International Journal of Management and Commerce Innovations ISSN 2348-7585 (Online)
Vol. 3, Issue 1, pp: (122-132), Month: April 2015 - September 2015, Available at: www.researchpublish.com

Effect of Corporate Governance Practices on Financial Performance of Public Limited Companies in Kenya

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Abstract: **The literature on corporate governance has stirred a lot of debate and led to the large body of theoretical and empirical research. The study examined how the corporate governance of selected public companies in Kenya affects the financial performance during the period 1998 to 2004. Financial performance was measured by use of profitability. The study mainly focused on public listed in Nairobi securities exchange. A sample of public 26 companies was drawn using purposive sampling. Both descriptive and inferential statistics were used. Data was analyzed using a multiple linear regression model. The study found that a strong relationship exist between the Corporate Governance practices under study and the firms' financial performance. There was a positive relationship between board members and firm financial performance. Thus the study reveals that generally corporate governance is important in the financial performance of the company.**

Keywords: **corporate governance, board members, management, audit committee and financial performance.**

1. INTRODUCTION

Corporate governance structure spells out the rules and procedures for making decisions on corporate affairs and provides the structure through which the company objectives are set as well as the means of attaining and monitoring the performance of those objectives. It defines the accountability of those charged with the responsibility of steering the company affairs (Ajogrou, 2007).

In the United States of America, Regulators and governance advocates argue that the stock price collapse of such former corporate stalwarts as Adelphia, Enron, Parmalat, Tyco, and WorldCom was due in large part to poor governance. If their contentions are valid, a market premium should exist for relatively well-governed firms. (Gompers *et al*, 2003)..

Good corporate governance is focused on the protection of the rights of shareholders and plays an important role in the development of capital markets by protecting their interest (Kahan & Rock, 2003). Owners of capital needs to be assured of getting back their investment as production capital is highly specific and sunk. Corporate governance mechanisms provide this assurance. Managerial opportunism in the form of expropriation of investors or of misallocation of company funds have been found to reduce the amount of resources that investors are willing to put up ex ante to finance the firm (Williamson, 1985).

There exist twenty two core principles of good corporate governance. They include: authority and duties of shareholders/owners; recognition & protection of the rights and obligations of the members; leadership; appointments to the board; strategy and values; structure and organization; corporate performance, viability and financial sustainability; accountability to members; responsibility to stakeholders; balance of powers; internal control procedures assessment of performance of the board & directors; induction, development & strengthening of skills of directors & the board; appointment & development of executive management; adoption of technology and skills; management of corporate risk; corporate culture; social and environmental responsibility; recognition & utilization of professional skills and competencies; corporate compliance; corporate communication; and, corporate governance reporting (Institute of Directors, 2002).

1.1 Corporate governance in Kenya:

Kenya has undertaken several corporate governance reforms to address the agency problem and reduce agency cost of listed firms. In May 1999 the OECD approved the principles of corporate governance which includes recommendations regarding shareholder's rights and transparency and disclosure requirements for listed firms. The firms are required to comply or explain the extent of non-compliance with the provisions of these guidelines (Capital Markets Authority, 2002). S

The Capital market authority (CMA) in response to the growing importance of governance issues developed guidelines for good corporate governance practices by public listed companies in Kenya. A gazette notice no. 3362 of 2002 marked the adoption of the Guidelines on corporate governance practices by listed companies in Kenya. As per the gazette notice, listed firms are required to comply or explain the extent of non-compliance with the provisions of these guidelines (Capital Markets Authority, 2002). Being a gazette and not legal notice the adoption is voluntary and firms are not legally bound to comply with the provisions of this notice.

1.2 Statement of the Problem:

Corporate failures have become a major issue with respect to the firms in developing and developed countries which has been attributed to the poor governance practices (Wanyama & Olweny 2013). Kenya has been one of the developing countries whose companies are affected by poor governance practices. Despite tight regulatory framework, Corporate Governance continues to weaken in Kenya (Mang'unyi, 2011).According to Muriithi, (2009), many companies have been characterized by scandals. Directors have acted illegally or in bad faith towards their shareholders. Indeed, the Insurance Regulatory Authority identified poor Corporate Governance in insurance Companies as one of the threats to achieving its strategic plan 2008-2012.Since corporate governance is concerned with processes ,systems, practices and procedures that govern firms to achieve the objectives of the firms, these has not been the case and most public companies government institutions banking sector and other financial institutions in Kenya have not fully adopted good corporate governance practices(Gakeri, 2013).

1.3 Objectives of the study:

The general objective of the study is to establish the effect of corporate governance practices on financial performance in public limited companies in Kenya.

1.4 Specific objectives:

1. To determine if board members have influence on the financial performance of public limited companies listed in securities exchange Kenya.
2. To determine if management have influence on financial performance of the public limited companies listed in securities exchange in Kenya.
3. To determine if audit committee have influence on financial performance of the public limited companies listed in securities exchange Kenya.

2. LITERATURE REVIEW

2.1 Theoretical framework:

Agency Theory:

Agency theory having its roots in economic theory was exposited 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, hires 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 conceptually and 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, 2000). Such a problem was first highlighted by Adam Smith in the 18th century and subsequently explored by Ross (1973) and 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 & Donaldson (1997).

Stewardship Theory:

Stewardship theory has its roots from psychology and sociology. Steward protects and maximizes shareholders wealth through firm performance, because by so doing, the steward's utility functions are maximized (Davis, Schoorman & Donaldson 1997). In this perspective, stewards are company executives and managers working for the shareholders, protects and make profits 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 being as stewards, integrating their goals as part of the organization. The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained. 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, Daly *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) contend 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) insists that managers return finance to investors to establish a good reputation so that that can re-enter the market for future finance.

2.2 Conceptual framework:

The conceptual framework shows the relationship between the independent variables and the dependent variable. The independent variables are the board members, management, audit committee. As shown in the figure 2.1. The effect of independent variables is linked to the dependent variable which is financial performance of public limited companies.

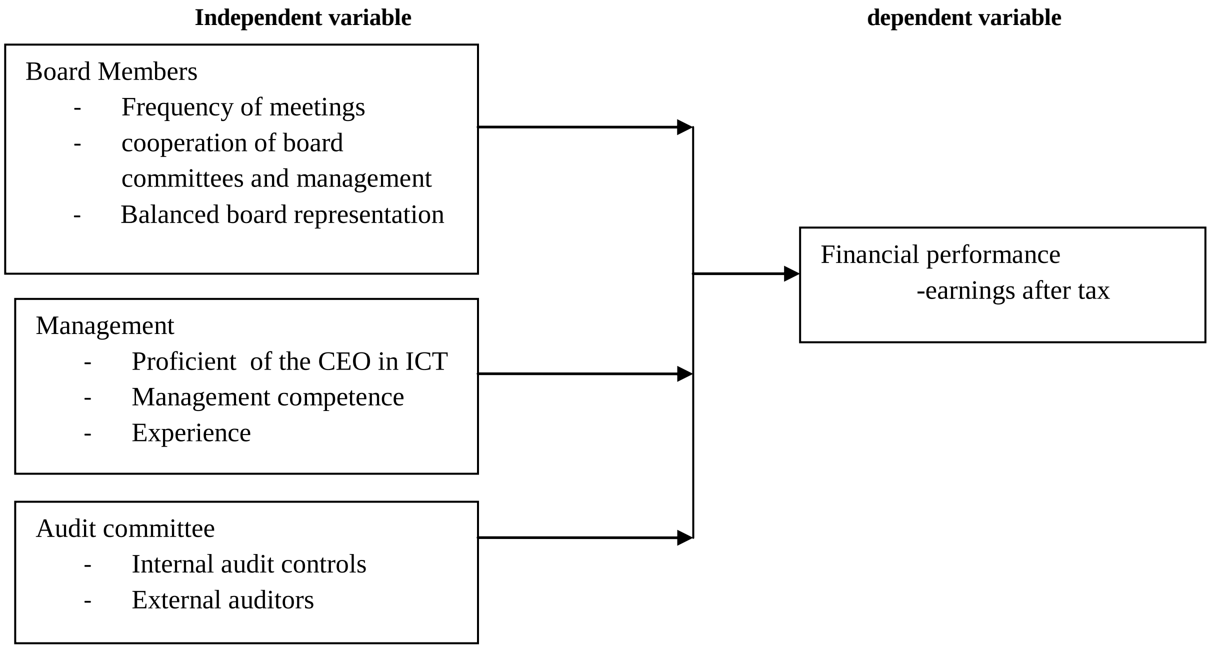

Figure 2.1: Conceptual framework

2.3 Empirical literature:

Board Members:

According to Stewardship theory, Directors are regarded as the stewards of the company assets and are pre-disposed to act in the best interest of the shareholders (Mallin, 2007). Stewardship theory relates to the board's task of providing support and advice to management (Davis, 1991). The stewardship theory has its roots from psychology and ssociology. According to Abdulla and Valentine (2009), stewards are company executives and managers working for the shareholders. The stewards protect and make profits for shareholders and are satisfied and motivated when organizational success is attained. Stewardship theory argues that the effective control held by professional managers empowers them to maximize firm performance and corporate profits. Regarding the leadership structure, stewards maximize their utility because they achieve organizational rather than self-serving objectives (Davis, 1991; Balta, 2008).

Many scholars predict that the effectiveness of firms' board depends not only on the board size but also on its mix of outside and inside directors (John and Senbet, 1998). Beasley (1996) finds evidence that outside directors fulfill their monitoring role with respect to corporate financial reporting. He finds that firms committing financial fraud have fewer independent directors than similar firms who are not found to commit financial. According to Dechow (1996) outside directors fulfill their monitoring role with respect to corporate financial reporting.

The presence of board committees helps to increase the effectiveness of the board. Rambo (2013) found significant differences in the composition of board committees attributable to the adoption of the guidelines. The nomination committee's key function is to ensure that director appointments, whether executive or non-executive, are made on merit rather than by patronage. An effective nomination committee should therefore ensure the appointment of non-executive directors whose interests are aligned with those of the shareholders and so help reduce agency costs. (Capital Markets Authority, 2002).

The effectiveness of the board may also depend on its composition. Provision that at least a third of the boards of listed firms be composed of non-executive members aims at increasing the proportion of outsiders who sit in the boards of listed firms. Significant differences in board composition between listed and non-listed insurance firms have been established in Kenya (Rambo, 2013). Adoption of the guidelines has been attributed for this significant difference. Empirical literature on board composition however remains unsettled as to its influence on agency cost. Some studies have supported the view that the presence of non-executive directors in the boards reduces agency cost (Hermalin and Weisbach, 1991; Byrd and Hickman, 1992).

Boards dominated by outside directors are seen to be more likely to act in shareholder's best interest. Boards with a significant proportion of non-executive directors are found to be more effective in monitoring management and therefore can limit the exercise of managerial discretion. This monitoring and control role by non-executive board members serves to reduce agency cost (Gakeri, 2013). Positive relationship between ROE and board composition of commercial state corporations has been established in Kenya (Miring'u and Muoria, 2011). Another study by Ongore and K'obonyo (2011) also finds significant positive relationship between foreign insiders and firm performance.

Audit Committees:

The Cadbury Report called for boards to establish audit committees comprising at least three members, all of whom should be NEDs. In research conducted on a pre-Cadbury sample of firms, Collier (1993) analyses responses to a 1991 questionnaire sent to 250 companies in the Times 1000 for 1989 to1991. Of the 142 respondent firms, 89 (62.7%) had formed an audit committee by 1 January 1991. In line with his hypotheses that audit committees are more likely to be formed where agency costs are high, Collier finds a positive association between gearing levels and audit committee formation and a negative association between directors' share ownership and audit committee formation. Large firms with more NEDs are more likely to employ an audit committee, as are firms whose auditor is one of the UK Big 6. By 1994, researchers observe an increase in the number of firms establishing such committees. In their sample of 250 non- financial, non-utility firms whose details are included in the Global Vantage database for 1995, 4 Vafeas and Theodorou (1998) find that 85% of firms have an audit committee, comprising an average of 74% NEDs. These are similar findings to those of the Cadbury follow-up survey which reports 83% of their sample of 500 listed firms as having an audit committee. Later, Gay

(2001), in his survey of non- financial FTSE 350 companies, finds that of 35 firms that did not have audit, remuneration or nomination committees in 1991, 31 had moved towards establishing such committees by 1999.

2.4 Management:

Separation of the office of the chairman of the board from that of the chief executive of the firm ensures that one person does not have too much power over decision making (Jensen M. C., 1993). CEO duality has been found to negatively affect corporate performance for firms characterized by large boards and low top management (Kholeif, 2008). However other studies have associated executive chaired boards with higher corporate financial performance (Lin, 2005).

The Chief Executive Officer (CEO) of an organization can play an important role in creating the value for shareholders. The CEO can follow and incorporate Governance provisions in a firm to improve its value (Defond & Hung, 2004). In addition, the shareholders invest heavily in the firms having higher Corporate Governance provisions as these firms create value for them (Morin & Jarrell, 2001). The turnover of CEO is negatively associated with firm performance especially in developed markets because the shareholders lost confidence in these firms and stop making more investments. It is the responsibility of the board to determine the salary of the CEO and give him proper remuneration for his efforts (Monks & Minow, 2001). The board can also align the interests of the CEO and the firm by linking the salary of a CEO with the performance of a firm. This action was motivated by the CEO to perform well because his own financial interest is attached to the performance of the firm.

The tenure of a CEO is also an important determinant of the firm's performance. CEOs are hired on short-term contracts and are more concerned about the performance of the firm during their own tenure causing them to lay emphasis on short and medium-term goals. This tendency of the CEO limits the usefulness of stock price as a proxy for corporate performance (Bhagat & Jefferis, 2002). The management of a firm can overcome this problem by linking some incentives for the CEO with the long-term performance of the firm (Heinrich, 2002).

3. RESEARCH METHODOLOGY

This study adopted a descriptive research design. According to Mugenda and Mugenda (2003), descriptive research is a process of collecting data in order to test hypotheses or to answer questions concerning the current status of the subjects in the study. The target population for the study will consist of the employees of public companies listed in on NSE. Nairobi securities exchange which are classified into ten sectors. These sectors comprises of; Agricultural, commercial and services, telecommunication and technology, automobiles and accessories, banking, insurance, investment, manufacturing and allied, construction. A questionnaire with both closed ended and open ended questions was used as a tool for the collection of primary data. The researcher preferred the use of a questionnaire because it was free from bias of the interviewer and answers are in respondents own words; respondents had adequate time to give well thought out answers and respondents who were not easily approachable were reached conveniently. The data collected was analyzed using a linear regression model. To determine the factors that influence the financial performance, the dependent variable was a (Y), while the independent variables which were board members, management and audit committee.

Model specification

The Linear Regression model

$Y = \beta 0 + \beta 1BM + \beta 2M + \beta 3AC + \varepsilon$

Where:

Y= Earnings after TAX (EAT)

β0= Beta coefficient (the value of Y when all X values are zero)

BM= Board members

M= management

AC= Audit committee

ε = error term or stochastic error

4. RESULTS FINDINGS AND DISCUSSIONS

Table 4.1 Board Members

Variables	Agreement	Neutral	Disagreement
High cooperation of management and board of directors.	18	4	4
Board of directors takes immediate action on audit recommendation	16	7	3
High frequency of holding meetings	14	8	4
Balanced board representation of largest And non large shareholder	10	9	7

Management:

The study revealed that the management of firms portrays competence and have effective skills in administration of the firms at 14.3 % (9 respondents) strongly agreed that the management was competent 81% (34 respondents) agreed and had skills while 4.7%(2 respondents were neutral on the management competence. On the chief executive officer 14.3% (6 respondents) strongly agreed, 73.8% (31 respondents) agreed that the CEO was proficient with ICT and embrace in operations while 11.9% (5 respondents) were neutral on proficient with ICT and embrace in operations. The research revealed that 14.3% (6 respondents) strongly agreed that the firms regularly conducts training needs assessment and implements its recommendation. Further 38.1 %(16 respondents) agreed while 35.7% (15 respondents) agreed while 9.5% (4 respondents) were neutral on regular assessment of training need and implementation of the recommendation. Further the research revealed that 4.8% (2 respondents) of the respondents strongly feel that the firms set aside resources and time to appraise performance.50% agreed (21 respondents) that the firm's 35.1% were neutral on the firm setting aside resources and time to appraise performance and 9.5% disagreed. On whether the top management adopts consultative approach to decision making 38.1% (16) of the respondents felt that management adopts the consultative approach on decision making while 16.7% (7 respondents) were neutral and 45.2% (19respondents) disagreed. The study also revealed that 54.8 % (23 respondents) agreed that the management tables to the relevant committees any issues which have financial implication.33.3 %(14 respondents) of were neutral on the issue and11.9 % (5 respondents) disagreed.

Table 4.2 management of firms listed in securities exchange

Variables	agreement	neutral	disagreement
Management portrays competence and effective skills	17	5	4
CEO is proficient with ICT and embrace ICT operations	12	8	6
Firm regularly conducts training needs assessment and implements its recommendation	13	8	5
Firm set aside resources and time to appraise performance	14	7	5
Management adopts consultative approach to decision making	15	6	5
Management tables to committees issues that have financial implication	18	7	1

Audit committee:

In this section several comparison questions were asked to establish the contribution of audit committee on financial performance as summarized on table 4.3. The study shows that 21.9% correspondence strongly attested that the firm appoints to its management, 69% agreed that auditors with balanced mix of proficient individuals who are able to add value and independent judgment to bear decision making 7.1 % of the respondents were neutral on the matter while 2.4% disagreed. Also the study reveals that 23.8% of the respondents strongly feel that the firm exercises regular review of systems processes and procedure to ensure the effectiveness of the internal systems so that decision making capability and accuracy of reporting and financial results are always maintained at the highest level, 7.1% were neutral on the matter while 4.8 % respondents disagreed. Further the research revealed that 64.3% audit committee meets often enough to discuss matters raised by internal adequately, while 14.3% of respondents were neutral on the issue and 4.8% disagreed on the matter. The study also revealed that 73.8% of respondents agreed that members of the audit are informed and effectively oversees of the financial reporting process and the firm internal controls, while 9.5% were neutral on the matter while 2.4% disagreed on the matter .Further the study revealed that 16.7% of audit committee has adequate resources and autonomy to discharge its responsibilities while 54.8% agreed and 28.6% were neutral on the matter. The study also revealed that 26.2% strongly agreed that external auditors report and table the reports to the audit committee and discuss the queries raised and are discuss while 61.9% were agreed on the issue while 11.9% were neutral.

Table 4.3 audit committee of firms listed in the securities exchange

	Agreement (f)	Neutral (f)	Disagreement (f)
The firm appoints to its management Auditors with balanced mix of proficient individuals	18	6	2
Firm exercises regular review of systems processes and procedures to ensure effectiveness of internal system controls	16	7	3
Audit committee meets more often to discuss matters raised by internal adequately	18	3	5
Members of the audit committee are informed and effectively oversees financial reporting and internal controls	20	4	2
audit committee has adequate resources and autonomy to discharges its responsibilities	22	2	2
audit committee is independent and deals with issues raised by internal auditors professionally	17	7	2
All heads of department are members of the committee and are invited to each audit meetings	18	5	3
External auditors report and the reports are tabled and the audit committee and the queries discussed	16	6	4

4.6 Multiple regression of financial performance after and before 2002

The researcher conducted a multiple regression analysis. This was done to test relationship among variables (independent) on the financial performance among firms listed in Nairobi securities exchange in Kenya. The statistical package for social sciences (SPSS) was applied to code, enter and compute the measurements of the multiple regressions for the study.

Coefficient of determination explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable (financial performance) that is explained by all the three independent variables (management, board members and audit committee).

Table 4.4 MULTIPLE REGRESSION EAT BEFORE 2002

Model Summary[b]

Mode	R	R square	adjusted r square	std error estimate
1	0.527[a]	0.278	0.21	0.13790

Table 4.5 MULTIPLE REGRESSIONS EAT AFTER 2002

Model Summary[b]

Mode	R	R square	Adjusted R Square	std .error of estimate
1	0.826[a]	0.682	0.646	0.13790

5. DISCUSSION OF RESULTS

The study analyses the adjusted R square before the year 2002 which is the year capital market authority recommended corporate governance. The adjusted R square before 2002 was R=0.212 meaning that 21.2% of financial performance was caused by management, auditors committee and board members while 78.8% was caused by other factors outside the model. While after the recommendation in 2002 the study revealed that the adjusted R square was R= 0.646 meaning that 64.6% was caused by management, board members and audit committee while 35.4% was caused by other factors outside the model. Thus the study reveals that generally corporate governance is important in the financial performance of the company.

Table 4.6 Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	Sig.
	B	**std. error**	**beta**	
(Constant)	-0.300	0.061	-	0.000
AC	0.068	0.061	0.168	0.273
BM	0.058	0.064	0.139	0.366
M	-0.187	0.060	-0.479	0.004

The researcher conducted a multiple regression analysis so as to explaining financial performance in Kenya and the three variables. As per the SPSS generated table 4.5, the equation ($Y = \beta0 + \beta1BM + \beta2M + \beta3AC + \varepsilon$) becomes:

$Y =-0.300+0.068AC+0.058BM-0.187M$

Where Y is the dependent variable (Financial performance), BM is the board members variable, M is the management and AC audit committee.

According to the regression equation established, taking all factors into account (board members, management and audit committee) constant at zero, entrepreneurial intentions will be 0.300. The data findings analyzed also showed that taking all other independent variables at zero, a unit increase in audit committee will lead to a 0.068 increase in financial performance; a unit increase in management will lead to a 0.187 decrease in financial performance, a unit increase in board members will lead to a 0.058 increase in financial performance. This infers that audit committee contributes more to financial performance of public companies listed in the Nairobi stock exchange in Kenya followed by the board members. At 5% level of significance and 95% level of confidence, audit committee had a 0.273 level of significance; board members showed a 0.366 level of significant, management showed a 0.004 level of significant hence the most significant factor is management.

Table 4.7 Coefficients

Model	**Unstandardized Coefficients**		**Standardized Coefficients**	**Sig.**
	B	**std. error**	**beta**	
(Constant)	-0.268	0.013	-	0.000
AC	0.38	0.013	0.165	0.009
BM	0.79	0.015	0.277	0.000
M	-0.194	0.013	-0.828	0.004

The researcher conducted a multiple regression analysis so as to explaining financial performance in Kenya and the three variables. As per the SPSS generated table 4.7, the equation ($Y = \beta0 + \beta1BM + \beta2M + \beta3AC + \varepsilon$) becomes:

$Y=-0.268+0.38AC+0.79BM-0.194M$

Where Y is the dependent variable (Financial performance), BM is the board members variable, M is the management and AC audit committee. According to the regression equation established, taking all factors into account (board members, management and audit committee) constant at zero, entrepreneurial intentions will be 0.268. The data findings analyzed also showed that taking all other independent variables at zero, a unit increase in audit committee will lead to a 0.38 increase in financial performance; a unit increase in management will lead to a 0.194 decrease in financial performance, a unit increase in board members will lead to a 0.79 increase in financial performance. This infers that audit committee contributes more to financial performance of public companies listed in the Nairobi stock exchange in Kenya followed by the board members. At 5% level of significance and 95% level of confidence, audit committee had a 0.009 level of significance; board members showed a 0.000 level of significant, management showed a 0.000 level of significant hence the most significant factor is management and board members.

6. CONCLUSIONS

The study shows that good corporate governance if applied to organization can improve the financial performance of firms. Management aspects, audit committees, board of directors have an upper hand in driving the organization towards better financial performance.

The board members are another factor of corporate governance that can influence the financial performance of the firm. Cooperation between board of directors and management improves decisions and better financial performance.

Audit committee should be established to public listed companies. It discloses that after the CMA recommendations in the year 2002 the company has audit committee, internal audit unit and external auditors. The independence of the audit committee exists making the audit committee to carry out its oversight role more accurately and transparently. On external auditors role on financial performance external auditors contribute to the financial performance.

7. RECOMMENDATIONS

Based on the findings the researcher proposes the following recommendations;

The management should be more committed to the organization by implementing of budgets, planning, successive leadership to be employed, and more professional cooperation between the management and the board. Management tenure and remuneration should be properly addressed to increase motivation on management.

The board of directors should play a role of oversight to the management activities, on leadership and corporate governance for board of directors should be implemented more frequently. Board members should behave a balanced representation of and more qualified individuals should be appointed.

Audit committees should be given more support from the management so as to enable them carry out their roles more effectively. Audit independence should be a priority and more internal controls should be established and implemented.

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