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# The influence of Corporate Governance on Corporate Performance Among Manufacturing Firms in Kenya: A Theoretical Model

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***Abstract*** *This study discusses on the relationship between corporate governance mechanisms and corporate performance of manufacturing firms in Kenya. It argues stagnation of manufacturing sector in Kenya has come about largely as a result of corporate governance challenges in the industry which leads to poor corporate performance. The paper examines the influence of corporate governance mechanisms such as board diversity, board duality, government ownership and management ownership on corporate performance. This study contributes to the literature by demonstrating the significance of manufacturing sector in Kenya in achievement of Vision 2030 .In addition, the study demonstrate how corporate governance influences corporate performance in order to address stagnation of manufacturing sector in Kenya*

***Key words*** *Corporate Governance, Corporate Performance, Board Duality, Board Diversity, Government Ownership, Managerial Ownership And Kenya*

## 1. Introduction

Kenya Vision 2030 identifies the manufacturing sector as one of the key drivers for realizing a sustained annual GDP growth of 10 per cent(Government of Kenya, 2007). The manufacturing sector has high, yet untapped potential to contribute to employment and GDP growth. The manufacturing sector in Kenya constitutes 70 per cent of the industrial sector contribution to GDP, with building, construction, mining and quarrying cumulatively contributing the remaining 30 per cent (KIPPRA, 2013). Kenya needs to create a competitive manufacturing sector if it is to meet its ambitious goal of becoming a globally competitive and prosperous upper-middle-income country with a high quality of life by 2030(Government of Kenya, 2007).

Policy makers in Kenya appreciate that accelerated investments is required in the manufacturing sector and that the ability of the board of directors to ensure their profitability is instrumental if the country is to achieve Vision 2030's target of the manufacturing industry

delivering 30% of the GDP(Lekaram, 2014).The manufacturing sector is particularly important given the demographic structure in Kenya, which is adding more than half a million people to the labor force every year. However, the formal manufacturing sector is small, and trends are not promising. It contributed just 11 percent of Kenya's GDP in 2013 and employed a mere 280,000 people (12 percent of the 2.3 million people in Kenya's labor force).In addition, although the contribution of the manufacturing sector to GDP is in line with comparator countries, sector growth trails that of the Kenyan economy as a whole and of comparator countries(World Bank Report, 2014)

Corporate governance deals with the way in which supplier of finance to corporations assure themselves of getting a return on their investment(Shleifer & Vishny, 1997). From global perspective, corporate governance is still a hot topic among shareholders, regulators and society at large and received increased attention in the past decades(Smolo & Smajic, 2011). This is due to collapsed of big corporation such as Lehman Bros., J.P. Morgan, Morgan Stanley and others, fraudulent activities, several major corporate scandals and long-lasting economic depression that raised the questions on the suitability of existing governance practices of business firms(Mazudmer, 2013). In Kenya context , corporate governance has also gained prominence in the Kenyan context(Ekadah & Mboya, 2012).This has been caused partly by corporate failure or poor performance of public and private companies(Barako et al., 2006). In Kenya, corporate failures and regulatory initiatives have also placed corporate governance systems under closer scrutiny than ever for instance, CMC Motors and NHIF(Lekaram, 2014).The challenges of corporate governance in Kenya are yet to be fully addressed. Capital Market Steering Committee report (2014) explained that in the past few years there have been a number of governance scandals and boardroom wars among Kenya's large companies. In the face of corporate governance challenges in Kenya, manufacturing sector which is backbone of vision 2030 has stagnated. There is need to carry a research to demonstrate how corporate governance influences corporate performance in order to address stagnation of manufacturing sector in Kenya

## 2. Problem statement

Kenya Vision 2030 identifies the manufacturing sector as one of the key drivers for realizing a sustained annual GDP growth of 10 per cent(Government of Kenya, 2007). Progressive growth is key to the achievement of the government's ambitious development blueprint Vision 2030. However, the growth in manufacturing sector trails that of the overall economy, and the percentage contribution of manufacturing to GDP and merchandise exports has stagnated (World Bank Report, 2014). Growth of the sector (4.3 percent) lagged average growth of the economy (6.2 percent) between 2010 and 2013 and was slower in Kenya than in comparator countries. In addition, the sector's share of GDP declined, from 13 percent in 2006 to 12 percent in 2011 and 11 percent in 2012 and 2013(World Bank Report, 2014).

Despite the important role of manufacturing industry in achievement of vision 2030, research on how corporate governance influences corporate performance among manufacturing firms in Kenya is scanty. Few poor local studies carried out on corporate governance concentrate on firms listed at Nairobi Securities Exchange and disregards manufacturing firms (Ekadah & Mboya, 2012; Lekaram, 2014; Ongore & K'Obonyo, 2011) yet the sector is the main driver of the Kenya's economy toward achievement Vision 2030. In addition, the growth of manufacturing sector in Kenya has stagnated in the face of many corporate governance challenges threatening the achievement of Vision 2030.Further,existing

studies are restricted in scope thus for these researches a problem of generalizing the results to a whole manufacturing sector arises due to sample bias. Consequently, this study seeks to fill the foregoing knowledge gaps by examining the influence of corporate governance on corporate performance of manufacturing firms in Kenya.

**3. Justification of the Study**

The aim of Kenya Vision 2030 is to create a globally competitive and prosperous country with a high quality of life by 2030. It aims to transform Kenya into a newly-industrializing, middle-income country providing a high quality of life to all its citizens in a clean and secure environment(Government of Kenya, 2007). Kenya need to achieve and maintain its economic growth of 10% as envisaged in the national development blueprint vision 2030. However, although manufacturing sector plays a central role in Kenya's Economy, the share of the manufacturing sector in GDP has stagnated at about 10 per cent in the last few years. (Onuonga et al., 2011; Were, 2007).The sector's growth during the first medium term plan being a mere 3.16 per cent.(KIPPRA, 2013).The causes of stagnation of manufacturing sector should be investigated and resolved in order to support the country in achievement of Vision 2030.

The findings of this study will be used to influence government regulatory framework and policy in order to grow the manufacturing sector to enhance the sector performance and support the achievement of country's vision 2030. Therefore, this study is expected to influence policy decision in corporate governance and corporate performance to address problem of stagnation of manufacturing sector and support the country in achievement of Vision 2030. Specifically, the study will benefit the entire Kenyan society, the government, The Kenya Association of Manufacturers, the Capital Markets Authority, the Kenya Private Sector Alliance, institutional and individual investors.

**4. Corporate Governance and Relevant Theories**

Corporate Governance theories are important especially in monitoring the performance of the management and board. This paper examines corporate governance variables based on agency, stakeholders and transaction costs theories.

**4.1 *The Agency Theory***

Agency theory was developed by Jensen and Meckling (1976) who argued the theory refers to 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 gents to perform work. Principals delegate the running of business to the directors or managers, who are the shareholder's agents. Jensen and Meckling (1976) further specified the existence of agency costs which arise owing to the conflicts either between managers and shareholders (agency costs of equity) or between shareholders and debt holders (agency costs of debt). According to agency model, the separation of ownership and control creates an inherent conflict of interest between the shareholders (Principal) and the management (Agent) (Aguilera et al., 2008). Although managers are said to be rational, but cannot be trusted to remain faithful by always acting in the best interest of the principal since they are also presumed to be self-interested(Williamson, 1975) Therefore, managers must be controlled to avoid moral hazard using some risk-bearing and monitoring mechanisms that checkmate their deviant behaviors . Agency theory advocated for a clear separation between

decision management and control (Fama & Jensen, 1983; Jensen, 1986; Jensen & Meckling, 1976) Further, Eisenhardt (1989) elaborated that agency theory is concerned with resolving two problems that can occur in agency relationships. Agency problem that arises when the desires or goals of the principal and agent conflict and/or when it is difficult or expensive for the principal to verify what the agent is actually doing. Eisenhardt (1985) posits agency theory suggests two underlying strategies of control: behavior based and outcome based. Both strategies rely upon performance evaluation.Taking agency theory into consideration, firm performance may be indicative of an agency problem. As a consequence, enhancing corporate governance should result in increased firm performance and achievement of Vision 2030.

**4.2 Stakeholder Theory**

Stakeholders have been broadly defined as any group or individual who can affect or is affected by the achievement of the organization's objectives (Freeman, 1984).The theory argues that corporations should serve all groups or individuals who have a stake in the corporation, typically including employees, customers, suppliers, and local communities. While shareholder theory espouses the "free market" doctrine, stakeholder theory argues that the problems of free rider, moral hazards, and monopoly power inherent to the free market justify government intervention and corporate social responsibility. In the stakeholder view, corporations cannot maximize the shareholder interests at the expense of other stakeholders because doing so is neither moral nor economically efficient(Alkhafaji, 1989). According to Ayuso et al (2012) the stakeholder model proposes extending the focus of managers beyond the traditional interest group of shareholders in order to understand the needs, expectations, and values of groups previously perceived to be external to the company. In this sense, stakeholders of a firm can be defined as "individuals and constituencies that contribute, either voluntarily or involuntarily, to its wealth-creating capacity and activities, and who are therefore its potential beneficiaries and/or risk bearers (Post et al., 2002). In this evolving literature, stakeholder theory has been presented in three broad ways: descriptive, instrumental, and normative. Stakeholder theory has both normative (moral/ethical),descriptive and instrumental (profit/wealth-enhancing) implications, as dealing with stakeholders can be regarded as a responsibility to meet the legitimate claims of all stakeholders and/or as a means to maximize organizational wealth (Donaldson & Preston, 1995; Jones & Wicks, 1999).

In order to actualized board effectiveness and performance derive, the stakeholder theory advocated for large and well diversified corporate board size that accommodate and facilitate the alignment of the interest of each constituent especially those that create value to the firm(Clarkson, 1995; Evan & Freeman, 1993; John & Senbet, 1998; Zingales & Rajan, 1998) .As a consequence, enhancing stakeholders participation in corporate governance should result in increased firm performance, growth of manufacturing sector and achievement of Vision 2030

**4.2 Transaction Costs Theory**

The theory argues that governance regimes consist of formal and informal structures and rules that enable carrying out economic transactions in an economic manner. The theory explains why companies expand or source out activities to the external environment. When external transaction costs are higher than the company's internal bureaucratic costs, the company will grow, because the company is able to perform its activities more cheaply, than if

the activities were performed in the market(Ronald 1937; Wieland, 2005; Williamson, 1975; Williamson, 1981; Williamson, 1996).Transaction cost theory explains why companies exist, and why companies expand or source out activities to the external environment. According to Ronald (1937) every company will expand as long as the company's activities can be performed cheaper within the company, than by e.g. outsourcing the activities to external providers in the market. Williamson(1981) asset that a transaction cost occurs when a good or a service is transferred across a technologically separable interface. Therefore, transaction costs arise every time a product or service is being transferred from one stage to another, where new sets of technological capabilities are needed to make the product or service. The central problem of transaction cost economics is carrying out of economic transactions by the efficiency of the chosen governance structures that have been tailored to carry out the transactions at hand(Wieland, 2005).

In other words, the organization and structure of a firm can determine price and production. The unit of analysis in transaction cost theory is the transaction. Therefore, the combination of people with transaction suggests that transaction cost theory managers are opportunists and arrange firms' transactions to their interests (Williamson, 1996). Governance regimes consist of formal and informal structures and rules that enable carrying out economic transactions in an economic manner. Transaction cost economics focus on hierarchical governance structures such as firms and other organizations as alternative to the market as governance structure. The corporate governance problem of transaction cost economics is, therefore, not the protection of ownership rights of shareholders, rather the effective and efficient accomplishment of transactions by firms in their cultural and political environment(Williamson, 1996).

## 5. Corporate Governance Mechanism

The corporate governance mechanisms discussed hereunder are board diversity, board duality, government ownership and managerial ownership that influence manufacturing firm's performance.

### 5.1 Board Diversity

Gender is arguably the most debated diversity issue not only in terms of board of directors, but also in many other societal situations. Board diversity has been a growing area of corporate governance research in recent years(Habbash, 2010). Considerable number of studies has examined the effects of board diversity on firm's performance. Recent research in Kenya by Ekadah & Mboya (2012) examined effect of board gender diversity on the Performance of commercial banks in Kenya using forty four commercial banks between 1998 to 2009. The study established that board diversity has no effect on performance of banks in Kenya. Randoy et al (2006) investigated 500 largest companies from Denmark, Norway, and Sweden and also found no significant diversity effect of gender, age, and nationality on stock market performance or on return on assets. Kang et al (2007) also researched on diversity and independence of Australian top 100 companies and asserted that among the most significant governance issues currently faced by the modern corporation are those relating to diversity, such as gender and age, and independence of directors.

Gender diversity on boards is well supported by agency theory. The agency theory emphasizes the board balance, thus, representation from diverse groups provides a more balanced board that is likely to prevent an individual or a small group of individuals from dominating its decision-making(Hampel, 1998) Therefore, agency theory predicts the presence of women directors on board improves performance. More recently, Wilson (2014) examined gender board diversity and posit that women are still underrepresented on corporate boards of directors. The study found that smaller firms lagging far behind their larger counterparts with respect to gender diversity. However, there was no evidence that gender diversity is hampered by the specialized skills and experiences required of a financial expert. Another study in United States by Bart & McQueen (2013) studied why women make better directors. Using the Defined Issues Test (DIT) instrument , 624 board directors (75% male; 25% female) were surveyed to determine their reliance on three reasoning methods (personal interest, normative and complex moral reasoning) to make decisions .The study reported positive correlation between the presence of female directors on boards and corporate performance suggesting that women appear to make better directors than men. Nielsen & Huse (2010) surveyed 201 Norwegian firms and examined the contribution of women on boards of directors. The study established that the ratio of women directors is positively associated with board strategic control. In addition, the positive effects of women directors on board effectiveness are mediated through increased board development activities and through decreased level of conflict. Carter et al (2010) examined the gender and ethnic diversity of boards and board committees and firm Financial performance. The study reported no significant relationship between the gender or ethnic diversity of the board, or important board committees, and financial performance for a sample of major US corporations.

**5.2 Board Duality**

According to AlManaseer et al (2012) duality refers to the situation when one person holds the two most powerful positions on the board of directors namely, CEO and chairman. Separation promotes checks and balances, and opens the space for objective assessment of all major investment and policy choices of the firm(Duke-II & Kankpang, 2011). Critically, Duke-II & Kankpang (2011) found that firms with separate offices generally had a higher-than-study average return on asset and profit margin. Grove et al (2011) asserts that agency theory argues that separating the roles of CEO and chairman of the board can mitigate agency costs. As a leader of the board, the chairman of the board is responsible for monitoring the CEO's decision-making and overseeing the process of CEO hiring, firing, evaluation and compensation(Grove et al., 2011). Therefore, agency theory predicts that CEO-duality weaken the financial performance of the firm(Donaldson & Davis, 1991) . Vo & Phan (2013) carried empirical study on the relationship between corporate governance and the performance of firms in Vietnam. The study found duality of the CEO has positive effects on the performance of firms as measured by the return on asset. Ramdani & Witteloostuijn (2010) carried a study on the effect of board independence and CEO duality on firm performance for a sample of stock-listed enterprises from Indonesia, Malaysia, South Korea and Thailand. They provided empirical evidence that the effect of board independence and CEO duality on firm performance is different across the conditional quantiles of the distribution of firm

performance. Ahmad(2010)explored the factors that influence the relation between corporate governance and performance of banks operating in Palestine relying on financial ratios, namely return on asset. The researcher reported CEO duality has positive impact with statistical significance on the performance of the sampled banks. Additionally, Bhagat & Bolton (2008) found CEO-Chair separation is significantly positively correlated with better contemporaneous and subsequent operating performance. In Kuwait, Al-Shammari and Al-Sultan(2009) investigated the relationship between corporate governance mechanisms and firm performance for non-financial companies on the KSE from 2004 to 2007 and found a positive relationship between role duality and firm performance measures. Furthermore, AlManaseer et al. (2012) found a positive relationship between bank performance and role duality in Jordan. They also found that combining the roles sometimes avoided ambiguity in responsibilities. In the same vein, Al- Haddad et al. (2011) found evidence on positive direct relationship between corporate governance and corporate performance. Abor and Biekpe (2007) argued that effectiveness of the board to oversight the top management is diminished by the duality of the CEO. They asserted that CEO duality is concentration of decision management and decision control in one individual. For the systems where the CEO also acts as chairman of the board that often increases the possibility of conflict of interest and agency problems

**5.3 Government Ownership**

Government ownership refers to the percentage of ownership by the government(Alipour, 2013). From agency theory perspective, Jensen & Meckling (1976) argued that separation of ownership and control, as is characteristic of the modern corporation, potentially leads to self interested actions by those in control- managers. State ownership would be deemed inefficient due to the lack of capital market monitoring which according to the Agency theory would tempt manager to pursue their own interest at the expense of the enterprise(Kiruri, 2013). Similarly, Najid and Abdul-Rahman (2011) claim that state-owned firms generally lack sufficient entrepreneurial drive and tend to be politically rather than commercially motivated, which leads to a poor financial performance. Therefore, from agency theory perspective government ownership deteriorates firm’s performance.

Empirical evidence on the effect of government ownership and corporate performance presents mixed results. Prior studies have reported both positive and negative relationship between the two variables. For example, In Kenya, Kiruri (2013) using a sample of 43 banks and simple linear regression analysis investigated the effects of ownership structure on bank profitability in Kenya. The study found that ownership concentration and state ownership had negative and significant effects on bank profitability. In Kuwait, Alfaraih et al (2012) based on a sample of 134 firms listed on the Kuwait Stock Exchange in the year 2010, regression analysis results showed a negative relationship between government ownership and Kuwait Stock Exchange firm performance, implying worse market performance when government ownership exists. Both a market-based measure (Tobin’s Q) and an accounting-based measure (ROA) are used to measures firm performance. Ghazali (2010) carried a study in

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Malaysia using data from the year 2001 annual reports of 87 non-financial listed companies included in the composite index and found that two ownership variables, namely the government as a substantial shareholder and foreign ownership were statistically significant and positively associated with corporate performance positively associated with market based performance as measured by Tobin's Q. In France, Mrad & Hallara (2012) evaluated the relationship between the residual Government ownership, performance and value creation on the post privatization period. The study revealed that very high levels of government ownership are associated with an increase in performance and value creation within the privatized company, while low levels of government ownership are associated with a decrease in performance and value creation. Zeitun (2009) evaluated the impact of ownership structure on company performance and failure in a panel estimation using 167 Jordanian companies during 1989-2006.The research found that there is a significant negative relationship between government ownership and firms accounting performance

**5.4 Managerial ownership**

Managerial ownership refers to the percentage of shares owned by CEO and board members(Bayrakdaroglu et al., 2012) It may also refer to the percentage of outstanding shares held by executive directors in the firm(Cheng et al., 2012). From agency theory perspective, managerial ownership is suggested as one major internal governance mechanism that mitigates the agency problem between managers and shareholders. Managerial ownership is a way to curb agency problems by encouraging manager-owners to look to entrepreneurial gain, which gives them an incentive to increase the value of the organization rather than to shirk (Jensen & Meckling, 1976).Agency theorists posit that firm performance can be improved by aligning the interests of managers with those of shareholders through increasing management stock holdings. When holding substantial equity ownership, insiders are more likely to act in accordance with the interests of shareholders(Bryan et al., 2000; Perry & Zenner, 2000) otherwise, they are more likely to pursue their own interests such as job security, remuneration, status, and power, often at the expense of shareholders (Himmelberg et al., 1999; Zahra et al., 2000)

However, high managerial ownership also results in reduced external discipline from managerial labour market, the product market and the market for corporate control(Denis et al., 1997). Empirical evidence exists regarding the relationship between director /managerial ownership and corporate performance, however, the evidence is mixed. In Australia, Khan et al.(2014) using a sample of 1154 firm-year observations over the seven-year period 2000-2006 investigated the relationship between managerial share ownership and earnings as a measure of operating performance. The researchers documented a negative relation between managerial share ownership and performance followed by a positive relation. Likewise, Chiang(2005)also found that director shareholding was statistically significant but negatively related to corporate performance. A study in Finnish, Lappalainen & Niskanen (2012) evaluated the impact that ownership structure and board composition have on financial performance in a sample of Finnish small to medium-sized enterprises. The study found that ownership structure affects both the growth and the profitability of small private firms. Firms with high managerial ownership levels exhibit higher profitability ratios but have lower growth rates.

**6. Corporate Performance**

Corporate Performance will be measured using financial measures. Financial performance is any mathematical indicator used to assess how efficiently a firm utilizes its resources to generate income over a specified period(Wang & Huynh, 2013). Financial performance is often evaluated on various indicators such as the growth in returns on asset (ROA), returns on equity (ROE) and profit(Zack et al., 2009). Financial performance has also been measured using a five point scale from no growth, a little growth, average growth, fast growth to very fast growth using a comparison of industry average during the last three years for the following three items, namely returns on asset, returns on equity and profit (Wang & Huynh, 2013)

This paper will measure financial performance using return on assets and return on equity based on a five point scale from no growth, a little growth, average growth, fast growth to very fast growth. Return on asset as measure of financial performance has been widely used in similar previous studies such as (Maltz et al., 2003; Wang & Huynh, 2013; Zack et al., 2009) thus justifying its use in the current study.

**7. Moderating Variable**

This study will use firm size as moderating variable in the relationship between corporate governance and corporate performance. Firm size has been measured as Natural logarithm of total assets(Shao, 2009).Other studies measures firm size by sales or market capitalization(Baptista, 2010) and the number of employees(Richarda et al., 2009). The resource dependence theory argues that as the size increases, more resources are available to the firm to pursue its objective(Waithaka, 2013).Therefore, resource dependency theory predicts a positive relationship between firm size and performance .In contrast, the proponent of Agency theory argues that firm size is taken as a proxy for the complexity of the firm(Fama & Jensen, 1983). As the firm's size increases, the agency costs are expected to increase and allow for greater managerial discretion and opportunism(Jensen & Meckling, 1976).

**8. The Conceptual Framework**

A conceptual framework refers to when a researcher conceptualizes the relationship between variables in the study and shows the relationship graphically or diagrammatically. It is a hypothesized model identifying concepts under study and their relationship(Mugenda & Mugenda, 2003).The conceptual framework hereunder illustrates the perceived link between the independent (corporate governance variables) and dependent variable (Firm's financial performance) moderated by the firm size. The variables considered to affect firm performance in this study comprised of board diversity, board duality, government ownership and managerial ownership. The study's conceptual framework is illustrated in Figure 1.0.

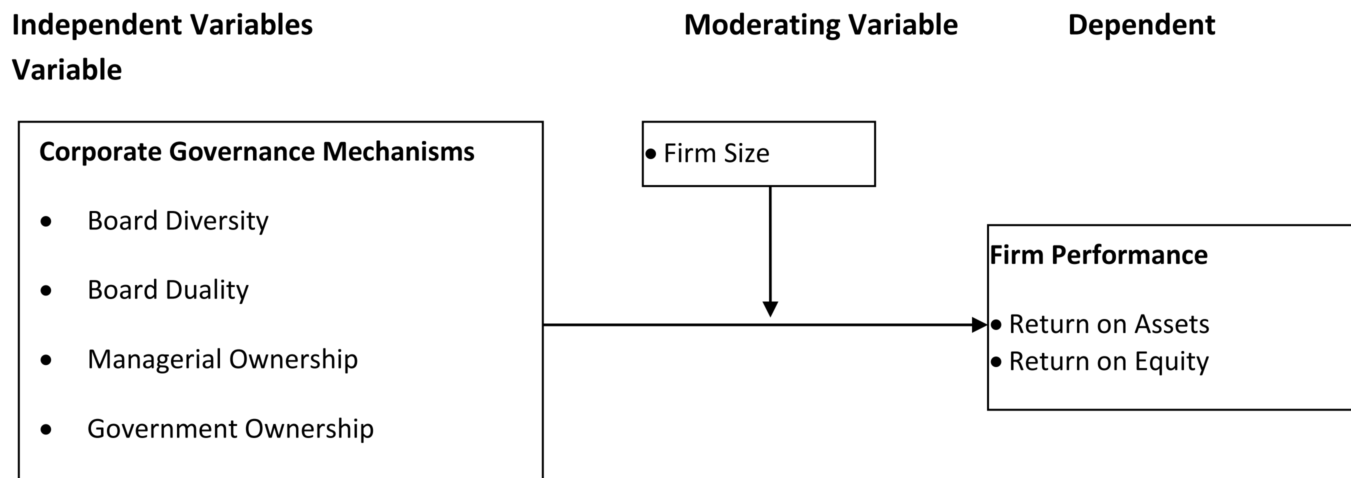


**Figure 1.0 The Conceptual Framework**

**9. Conclusions**

The purpose of this article is to examine the influence of corporate governance on corporate performance among various Kenya Manufacturing firms. This article outlines the drivers of corporate performance. On the basis of the literature review, a conceptual model has been developed. Further research should be carried out to test, validate and enhance the model. The results obtained will be presented in a later article.

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