



**THE RELATIONSHIP BETWEEN SELECTED CORPORATE GOVERNANCE  
PRINCIPLES AND FINANCIAL PERFORMANCE OF INVESTMENT BANKS IN THE  
NAIROBI SECURITIES EXCHANGE**

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**Abstract**

*Corporate governance is an area that has grown rapidly in the recent years as an emerging issue due to the global corporate scandals and collapse of big companies. The corporate governance principles hence adopted by any corporate entity affects the firm's ability to respond to the content and context in which it operates and its overall performance. The purpose of this study was to assess the relationship between selected corporate governance principles on financial performance of investment banks in the Nairobi Securities Exchange Kenya. The objective of the study was to investigate the relationship between corporate governance principle aspects (board composition, CEO duality and board size principles) and financial performance of investment banks in the Nairobi Securities Exchange. The study used a descriptive research design where primary data was collected from the seven investment banks in the Nairobi Securities Exchange in Nairobi County using a questionnaire issued to the managers while secondary data was extracted from published financial statements. Statistical Packages for Social Sciences (SPSS) was used by the researcher to facilitate the analysis and interpretation of data and the results obtained were presented using tables, frequencies, graphs and charts for easy interpretation. The results indicated that the corporate governance principles (CEO duality and Board composition) had a strong negative correlation on financial performance in*

*investment banks while board size had a weak negative correlation on financial performance in investment banks. The regression analysis showed that CEO duality, board composition and board size had a significant effect on the financial performance in investment banks. The study recommends that investment banks operations to be governed through a clear management structure that enhances security of shareholder wealth and sustainability of the organisation. This is to be achieved by continually reviewing regulations regarding management governance structures so as to assure transparency in limiting CEO duality thus assuring legitimacy in the firm performance.*

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**Key Words:** *Corporate Governance, Financial Performance, Investment Banks, CEO Duality*



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## **Introduction**

Corporate governance entails a set of relationships between a company's management, its board, its shareholders and other stakeholders. It further provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance. Therefore, the attainment of the objectives and monitoring performance has wider implications that are critical to economic and social well-being. This is through the provision of the requisite incentives and performance measures to achieve the predetermined business success as well as to enhance the stewardship of the resources through transparency to ensure the equitable distribution of the resulting wealth. (OECD, 2009)

The corporate governance principles hence adopted by any corporate entity affects the firm's ability to respond to the content and context in which it operates and its overall performance. It is thus evident that well governed firms perform better to a greater extent than poorly governed ones hence the need of appropriate corporate governance principles. A sound corporate framework benefits firms through greater access to financing, lower cost of capital, better financial performance and more favourable treatment of all stakeholders. They argue that weak corporate governance leads to poor firm financial performance and risky financing patterns. (Claessens et al., 2002)

Corporate governance has been a major policy reform and discussion in Kenya for over a decade evidenced by corporate governance guidelines issued by the Capital Markets Authority and

supported by private sector initiatives, including widespread director training, improving governance across listed companies. Revived privatization, performance contracts, vetting of state officers, establishment of independent commissions and other reforms have placed increasing emphasis on the corporate governance of state corporations, which continue to play a major role in the economy. Kenya recognizes the value of good governance as demonstrated in the constitution in Chapter 2 article 10 (1) on National Values and Principles of Governance commits all persons, state organs and any other parties to the national values, good governance being one of the values. (Capital Markets Authority, 2014)

Investment banks entail financial institutions that deal mainly with corporate and retail customers with specialisation in securities markets activities including underwriting, trading, asset management, advisory activities and corporate restructuring such as mergers and acquisitions. They thus play a vital role in assisting mid-market businesses maximize value. The key success factor for the development of such investment banks in the developed world has been their access to capital in their own right, thus enabling them to make the guarantee in the first place.

### **Statement of the problem**

The financial scandals around the world and the recent collapse of major financial institutions in USA, South East Asia and Kenya have shook investors faith in the capital markets. Capital Markets Authority of Kenya (CMA) the regulatory body in the capital market has key interests on the shareholders who invest in the quoted companies so as to determine the value for the investment is maximised. Corporate governance therefore, receives high priority on the agenda of policymakers, financial institutions, investors, companies and academics. (Heracleous, 2001)

In Kenya, Francis Thuo and Partners went under in early 2007, marking the first of a series of stockbroker failures that were largely blamed on weak management and fraudulent selling of investors' shares by the intermediaries. Nyagah stockbrokers were put on statutory management in 2008 after failing to meet its financial obligations. In addition, a forensic audit done by Price water house Coopers (PwC) revealed that the firm might have gone down with about Shs1.3billion of public funds through the diversion of funds by management, fraud by the staff, occurrences of collusion by other stockbrokers in the NSE and even office of the regulator (CMA, 2014).

A number of studies have sought to investigate the relation between corporate governance mechanisms and financial performance ( Berglof and Thadden, 1999). Most of the studies have

shown mixed results without a clear-cut relationship. A study by Becht et al., (2002) show that corporate governance practices positively influences the profitability of the organization while MacAvoy and Millstein (2003) found that board composition does not have any effect on financial performance. Further, the limited studies in the area have focused mainly on developed economies (Becht et al., 2002). It is therefore crucial to examine the relationship in the context of a developing economy.

Studies done locally regarding corporate governance have majored on public institutions, the private institutions and the listed companies. Jebet (2001) conducted a study of corporate governances, the case of quoted companies in Kenya, Muriithi (2005) did a study on the relationship between corporate governance mechanisms and performance of firms quoted on the NSE, Manyuru (2005) researched on corporate governance and organizational performance :the case of state corporations in Kenya while Matengo (2008) did a study on the relationship between corporate governance practices and performance, the case of banking industries in Kenya. In addition, Ada (2013) researched on the relationship between corporate governance practices and dividend payout of commercial banks in Kenya.

None of these studies have focused on financial performance of the investment banks in the NSE. Investment banks occupy a special place due to their centrality in the transmission of monetary policy and the functioning of the payment and settlement systems. There is need to determine whether corporate governance principles influence their financial performance. Therefore based on the limited empirical data and the great exposure of such institutions in the financial sector this study sought to provide more empirical data in Kenya.

### **General Objective of the Study**

The general objective of the study was to assess the relationship between selected corporate governance principles and financial performance of investment banks in the NSE.

### **Specific Objectives**

- i. To establish the relationship between board composition and financial performance of investment banks in the NSE.
- ii. To determine the relationship between CEO duality and financial performance of investment banks in the NSE.
- iii. To determine the relationship between board size and financial performance of investment banks in the NSE.

### **Research Hypotheses**

Ho<sub>1</sub>; there is no relationship between board composition and financial performance of investment banks in the NSE.

Ho<sub>2</sub>; there is no relationship between CEO duality and financial performance of investment banks in the NSE.

Ho<sub>3</sub>; there is no relationship between board size and financial performance of investment banks in the NSE.

### **Research Methodology**

The study used a descriptive research design which was appropriate for the study since it involved collecting data in order to test the hypothesis or answer questions concerning the current status of the variables with no manipulation. (Mugenda and Mugenda, 2003). The target population consisted of seven investment banks licensed by the NSE and CMA since they had a high growth nature in the investment market and possess the specialised capacity evidenced by managerial capability to develop innovative financing solutions to steer investment activities to great heights with a sufficient capital base.

The study focused on six management staff in each of the investment banks located within Nairobi County. This was necessitated by their accessibility of the required information and their direct involvement in the running of the investment banks for the study. Both primary and secondary data was used. For the primary data, a 5-likert scale (strongly agree to strongly disagree) questionnaire was administered to the top, middle and low level managers in investment banks within Nairobi County with a view to collect desired data. It consisted of two main sections mainly the demographics that gave the general features of the company and the respondents while the other section outlined the objectives. The secondary data was based on the published financial statements such as statement of financial position, statement of financial performance and the cash flow for the period 2010 to 2013.

The regression model is presented below:

$$\mathbf{ROA_{ib} = a + b_1BC + b_2CD + b_3BS + e}$$

Where:

**ROA<sub>ib</sub>** = Return on Assets

**BC** = Board Composition

**CD** = CEO Duality

**BS** = Board Size

**e** = error term

## **Results and Discussion**

### **Introduction**

The chapter focuses on data analysis, presentation and interpretation. The data was gathered through questionnaires administered to forty two (42) respondents drawn from the seven licensed investment banks in Nairobi County. Results are presented in pie charts, tables and graphs. The findings of the study were organized based on specific objectives.

### **Response Rate**

**Table 1.1: Response Rate**

<b>Response</b>	<b>Frequency</b>	<b>Percentage (%)</b>
Responded (Valid)	36	85.7
Responded (Invalid)	4	9.5
No Response	2	4.8
<b>Total</b>	<b>42</b>	<b>100</b>

**Source: Field Data (2015)**

As per the table 1.1 above, the target respondents for the study were the management staff of the licensed investment banks. The researcher thus administered forty two (42) questionnaires out of which thirty six (36) were considered valid for analysis, giving an 85.7% (36 respondents), invalid 9.5% (respondents) and no response 4.8% (2 respondents). This is in agreement with what was indicated by Cooper and Schindler (2003) who indicated that a response rate between 30 % and 80% of the total sample size can be generalised to represent the opinion of the entire population.

### **Reliability Test**

The reliability of the variables of corporate governance was measured using the Cronbach's alpha by the help of the statistical package for social sciences (SPSS).

**Table 1.2: Cronbach's Alpha for the Variables**

<b>No.</b>	<b>of Cronbach</b>	<b>Mean</b>	<b>Standard</b>
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<b>Items</b>		<b>Deviation</b>		
<b>Board Composition, CEO Duality and Board Size</b>	17	0.778	2.144	0.388

From table 4.5, the Cronbach alpha value was 0.778 which indicated high reliability on the relationship of the variables. According to Struwig and Stead (2001), for consistency to be present, the alpha must be 0.7 or above. The number of items consists of the questions in the questionnaire for the three objectives totalling to seventeen with a high mean of 2.144 with a low standard deviation of 0.388.

**Return on Assets**

Secondary data was collected from the Nairobi Securities Exchange (NSE) for the firm’s financial statements for the years between 2010 and 2013. The study collected data on Return On Assets as a dependent variable which was measured as the amount of net income returned as a percentage of average total assets.

**Table 1.3: Return on Assets**

<b>YEAR</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>ROA (Mean)</b>	<b>Standard Deviation</b>
<b>African Alliance Kenya Investment Bank Ltd</b>	-0.05	-0.16	0.15	0.13	0.02	0.15
<b>Dyer &amp; Blair Investment Bank Ltd</b>	0.09	0.01	0.05	0.01	0.04	0.04
<b>Faida Investment Bank Ltd</b>	0.04	-0.004	0.004	0.01	0.01	0.02
<b>Renaissance Capital Ltd</b>	-0.12	0.14	0.06	0.01	0.02	0.11
<b>Sterling Capital Ltd</b>	0.08	0.02	0.09	0.03	0.05	0.04
<b>Standard Investment Bank Ltd</b>	0.03	0.01	0.02	0.02	0.02	0.01
<b>Suntra Investment Bank Ltd</b>	0.04	-0.03	-0.02	0.02	0.003	0.03

Source: Nairobi Securities Exchange (2010-2013)

Table 1.3 above shows the return of assets for each of the seven investment banks in the NSE for the period 2010 to 2013. In African Alliance Kenya investment bank ltd, the ROA grew from the negative to the positive with its lowest in 2011 at (0.16) with the highest in 2012; the mean for the period was 0.02 and the standard deviation at 0.15. In Dyer and Blair investment bank ltd, the ROA was maintained on the positive with the lowest in 2011 and 2013 at 0.01 with the highest at 0.09 in 2010; the mean and standard deviation for the period were at 0.04. In Faida investment bank ltd, the ROA was averagely positive with the lowest in 2011 at (0.004) with the highest in 2010 at 0.04; the mean was at 0.01 and standard deviation for the period at 0.02.

In Renaissance Capital ltd, the ROA was averagely positive with the lowest at (0.12) in 2010 with the highest at 0.14 in 2011; the mean was at 0.02 and standard deviation for the period at 0.11. In Sterling Capital ltd, the ROA was stable on the positive with the lowest in 2011 at 0.02 with the highest at 0.09 in 2012; the mean was at 0.05 and standard deviation for the period was at 0.04. In Standard investment bank ltd, the ROA was maintained on the positive with the lowest in 2011 at 0.01 with the highest at 0.03 in 2010; the mean was at 0.02 and standard deviation for the period was at 0.01. In Suntra investment bank ltd, the ROA was relatively positive with the lowest in 2011 at (0.03) with the highest at 0.04 in 2010; the mean was at 0.003 and standard deviation for the period was at 0.03.

For the period 2010 to 2013 the lowest ROA for majority of the investment banks was in 2011 with the lowest as (0.004) in Faida investment bank ltd while the highest ROA for most of the firms was in 2012 with the highest as 0.15 in African Alliance Kenya investment bank ltd. For the mean for the period 2010 to 2013 the companies maintained a positive return with the highest in Sterling Capital ltd at 0.05 with the lowest in Suntra investment bank ltd at 0.003. On the standard deviation for the period, the lowest was in Standard investment bank ltd at 0.01 with the highest in African Alliance Kenya investment bank ltd at 0.15.

**Table 1.4: Overall Descriptive Statistics**

<b>Variables</b>	<b>Mean</b>	<b>Standard Deviation</b>
<b>Board Composition</b>	1.958	0.591
<b>CEO Duality</b>	2.185	0.632
<b>Board Size</b>	2.316	0.556
<b>ROA</b>	0.02	0.056



In table 2.7 above, the overall means for the independent variables and dependent variables were assessed. For the means, the independent variables had the highest compared to the dependent variable with the highest as 2.316 on board size, 2.185 on CEO duality, 1.958 on board composition with the lowest for ROA as 0.02. This implies the high reliability of the independent variables for the study. On the other hand, the overall standard deviation for the dependent variable with the lowest as 0.056 while the independent variables as 0.556 on board size, 0.591 on board composition and 0.632 on CEO duality. This is indicated the high consistency of the results for the dependent variable for the study.

**Correlation Analysis**

**Table 1.5: Correlation Matrix**

		ROA	BC	CEO	BS
ROA	Correlation Coefficient	1.000	-.437	-.754	-.141
	Sig. (2-tailed)		.008	.000	.413
	N	36	36	36	36
BC	Correlation Coefficient	-.437	1.000	.877	-.126
	Sig. (2-tailed)	.008		.000	.464
	N	36	36	36	36
CEO	Correlation Coefficient	-.754	.877	1.000	.161
	Sig. (2-tailed)	.000	.000		.348
	N	36	36	36	36
BS	Correlation Coefficient	-.141	-.126	.161	1.000
	Sig. (2-tailed)	.413	.464	.348	
	N	36	36	36	36

On the correlation of the study variables the researcher conducted a spearman correlation as shown in table 1.5. From the findings on the correlation analysis between ROA and the various corporate governance principles the study found out that there was negative correlation coefficient between ROA and Board composition shown by correlation coefficient of (r= -0.437,p< 0.01) which is statistically significant at 99% confidence level. There is a strong negative correlation between ROA and CEO duality as shown by a correlation of (r= -0.754, p< 0.01) which is statistically significant at 99% confidence level .There is a weak negative correlation between ROA and Board size with a correlation coefficient of(r= -0.141, p> 0.01). This is an indication that there was a negative relationship between Board composition, CEO duality and Board size with financial performance of investment banks.

**Regression Analysis**

Regression analysis was used to determine the predictive power of board composition, CEO duality and board size on financial performance in investment banks. The three independent variables were regressed against the dependent variable on a simple linear regression analysis. Model summary table below shows the coefficient of determination ( $R^2$ ) which explains the percentage of variation in investment banks financial performance.

Model	R	R Square	Adjusted Square	R Std. Error of the Estimate
1	.909 <sup>a</sup>	.825	.809	.00613

a. Predictors: (Constant), BS, BC, CEO

From the table above, the regression model containing board size, board composition and CEO duality as the predictor variables explains 82.5% of the variation in investment banks financial performance. The remainder (17.5%) can be explained by other factors not included in the model.

The table below displays the ANOVA results that test the significance of the  $R^2$  for the model.

Model		Sum of Squares	of Df	Mean Square	F	Sig.
1	Regression	.006	3	.002	50.456	.000 <sup>b</sup>
	Residual	.001	32	.000		
	Total	.007	35			

a. Dependent Variable: ROA  
 b. Predictors: (Constant), BS, BC, CEO

An F statistics of 50.456 with a p value less than 5 % significance level indicates that the overall model was statistically significant at 95% confidence level. The table of coefficients below presents the unstandardized and standardized coefficients of the model, t statistic for each coefficient and the associated p values. The predictor variables had significant positive relationship for board composition and size with significant negative relationship for CEO duality with financial performance of investment banks.

**Table 1.8: Coefficients**

Model	Unstandardized Coefficients		Standardized Coefficient	t	Sig.
	B	Std. Error			
	(Constant)	.135	.027	5.005	.000
1	BC	.049	.010	.546	4.705
	CEO	-.140	.013	-1.353	-10.695
	BS	.042	.012	.285	3.365

The model that was used by the study was;

$$ROA_{ib} = a + b_1BC + b_2CD + b_3BS + e$$

Where:

**ROA<sub>ib</sub>** = Return on Assets

**BC** = Board Composition

**CD** = CEO Duality

**BS** = Board Size

From the data in the table the established regression equation was;

$$ROA \text{ Investment banks} = 0.135 + 0.049 BC - 0.140 CD + 0.042 BS$$

From the above regression equation, it was revealed that board composition, CEO duality and board size to a constant zero, financial performance of investment banks would stand at 0.135. A unit increase in board composition would lead to a 0.049 increase in financial performance (ROA) of investment banks, a unit increase in CEO duality would lead to a 0.140 decrease in financial performance (ROA) of investment banks and a unit increase in board size would lead to a 0.042 increase in financial performance (ROA) of investment banks.

**Testing Hypothesis**

The first hypothesis was,  $H_{01}$ ; there is no relationship between board composition and financial performance of investment banks in the NSE. This hypothesis was tested at 5% significance level which was rejected since the p value = 0.000 was less than 5% with  $t = 4.705$ . The researcher therefore adopted an alternate hypothesis;  $H_1$ ; There is a significant positive relationship between board composition and financial performance.

The second hypothesis was  $H_{02}$ ; there is no relationship between CEO duality and financial performance of investment banks in the NSE. This hypothesis was tested at 5% significance level which was rejected since the p value = 0.000 was less than 5% with  $t = -10.695$ . The researcher therefore adopted an alternate hypothesis;  $H_2$ ; There is a significant negative relationship between CEO duality and financial performance.

The third hypothesis was  $H_{03}$ ; there is no relationship between board size and financial performance of investment banks in the NSE. This hypothesis was tested at 5% significance level which was rejected since the p value = 0.002 was less than 5% with  $t = 3.365$ . The researcher therefore adopted an alternate hypothesis;  $H_3$ ; There is a significant positive relationship between board size and financial performance.

In conclusion, the hypothesis that corporate governance principles have no relationship on financial performance in investment banks was rejected since the predictor variables of the model, board composition, CEO duality and board size, were significant at 5% significant level.

### **Summary of Findings**

Based on the objectives of the study stated in the introduction above, the following are the summary of findings of the results obtained from the data analyzed.

On the first objective to establish the relationship between board composition and financial performance, the results showed that board composition influences financial performance in investment banks in the NSE. The competency of the board and sufficiency of information on qualification for board membership was found necessary for investment banks. The results showed that at 5% level of significance, board composition played a significant role in determining financial performance in investment bank in the NSE, where a unit increase in board composition led to a 0.049 increase in financial performance. The correlation analysis findings indicated a positive relationship between board composition and financial performance. The study rejected the null hypothesis that there is no relationship between board composition and financial performance of investment banks in the NSE. These findings support those of Dehaena et al. (2001), Omar (2003) and Rhoades et al. (2000) who found that board composition (proportion of independent directors on the board) has a positive relationship with financial performance

For the second objective to determine the relationship between CEO Duality and financial performance According to the research results, the study found that CEO duality influences financial performance in investment banks in the NSE. It was observed that the CEO position, the management structure and separation of the CEO and chairman position influenced performance of investment banks in the NSE. The results showed that at 5% level of significance, CEO duality played a significant role in determining financial performance in investment bank in the NSE, where a unit increase in CEO duality led to a 0.140 decrease in financial performance. The correlation analysis findings indicated a negative relationship between CEO duality and financial performance. The study rejected the null hypothesis that there is no relationship between CEO duality and financial performance of investment banks in the NSE. These findings support those of Bernstein (2004) who concluded that the split of roles of Chairman and CEO perform better than those companies which have the same individual in both positions. Amba (2013) opined CEO duality has a negative impact on business performance with regard to ROA, ROE, and Assets turnover.

Finally, on the third objective to determine the relationship between board size and financial performance, the results indicates that the board size influences financial performance in investment banks in the NSE. The results showed that at 5% level of significance, board size played a significant role in determining financial performance in investment bank in the NSE, where a unit increase in board size led to a 0.042 increase in financial performance. The correlation analysis findings indicated a positive relationship between board size and financial performance. The study rejected the null hypothesis that there is no relationship between CEO board size and financial performance of investment banks in the NSE. These findings concur with the findings of Vafeas (2000) that firms with the smallest boards (minimum of five board members) are better informed about the earnings of the firm thus better monitoring abilities

### **Conclusion**

The corporate governance principle that had the most significant relationship on financial performance was CEO duality mainly based on variables such as influence of CEO position on shareholder investment and the management structure. The second corporate governance principle which had a moderate significant relationship on financial performance was board composition mainly based on variables such as timely information on board member qualification and the competency of directors. The third corporate governance principle which

had a moderate significant relationship on financial performance was board size based mainly on variables such as the number of board members as five or less and adherence on clear guidelines for the provision of appropriate number of board members.

### **Recommendations**

Based on the research findings and conclusions drawn from this study, recommendations have been provided. The investment banks operations are required to be governed through a clear management structure. This is so as to enhance security of shareholder wealth and sustainability of the organisation. This could be achieved by continually reviewing regulations regarding management governance structures so as to assure transparency in limiting CEO duality thus assuring legitimacy in the firm performance.

The board members in investment banks should entail a pool of diverse skills and expertise to enhance innovative ways in steering business performance. This could be enhanced through independent recruitments from a pool of experts and the pre-allocation of equitable balance in the boards will assure diverse concepts and ideas in business performance. The board member number should be maintained on an optimal basis of five or less.

### **Areas for Further Research**

Further research should focus on the limitations of this study since numerous expansions of this research are possible. First, the study focused only on three corporate governance features on their relationship on firm performance. The features covered are important while other diverse variables such as the financial reporting, management style and the audit committee could be examined with their impact on firm performance. The firm of study was limited to investment banks which form part of the financial sector thus further studies could be done on other institutions in the private and public sector.

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