EFFECTS OF CORPORATE GOVERNANCE PRACTICES ON FINANCIAL PERFORMANCE OF SUGAR FIRMS IN KENYA

BY

NJAGI SILAS NYAGA

D53/PT/10786/07

A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENT OF THE MASTER OF BUSINESS ADMINISTRATION DEGREE IN THE SCHOOL OF BUSINESS OF KENYATTA UNIVERSITY

NOVEMBER, 2012
DECLARATION

This Research Project is my original work and has not been presented for degree or any other reward in any other University.

Signed........................................ Date 26/11/2012

NJAGI SILAS NYAGA
D53/10786/2007

This Research Project has been submitted for examination with my approval as University Supervisor.

Signed........................................ Date 28/11/2012

Supervisor:  Mr. Anthony Thuo
Department of Finance and Accounting
School of Business, Kenyatta University

Signed........................................ Date 28/11/2012

Mr. Fredrick Ndede
Chairman, Department of Finance and Accounting
School of Business, Kenyatta University
DEDICATION

This work is dedicated to my wife Fridah and our children Ann and Angela for their encouragement, moral, material, and spiritual support during the study.

Special thanks to our parents Mr and Mrs Ephantus Njagi and Mr and Mrs Erastus Rucha for their support and prayers.

To you I shall be forever grateful!
ACKNOWLEDGEMENT

I take this opportunity to thank Almighty God for His grace, guidance and protection throughout the study period. I am greatly indebted to my supervisor Mr. Anthony Thou for his guidance support and positive criticism during the entire study period as his wealth of knowledge and experience contributed greatly to the success of this study.

I would also want to thank all Kenyatta university lectures who offered support and valuable inputs without which my paper would not have been the same that has to be.

My sincere appreciation goes to my immediate family wife Fridah and daughters Ann and Angela for their encouragement, understanding, and accepting to spare apportion of family resources towards my study. Equally, I thank our parents, siblings and friends who offered moral support and encouraged me to complete this research project. Special thanks go to Faith Ngugi who led the pack.

The motivation, guidance and cooperation of these people has gone a long way making this a great working and learning experience that has turned to be.
<table>
<thead>
<tr>
<th>Content</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>DECLARATION</td>
<td>ii</td>
</tr>
<tr>
<td>DEDICATION</td>
<td>iii</td>
</tr>
<tr>
<td>ACKNOWLEDGEMENT</td>
<td>iv</td>
</tr>
<tr>
<td>TABLE OF CONTENTS</td>
<td>v</td>
</tr>
<tr>
<td>LIST OF TABLES</td>
<td>viii</td>
</tr>
<tr>
<td>LIST OF FIGURES</td>
<td>ix</td>
</tr>
<tr>
<td>ABBREVIATIONS AND ACRONYMS</td>
<td>x</td>
</tr>
<tr>
<td>ABSTRACT</td>
<td>xi</td>
</tr>
<tr>
<td>CHAPTER ONE</td>
<td>1</td>
</tr>
<tr>
<td>INTRODUCTION</td>
<td>1</td>
</tr>
<tr>
<td>1.1 Background of the Study</td>
<td>1</td>
</tr>
<tr>
<td>1.1.1 Corporate Governance</td>
<td>2</td>
</tr>
<tr>
<td>1.1.2 Financial performance</td>
<td>4</td>
</tr>
<tr>
<td>1.1.3 Relationship between corporate governance and financial performance</td>
<td>5</td>
</tr>
<tr>
<td>1.1.4 Sugar Industry in Kenya</td>
<td>6</td>
</tr>
<tr>
<td>1.2 Research problem</td>
<td>7</td>
</tr>
<tr>
<td>1.3 General objectives of the study</td>
<td>9</td>
</tr>
<tr>
<td>1.4 The specific objective of the study</td>
<td>9</td>
</tr>
<tr>
<td>1.5 Research Questions</td>
<td>9</td>
</tr>
<tr>
<td>1.6 Importance of the Study</td>
<td>10</td>
</tr>
<tr>
<td>1.7 Limitation of the Study</td>
<td>11</td>
</tr>
<tr>
<td>1.8 Scope of the study</td>
<td>11</td>
</tr>
<tr>
<td>CHAPTER TWO</td>
<td>12</td>
</tr>
<tr>
<td>LITERATURE REVIEW</td>
<td>12</td>
</tr>
<tr>
<td>2.1 Introduction</td>
<td>12</td>
</tr>
<tr>
<td>2.2 Theoretical Review</td>
<td>12</td>
</tr>
<tr>
<td>2.2.1 Stewardship Theory</td>
<td>12</td>
</tr>
<tr>
<td>2.2.2 Agency Theory</td>
<td>13</td>
</tr>
</tbody>
</table>
2.2.3 Stakeholders Theory (SHT) ................................................................. 13
2.3. Measure of Financial Performance ...................................................... 14
2.3.1 Corporate Governance Measures .................................................... 15
2.3.2 Principles of Good Corporate Governance ....................................... 16
2.3.3 The Corporate Governance Structure .............................................. 20
2.3.3.1 The Shareholders ........................................................................ 21
2.3.3.2 The Board ................................................................................... 21
2.3.3.3 The Management ........................................................................ 21
2.4 Corporate Governance Variables Under review ................................... 22
2.4.1 Size of the Board ............................................................................ 22
2.4.2 Independence of the Board .............................................................. 24
2.4.3 Corporate Disclosure ....................................................................... 25
2.4.4 Ownership Structure ...................................................................... 26
2.4.5: The Governance Role of Audit Committees .................................... 27
2.5. Empirical Studies on Corporate Governance and Financial Performance .................................................. 28
2.6: Conceptual Framework ...................................................................... 30
2.6.1 Size of the Board ............................................................................ 31
2.6.2 Independent Directors .................................................................... 31
2.6.3 Corporate Governance Disclosure .................................................. 31
2.6.4 Ownership Structure ...................................................................... 32
2.6.5 Audit Committee ............................................................................. 32
2.7 Intervening Variables .......................................................................... 32
2.7.1 Government policies ...................................................................... 32
2.7.2 Macroeconomic Variables ............................................................... 33
2.7.3 Production Technology ................................................................... 34
CHAPTER THREE ...................................................................................... 35
RESEARCH METHODOLOGY ................................................................. 35
3.1 Introduction ......................................................................................... 35
3.2 Research Design .................................................................................. 35
3.3 Population ........................................................................................... 36
3.4 Sample Size ........................................................................................ 36
<table>
<thead>
<tr>
<th>Content</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Table 4.1: Analysis of the Return on Equity</td>
<td>38</td>
</tr>
<tr>
<td>Table 4.2: Analysis of the Return on Assets</td>
<td>40</td>
</tr>
<tr>
<td>Table 4.3: Analysis of the Operating Income</td>
<td>41</td>
</tr>
<tr>
<td>Table 4.4: Analysis of the Net Profit after Tax</td>
<td>42</td>
</tr>
<tr>
<td>Table 4.5: Analysis of the Net Profit Margin</td>
<td>44</td>
</tr>
</tbody>
</table>
## LIST OF FIGURES

<table>
<thead>
<tr>
<th>Content</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Figure 2.6 Conceptual framework</td>
<td>30</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Description</td>
</tr>
<tr>
<td>--------------</td>
<td>-------------</td>
</tr>
<tr>
<td>CG</td>
<td>Corporate Governance</td>
</tr>
<tr>
<td>CGD</td>
<td>Corporate Governance Disclosure</td>
</tr>
<tr>
<td>CMA</td>
<td>Capital Market Authority</td>
</tr>
<tr>
<td>CAMELS</td>
<td>Capital Adequacy, Management, Earnings, Liquidity and Sensitivity to Market Risks</td>
</tr>
<tr>
<td>GCG</td>
<td>Guide on Corporate Governance</td>
</tr>
<tr>
<td>IRS</td>
<td>International Financial Reporting Standards</td>
</tr>
<tr>
<td>KCC</td>
<td>Kenya Cooperative Creameries</td>
</tr>
<tr>
<td>KPCU</td>
<td>Kenya Planters Cooperative Union</td>
</tr>
<tr>
<td>NOI</td>
<td>Net Operating Income</td>
</tr>
<tr>
<td>NSE</td>
<td>Nairobi Stock exchange</td>
</tr>
<tr>
<td>PSCGT</td>
<td>Private Sector Corporate Governance Trust</td>
</tr>
<tr>
<td>ROA</td>
<td>Return on Assets</td>
</tr>
<tr>
<td>ROE</td>
<td>Return on Equity</td>
</tr>
<tr>
<td>SHS</td>
<td>Stakeholders Theory</td>
</tr>
<tr>
<td>TD</td>
<td>Transparency and Disclosure</td>
</tr>
</tbody>
</table>
ABSTRACT

Due to the recent global high profile corporate failures across the world, corporate governance has become the center of the agenda for both business leaders and regulators all over the world today. This is because corporate governance which is hitherto seen as the foundation for good corporate performance had received lack-luster attention from corporate bodies globally for a considerable length of time. The governance structure of any corporate entity affects the firm’s ability to respond to external factors that have some bearing on its performance. In this regard, it has been noted that well governed firms largely perform better and that good corporate governance is of essence to firms. While many academicians have stated that sound corporate governance practices will reduce the risk of corporate failure. The key question faced by investors is whether an investment in sound corporate governance practices by a company results in an increase in shareholder value. The purpose of this study was to establish how corporate governance practices employed by sugar companies in Kenya affect their financial performance. The specific objectives included establishing the relationships between board size and the financial performance, independent directors and the financial performance, ownership structure and the financial performance, corporate disclosure and the financial performance and audit committee and the financial performance. The study was causal and censured all the seven sugar firms that were operational between 2005 and 2011. Seven years data for each of the seven sugar firms was extracted from their annual reports and financial statements all totaling to forty nine firm years. Data was then analyzed using profitability measures with the aid of statistical package for social science (SPSS). The study confirmed consistent results on the effects of the corporate governance variables selected on the companies’ financial performance as measured by the ROE, ROA, NOI, Net Profit after tax and Net Profit margin. In particular, the study confirmed that financial performance of companies improve with increase in financial literacy of the Board Audit Committee, independence of the Board Members as well as the increase in the disclosure of the corporate governance practices at any given point in time. The study also confirmed that the financial performance of the sugar companies was not directly affected by the size of the Board and the company’s ownership structure. Finally the study recommends in part that sugar firms should closely monitor and emphasize on financial literacy of audit committee, independence of the directors and corporate disclosure to be able to report positive financial performance.
CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The issue of corporate governance has become obverse and center of the agenda for both business leaders and regulators all over the world today. This is because corporate governance which is hitherto seen as the foundation for good corporate performance had received lack-luster attention from corporate bodies globally for a considerable length of time (Gompers and Metrick, 2003). This attitude which bordered on neglect of corporate strategies eventually led to the recent global high profile corporate failures. Notable among such failed corporate bodies are HIH Insurance and One-Tel both in Australia, Maxwell Communications Corporation, and Bank of Credit and Commerce International (BCCI) both in the United Kingdom; Enron and Worldcom both in the United States and Parmalat in Italy. All these failures have been attributed to poor corporate governance (Carcello and Neal, 2011).

In Kenya, the story is not different. There has been several corporate failures and large-scale misappropriation of funds in the recent past involving public organizations such as Pan African Paper Mills in Webuye, Kisumu Cotton Mills, Rift Valley Textiles, Kenya Planters Cooperative Union (KPCU), Kenya Corporate - Creameries (KCC), The Kenya Railways Corporation, Miwani sugar factory among many other privately owned entities. These failures raise some fundamental questions such as management style, audit independence, the nefarious practices of board members, ethics, professionalism and conflict of interest. Ikiara (2010) contends that the sheer scale of fraud, embezzlement and graft observed in some of these failed government establishments has brought into question the reliability and effectiveness of present-day operational and compliance control mechanism and financial reporting generally.

To formulate a Code of Best Practice for Corporate Governance in Kenya, a workshop on the Role of Non-Executive Directors was held at the Kenya College of Communications Technology in Nairobi in November 1998. The workshop sponsored and supported by leading organizations with specific interest in corporate governance including the Nairobi Stock Exchange (NSE), Capital Markets Authority (CMA), Institute of Certified Public Accountants (ICPAK) and the
Kenya Chapter of the Association of Chartered Certified Accountants (ACCA) drew participation from leading corporate organizations. An interim committee established in March 1999 was mandated to formulate a Code of Best Practice for Corporate Governance in Kenya and to coordinate with other efforts in the region and beyond for the purpose of improving Corporate Governance as well as seeking the establishment of a permanent organ to oversee the implementation of the Code if the effort was to be sustained. With the support of three development agencies, namely the Ford Foundation, the British Department for International Development and the Friedrich Ebert Foundation, a two-day workshop of experts was held at the Safari Park Hotel on the 6th and 7th October 1999 where participants at the two functions resolved among other things that the Code of Best Practice for Corporate Governance, as circulated and subsequently refined through expert input and comments from corporate respondents, be adopted, printed and circulated as a guide for Corporate Governance in Kenya (Jebet, 2001).

Interest in corporate governance has since grown in leaps and bounds during the past decade as corporate scandals, environmental concerns and globalization have all played their part in raising shareholder and public awareness of how companies should be governed (Mwangi, 2008). However, recent global events concerning high-profile corporate failures have put back on the policy agenda and intensified debate on the efficacy of corporate governance mechanisms as a means of increasing firm financial performance (Jebet, 2001). In spite of the fact that there are regulatory bodies and agencies established to oversee corporate governance in Kenya and ensure compliance with laid down rules and regulations, yet the corporate failures have escalated. The implication of this is that the regulatory agencies need to be reformed and restructured to reposition them and make them more effective and relevant in the 21st century.

1.1.1 Corporate Governance
According to Becht and Bolton (2005), corporate governance refers to the mechanism which ensures that the affairs of a corporate body are conducted in order to serve and protect the individual and collective interests of all stakeholders. Corporate governance can be defined as “ways of bringing the interests of investors and managers into line and ensuring that firms are run for the benefit of investors (Mayer, 1997). Corporate governance is concerned with the
relationship between the internal governance mechanisms of corporations and society’s conception of the scope of corporate accountability (Deakin and Hughes, 1997). It has also been defined by Keasey et al. (1997) to include ‘the structures, processes, cultures and systems that engender the successful operation of organizations’. From the foregoing analysis, we argue that corporate governance is represented by the structures and processes adopted by a corporate entity to minimize the extent of agency problems as a result of separation between ownership and control. It must also be indicated that different systems of corporate governance will embody what is considered to be legitimate lines of accountability by defining the nature of the relationship between the company and key corporate constituencies.

While issues in corporate governance have risen to prominence recently, the origins of corporate governance dates back many years to the time when ownership and management of businesses first became separated. It was necessary for owners to implement mechanisms to monitor the performance of managers. Effective corporate governance reduces the control rights shareholders confer on managers, increasing the probability that managers invest in positive net present value projects (Shleifer and Vishny, 1997). The process is concerned with ways in which all parties interested in the well-being of the firm (the stakeholders) attempt to ensure that managers and other insiders take measures or adopt mechanisms that safeguard the interests of the stakeholders. Such measures are necessitated by the separation of ownership from management, an increasingly vital feature of the modern firm (Black and Scholes, 1973).

A typical firm is characterized by numerous owners having no management function, and managers with no equity interest in the firm. Shareholders, or owners of equity, are generally large in number, and an average shareholder controls a minute proportion of the shares of the firm. This gives rise to the tendency for such a shareholder to take no interest in the monitoring of managers, who, left to themselves, may pursue interests different from those of the owners of equity. For example, the managers might take steps to increase the size of the firm and, often, their pay, although that may not necessarily raise the firm’s profit, the major concern of the shareholder. Much of the contemporary interest in corporate governance is concerned with mitigation of the conflicts of interests between stakeholders. Ways of mitigating or preventing these conflicts of interests include the processes, customs, policies, laws, and institutions which
have impact on the way a company is controlled. An important theme of corporate governance is the nature and extent of accountability of people in the business.

In Kenya, the Private Sector Corporate Governance Trust (PSCGT) is an independent, not-for-profit public trust established in 1999 by the private sector in partnership with other interested stakeholders in Kenya to address the concerns of corporate governance. The Trust is affiliated with the Commonwealth Association for Corporate Governance and acts as the Interim Secretariat to the Pan African Consultative Forum for Corporate Governance. The Trust works to help build appropriate institutions and national capacity to support the implementation, compliance and enforcement of good corporate governance practices and evaluation mechanisms in Kenya (Mwangi, 2008).

1.1.2 Financial performance

According to Kemei (2006) financial performance is a subjective measure of how well a firm uses assets from its primary mode of business to generate revenues. He further says that the term can also be used as a general measure of a firm's overall financial health position over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation.

Evaluating performance of firms is critical in order to ascertain whether the business is viable. A key performance measure used in modern financial management is the financial ratio analysis. The type of financial analysis varies according to the specific interests of the party involved or as may be required by regulators. According to Jebet (2001) trade creditors are interested primarily in the liquidity of the firm. Their claims are short term, and the ability of the firm to pay these claims is best judged by means of a thorough analysis of its liquidity. The claims of bondholders on the other hand are long term. Accordingly, they are more interested in the cash flow ability of the firm to service debts in the long run. The bondholders may evaluate this ability by analyzing the capital structure of the firm, the major sources and uses of funds, the profitability over time and projections of future profitability. Investors in a Company's common stocks are concerned principally with present and expected future earnings and the stability of these earnings as well as their covariance with earnings of other Companies. As result, investors might concentrate
their analysis on a company’s profitability. They would be concerned with the financial condition insofar as it affects its ability to pay dividends and avoid bankruptcy.

There are different ways of measuring financial performance, but all measures should be taken in aggregation. Most growing businesses ultimately target increased profits which make it important to know how to measure profitability. The key standard measures of financial performance include: gross profit margin which measures how much money an organization has made after direct costs of sales have been taken into account; operating margin lies between the gross and net measures of profitability after overheads are taken into account before interest and tax payments known as the EBIT (earnings before interest and taxes) margin. Net profit margin is a much narrower measure of profits, as it takes all costs into account, not just direct ones. All overheads, as well as interest and tax payments, are included in the profit calculation.

1.1.3 Relationship between corporate governance and financial performance

An argument has been advanced time and again that the governance structure of any corporate entity affects the firm’s ability to respond to external factors that have some bearing on its performance. In this regard, it has been noted that well governed firms largely perform better and that good corporate governance is of essence to firms. There is an ongoing debate on whether better corporate governance leads to better firm performance. Black et. al. (2006) concluded that firms having high governance score have a high market value. In expectation of the improvement in firm’s performance, the stock price might also respond instantaneously to the news indicating better corporate governance. Firms having weak governance structures face more agency problems and managers of those firms get more private benefits due to weak governance structures (Core et. al., 1999).

While many academics have stated that sound corporate governance practices will reduce the risk of corporate failure (Collis and Montgomery, 2005), the key question faced by investors is rather the issue of whether an investment in sound corporate governance practices by a company results in an increase in shareholder value. In more recent studies, the McKinsey Consulting Group found that investors in certain emerging market countries would pay a premium of 23 % and 28 % for shares in a company with “good” corporate governance, as opposed to a poorly
governed company with similar financial performance (Rose, 2003). Consequently, corporate
governance will increasingly affect both a country’s economic stability and its growth prospects.

1.1.4 Sugar Industry in Kenya

The sugar industry in Kenya dates back to 1922, with the establishment of the first sugar factory Miwani Sugar Mills. The industry directly and indirectly supports 5 million Kenyans representing about 16% of the entire Kenyan population. Sugar cane growing is also a major source of income to over 200,000 small scale farmers (www.knbs.or.ke). In Kenya, sugarcane is grown on fairly flat regions in the Western, Nyanza and Coast Provinces. About 85% of the total cane supply is from small-scale growers whilst the remaining is from the nucleus estates of the sugar factories (www.kenyasugar.co.ke). As at October 2012, the country has 11 sugar factories with an annual production capacity of between 550,000 and 600,000 tons of sugar. By-products from the factories include molasses which is mostly for alcohol production, bagasse used for generation of power as well as filter for manufacturer of fertilizer (Wanyande, 2001).

The Ministry of Agriculture has the overall responsibility for the sugar industry development. It also has its representatives in the board of directors of all government owned sugar mills as well as in other government institutions mandated to handle sugar and sugarcane matters. Sugar cane research and advisory services to farmers also falls under the Ministry through Kenya Sugarcane Research Foundation (KESREF). Kenya Sugar Board (KSB) which is the apex body of the sugar industry in the country is mandated to regulate, develop, promote, formulate and implement policies on sugar matters. (Sugar Act 2001).

Before liberalization of the sector in early 1990s, all sugar manufactured in the country was sold to Kenya National Trading Corporation (KNTC), which was responsible for distribution of the sugar throughout the country (Ikiara, 2010). With the advent of liberalization, factories are now free to sell their sugar through appointed distributors and wholesalers. They have adopted a number of methods for distribution including use of wholesalers, agents, retailers and even individuals. There are now more than 5,000 private wholesalers who buy sugar directly from the factories. Individual traders can also buy directly from the factories (www.knbs.or.ke)

Growth of the sugar sector is vital to the economic development of the country as this ensures increased incomes and employment to the rural population especially small-scale producers who
constitute 75% of Kenya's population (ww.knbs.or.ke). Considerable efforts have been made to promote growth in this sector through systematic process of tariff reduction, removal of price controls thus freeing the market of most of the constraints and imposition of duties on sugar importation (Ikiara, 2010). These are all aimed at raising domestic production efficiency to be able to compete effectively with imported sugar.

1.2. Research problem
An argument has been advanced time and again that the governance structure of any corporate entity affects the firm's ability to respond to external factors that have some bearing on its performance. In this regard, it has been noted that well governed firms largely perform better and that good corporate governance is of essence to firms, Wainaina, (2002). Van der Berghe and Levran, (2004), related the corporate governance to the performance of various firms in Europe by using a corporate governance ranking developed by a firm called Deminor, the results confirmed that ranking was positively correlated with performance ratios such as price-to-book value, return on assets, and return on sales. In the case of Switzerland, Beiner et al. (2004) found a positive relationship between a measure of corporate governance and valuation ratios.

Cadbury, (1992) examined the separation of CEO and chairman, positioning that agency problems are higher when the same person holds both positions. Demsetz and Lehn (2005) sought to establish the impact of corporate governance practices on firm's financial performance. A sample of 50 non-financial firms listed on Pakistan stock exchange was randomly selected. The study period covered from 2003 to 2005, hence 150 firm years. To measure the quality of Corporate Governance practices in the sample firms, a Corporate Governance Index (CGI) consisting of 30 indicators/parameters was developed which measured the strength and quality of Corporate Governance practices. The CG index scores for each firm were then compared with the financial performance indicators that included Return on Assets (ROA), Return on Equity (ROE), Price to Book ratio and Price Earnings (P/E) ratio of the sample firms to find out any relationship between them. The results showed that CGI scores were positively associated with ROA, ROE and Price to Book (P/B) ratio and statistically significant. P/E was also positively correlated with CGI scores but the impact is insignificant.
Adoption and practice of good corporate governance has become the means to ascertain shareholders and other investors who are not involved on day to day management of companies of reasonable returns on their investment (Crutchley and Hansen (1999).

According to Noordin (1999), the erosion of investor confidence in Malaysia was brought about by the country's poor corporate governance standards and a lack of transparency in the financial system. Therefore, the restoration of confidence in the economy by investors will rely on improvements in corporate governance standards, including the adoption of transparency as an important strategy in corporate management (Newman and Hegarty 1989). Good corporate governance is recognized to have an overall effect on reducing cost of capital, improving company management and providing a framework through which conflict among stakeholders is resolved, increases investor’s confidence, improves the prospects of an investor’s return, and aligns the rights of all stakeholders thus reducing conflict in the organization. Developing countries are now increasingly embracing the concept of corporate governance knowing it leads to sustainable economic growth. Indeed, corporate governance in Kenya is now gaining some level of recognition with very little work in the area even in the well-regulated institutions and sectors.

Masinga (2008) did a study on the effects of corporate governance practices on the financial performance of firms in the Kenyan coffee industry. The study analyzed the financial performance of the selected for a period of five years from 2003 to 2007. financial performance as measured by the Net Profit after tax and Return on Equity were computed and compared against the corporate governance practices that included the measure of, Board Size, independent directors, Corporate governance disclosure, ownership structure and audit committees. The finding established a direct relationship between financial performances of firms with the corporate governance practices. Kemei (2006) did a study on the impact of corporate governance practices on the financial performance of commercial banks in Kenya. The study compared financial performance of twelve banks for five years from 2000 to 2004 against the corporate governance practices for the same period. The findings confirmed that good corporate governance affected performance in a positive way.
Kenya Sugar Firms with almost identical operational structural and systematic processes have glaring disparities in organizational performance levels. Some of the companies are more competitive compared to others. The major difference could be the capital and asset base as well as the level of corporate governance practices adopted by the individual firms, since there has been no study done to have a conclusive evidence behind this, the researcher sought to fill the knowledge gap in the area by researching on the effects of corporate governance practices on the financial performance of sugar firms in Kenya.

1.3 General objectives of the study

The general objective of this study was to determine how corporate governance practices employed by sugar companies in Kenya affect their financial performance.

1.4: The specific objective of the study is:

a) To determine the relationship between Board size and financial performance of the companies.

b) To determine the relationship between ownership structure and the financial performance of the companies.

c) To determine the relationship between the audit committee and the financial performance of the companies.

d) To determine the effects of corporate governance disclosure on the financial performance of the companies.

e) To determine the relationship between independent directors and the financial performance of the companies.

1.5 Research Questions

1. What is the relationship between Board size and the financial performance of the company?

2. What is the relationship between the ownership structure and the financial performance of the company?

3. What is the relationship between the audit committee and the financial performance of the company?

4. Are firms with higher Corporate Governance Disclosure expected to have higher financial performance?
5. What is the relationship between independent directors and financial performance of the company?

1.6: Importance of the Study

In the light of the fact that mammoth resources both financially and non-financially are committed to research and effectively implement the corporate governance practices in any organization, it is noteworthy to establish whether the implementation of these practices does have an effect on the financial performance of firms in the Kenyan sugar industry. The submission of this fact will be of significant use to the following:

The Private Sector Corporate Governance Trust (PSCGT), an independent, not-for profit public trust established in 1999 to help build appropriate institutions and national capacity to support the implementation, compliance and enforcement of good corporate governance practices and evaluation mechanisms in Kenya.

The sugar companies in the country whose performance is affected by the level of corporate governance practices in place at a given point in time, this study will augment and validate the level of corporate governance practices adopted by the firms from time to time hence necessary managerial decisions.

Researchers and scholars interested in building on the already existing knowledge base about theoretical and empirical work on the corporate governance practices and the subsequent effects on the performance of firms in the Kenyan sugar industry.

Academicians who are interested in disseminating knowledge on the subject of corporate governance practices and its effects on the financial performances of firms in the Kenyan sugar industry.
1.7: Limitation of the Study

This study is subject to some limitations. First, employing proxies for actual corporate governance mechanisms and firms’ financial performance outcomes may not accurately capture the actual mechanisms or outcomes experienced by the sugar industry firms in the financial marketplace. Secondly, the use of secondary data by the study may not necessarily reflect the current circumstances affecting the firms due to many changes that have occurred during the review period.

1.8: Scope of the study

The research study was carried out on all the seven sugar firms in Kenya that were operational between 2005 and 2011. The study used secondary data where financial statements for the selected firms over the period shall be reviewed.
CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction

This chapter builds on the background research problem and the research questions identified in chapter one. Theories behind Corporate Governance and other relevant literature from broad and rich background are systematically discussed. The chapter also covers the measures of financial performance and corporate governance, the corporate governance structures and variables, empirical studies on corporate governances as well as the conceptual framework for the study.

2.2 Theoretical Review

Several theories have been advanced towards justification of corporate governance practices. For the purpose of this research, three theories being the stewardship theory, agency theory and the stakeholder’s theory shall be advanced.

2.2.1 Stewardship Theory

Stewardship theory has its roots from psychology and sociology and is defined by Donaldson and Davis (1997) as “a steward protects and maximizes shareholders wealth through firm performance, because by so doing, the steward’s utility functions are maximized”. In this perspective, stewards are company executives and managers working for the shareholders, protects and make profits for the shareholders.

According to Dryel (1988), Stewardship theory stresses not on the perspective of individualism 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. The theory recognizes the importance of structures that empower the steward and offers maximum autonomy built on trust (Donaldson and Davis, 1991). It stresses on the position of employees or executives to act more autonomously so that the shareholders’ returns are maximized. Fama and Jensen (1983), contend that executives and directors are also managing their careers in order to be seen as effective stewards of their organization. The theory suggests unifying the role of the CEO and the chairman so as to reduce agency costs and to have greater role as stewards in the organization.
2.2.2 Agency Theory

Agency theory having its roots in economic theory was expounded by Alchian and Demsetz (1972) and further developed by Jensen and Meckling (1976). Agency theory is defined as “the relationship between the principals, such as shareholders and agents such as the company executives and managers”. In this theory, shareholders who are the owners or principals of the company, hires the agents to perform work. Principals delegate the running of business to the directors or managers, who are the shareholder’s agents (Bhimani, 2008).

Alchian and Demsetz (1972) 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. Secondly, agency theory suggests that employees or managers in organizations can be self-interested. According to the 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).

2.2.3 Stakeholders Theory (SHT)

Stakeholder theory was embedded in the management discipline in 1970 and gradually developed by Freeman (1999) incorporating corporate accountability to a broad range of stakeholders. Wheeler et al., (2002) argued that stakeholder theory derived from a combination of the sociological and organizational disciplines. Indeed, stakeholder theory is less of a formal unified theory and more of a broad research tradition, incorporating philosophy, ethics, political theory, economics, law and organizational science. According to the theory, a stakeholder is any group or individual who can affect or is affected by the achievement of the organization’s objectives. Unlike agency theory in which the managers are working and serving for the stakeholders, stakeholder theorists suggest that managers in organizations have a network of relationships to serve, this include the suppliers, employees and business partners. And it was argued that this group of network is important other than owner-manager-employee relationship as in agency theory (Freeman, 1999).

Sundaram & Inkpen (2004) contend that stakeholder theory attempts to address the group of stakeholder deserving and requiring management’s attention. Whilst, Donaldson & Preston
(1995) claimed that all groups participate in a business to obtain benefits. Clarkson (1995) suggested that the firm is a system, where there are stakeholders and the purpose of the organization is to create wealth for its stakeholders. Freeman (1984) contends that the network of relationships with many groups can affect decision making processes as stakeholder theory is concerned with the nature of these relationships in terms of both processes and outcomes for the firm and its stakeholders.

2.3. Measure of Financial Performance

According to Williamson (1996), financial performance is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. This term is also used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. Financial performance can be measured using five variables that include profitability, liquidity, solvency, financial efficiency and finally the repayment capacity of an entity for given period (Wheeler, et al. 2003).

Profitability measures the extent to which a business generates a profit from the factors of production: labor, management and capital. Profitability analysis focuses on the relationship between revenues and expenses and on the level of profits relative to the size of investment in the business (Williamson, 1996).

Liquidity measures the ability of the business entity to meet its financial obligations as they come due, without disrupting the normal, ongoing operations of the business. Liquidity can be analyzed both structurally and operationally, structural liquidity refers to balance sheet measures of the relationships between assets and liabilities and operational liquidity refers to cash flow measures (Wheeler, et al. 2003).

Solvency measures the amount of borrowed capital used by the business relative the amount of owner's equity capital invested in the business. In other words, solvency measures provide an indication of the business' ability to repay all indebtedness if all of the assets were sold (Maisenbach, 2006).
Repayment capacity measures the ability to repay debt from both farm and non-farm income. It evaluates the capacity of the business to service additional debt or to invest in additional capital after meeting all other cash commitments (Williamson, 1996).

Financial efficiency measures the degree of efficiency in using labor, management and capital. Efficiency analysis deals with the relationships between inputs and outputs. Because inputs can be measured in both physical and financial terms, a large number of efficiency measures in addition to financial measures are usually possible (Maisenbach, 2006).

For this researcher, the researcher shall specifically use four approaches of measuring profitability of the selected firms. The measures shall include the Net operating income, Net profit after tax, Return on assets and finally the Return on Equity. Net operating income refers to the revenues available from normal operations after fixed and variable expenses have been deducted. This income is available to compensate unpaid labor, management, and equity capital. Net profit after tax is computed by netting the tax liability from the net operating income. The ROA measures the return to all the entity’s assets and is often used as an overall index of profitability, and the higher the value, the more profitable the business entity is. The Return on Equity measures the rate of return on the owner’s equity employed in the business entity.

2.3.1 Corporate Governance Measures.

In the wake of the global recession, attention on corporate governance is at an all-time high. Many investors lost a lot of money, particularly on investments in companies that went bankrupt due to corporate scandals, mismanagement and fraud. Many investors are looking for a way to prevent this happening again, and are hoping to spot the mismanaged companies before they implode (Mwangi, 2008). This has resulted in a global call for a system to be developed that can measure a company’s system of corporate governance. In almost all of the systems developed so far, executive compensation has been one of the topics used as a measure (Wild, 1994). Should governance measurement tools gain international recognition, they will play a large role in determining the structure and size of director’s compensation.
According to Wainaina (2002), the main challenge has been how the Corporate governance can be subjective or objectively measured. This is because however detailed a study is done on the policies within a company, it would be impossible to measure the culture accurately within a company. Despite these difficulties, many organizations and bodies have attempted to set up a method to measure how various entities are performing with regard to governance. On a global scale, the United Nations University drew up the World Governance Survey in 2002, in order to effectively assess and analyze governance issues (Van der Berghe and Levran, 2004). The World Bank attempted to measure the governance of governments in 2007, using data and annual indicators from the previous ten years. More specifically focused on governance within the corporate setting, there have also been various projects undertaken to set standards by which to measure the governance of companies, commonly referred to as governance rating or index (Ikiara, 2010).

Governance Metrics international (GMI), created in 2000, claims to be the first such company. The organization produced a questionnaire with hundreds of metrics which, once answered, gave a score between one and ten for that company. Companies were scored against best practices in four areas, one of them being compensation. Companies were then treated as low, medium or high concern in each area, depending on their ratings. Indicators that decided ratings with regards to compensation included the executive directors' ownership of shares, disclosure regarding the minimum vesting periods of executive shares, policy towards re-pricing of share options and finally the change in control agreements (Jebet, 2001).

2.3.2 Principles of Good Corporate Governance

According to Hawley and Williams, (1996), Principles of Corporate Governance were endorsed by the Organization for Economic Co-Operation and Development (OECD) Ministers in 1999 and have since become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide. They have advanced the corporate governance agenda and provided specific guidance for legislative and regulatory initiatives in both OECD and non-OECD countries. There is no single model of good corporate governance. However, work carried out in both OECD and non-OECD countries and within the organization has identified some common elements that underlie good corporate governance (Shleifer and Vishny 1997).
Principles build on these common elements and are formulated to embrace the different models that exist and include the following.

Effective Corporate Governance Framework; the corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities (Steiner and Steiner, 2003).

The Equitable Treatment of Shareholders; According to (Stulz 2006) the corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

Recognition of Roles of Stakeholders in Corporate Governance; the corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises (Freeman, 1984)

Authority and Duties of Members or Shareholders; According to Hawley and Williams (1996) Members or shareholders as owners of the corporation shall jointly and severally protect, preserve and actively exercise the supreme authority of the corporation in general meetings. They have a duty, jointly and severally, to exercise that supreme authority of the corporation to ensure that only competent and reliable persons, who can add value, are elected or appointed to the Board of Directors, ensure that the Board is constantly held accountable and responsible for the efficient and effective governance of the corporation so as to achieve corporate objectives, prosperity and sustainability and finally change the composition of a Board that does not perform to expectation or in accordance with the mandate of the corporation.

Leadership; Every corporation should be headed by an effective Board that should exercise leadership, enterprise, integrity and judgment in directing the corporation so as to achieve
continuing prosperity and to act in the best interest of the enterprise in a manner based on transparency, accountability and responsibility (Hillman, et al 2000).

Appointments to the Board; According to Balasubramaniam, (1999), appointments to the Board of Directors should, through a managed and effective process, ensure that a balanced mix of proficient individuals is made and that each of those appointed is able to add value and bring independent judgment to bear on the decision-making process.

Strategy and Values; The Board of Directors should determine the purpose and values of the corporation, determine the strategy to achieve that purpose and implement its values in order to ensure that the corporation survives and thrives and that procedures and values that protect the assets and reputation of the corporation are put in place (Daily and Canella (2003).

Corporate Performance, Viability and Financial Sustainability; The Board should monitor and evaluate the implementation of strategies, policies and management performance criteria and the plans of the corporation. In addition, the Board should constantly review the viability and financial sustainability of the enterprise and must do so at least once every year (Ejiofor, 2009).

Responsibility to Stakeholders; According to Wild (1994), The Board should identify the corporation’s internal and external stakeholders; agree on a policy or policies determining how the corporation should relate to, and with them, in creating wealth, jobs and the sustainability of a financially sound corporation while ensuring that the rights of stakeholders whether established by law or custom are respected, recognized and protected.

Internal Control Procedures; According to Singh and Davidson (2003), the Board should regularly review systems, processes and procedures to ensure the effectiveness of its internal systems of control so that its decision-making capability and the accuracy of its reporting and financial results are maintained at the highest level at all times.

Assessment of Performance of the Board of Directors; Jebet (2001), argues that the Board should regularly assess its performance and effectiveness as a whole and that of individual members, including the Chief Executive Officer. A summary of the major findings together with a
statement confirming that the Board has carried out a self-assessment exercise should be made to
the annual general meeting.

Induction, Development and Strengthening of Skills of Board Members; Wild (1994), argues
that the Board should recognize the need for new members to be inducted into their roles and for
all Board members to develop and strengthen their governance skills in light of technological
developments, changing corporate environment and other variables. The Board should
accordingly organize for the systematic induction and continuous development of its members.

Appointment and Development of Executive Management; Young (2003) postulates that the
Board should appoint the Chief Executive Officer and participate in the appointment of all senior
management, ensure motivation and protection of intellectual capital crucial to the corporation,
ensure that there is appropriate and adequate training for management and other employees and
put in place a succession plan for senior management.

Social and Environmental Responsibility; The Board should recognize that it is in the
enlightened self-interest of the corporation to operate within the mandate entrusted to it by
society and shoulder its social responsibility. For this reason, a business entity does not fulfill its
social responsibility by short-changing beneficiaries or customers, exploiting its labor, polluting
the environment, failing to conserve resources, neglecting the needs of the local community,
swarding taxation or engaging in other anti-social practices (Sanda and Garba, 2005).

Recognition and Utilization of Professional Skills and Competencies; The Board should
recognize and encourage professional development and, both collectively and individually, have
the right to consult the corporation’s professional advisers and, where necessary, seek
independent professional advice at the corporation’s expense in the furtherance of their duties as
directors. This is in addition to and not a substitute to their personal duty to acquire competence,
training and information that would help them make informed, independent and astute decisions
in issues relevant to the corporation (Singh, and Davidson, 2003).

Recognition and Protection of Members’ Rights and Obligations; Members of the business entity
have a right to receive any information that would materially affect their membership, to
participate in any meeting of members and to participate in the election of directors and be facilitated to fully participate in all other resolutions of interest to them as members (Young, 2003).

2.3.3 The Corporate Governance Structure

There is no universally accepted structure of Corporate Governance. According to Johnson and Whittington (2007), the principle actors in governance include Shareholders, management and the Board of Directors. Effective corporate governance requires a clear understanding of the respective roles of the board and of senior management and their relationships with others in the corporate structure (Montgomery and Kaufman, 2003). The relationship of which is depicted in the diagram below.

![Diagram of Corporate Governance Structure]

The focus is on the weak relationship between the Board and shareholders which is critical as it undermines the efficiency in governance of the organization. The lack of information flow negates the principle of transparency and accountability (Montgomery and Kaufman, 2003). The directors' failure to provide useful feedback and information to shareholders leaves a lot of questions unanswered. The Board is presumed to have the ability to change the behavior of the corporation, thus the need for carefully constituted Board (Mat-Nor and Redzuan, 1999).
shift to more outside directors and the pressure for special interest representation on Boards reflects in part the public concern. Business corporations can disregard this challenge to past board practices at their peril (Newman and Hegarty, 1989).

2.3.3.1 The Shareholders

According to Park and Shin (2003), shareholders are the owners of the corporations by virtue of their capital invested in the businesses. They do not manage the day to day affairs of the corporations but appoint directors, who collectively as a board represent them and oversee the management on their behalf. They control the long term direction of the corporation and meet once in a year to appoint directors and auditors. They get reports on the performance of the company and this enables them evaluate the performance of Directors (Jebet, 2001).

2.3.3.2 The Board

According to Donaldson and Preston (1995), the Board of Directors refers to a body of elected or appointed members who jointly oversee the activities of a company or organization. The composition of the Board of Directors varies from Corporation to corporation with a number between eleven and seventeen members. Several factors need to be considered while constituting the Board structure (Park and Shin (2003).

The Board is the bridge between the shareholders and the executives who are in-charge of the affairs of the enterprise. They are responsible for the standing of their company in the community (Donaldson and Preston, 1995). The Board is vested with the responsibility of governing the organization by establishing broad policies and objectives; selecting, appointing, supporting and reviewing the performance of the chief executive; ensuring the availability of adequate financial resources; approving annual budgets; accounting to the stakeholders for the organization's performance; setting the salaries and compensation of company management, (Clarkson, 1995).

2.3.3.3 The Management

According to Byrd and Hickman (1999), Management in any business organizational is the act of getting people together to accomplish desired goals and objectives using available resources efficiently and effectively. Management involves planning, organizing, staffing, leading or
directing and controlling an organization for the purpose of accomplishing a goal and they are headed by the chief executive officer (CEO), (Bilimoria, 1997). The CEO is appointed by the Board and reports to the board of directors. Effective top managers are people who see the business as a whole, and can balance the present needs of the business against the future needs, who can make sound timely decision (Johnson and Whittington, 2007).

The Corporate Governance framework should ensure strategic guidance of the company, effective monitoring of management by the Board and the Board’s accountability to the company and to all shareholders (Johnson and Whittington, 2007). It is the Boards responsibility to monitor the managerial performance in order to ensure efficiency and effectiveness of the business. The CEO delegates responsibility for the performance to the senior executive officers through a performance contract and replicates the same to subordinates. This would ensure that individual responsibility for management decisions is established and that individuals are accountable for their actions in the organization (Dryel, 1988).

2.4 Corporate Governance Variables Under review

In determining the effect of corporate governance practices on the financial performance, five corporate governance variables was selected; Size the Board, Independence of the Board, Corporate disclosure, and Ownership structure, Audit Committee.

2.4.1 Size of the Board

According to Donaldson and Preston (1995), Board of Directors is a group of individuals that are elected as, or selected in a predetermined criteria to act as, representatives of the stockholders to establish corporate management related policies and to make decisions on major company issues. Such issues include the hiring/firing of executives, dividend policies, options policies and executive compensation. Every public company must have a board of directors. In general, the board makes decisions on shareholders' behalf. Most importantly, the board of directors should be a fair representation of both management and shareholders' interests; too many insiders serving as directors will mean that the board will tend to make decisions more beneficial to management. On the other hand, possessing too many independent directors may mean management will be left out of the decision-making process and may cause good managers to face frustration (Prevost and Hossain, 2002).
Human beings work best in groups of a certain size and the size varies from board to board, depending on factors such as the type of organization, the asset size, the board culture and the nature of its work. A board of four might be perfectly suitable for a family foundation, for example, but unheard of for a community or public foundation (Heimovics and Herman, 1990). Over the years a number of studies have been conducted on the effectiveness of group decision making. One such study by Hillman and Paetzold, (2000) determined that the optimum size for a decision-making group was seven people and that for each person added above this, the group’s decision making effectiveness was reduced by 10%. Another study by Kemei (2006) found that the most effective number was five, but then noted that the effectiveness of the group decision making in groups between five and eight neither increases nor decreases. Drawing from these studies, it would seem that the ideal board size as far as human decision making is somewhere between five and eight.

As corporations grow in size and complexity the board will also grow (Demsetz and Lehn 2005). Specifically they noted that the complexities of the new regulatory environment had a tendency to increase the size of boards. This same study indicated that corporations increasing the complexity of their operations by introducing new product lines or expanding into new territories had a tendency to increase the size of corporate boards. Also impacting the size of public corporation boards has been activist investors who have shown an interest in increasing the percentage of independent outside directors on corporate boards.

According to Demsetz, and Lehn, (2005) the board itself needs to determine the right size, the board needs to sit down and carefully examine its own situation and determine an appropriate size. Before settling on a final number, the board should evaluate two final conditions; can they carry out all of their functions, including committee work, without overburdening the individual volunteer board members and secondly, do they allow all board members to stay personally involved and interested in the activities of the board. If the board can answer “yes” to both of these questions, you have probably arrived at the right number for your board that enhances firm’s performance (Demsetz, and Lehn, 2005).
directors is to ensure that the board includes directors who can effectively exercise their best judgment for the exclusive benefit of the company by making sure that their judgment is not clouded by real or perceived conflicts of interest (www.cma.or.ke.)

According to Jebet (2001) the measure of independency of the board is defined by the proportion of independent directors to the total number of directors in the board with no business or contractual relationship with the firm other than their role as director. For the purpose of this study, for each company, the researcher shall obtain the total number of directors from which the independent directors shall be identified at a given point in time.

2.4.3 Corporate Disclosure

As a result of the post-Enron heightened awareness of the economic benefits of good corporate governance (CG) and transparency and disclosure (T&D), many countries have been increasing their mandatory disclosure requirements through new laws and regulations, (Ikiara, 2010). In addition, most companies have adopted additional voluntarily disclosures.

In the United States of America Corporate Governance Disclosure (CGD) gained momentum after adoption of Sarbanes Oxley Act 2002 in acted after collapse of Enron. In Kenya, CGD originated from Companies Act Cap 486. Subsequent legislations such as Capital Market Act and Guidelines (2002), Banking Act, Retirement Benefit Authority Act, State Corporations Act and other standards such International Financial Reporting Standards (IFRS) have emphasized on specific disclosure issues required of the reporting entities (Kemei, 2006). Corporate governance practices have gained momentum in Kenya with key regulators such as Central Bank of Kenya, Capital Market Authority and Retirement Benefits Authority leading compliance crusade. It is now mandatory for newly appointed directors in state corporations to attend a five day corporate governance training offered by Centre for Corporate Governance (Jebet, 2001).

Full disclosure and transparency of financial information are vital components of the CG framework and are regarded as an important indicator of quality make. Sanda and Garba (2005) provide both theoretical and empirical evidence that the public sharing of financial and analyst report and market transparency has enhance factor productivity and economic growth in 30 countries in Europe. The researcher concluded that timely and adequate disclosure of the operating and financial performance
of the firm and its corporate governance practices related to its ownership, board, and management structures and processes is critical to regulators and other stakeholders.

According to Jebet (2001), the measure of corporate disclosure defines the proportion of corporate governance issues disclosed out of the average thirty items. To fulfill the research objectives, the researcher shall identify sixteen corporate governance disclosures (see appendix 2) against which the disclosures by the selected companies shall be compared.

2.4.4 Ownership Structure

Balasubramaniam, (1999) defines ownership structure as the distribution of equity with regard to votes and capital or the identity of the equity owners. These structures are of major importance in corporate governance because they determine the incentives of managers and thereby the economic efficiency of the corporations they manage. Business organizations are owned by individuals commonly referred to as shareholders. The numbers of shareholders may vary from one business to another depending on the registration status and size of the business (Becht et al, 2005).

According to Bilimoria (1997), concentrated and owner controlled firms are better monitored and motivated leading to better performance. The principal-agent model by Jensen and Meckling, (1976) suggests that managers are less likely to engage in strictly profit maximizing behavior in absence of the strict monitoring by shareholders. Therefore if owner controlled firms are more profitable than manager-controlled firms, it would seem that insiders systems have an advantage in that they provide better monitoring which lead to better performance.

Once concentration level reach very high, it is not clear whether more monitoring will continue to improve things and could actually work in the opposite direction. Cadbury (1992), observed that at low level of concentration, performance increases as concentration increases, but then declines as concentration levels keep on increasing. Furthermore, whether or not owner controlled firms outperform manager controlled firms may depend not only on initial level of ownership concentration but also on the industry in question. A study by Crutchley and Hansen (1999), established that whether or not owner controlled firms outperform manager controlled
firms does indeed depend on the type of industry. They argue that the superior performance that
the owner controlled firms holds in industries with relatively low assets but no difference in
industries with high assets. This suggests that the nature of the firm’s investments and production
decisions influence the asymmetry of information between principal and agent. Thus, large
shareholders will be less effective in high asset specificity industries.

According to Jebet, (2001) measuring the ownership structure is done on two aspects; first, it is
on investors where it defines the number of shareholders holding more than 3% of the ownership
structure in the firm. The second measure is that of Management ownership where a binary
variable of is given if management owns more than 3% of company shares. For the purpose of
this study, the researcher shall establish the total number of shares in each company at a given
point in time and compute the percentage of shares owned by insiders for the same period.

2.4.5: The Governance Role of Audit Committees

The audit committee’s role has come under scrutiny in recent years. In response, both minimum
qualification requirements for audit committee membership and required public disclosure over
audit committee processes have increased (Carcello and Neal, 2011). In light of Enron scandal
and other similar situations including the economic crisis that started in 2008, there has been an
increased focus on the role of the audit committee and the information disclosed by companies.
Clearly, the audit committee’s role in ensuring accurate and transparent disclosure is more
difficult and challenging than ever given increased expectations by shareholders, regulators, and
other stakeholders; heightened scrutiny when things go wrong; more responsibility for risk
management; and more focus on the need for fraud prevention, (Gakuo, 2003).

The most important aspects of establishing and maintaining an effective audit committee is to
make sure that the committee members are suited to perform their duties and they meet regularly
to chart the way forward (Carcello and Neal, 2011). Audit committee must consist of minimum
of three directors each of who is Independent and financially literate. A director is considered
independent if he or she has no relationship to the company that would interfere with judgment
in carrying out his or her responsibilities.
According to Jebet, (2001), evaluating the effectiveness of the committee comprises of three measurements. First, there is the Audit experience where a binary variable measuring financial expert equal to 1 if one member is a financial expert, otherwise the score is zero. Secondly, to get the Independence of the committee, a binary variable measuring proportion of independent directors equal to 1 if majority of members are independent otherwise the score is zero. The third and last measure is confirm the existence of the audit charter where a binary variable measuring existence of audit charter equal to 1 is given if the audit charter exist otherwise a score of zero is awarded. For the purpose of this study, the researcher shall establish for each company the number of directors in the Board Audit Committee at a given point in time from which those directors who are independent and financially literate shall be identified.

2.5. Empirical Studies on Corporate Governance and Financial Performance

A study carried out by Mat-Nor and Redzuan (1999), to establish relationship between the market share prices of listed public companies and corporate governance practices in Malaysia found that investors would a pay a premium of between 18% to 25% for shares in a company with “good” corporate governance as opposed to poorly governed company with the similar financial performance. Similar study by Mayer (1997) concluded that corporate governance rating is positively correlated with firm value. They discovered that investment strategy that bought companies with high corporate governance rating and sold short companies with low rating would have gained 12% annualized abnormal returns for the same period.

Sanda and Garba (2005) argue that the expected rate of return should compensate the investors for expected monitoring, auditing and other private costs associated with different corporate governance mechanisms. In their model strong corporate governance mechanisms in the firm reduce the expected return on equity to the extent that it reduces shareholders monitoring and auditing costs. Becht, and Roell, (2005) related Gov-Score, a composite measure of 52 factors encompassing eight governance categories, to five measures of performance using Computed statistics and established that better governed firms are more profitable, more valuable, less risky, less volatile, and pay out more cash to their shareholders.

Ejiofor (2009) did a study on the relationship between ownership concentration and firm performance with the case of stocks listed on the New York stock exchange. The study
confirmed no significant correlation between ownership concentration and profit rates for 217 out of the 250 companies that were studied. A similar study by Dryel (1988) on the effects of board composition and ownership structure and board composition on the financial performance of listed companies on the Johannesburg Stock exchange reported a positive relationship of Tobin's Q with board member ownership for 26 companies out of 30 firms studied, and found evidence of an inverted U-shaped relationship between the degree of ownership concentration and profitability.

Hillman and Paetzold (2000,) did a survey on the voluntary formation of audit committees to identify factors affecting the decision to create an audit committee directly responsible for overseeing the financial reporting process. The study established that larger companies, which were audited by very large auditing companies, and which had bigger boards with a greater representation of outside directors, were more likely to voluntarily form an audit committee. The study also document that the presence of an audit committee was associated with fewer incidences of financial reporting problems as entities with more reliable financial reporting, such as those without material errors, irregularities and illegal acts, were significantly more likely to have audit committees.

The study by Kemei (2006) on corporate governance practices and performance of Small Scale Tea Industry in Kenya confirmed a positive correlation between the corporate governance and financial performance or other form of performance. The study however was not conclusive as to the level of positive or negative correlation between corporate governance and organizational performance. The study also established that Small Scale Tea Industries Practiced good corporate governance and that good corporate governance had some positive effects on the level of financial performance.

Galebu (2007) examined the effect of corporate governance on the performance of firms in Africa by using both market and accounting based performance measures. Unique data from 103 listed firms drawn from Ghana, South Africa, Nigeria and Kenya covering the five year period 1997-2001 was used and analysis done within the dynamic panel data framework. Results indicated that the direction and the extent of impact of governance was dependent on the
performance measure being examined. Specifically, the findings showed that large and independent boards enhance firm value and that combining the positions of CEO and board chair had a negative impact on corporate performance. The study also established that the CEO’s tenure in office enhanced a firm’s profitability while board activity intensity affected profitability negatively. The size of audit committees and the frequency of their meetings had positive influence on market based performance measures and that institutional shareholding enhanced market valuation of firms. Finally, the study also pointed out that both country and sector characteristics influenced the impact of governance on corporate performance. For enhanced performance of corporate entities, the study recommended a clear separation of the positions of CEO and board chair and also to maintain relatively independent audit committees.

2.6: Conceptual Framework

The following was the independent, dependent and intervening variables that the researcher concentrated on in the literature review.

\[ \text{Size of the Board} \rightarrow \text{Corporate Governance Disclosure} \rightarrow \text{Audit Committees} \rightarrow \text{Financial Performance} \]

\[ \text{Independent Variables} \]

Source (Author, 2012)

\[ \text{Dependent Variable} \]

1. Government Policies
2. Macroeconomic variables
3. Production Technology

\[ \text{Intervening variables} \]

\text{study model adopted is the regression model as indicated the following form;}

30
\[ Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \varepsilon \]

Where: \( Y \) = Financial performance as measured by the Net Operating Income, Net Profit after Tax, Return on Assets and Return on Equity.

\( \beta_0 \) = Constant term

\( \beta_1, \beta_2, \beta_3, \beta_4, \beta_5 \) = Beta coefficients,

\( X_1 \) = Size of the Board

\( X_2 \) = Independent Directors

\( X_3 \) = Corporate Governance Disclosure

\( X_4 \) = Ownership structure

\( X_5 \) = Audit committee

\( \varepsilon \) = the standard error term.

2.6.1 Size of the Board

Board of Directors is a group of individuals that are elected as, or selected in a predetermined criteria to act as, representatives of the stockholders to establish corporate management related policies and to make decisions on major company issues. Such issues include the hiring/firing of executives, dividend policies, options policies and executive compensation.

2.6.2 Independent Directors

An independent director as an individual who is independent in character and judgment and not having any material relationship with the company beyond his/her directorship directly or as a partner, shareholder, or officer of an organization that has a “material” relationship with the company.

2.6.3 Corporate Governance Disclosure

Companies are required to transparently disclose their corporate governance structures, processes and issues faced at the time of reporting. Organizations need to demonstrate their authentic commitment to these values in order to create and sustain the confidence of investors, stakeholders and society as a whole.
2.6.4 Ownership Structure
Ownership structure refers to the distribution of equity with regard to votes and capital or the identity of the equity owners. The structures are of major importance in corporate governance because they determine the incentives of managers and thereby the economic efficiency of the corporations they manage.

2.6.5 Audit Committee
The audit committee's role has come under scrutiny in recent years. In response, both minimum qualification requirements for audit committee membership and required public disclosure over audit committee processes have increased.

2.7 Intervening Variables
According to Wanyande (2001), an intervening variable is a hypothetical internal state that is used to explain relationships between observed variables, such as independent and dependent variables, in an empirical research. The intervening variable facilitates a better understanding of the relationship between the independent and dependent variables when the variables appear to have a definite connection (Wainaina, 2002). To accomplish the research objectives of the study, the researcher identified three intervening variables that includes; government policies, macroeconomic variables and the level of the production technology.

2.7.1 Government policies
After the Great Depression of the 1930s, Keynes showed that government policies could affect business. According to Keynes, if a government imposes more taxes and duties on a particular sector than is justified by its profit margin, it would go down or the businessmen in it can lose their interest in the sector and can give up their business (Alchian and Demsetz, 1972). Similarly, tax and duty exemption for a particular sector would encourage businessmen to invest in it. As a result the sector will grow. If a country's monetary policy ensures availability of loans at reasonable rates, investment will go up. The government policy of a country depends upon its political culture. It can also vary depending on the form of government such that policies in a communist country will be different from that in a democracy or monarchy (Galebu, 2007).
The government policy in a politically stable country will be different from an unstable country. In a stable political system, a government can take sustained business-friendly decisions to strengthen local business (Ikiara, M 2010). The government, in this situation, gets the help of the opposition. But in an unstable political system in which the opposition boycotts parliament and takes to street agitations businesses and investment would suffer. In such a negative political culture, a country cannot have a sustained business-friendly environment or policy. In an unstable system, a government finds it difficult to maintain law and order which affects the business environment. It hampers business. Foreign investors do not invest in such an environment.

2.7.2 Macroeconomic Variables

According to Alchian and Demsetz (1972), macro-economy is an aggregate picture of an entire economic environment. Data on classified activities, including consumer spending, inflation, interest rates as well as the hiring rates of employees by private sector businesses, is compiled into averages and analyzed to determine the economy's overall financial health. Kemei (2006), postulates that there are several key variables that are measured in a macroeconomic analysis. These variables include economic output or gross domestic product (GDP), the unemployment rate, the inflation rate and the interest rate.

According Jebet, (2001), Interest rates are a reflection of the risk of borrowing. Lending rates of commercial banks and the financial policy of a government of the day can affect the economy. If interest rate rises, investment falls because businessmen would not borrow at unviable rates.

The inflation rate measures changes in the average price level (Kemei, 2006). A price index is used to measure these fluctuations. The most commonly known index measure of inflation is the Consumer Price Index (CPI). This index measures average retail prices that consumers pay. A high or increasing CPI indicates the existence of inflation. Higher prices tend to decrease overall consumer spending, which in turn leads to an overall decrease in the Gross Domestic Product (GDP).

Economic output or income is measured in terms of the Gross Domestic Product (GDP). The income obtained from GDP is measured by adding consumer spending, private investment,
government spending and net exports (Kemei, 2006). Economic analysts arrive at net exports by subtracting the country's total imports from its total exports. GDP reflects the total income earned from internal factors of production (Jebet, 2001). A higher GDP tends to indicate a more economically solvent nation.

2.7.3 Production Technology

According to Ikiara (2010), technology is the knowledge of using tools and machines to do tasks more efficiently. Technology today has a great impact on production. Advancement in technology makes production easier, quicker and at a low cost. Technology has a great impact on output in any given business organization or in industrial production because when technology advances so does the production of units increase which causes the average variable cost to decrease.

With the advancement of technology today the decreasing variable cost is also reflected by the labor as machinery is replacing human labor. By buying new technology and hiring fewer workers a small firm will receive more production of units on average at a reduced cost
CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction
This chapter details the blueprint that was followed in this research to establish effects of corporate governance on financial performance of sugar firms in Kenya. The specific areas covered include the research design, population and sample size for the study, data collection as well as the data analysis.

3.2 Research Design
This was a causal study that relied on control factors. Causal studies are concerned with learning why, that is, how one variable produces changes in another (Cooper & Schindler, 2003). The study used the audited financial statements for seven sugar firms that were operational for seven years between the year 2005 and 2011, (See Appendix I). The study employed a census approach that requires the researcher to carry out a survey on all the members of the target population.

A census study was suitable as it enabled the researcher to critically analyse the data to find the insight that would otherwise not be discovered if another research design was employed. The study sought to establish and explain the relationships among variables, in this case the researcher shall compare the financial performance of the selected firms for the seven year period between 2005 and 2011 vis-à-vis the corporate governance practices and disclosures for respective years, the corporate governance variables used will be the measure of, Board Size, independent directors, Corporate governance disclosure, ownership structure and audit committees.

Since the study sought to establish and explain the relationship between corporate governance practices and the financial performance, a correlation analysis was employed to establish the relationship between the two variables being the corporate governance practices and the financial performance for the period under review. The dependent variable denoted by Y measured the financial performance while the independent variable denoted by X₁ was Corporate governance...
variable as measured by Board Size, independent directors, Corporate governance disclosure, ownership structure and audit committees.

3.3 Population

The population of this study consisted of seven firms that were operational in the sugar industry for seven years between 2005 and 2011. Complete audited financial statements for the firms were obtained from the Kenya Sugar Board (KSB) where all registered firms in the sugar industry make quarterly reports on their financial operations.

3.4 Sample Size

Currently, there are eleven operating sugar companies as per the statistics at the Kenya Sugar Board. Out of the eleven companies, only seven were operational by the year 2005. The study analyzed the financial performance of firms for a period of seven years from the year 2005 to 2011. Based on the above information, the researcher used all the seven companies that were operational as at 2005 which is the base year for the research.

3.5 Data Collection

The study used secondary sources of data from published audited annual reports and financial statements for the selected firms in the sugar industry. Financial data was obtained from the Statements of Financial Position, Comprehensive Income as well as Cash flow statements relating to the selected firms for the period 2005 and 2011. For each year of study, the researcher calculated and analyzed the financial performance as measured by the Net Operating Income (NOI), Net profit after tax, Return On Assets (ROA) as well as Return On Equity (ROE). In addition to the above computations, the researcher established the following from the presented financial statements, the board size as indicated by the names of the directors for each company, the ownership structure, the composition and frequency of audit committee meetings, the independence of directors as well as the corporate governance disclosures.

3.6 Data Analysis

The financial performance of the firms for the period of review was analyzed using profitability measures. The Net Operating Income, Net profit after tax, Return on Assets (ROA) and Return on Equity (ROE) were computed for the selected population. Data collected was presented using
tables, figures and graphs to analyse the trend. The researcher then established the relationship between corporate governance and financial performance using correlation analysis. Correlation is a statistical measurement of the relationship between two variables. Possible correlations range from $+1$ to $-1$. A zero correlation indicates that there is no relationship between the variables. A correlation of $-1$ indicates a perfect negative correlation, meaning that as one variable goes up, the other goes down. A correlation of $+1$ indicates a perfect positive correlation, meaning that both variables move in the same direction together (Cooper & Schindler, 2003).

A regression analysis was conducted to establish the relationship and variation between dependent and independent variables. Multivariate regression analysis was used to establish the relationship between the dependent and independent variables. The dependent variables being the financial performance as denoted by $Y$ against the independent variables being the Board Size, Independent directors, Corporate governance disclosure, ownership structure and audit committee respectively. The regression model to be adopted took the following form;

$$Y = \beta_0 + \beta_1X_1 + \epsilon$$

Where: $Y =$ Financial performance as measured by the Net Operating Income, Net Profit after Tax, Return on Assets and Return on Equity.

$\beta_0 =$ Constant term

$\beta_1 =$ Beta coefficients,

$X_1 =$ Corporate governance variable as measured by the Size of the Board, Independence of directors, Corporate governance disclosures, ownership structure and audit committee.

$\epsilon =$ the standard error term.

To establish the strength of the model, the researcher conducted an ANOVA test. This was to help in establishing whether the model is significant in explaining the relationship between the corporate governance practices and financial performance of firms. A significance test at 5% and confidence level was conducted at 95% to measure the significance of the factors in explaining the changes in the dependent variables.
CHAPTER FOUR
DATA ANALYSIS, FINDINGS AND DISCUSSIONS

4.1 Introduction
This chapter presents the analysis and findings of the study as set out in the research objective and research methodology. The study findings are presented on the effects of corporate governance practices on financial performance of sugar firms in Kenya. The data was gathered exclusively from the secondary data on the financial performance of the selected companies for the review period. For each set of data to be analyzed, an industrial average was obtained for the researcher to establish a trend across the industry.

4.2 Findings of the study.

4.2.1 Return On Equity.

Table 4.1: Analysis of the Return on Equity

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 (Constant)</td>
<td>-5.656</td>
<td>8.703</td>
<td>-.650</td>
<td>.633</td>
</tr>
<tr>
<td>Financial Literacy</td>
<td>0.175</td>
<td>.310</td>
<td>2.245</td>
<td>3.054</td>
</tr>
<tr>
<td>Board Size</td>
<td>.034</td>
<td>.028</td>
<td>.826</td>
<td>1.209</td>
</tr>
<tr>
<td>Ownership</td>
<td>1.161</td>
<td>.666</td>
<td>2.408</td>
<td>1.743</td>
</tr>
<tr>
<td>Disclosure</td>
<td>8.792</td>
<td>11.831</td>
<td>.682</td>
<td>.743</td>
</tr>
<tr>
<td>Board Independence</td>
<td>2.45</td>
<td>0.254</td>
<td>1.58</td>
<td>0.25</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Return on Equity
From the results above, it is clear that financial literacy of audit committee members, corporate governance disclosure and board independence were positively and significantly related with Return on Equity (ROE) as the p-value for the three variables are all less than 0.05. The results also showed that the Board size and ownership structure did not have a significant effect on the Return on Equity (ROE) of the selected sugar companies since the p-values of the variables were all greater than 0.05 at 5% level of significance.
4.2.2 Return on Assets

Table 4.2: Analysis of the Return on Assets

<table>
<thead>
<tr>
<th>Model</th>
<th>B</th>
<th>Std. Error</th>
<th>Beta</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>-5.656</td>
<td>8.703</td>
<td>-.650</td>
<td>.633</td>
<td></td>
</tr>
<tr>
<td>Financial Literacy</td>
<td>0.175</td>
<td>.310</td>
<td>2.245</td>
<td>3.054</td>
<td>.001</td>
</tr>
<tr>
<td>Board Size</td>
<td>.034</td>
<td>.028</td>
<td>.826</td>
<td>1.209</td>
<td>.440</td>
</tr>
<tr>
<td>Ownership</td>
<td>1.161</td>
<td>.666</td>
<td>2.408</td>
<td>1.743</td>
<td>.332</td>
</tr>
<tr>
<td>Disclosure</td>
<td>8.792</td>
<td>11.831</td>
<td>.682</td>
<td>.743</td>
<td>.013</td>
</tr>
<tr>
<td>Board Independence</td>
<td>2.45</td>
<td>0.254</td>
<td>1.58</td>
<td>0.25</td>
<td>0.002</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Return on Assets

Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.988</td>
<td>.977</td>
<td>.884</td>
<td>.02268</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), Disclosure, Board Size, Financial Literacy, Ownership and Board Independence

ANOVA

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>Df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>.022</td>
<td>4</td>
<td>.005</td>
<td>10.505</td>
<td>.227</td>
</tr>
<tr>
<td>Residual</td>
<td>.001</td>
<td>1</td>
<td>.001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>.022</td>
<td>5</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source (Research findings)

a. Predictors: (Constant), Disclosure, Board Size, Financial Literacy, Ownership and Board Independence
b. Dependent Variable: Return on Assets
The results show that financial literacy of audit committee members, corporate governance disclosure and board independence are positively and significantly related with Return on Assets (ROA) as the p-value for the three variables were all less than 0.05 at 5% level of significance. The results also indicate that the Board size and ownership structure did not have a significant effect on the Return on Assets (ROA) of the selected companies in the since the p-value of the variables were all greater than 0.05 at 5% level of significance.

4.2.3 Net Operating Income

Table 4.3: Analysis of the Operating Income

<table>
<thead>
<tr>
<th>Coefficientsa</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model B Std. Error Beta</td>
<td>t</td>
<td>Sig.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 (Constant)</td>
<td>-33398340.194</td>
<td>9706716.705</td>
<td>-3.441</td>
<td>.180</td>
</tr>
<tr>
<td>Financial Literacy</td>
<td>2559196.344</td>
<td>345364.015</td>
<td>2.241</td>
<td>.0065</td>
</tr>
<tr>
<td>Board Size</td>
<td>177573.564</td>
<td>31645.073</td>
<td>1.577</td>
<td>.112</td>
</tr>
<tr>
<td>Ownership</td>
<td>4838008.522</td>
<td>743012.892</td>
<td>3.700</td>
<td>.097</td>
</tr>
<tr>
<td>Disclosure</td>
<td>46533810.189</td>
<td>13195498.148</td>
<td>1.332</td>
<td>.016</td>
</tr>
<tr>
<td>Board Independence</td>
<td>20065.235</td>
<td>14568.258</td>
<td>1.235</td>
<td>.006</td>
</tr>
</tbody>
</table>

Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.998a</td>
<td>.996</td>
<td>.980</td>
<td>25299.18174</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Net Operating Income

a. Predictors: (Constant), Disclosure, Board Size, Financial Literacy, Ownership and Board Independence
ANOVA

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>162079963454.062</td>
<td>4</td>
<td>40519990863.515</td>
<td>63.308 .094</td>
<td></td>
</tr>
<tr>
<td>Residual</td>
<td>640048596.630</td>
<td>1</td>
<td>640048596.630</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>162720012050.692</td>
<td>5</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source (Research findings)

a. Predictors: (Constant), Disclosure, Board Size, Financial Literacy, Ownership and Board Independence

b. Dependent Variable: Net Operating Income

From the above analysis, the financial literacy of audit committee members, corporate governance disclosure and board independence were positively and significantly related with Net operating Income (NOI) as the p-value for the three variables were all less than 0.05 at 5% level of significance. The results also indicated that the Board size and ownership structure did not have a significant effect on the Net operating Income (NOI) of the selected companies since the p-value of the variables were all greater than 0.05 at 5% measure of significance.

4.2.4 Net Profit after Tax

Table 4.4: Analysis of the Net Profit after Tax

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
</tr>
<tr>
<td>-------------</td>
<td>-----------------------------</td>
<td>---------------------------</td>
</tr>
<tr>
<td>l (Constant)</td>
<td>808967694.440</td>
<td>95591048.243</td>
</tr>
<tr>
<td>Financial Literacy</td>
<td>13580217.411</td>
<td>3401119.993</td>
</tr>
<tr>
<td>Board Size</td>
<td>-2403325.746</td>
<td>311638.406</td>
</tr>
<tr>
<td>Ownership</td>
<td>-46391911.057</td>
<td>7317137.539</td>
</tr>
<tr>
<td>Disclosure</td>
<td>1082637928.103</td>
<td>129948317.064</td>
</tr>
<tr>
<td>Board Independence</td>
<td>145848.23</td>
<td>145698.21</td>
</tr>
</tbody>
</table>
Coefficients

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>1 (Constant)</td>
<td>808967694.440</td>
<td>95591048.243</td>
<td>8.463</td>
<td>.075</td>
</tr>
<tr>
<td>Financial Literacy</td>
<td>13580217.411</td>
<td>3401119.993</td>
<td>1.395</td>
<td>.399</td>
</tr>
<tr>
<td>Board Size</td>
<td>-2403325.746</td>
<td>311638.406</td>
<td>-2.504</td>
<td>.082</td>
</tr>
<tr>
<td>Ownership</td>
<td>-46391911.057</td>
<td>7317137.539</td>
<td>-4.162</td>
<td>.100</td>
</tr>
<tr>
<td>Disclosure</td>
<td>1082637928.103</td>
<td>129948317.064</td>
<td>3.636</td>
<td>.036</td>
</tr>
<tr>
<td>Board Independence</td>
<td>145848.23</td>
<td>145698.21</td>
<td>-4.256</td>
<td>.017</td>
</tr>
</tbody>
</table>

- Dependent Variable: Net Profit After Tax

Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.997a</td>
<td>.995</td>
<td>.974</td>
<td>2.49145E5</td>
</tr>
</tbody>
</table>

- Predictors: (Constant), Disclosure, Board Size, Financial Literacy, Ownership

ANOVA

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>Df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Regression</td>
<td>11759242398144.520</td>
<td>4</td>
<td>2939810599536.130</td>
<td>47.361</td>
<td>.109a</td>
</tr>
<tr>
<td>Residual</td>
<td>62072993269.755</td>
<td>1</td>
<td>62072993269.755</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>11821315391414.273</td>
<td>5</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source (Research findings)

- Predictors: (Constant), Disclosure, Board Size, Financial Literacy, Ownership and Board Independence.
- Dependent Variable: Net Profit After Tax

At 5% level of significance, the financial literacy of audit committee members, board independence as well as disclosure of corporate governance had a positive and significant impact on the Net profit after tax of the selected companies in the sugar industry as the p-values of the
respective variables were less than 0.05. The results also indicate that the ownership structure and board size did not impact on the net profit after tax of the selected companies since their p-values were greater than 0.05 at 5% level of significance.

4.2.5 Net Profit Margin

Table 4.5: Analysis of the Net Profit Margin.

<table>
<thead>
<tr>
<th>Coefficientsa</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model</td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>1 (Constant)</td>
<td>118.651</td>
<td>161.112</td>
<td>.736</td>
<td>.596</td>
</tr>
<tr>
<td>Financial Literacy</td>
<td>2.540</td>
<td>5.732</td>
<td>.971</td>
<td>.443</td>
</tr>
<tr>
<td>Board Size</td>
<td>-.372</td>
<td>.525</td>
<td>-1.441</td>
<td>-708</td>
</tr>
<tr>
<td>Ownership</td>
<td>-10.030</td>
<td>12.333</td>
<td>-3.348</td>
<td>-.813</td>
</tr>
<tr>
<td>Disclosure</td>
<td>165.145</td>
<td>219.019</td>
<td>2.064</td>
<td>.754</td>
</tr>
<tr>
<td>Board Independence</td>
<td>54680.845</td>
<td>63.587</td>
<td>2.365</td>
<td>0.254</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Net Profit Margin

Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.891a</td>
<td>.793</td>
<td>-.033</td>
<td>.41992</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), Disclosure, Board Size, Financial Literacy, Ownership and Board Independence

ANOVAb

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>Df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Regression</td>
<td>.677</td>
<td>4</td>
<td>.169</td>
<td>.960</td>
</tr>
<tr>
<td></td>
<td>Residual</td>
<td>.176</td>
<td>1</td>
<td>.176</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>.854</td>
<td>5</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

44
Source (Research findings)

a. Predictors: (Constant), Disclosure, Board Size, Financial Literacy, Ownership and Board Independence
b. Dependent Variable: Net Profit Margin

Analysis of the above indicates that the financial literacy of audit committee members, board independence as well as disclosure of corporate governance had a positive and significant impact on the Net profit margin of the selected companies since the p-values of the respective variables measured at 5% level of significance were all less than 0.05. The results also indicate that the ownership structure and board size did not impact on the net profit margin of the selected companies since the p-value is greater than 0.05 as measured at 5% level of significance.
CHAPTER FIVE:
SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction
The chapter presents a summary of the results on the effects of corporate governance practices on financial performance of sugar firms in Kenya; the study gives recommendations on what management of sugar companies in Kenya can do to improve their financial performance following the concept of corporate governance and disclosure practices. The recommendations are presented based on the objective of the study after which recommendations for further studies are drawn.

5.2 Summary of Interpretations.
The study aimed at establishing whether corporate governance practices and disclosures affect the financial performance of the sugar companies in Kenya. The objective of the study was to determine the effects of corporate governance practices on financial performance of sugar firms in Kenya. From the financial statistics discussed in chapter four above, the study established that financial performance of Sugar companies in Kenya were affected by the financial literacy of the Board Audit Committee members, Independence of the Board members as well as the level of disclosures of the corporate governance practices by each company at a given point in time. The study also confirmed that the ownership structure and the size of the Board did not directly affect the financial performance of the selected sugar factories in Kenya.

The research confirmed consistent results on the effects of the corporate governance variables selected on the companies’ financial performance as measured by the ROE, ROA, NOI, Net Profit after tax and Net Profit margin. In particular, the study confirmed that financial performance of companies improve with increase in financial literacy of the Board Audit Committee, independence of the Board Members as well as the increase in the disclosure of the corporate governance practices at any given point in time. The study also confirmed that the financial performance of the sugar companies were not be directly affected by the size of the Board and the company’s ownership structure.
5.3 Interpretations

The financial performance of sugar companies was directly affected by the independence of directors. This is because the decisions on the day to day running of an organization shall be directly influenced by the relationship between the organization and the person making the decision. An independent director will exercise their best judgment for the exclusive benefit of the company as a whole without any real or perceived conflicts of interest as compared to a dependent director whose decisions shall be impaired due to the conflict of interest.

Increase in the corporate governance practices and disclosures by the sugar industry directly led to an increase in the financial performance of the respective company. This is because the disclosures and transparency of financial information are vital components of the corporate governance framework and are regarded as an important indicator of quality of decisions made by management. An increase in the corporate governance disclosures also leads to an increase in the awareness of what is happening in the company to the outside stakeholders leading to increased chances of winning the confidence of potential investors and new customers to the company.

Financial literacy of the Board Audit Committee members directly affected the financial performance of the selected companies in a positive way. This is because financial literacy enables the director to critically analyze and evaluate any financial decisions before adoption by the company. As a result only sound decisions and projects shall be adopted by the organization leading to a positive impact on the financial performance of any company. On the other hand, if the Board Audit committee is composed of financial illiterate members, it shall be a challenge for them to identify and critically evaluate any financial decision leading to increased chances of poor investment decisions that would result to negative cash flows in the company.

The ownership structure of the selected companies did not have a positive and direct influence on the financial performance of the company. This is attributed to the fact that decision making process in an organization is not necessarily vested with the owners but with the people mandated or experts employed to do that otherwise called managers. As a result of this the financial performance of any organization shall be largely depend on the quality of its managerial or managerial decisions organ other than the owners. Most organizations in today’s business
world are established by owners who in turn hand over the management of the company affairs to a team of experts in a particular field of specialization. In such scenarios, the owners do not in any way interfere with the responsibilities of the managers hence financial performance of the companies is not affected by the ownership structure.

The study also confirmed that the size of the Board do not directly affect the financial performance of companies. This is because size varies from board to board, depending on factors such as the type of organization, the asset size, the board culture and the nature of its work. A small organization needs a small board size to be effective in the execution of its roles and responsibilities. An increased size of the board for any organization does not only lead to an increase in the organizational expenses but also inefficiencies in the decision making process. In addition, the board members are not directly involved in the day to day running of the organization as this is the duty of the management who are employed to make decisions on the day to day running of the organization.

5.4 Conclusions

The study concludes based on the data presentations in chapter four and the summary of the findings above that the financial literacy of the Board Audit committee members directly affects the financial performance of sugar companies in Kenya. This is because the financial literacy enables them to critically analyze and evaluate any financial investment decisions before approving it for adoption by the company.

The study also concluded that the independence of directors have a direct impact on the financial performance of sugar companies in Kenya. This is because the independence of directors will determine the kind of decisions they make for the organization. An independent director will exercise his or her best judgment for the company as a whole without any conflicts of interest as compared to a dependent director whose decisions shall be impaired due to the conflict of interest.

The study concluded that an increase in disclosure of corporate governance practices had a positive impact on the financial performance of sugar companies in Kenya. This is because an
Increase in disclosures and transparency of financial information are vital components of the corporate governance framework and are important indicator of quality of decisions made by management. The disclosures also lead to an increase in stakeholder awareness of the developments within the company thereby winning the potential investors and new customers.

The study confirmed that the ownership structure does not directly affect the financial performance of sugar companies in Kenya. This is because most companies are managed by experts who run the day to day operations of the company on behalf of its owners who often do not interfere with the company operations. As such, it is the quality of managers employed to run the company that will largely determine its financial performance but not the owners of the company.

Finally, the study confirmed that the size of the board does not directly influence the financial performance of the company. This is because the board size of any business organization varies from board to board, depending on factors such as the type of organization, the asset size, the board culture and the nature of its work. On the other hand, an increased size of the board leads to an increase in the organizational expenditure and leads to inefficiencies in the decision making process.

5.5 Policy Recommendations

From the findings presented in chapter four and summary above, this study recommends that the Kenya Sugar Board establishes a standard guideline for disclosures of corporate governance practices in the Kenyan Sugar Industry. This is because they are involved in the formulation and implementation of all policies relating to the sugar industries in Kenya and will go along way in ensuring enhanced corporate governance practices in the sugar industry.

The study also recommends that management of Sugar firms in Kenya should invest in the corporate governance and social responsibility as a way of improving their company image on the market. This is because a positive image on the market translates to an increased goodwill for the company and will ultimately lead to an increase in the financial performance.
Management of sugar firms should emphasize on the financial literacy of audit committees as well as independence of directors serving in their boards. The study has revealed that the two aspects of corporate governance have positive influence on the financial performance of the firms and could benefit the industry if fully adopted.

5.6 Limitations of the Study

A limitation for the purpose of this research was regarded as a factor that was present and contributed to the researcher getting either inadequate information or if otherwise the response given would have been totally different from what the researcher expected. The main limitations of this study were: the data used was secondary data generated for other purposes. In addition the data availability was limited as the organizations meant to provide the data referred the researcher to their website and other reports. In some instances, the data was limited and only and the researcher worked on what was availed.

Another limitation of the study was the difference in the ownership structure of the sugar firms that were selected for the study. This is because some of the companies were government owned while others were privately owned hence difference in the reporting and other disclosures as required by the management structure and other governing acts or regulations in the country.

The study focused only on profitability ratios as a measure of financial performance. This alone may not adequately measure financial performance of the company without considering other measures like liquidity and gearing.

The study was limited to only seven sugar industries that were operational between the year 2007 and 2011. This may not give a conclusive opinion on the effects of corporate governance practices on financial performance of sugar firms in Kenya hence need to increase the sample for a more conclusive opinion on the area of study.

5.7 Suggestions for Further Studies.

This study only used profitability as a measure of financial performance; we recommend a similar study to done in the area using all the measures of financial performance for an
organization that includes liquidity ratios, debt/leverage/gearing ratios, market value and growth ratios.

With a recent increase in the number of individual private sugar industries in Kenya, the study recommends that a similar study be conducted on them to establish the effects of corporate governance practices on their financial performance.

The study further recommends that another study be done on the effects of corporate governance practices on financial performance of sugar firms in Kenya using a case study of an individual sugar company in Kenya for an insight analysis in the area.

The researcher analysed the financial performance of the selected sugar firms for a period of seven years, the study therefore recommends that further research be carried out for a longer period of time e.g. ten years to determine whether there is significant impact of corporate governance practices on financial performance of sugar companies in Kenya.

The study further recommends that another study be conducted in the same area with the use of more variables both quantitative and qualitative e.g. the use of the CAMELS ratings system to evaluate the financial performance of Sugar firms in Kenya to come up with a more comprehensive conclusion.
BIBLIOGRAPHY


Dilimoria D (1997), "Perspectives on Corporate Control: Implications for CEO Compensation”. Human Relations, (The Tavistock Institute, Ohio) 50; 7:56-78.


www.cma.or.ke, the composition, size, role and independency of the Board of Directors, (website accessed on 5th November 2012).

www.knbs.or.ke, the economic contribution of sugar industry in the country’s GDP (website accessed on 7th October 2012).


<table>
<thead>
<tr>
<th>Company</th>
<th>Ownership</th>
<th>Year Established</th>
<th>Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mumias Sugar Co. Ltd.</td>
<td>Public</td>
<td>1973</td>
<td>Mumias</td>
</tr>
<tr>
<td>Nzoia Sugar Co. Ltd</td>
<td>Government</td>
<td>1978</td>
<td>Bungoma</td>
</tr>
<tr>
<td>West Kenya Sugar Co. Ltd.</td>
<td>Private</td>
<td>1979</td>
<td>Kakamega</td>
</tr>
<tr>
<td>Butali Sugar Ltd.</td>
<td>Private</td>
<td>2010</td>
<td>Kakamega</td>
</tr>
<tr>
<td>Kibos Allied Industries Ltd.</td>
<td>Private</td>
<td>2009</td>
<td>Nyando</td>
</tr>
<tr>
<td>Chemilil Sugar Co. Ltd.</td>
<td>Government</td>
<td>1965</td>
<td>Nyando</td>
</tr>
<tr>
<td>Muhoroni Sugar Co.</td>
<td>Government</td>
<td>1966</td>
<td>Nyando</td>
</tr>
<tr>
<td>Soin Sugar Co. Ltd.</td>
<td>Private</td>
<td>2010</td>
<td>Kericho</td>
</tr>
<tr>
<td>Sukari Industries Ltd.</td>
<td>Private</td>
<td>2011</td>
<td>Ndhiwa</td>
</tr>
<tr>
<td>Sony Sugar Co. Ltd.</td>
<td>Government</td>
<td>1976</td>
<td>Awendo</td>
</tr>
<tr>
<td>Transmara Sugar Co. Ltd.</td>
<td>Private</td>
<td>2011</td>
<td>Transmara.</td>
</tr>
<tr>
<td>Miwani Sugar Company Ltd.</td>
<td>Government</td>
<td>1989</td>
<td>Kisumu</td>
</tr>
</tbody>
</table>
## APPENDIX 2: CORPORATE GOVERNANCE DISCLOSURES

<table>
<thead>
<tr>
<th>No.</th>
<th>Corporate Governance Disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Board Composition</td>
</tr>
<tr>
<td>2</td>
<td>Directors serving during the year</td>
</tr>
<tr>
<td>3</td>
<td>Committees of the Board</td>
</tr>
<tr>
<td>4</td>
<td>Qualification of Board</td>
</tr>
<tr>
<td>5</td>
<td>Role and Responsibility of the Board</td>
</tr>
<tr>
<td>6</td>
<td>Board Meetings</td>
</tr>
<tr>
<td>7</td>
<td>Ownership Structure</td>
</tr>
<tr>
<td>8</td>
<td>Complete Financial Statement</td>
</tr>
<tr>
<td>9</td>
<td>General Accounting Policies</td>
</tr>
<tr>
<td>10</td>
<td>Critical judgments in applying accounting Policies</td>
</tr>
<tr>
<td>11</td>
<td>Disclosure of major revenue items</td>
</tr>
<tr>
<td>12</td>
<td>Disclosure of major cost items</td>
</tr>
<tr>
<td>13</td>
<td>Disclosure of major debtors</td>
</tr>
<tr>
<td>14</td>
<td>Disclosure of major liabilities</td>
</tr>
<tr>
<td>15</td>
<td>Details of related party transactions</td>
</tr>
<tr>
<td>16</td>
<td>Risk management policies</td>
</tr>
</tbody>
</table>