on Assets for each listed firm following its performance after two consecutive years starting from the base year of 2007, the researcher arrived at the below groups as presented in table 2.

TABLE 2

Performance of Firms Listed at Nairobi Securities Exchange 2009-2012

	2009		**2010**		**2011**		**2012**	
GROUP	**N**	**%**	**N**	**%**	**N**	**%**	**N**	**%**
Declining	8	16%	5	10%	8	15%	13	23%
Improving	13	26%	11	22%	6	12%	8	15%
Mixed	29	58%	34	68%	38	73%	34	62%
TOTAL	**50**	**100%**	**50**	**100%**	**52**	**100%**	**55**	**100%**

The findings in table 2 which is a summary of appendix II indicated that in 2009 16% of the firms listed at Nairobi Securities Exchange experienced declining performance, 26% demonstrated improving performance while 58% of the firms displayed mixed performance. This was in comparison to performance in 2008 & 2007. In 2010 the number of firms displaying declining performance decreased by 3 firms to 10 %, 22% of the firms displayed improving performance while 68% of the firms demonstrated mixed performance. In 2011 15 % of the firms displayed declining performance, 12% increased in performance and 73 % displayed mixed performance. In 2012 a whopping 23 % of the firms displayed declining performance, 15 % of the firms increased in performance while 62 % of the firms demonstrated mixed performance.

4.3 Effect of Firm Performance on Corporate Governance Practices

The study aimed at establishing the effect of firm performance on corporate governance practices. After grouping the firms into either improving, declining or mixed performers, the corporate governance practices were studied a year later to observe any changes that might have occurred. The firms considered were declining which were firms that recorded declining financial performance for two consecutive years and improving firms which were firms that recorded improving financial performance for two consecutive years. Below is a discussion in relation to the study objectives which were the effect of firm performance on board size, number of outside directors, frequency of board meetings and CEO replacement.

4.3.1 Effect of Firm Performance on Board Size

Table 3 indicated that in 2010 37.5% of declining firms displayed a change in number of directors sitting at the board while 38.5% of improving firms displayed a change in number of directors. The recorded figures were in comparison to 2009 figures when the classification was made. In 2011 the figure increased to 40 % for declining firms and dropped to 27.2 % for improving firms. In 2012 50 % of declining firms experienced a change in board size while 33% of improving firms experienced a change in board size.

In 2013 46.1 % of the declining firms displayed a change in board size while 25 % of the improving firms displayed a change in board size.

TABLE 3

Firms Displaying Change in Board Size

	Change in Board Size						
Year	**Number of directors sitting at board at AGM**	**Declining Firms**			**Increasing Firms**		
		Frequency	**Total Sample**	**Percentage**	**Frequency**	**Total Sample**	**Percentage**
2010	Firms displaying change	3	8	37.50%	5	12	38.50%
2011	Firms displaying	2	5	40.00%	3	11	27.20%

	change						
2012	Firms displaying change	4	8	50.00%	2	6	33.00%
2013	Firms displaying change	6	13	46.10%	2	8	25.00%

4.3.2. Effect of Firm Performance on Number of Outside Directors

The study sought to establish the effect of firm performance on the number of outside directors. From the results on table 4 both declining and improving firms experienced a change in number of outside directors a year after reporting performance. In 2010 majority of the declining firms at 62.5% displayed a change in number of outside directors while 38.4% of improving firms displayed a change in the number of outside directors. In 2011 40% of declining firms demonstrated a change in number of outside directors while 27.2 % of the improving firms displayed a change in the number of outside directors. In 2012 37.5 % of the declining firms recorded a change in the number of outside directors with 33.3 % of the improving firms recording a similar change. 2013 marked the lowest observation of declining firms at 30.77% showing a change in the number of outside directors with 25 % of improving firms showing a change in number of outside directors.

TABLE 4

Firms Displaying Change in Outside Directors

	Change in Number of Outside Directors						
Year	**Number of Outside Directors**	**Declining Firms**			**Increasing Firms**		
		Frequency	**Total Sample**	**Percentage**	**Frequency**	**Total Sample**	**Percentage**
2010	Firms displaying change	5	8	62.50%	5	13	38.46%
2011	Firms displaying change	2	5	40%	3	11	27.27%
2012	Firms displaying change	3	8	37.50%	2	6	33.33%
2013	Firms displaying change	4	13	30.77%	2	8	25%

4.3.3. Effect of Firm Performance on Frequency of Board Meetings

The third objective of the study was to establish the effect of firm performance on the frequency of board meetings. From the results on table 5, 12.5% of declining firms in 2010 experienced a change in the frequency of board meetings with 30.7% of improving firms experiencing a change in frequency of board meetings. In 2011 none of the declining firms recorded movement in the frequency of board meeting while 27.2 % of the improving firms recorded a change in the frequency of board meetings. In 2012 12.5 % of declining firms and 16.7% of improving firms displayed a change in the frequency of board meetings. In 2013 both declining and improving firms demonstrated change in frequency of board meetings after recording the highest observations at 50% and 37.5% respectively.

TABLE 5

Firms Displaying Change in Frequency of Board Meetings

	Change in Frequency of Board Meetings Held in the Year						
Year	**Frequency of Board Meetings**	**Declining Firms**			**Increasing Firms**		
		Freque ncy	**Total Sample**	**Percentage**	**Freque ncy**	**Total Sample**	**Percentage**
2010	Firms displaying change	1	8	12.50%	4	13	30.70%
2011	Firms displaying change	0	5	0.00%	3	11	27.20%
2012	Firms displaying change	3	8	37.50%	1	6	16.70%
2013	Firms displaying change	7	13	53.85%	3	8	37.50%

4.3.4. The Effect of Firm Performance on Chief Executive Officer (CEO) Replacement

The final objective of the study was to establish the effect of firm performance on CEO replacement. The results on table 6 indicates that in 2010 and 2011 none of the declining or improving firms replaced their CEO a year after reporting their performance. In 2012 however, 37.5 % of declining firms replaced their CEOs while none of the improving firms replaced their CEOs. In 2013 15.38% of the declining firms replaced their CEOs while none of the improving firms replaced their CEOs.

TABLE 6

Firms Displaying Change in Chief Executive Officer (C.E.O)

	Change in Company Chief Executive Officer						
Year	**Change in CEO**	**Declining Firms**			**Increasing Firms**		
		Frequency	**Total Sample**	**Percentage**	**Frequency**	**Total Sample**	**Percentag e**
2010	Firms displaying change	0	8	0.00%	0	13	0.00%
2011	Firms displaying change	0	5	0.00%	0	11	0.00%
2012	Firms displaying change	3	8	37.50%	0	6	0.00%
2013	Firms displaying change	2	13	15.38%	0	8	0.00%

TABLE 7

Degree of Correlation between Firm performance (ROA) and Corporate Governance Variables

	Declining Firms			**Improving Firms**		
	R	**R^2**	**Adjusted R^2**	**R**	**R^2**	**Adjusted R^2**
Board size(Y_1)	0.64	0.41	0.39	0.30	0.09	0.04
Number of outside directors (Y_2)	0.58	0.34	0.30	0.27	0.07	0.03

Frequency of board Meetings (Y_3)	0.25	0.06	0.02	0.23	0.05	0.00

Table 7 reports the finding of the degree of correlation of the variables in the regression models employed. It assists in determining the strength of association between the X and Y variables as well as indicating what variance of Y is explained by X. R is the correlation coefficient which measures the strength and direction of the linear relationship between the dependent and independent variables. Between Firm performance (X) and Number of outside directors (Y_1) the R was 0.64 for declining firms and 0.30 for improving firms showing fairly strong correlation between X and Y for declining firms but weak correlation for the improving firms. The adjusted R^2 between (X) and Y_1 was 0.39 for declining firms and 0.09 for improving firms. These results suggest that approximately 39% % of the variations in board size can be explained by firm performance in declining firms and for improving firms only 9% of the variations in board size can be explained by firm performance suggesting that significant variations in board size may be resulting from other factors not captured in the model.

Between Firm Performance (X) and Y_2 (Number of outside directors) the R was 0.58 for declining firms and 0.27 for improving firms showing moderate correlation in declining firms but weak correlation in improving firms. The adjusted R^2 between X and Y_2 for declining firms was 0.30 for declining firms indicating that 30 % of the variations in number of outside directors could be explained by firm performance, for improving firms only 7% of the variations in the number of outside directors could be explained by firm performance with the rest being as a result of other factors not captured in the model. The final relationship to be tested was between Firm Performance (X) and Y_3 (Frequency of Board Meetings) with an R of 0.25 for declining firms and 0.23 for improving firms, both declining and improving firms indicated fairly weak

correlation between X and Y_3.The adjusted R^2 was 0.02 and 0.00 for declining and improving firms respectively showing that only 2 % of the variations in frequency of board meetings could be explained by firm performance in declining firms, the rest of the variations were as a result of other factors.

From table 6 which indicated the frequency of firms demonstrating change in CEO a year after reporting performance it was evident that over the four years studied only 14.7% (5 out of 34) of declining firms replaced their CEOs after reporting performance and none of the 38 improving firms replaced their CEO. Inferential statistics was therefore not conducted for these variables as the data did not meet the assumptions of the simple regression model.

4.4 Regression Analysis

Regression analysis was applied to establish the relationship between firm performance and each of the four corporate governance variables. Prior to hypothesis testing the data was tested for normality, linearity and independence of residuals which are properties of a simple regression equation. For the three variables of corporate governance practices namely board size, number of outside directors and frequency of board meetings, skewness of data indicated approximately symmetrical distribution with a linear relationship between the dependent and independent variables. However for CEO replacement, the data collected did not meet the assumptions of the simple linear regression model and the variable was dropped from hypothesis testing.

4.4.1. Board Size

The hypothesized relationship between firm performance and size of the board was tested using the below regression equation:

$Y_1 = \alpha + B_1X_1 + \mu$ *(Equation i)*

Board Size = $\alpha + B_1$ (ROA) $+\mu$

According to hypothesis H_{01}, Firm performance has no significant effect on the board size of firms listed at Nairobi Securities Exchange. From the research findings, documented on Table 8 declining firms recorded a beta coefficient of (0.537, $p= 0.001<0.05$) leading to rejection of the null hypothesis since the p value of 0.001 suggested that firm performance had a significant positive effect on the board size of firms listed at NSE. Improving firms on the other hand recorded a beta coefficient of (0.222, $p= 0.393>0.05$) thus supporting the null hypothesis that firm performance has no significant effect on board size of firms listed at the NSE.

TABLE 8

Regression Coefficients for Board Size

Model: Board Size = $\alpha + B_1$ (ROA)						
		Std. Error	**Beta**	**T**	**Sig.**	**Decision**
Declining Firms	Constant	0.574	19.45	13.144	0.000	
	Board Size	5.396	0.537	3.603	0.001	Reject H_{01}

Improving Firms	Constant	0.711	1.89	12.817	0.000	
	Board Size	2.147	0.222	0.880	0.393	Fail to Reject H_{01}

4.4.2. Number of outside directors:

The hypothesized relationship between firm performance and the number of outside directors was tested using the below regression equation

$Y_2 = \alpha + B_1X_1 + \mu$ *(equation ii)*

Number of outside directors = $\alpha + B_1$ (ROA) $+\mu$

According to hypothesis $H_{02,}$ Firm performance has no significant effect on the number of outside directors of firms listed at Nairobi Securities Exchange. From the results of the findings documented on table 9, declining firms recorded a beta coefficient of (0.48, $p= 0.004<0.05$) thus the null hypothesis H_{02} was rejected. Improving firms on the other side recorded a beta coefficient of (-0.038, $p= 0.885>0.05$) thus the null hypothesis H_{02} was accepted for the improving firms.

TABLE 9

Regression Coefficients for Number of outside directors

Model: Number of outside directors = α +B₁ (ROA)						
		Std. Error	**Beta**	**T**	**Sig.**	**Decision**
Declining Firms	Constant	0.522	15.19	11.817	0.000	

	No. of outside directors	4.908	0.480	3.096	0.004	Reject H_{02}
Improving Firms	Constant	0.730	-0.323	10.781	0.000	
	No. of outside directors	2.203	-0.038	-0.146	0.885	Fail to Reject H_{02}

4.4.3. Frequency of board meetings

The hypothesized relationship between firm performance and the frequency of board meetings was tested using the below regression equation

$Y_3 = \alpha + B_1X_1 + \mu$ *(Equation iii)*

Frequency of Board Meetings = $\alpha + B_1$ (ROA) $+\mu$

Hypothesis H_{03} stated that Firm performance has no significant effect on the frequency of board meetings of firms listed at Nairobi Securities Exchange. From the result of the study documented on Table 10, for both declining and improving firms the null hypothesis (H_{03}) was accepted with a recorded beta coefficient of (0.182, p= 0.303>0.05) and (0.150, p= 0.564>0.5) respectively.

TABLE 10

Regression Coefficients for Frequency of Board Meetings

Model: Frequency of Board Meetings = α +B1 (ROA)						
		Std. Error	**Beta**	**T**	**Sig.**	**Decision**

Declining Firms	Constant	0.577	5.424	7.713	0.000	
	Frequency of Board Meetings	5.424	0.182	1.048	0.303	Fail to Reject H_{03}
Improving Firms	Constant	1.248	-2.20	4.799	0.000	
	Frequency of Board Meetings	3.767	-0.150	-0.590	0.564	Fail to Reject H_{03}

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

The chapter presents the summary of the research findings in relation to the study objectives, it discusses in depth the study findings, conclusions drawn from the findings, recommendations and makes suggestions for further research.

5.2 Summary of Research Findings

The study sought to establish the effect of firm performance on corporate governance practices of firms listed at Nairobi Securities Exchange. The proxy for firm performance was Return on Assets (ROA) while the four corporate governance practices which were studied a year after firm performance was recorded included board size, number of outside directors, frequency of board meetings and CEO replacement.

The findings indicate mixed results for the declining and improving firms. For declining firms the results from the study suggest that firm performance has a significant positive effect on the board size as well as the number of outside directors but no significant effect on the frequency of board meetings as well as on CEO replacement. However, for improving firms, the study results indicated that firm performance had no significant effect on all the four corporate governance practices as demonstrated by acceptance of the null hypothesis. Similar to the findings of (Valenti et al, 2011) the study results indicate that firm performance affects board

size as well as the mix of directors more dramatically for declining firms as opposed to improving firms.

These findings indicate that it may not be value adding for improving firms to makes changes in their existing corporate governance practices as they are already reaping great returns. On the other side of the spectrum, declining firms may derive additional benefits by changing their corporate governance practices as demonstrated by increase in their board sizes as well as the number of outside directors. Such adjustments may allow injection of greater insight and may offer the support needed in aiding the declining firms achieve successful turn a rounds.

5.3 Discussion of Findings

The study aimed at investigating the effect of firm performance on the corporate governance practices of firms listed at Nairobi Securities Exchange. In establishing the effect of firm performance on board size of firms listed at NSE, the results obtained from the study indicated that for declining firms, prior year performance (ROA) had a significant positive effect on the board size. Board size increased a year after reporting performance. These results are consistent with the views of (Pearce & Zahra, 1992, Lishenga, 2006, Kumuduni & Anona, 2010) that board size has a positive relationship to firm performance. The results however differed with the findings of Valenti, Luce & Mayfield (2011) who established a significant relationship between declining firm performance and a decrease in board size. For improving firms however the results from the study indicated that prior year performance (ROA) had no significant effect to board size hence supporting the null hypothesis that firm performance has no significant effect on board size. The results were consistent with the views of Kavulya (2011) that board size and composition had no significant relationship with financial performance in SACCOs. The findings

implied that improving firms may not feel the pressure to change their existing corporate governance practices as they are already delivering value to their stakeholders and may want to retain status quo with regards to their corporate governance practices. It is also expensive to increase the board size in terms of allowances paid to directors.

In establishing the effect of firm performance on the number of outside directors of firms listed at NSE, the results from the study were mixed. Whereas evidence from the sampled declining firms rejected the null hypothesis (H_{02}) that firm performance has no significant effect on the number of outside directors, evidence from improving firms supported the null hypothesis.

The results indicated that prior year firm performance had a significant effect on the number of outside directors sitting at the board. Over the 4 year period studied 41 % of the declining firms recorded a change in number of outside directors a year post reporting their performance. A possible explanation for the increase in the number of outside directors after recording a decline in performance is the assumption that outside directors may possess much needed linkage with the external environment which may be critical in turning round a declining firm into a profitable one. In support of the current research findings are the works of Udueni (1999) who contends that companies experiencing declining performance may seek financial experts to assist in turning round the companies back to profitability. Results for improving firms concurred with the study finding of (Krishnan, 2005) which found no evidence to support the relationship between board independence and firm performance. This implied that improving firms may not need to change bear the high costs of bringing on board outside directors.

The third research objective was to establish the effect of firm performance on the frequency of board meetings of firms listed at NSE, the findings from the study supported the null hypothesis (H_{03}) for both declining and improving firms. The study indicated that firm performance had no significant effect on the frequency of board meetings in both sets of data which was contrary to the findings of Vafeas (1999) that a higher meeting frequency was a reaction of failing performance as such boards attempted to place greater effort in their monitoring role. Although Chen et al, (2014) documents that shareholder interests are taken care of by allowing shareholders to actively participate in board meetings it is possible that the reason as to why neither the declining nor improving firms under the study significantly changed the frequency of their meetings post reporting firm performance is the cost implication related to increasing the frequency of board meetings. More so the declining firms may have shunned from changing the frequency of board meetings probably as a strategy of saving the costs of running more frequent board meetings especially in the face of reduced profit.

The final research objective was to establish the effect of firm performance on the CEO replacement of firms listed at NSE. Descriptive statistics indicated that over a period of 4 years only 5 out of 34 declining firms replaced their CEOs a year after reporting performance (Table6). None of the improving firms replaced their CEOs leading to the conclusion that firm performance had no significant effect on CEO replacement. Whereas this result is consistent with the findings of Jensen & Murphy's 1990 study which indicated a weak correlation between firm performance and CEO turnover, it was contrary to Perry and Shivdasani (2005) study which documented that the probability of a forced CEO departure rose significantly when the firm was a poor performer. A possible explanation for these result is that the boards of the sampled firms were not purely reactive boards who would radically replace the CEO as a response to poor

performance, it is possible that CEO replacement is an unpopular strategy of improving declining firm performance.

5.4 Conclusions

From the findings, the study demonstrates that indeed firm performance bears significant effect on some corporate governance practices instituted by declining firms possibly due to the level of scrutiny such firms face from stakeholders. The results from the study indicated that firm performance had an effect on board size as well the number of outside directors but no effect on the frequency of board meetings and CEO replacement. It is therefore important for such firms to evaluate their existing governance practices and seek avenues of improvement e.g.by bringing on board more outside directors who have expertise in setting strategy geared towards improvement of firm performance. Although the study has indicated that firm performance has a significant effect on the board size and number of outside directors in declining firms, it is important to note that the board characteristics and the quality of board decisions matter. It is also important for the board to provoke timely and appropriate remedial action whenever there spot an alarm signal.

The study established that for improving firms, prior year firm performance did not affect the any of the four corporate governance practices studied and therefore management may not need to spend much effort changing the existing corporate governance practices.

5.5 Recommendations

Bearing in mind the enormous contribution corporations make to the economy, the extent to which corporations deviate from value maximization cannot be underscored. Declining firms therefore need to analyze the activities that may be causing their downfall and change course. Part of what needs to be evaluated are their corporate governance practices and from the study it

is recommended for declining firms to increase their board size with outside directors who have a wealth of knowledge in the industry and may help turn around such firms into profitability. The frequency of board meetings and CEO replacement were not affected by firm performance suggesting that the two practices although costly to the firms, may not result in significant improvements in firm performance. It may therefore not be necessary for declining and improving firms to increase board meetings or replace CEOs following prior year performance.

5.6 Areas of Further Research

Considering the study focused on only four corporate governance practices, further research can be done on other corporate governance structures like for instance insider shareholding levels, CEO duality and institutional investors. This would help management explore the impact of adopting particular corporate governance practices to firm performance. Future research can also seek to establish the effect of firm performance on corporate governance practices of non listed firms since the current study was limited to firms listed at Nairobi Securities Exchange. This will help non listed firms which contribute significantly towards the Kenyan economy identify and adopt sound corporate governance practices which may impact positively towards their performance.

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APPENDICES

APPENDIX I

Firms Listed at Nairobi Securities Exchange (2009-2012)

Firms Listed at NSE	
AGRICULTURAL	**ENERGY & PETROLEUM**
Eaagads Ltd	KenGen Co. Ltd
Kakuzi Ltd	KenolKobil Ltd
Kapchorua Tea Co. Ltd	Kenya Power & Lighting Co Ltd
The Limuru Tea Co. Ltd	Total Kenya Ltd
Rea Vipingo Plantations Ltd	Umeme Ltd
Sasini Ltd	
Williamson Tea Kenya Ltd	
AUTOMOBILES & ACCESSORIES	**INSURANCE**
Car & General (K) Ltd	British-American Investments Co.(Kenya) Ltd
CMC Holdings Ltd	CIC Insurance Group Ltd
Marshalls (E.A.) Ltd	Jubilee Holdings Ltd
Sameer Africa Ltd	Kenya Re Insurance Corporation Ltd
	Liberty Kenya Holdings Ltd
BANKING	Pan Africa Insurance Holdings Ltd
Barclays Bank of Kenya Ltd	
CFC Stanbic of Kenya Holdings Ltd	**INVESTMENT**
Diamond Trust Bank Kenya Ltd	Centum Investment Co Ltd
Equity Bank Ltd	Olympia Capital Holdings Ltd
Housing Finance Co.Kenya Ltd	Trans-Century Ltd
I&M Holdings Ltd	
Kenya Commercial Bank Ltd	**MANUFACTURING & ALLIED**
National Bank of Kenya Ltd	A.Baumann& Co Ltd
NIC Bank Ltd	B.O.C Kenya Ltd
Standard Chartered Bank Kenya Ltd	British American Tobacco Kenya Ltd
The Co-operative Bank of Kenya Ltd	Carbacid Investments Ltd

APPENDIX II

Classification of Firms Listed at Nairobi Securities Exchange (2009-2012)

	Declining Firms				Totals
Year	**2009**	**2010**	**2011**	**2012**	
	Car & General (K) Ltd	Car & General (K) Ltd	Car & General (K) Ltd	Sasini Ltd	
	Marshalls (E.A.) Ltd	Marshalls (E.A.) Ltd	Standard Chartered Bank Kenya Ltd	Williamson Tea Kenya Ltd	
	Diamond Trust Bank Kenya Ltd	Equity Bank Ltd	ARM Cement Ltd	Car & General (K) Ltd	
	Express Kenya Ltd	East African Breweries Ltd	Kenya Power & Lighting Co Ltd	National Bank of Kenya Ltd	
	KenolKobil Ltd	Unga Group Ltd	CIC Insurance Group Ltd	Kenya Airways Ltd	
	Jubilee Holdings Ltd		East African Breweries Ltd	Uchumi Supermarket Ltd	
	Centum Investment Co Ltd		Eveready East Africa Ltd	ARM Cement Ltd	
	Safaricom Ltd		Mumias Sugar Co. Ltd	Kenya Power & Lighting Co Ltd	
				Total Kenya Ltd	
				Pan Africa Insurance Holdings Ltd	
				Centum Investment Co Ltd	
				Mumias Sugar Co. Ltd	

				E.A.Portland Cement Co. Ltd	
				Safaricom Ltd	
Totals	**8**	**5**	**8**	**13**	**34**

	Increasing Firms				**Totals**
	Kakuzi Ltd	The Limuru Tea Co. Ltd	NIC Bank Ltd	Sameer Africa Ltd	
	Rea Vipingo Plantations Ltd	Williamson Tea Kenya Ltd	Express Kenya Ltd	Diamond Trust Bank Kenya Ltd	
	Sameer Africa Ltd	Barclays Bank of Kenya Ltd	KenolKobil Ltd	Express Kenya Ltd	
	Housing Finance Co.Kenya Ltd	CFC Stanbic of Kenya Holdings Ltd	Olympia Capital Holdings Ltd	Umeme Ltd	
	National Bank of Kenya Ltd	I&M Holdings Ltd	B.A.T Kenya Ltd	Jubilee Holdings Ltd	
	Nation Media Group Ltd	Kenya Commercial Bank Ltd	Kenya Orchards Ltd	Kenya Re Insurance Corporation Ltd	
	Uchumi Supermarket Ltd	National Bank of Kenya Ltd		Olympia Capital Holdings Ltd	
	E.A.Cables Ltd	Nation Media Group Ltd		B.O.C Kenya Ltd	
	CIC Insurance Group Ltd	Uchumi Supermarket Ltd			
	Kenya Re Insurance Corporation Ltd	Pan Africa Insurance Holdings Ltd			
	Trans-Century Ltd	Trans-Century Ltd			
	BAT Kenya Ltd				
	Eveready East Africa Ltd				
Total	**13**	**11**	**6**	**8**	**38**