THE EFFECT OF CORPORATE GOVERNANCE MECHANISMS ON THE OPERATIONAL PERFORMANCE OF SMALL AND MEDIUM-SIZED ENTERPRISES IN NAIROBI

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DECLARATION

Declaration by the Candidate

I declare that this work has not been previously submitted and approved for the award of a degree by this or any other University. To the best of my knowledge and belief, the thesis/dissertation (use as appropriate) contains no material previously published or written by another person except where due reference is made in the thesis/dissertation itself.

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This dissertation is dedicated to my wife Rose Naishorua, son Allan Shira and family members for their unwavering support and their tireless sacrifices of their precious family time throughout the entire degree programme and especially during research project.

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ACRONYM AND ABBREVIATIONS

ASMEP	Assistance to Micro and Small Enterprises Programme
DMSED	Department of Micro and Small Enterprise Development
GDP	Gross Domestic Product
KNBS	Kenya National Bureau of Statistics
MSME	Micro, Small and Medium Establishment
SACCOs	Savings and Credit Cooperative Societies
SMEs	Small and Medium Enterprises
SPSS	Statistical Package for Social Sciences

ABSTRACT

Entrepreneurial firms require good operational performance to achieve full profits potential of the business. They also require inputs on business operations, good strategy and best practices in the industrial sector. In order to realize this, good corporate governance practices are vital in assisting SMEs (small to medium-sized enterprises) in improving on their operational performance. The issue of corporate governance has been a growing area of management research especially among SMEs firms. The limited studies in the area with respect to SMEs have focused mainly on developed economies. This study therefore sought to examine the effects of corporate governance on the operational performance of SMEs. The study specifically assessed the adoption of corporate governance structures among SMEs by testing for the effects of formal board, board roles, board competency and audit committee on the performance of SMEs. The main objective of the study was to determine the effect of corporate governance mechanisms on the operational performance of SMEs in Nairobi. The specific objectives of the study were to examine the influence of the existence of SME board on the operational performance of the SMEs in Nairobi; to establish the effect of board roles and mandates on the operational performance of the SMEs in Nairobi; to determine the effect of Board Managerial competency on the operational performance of the SMEs in Nairobi and to establish the effect of audit committee on the operational performance of the SMEs in Nairobi. The study target population was drawn from 83 selected managers of SMEs in Nairobi. The sourced data was quantitative primary data. In analyzing quantitative data, the study used descriptive statistics. In addition, regression analysis was used to determine the significance of independent variables affecting the operational performance of the SMEs. The results of the study indicated that corporate governance mechanisms sampled on the study had a positive influence and significant on the operational performance of the firms except for the formal board which was not significant. The regression analysis established that audit committee contributes most to the operational performance of SMEs followed by board competency, board roles and formal board respectively. The study recommends that the management of SMEs should monitor the size of the board to ensure there are smooth coordination; board duality and composition, which are very important to operational performance of the SMEs. Finally, the study also recommends that SMEs should hold committee meetings regularly and they should be keen on the audit committee composition. The main contribution of this study to knowledge lies in the effort to strengthen the corporate governance of SMEs in order to positively help in improving the operational performance of firms.

CHAPTER ONE
INTRODUCTION

1.1 Background of the Study

The concept of corporate governance has become of great contributor to development of nations like Kenya because it is the internal system, which serves the needs of shareholders and other stakeholders by directing and controlling management activities with good business savvy, objectivity, accountability and integrity. Directors, owners & corporate managers have started to realize that there are benefits that can accrue from having a good corporate governance structure (McGee, 2008).

According to Shleifer & Vishny, (1997), corporate governance in small firms is still in its early stages of development. Different legal frameworks and therefore different corporate governance systems characterize different countries. The question of interest would therefore be whether these different corporate governance systems do actually lead to different operational performances of SMEs. SMEs in developing countries face a number of challenges including access to finance both domestically and internationally. The main underlying constraint to their growth is lack of good corporate governance practices which deal with the ways in which supplies of finance to corporations assures themselves of getting a return on their investment. (Shlefer & Vishny, 1997).There is generally a lack of awareness among these enterprises regarding significance of corporate governance practices as a competitive tool and if there is awareness, there is a general aversion to adopting these practices because of the high cost of implementation (Mahmood, 2008). Corporate governance within SMEs is becoming more popular however; there is a danger in trying to apply the concepts of large firm governance to small firms, which may not have formal board or management structures (Gibson, 2009).

Certain elements of the corporate governance system date back to the formation of the enterprise and thus are deeply rooted in the firm. Consequently, the change process may be hampered by a mismatch between the traditional procedure and the new one. Based on this it can be concluded that the corporate governance system found in SMEs reveal certain path dependencies that greatly influence the firm’s ability to transform, even if a need for change is perceived.

1.1.1 Operational Performance

Performance can be defined as the measure of how well a given firm achieves its goal, Sheriff, Poeus & Ali (2010). Measure of operational performance includes productivity, resource acquisition, efficiency and employee reaction on workflow as well as work support in organizations (Kofar Mata & Aliyu, 2014). SMEs can be evaluated in terms of employment level, firm size, strength in working capital as well as its profitability. Operational performance is the backbone of organizational performance (Salem, 2003). Organizational performance is the capability of an organization to fulfill its mission through governance, excellence and dedication to meeting its goals and objectives. Operational performance on the other hand is the performance of an organization against its set standards such as waste reduction, productivity, cycle time, environmental responsibility and regulatory compliance (O‟Brien, 2009).

The operations of a firm should be efficient and effective. Effectiveness is the expanse to which customers‟ needs are fulfilled, while efficiency is defined as a measure of how economical firms‟ resources are employed. In order to accurately enhance accessibility and evaluation of operational performance, the correct measurement systems should be planned, developed and implemented. Performance measurement networks are hence developed in order to monitor and maintain operational control. Operational Control is the process that ensures an organization is able to pursue action with the aim of achieving the overall goals and objectives. Achievement of these goals is a manifestation of excellence in organizational performance (Hubbard, 2009).

1.1.2 Corporate Governance

Corporate governance is the system of rules, practices, and processes by which a firm is directed and controlled. Corporate governance essentially involves balancing the interests of a company's many stakeholders, such as shareholders, senior management executives, customers, suppliers, financiers, the government, and the community. Since corporate governance also provides the framework for attaining a company's objectives, it encompasses practically every sphere of management, from action plans and internal controls to performance measurement and corporate disclosure.

Corporate governance system is defined by the Cadbury Committee as ‘‘a system by which companies are directed and controlled’’ (Cadbury, 1992). Keasey, Thompson and Wright (1997) suggested that corporate governance comprises the processes, structures, systems and cultures that ensure that the operations of the firm are successful. Corporate governance also involves the processes and structures put in place to safeguard the welfares of the stakeholders. According to Papesch (2010), corporate governance structures include the balancing of the different stakeholders' interests with the management and control of the firm besides the processes and structures to facilitate the organization's long-term survival. Gibson (2009) argues that although the study of corporate governance within SMEs has become more popular over time, its application to SMEs still lags behind since most of the SMEs do not have management structures or even formal boards. This is also because corporate governance frameworks and approaches were in the first place developed for large corporations (The Association of Chartered Certified Accountants, 2015).

Global perspective: SMEs have over time been the backbone and drive for the country's economic growth. On a global perspective, SMEs on average contribute to up to 49 per cent of GDP in developed countries and 29 per cent in low-income countries. This implies that they are crucial on economic development (Beck & Demigurc-Kunt, 2006). According to Bosch and Farrar (2009), SMEs ought to adopt corporate governance mechanisms in their operations to enhance continuous importance in an increasingly globalized and competitive world. The reasons for the increasing importance of corporate governance include; the recent corporate scandals globally especially in the USA, the reforms in the pension funds and the growth in private savings, the world-wide wave of business privatization, crises and the deregulation and integration of capital markets (Becht, Bolton & Rosell, 2002) as cited by Afande (2015).

Durst and Henschel (2013) evaluated the practice of governance among small firms in the principality of Liechtenstein and Scotland and established that managing directors of small firm's view governance as not a control concept but rather as concept for managing the internal and external associations with the different stakeholders. Hatani and Farhan (2014) assessed the impact of personality traits and governance mechanisms on business performance of SMEs in Kendari City, Southeast Sulawesi in Indonesia and established that both personality traits and governance mechanisms positively effects the performance of SMEs in Kendari City. Umrani, Johl and Ibrahim (2015) examined the corporate governance practices and problems faced by Malaysian

SMEs and established that SMEs Malaysia have no documented code of governance- which has brought about challenges such as expropriation of the minority shareholders.

According to Lappalainen and Niskanen (2012) and Audretsch and Lehman (2011), the topic of governance among small firms is still in its initial stages of development and as such there are few empirical studies that have been conducted on this area of knowledge. For instance, Zahra, Neubaum and Naldi (2007) determined the effect of ownership and governance on SMEs' international knowledge-based resources in the United States of America and established the presence of independent outside directors and equity held by top management team positively affect the development of knowledge-based resources necessary for internationalization. Rashid and Lodh (2011) determined the corporate governance and performance of Bangladesh SMEs through a review of 769 SMEs firms and established a positive relationship between various corporate governance mechanisms such as executives' pay, debt ratio and largest block holding and firm performance. Debt to equity ratio was on the other hand found to be negatively related to SME performance.

From Regional Perspective, developing countries too especially in Africa have embarked on adopting the best mechanisms in corporate governance for their ability to positively influence sustainable growth. Hamad and Karoui (2011) determined the relationship between governance Mechanisms, practices, and the financial performance of 50 Tunisian Industrial SMEs established that both the ownership structure and the board of directors play an important role in enhancing the performance of SMEs. The study also found that existence of the board does not affect the performance of SMEs. A survey by Abdelmoula (2014) who examined the influence of culture and governance on 120 Tunisians SMEs found that the experience and the training of managers of SMEs influence the organizational culture hence governance.

Dzigba (2015) determined corporate governance practice among SMEs in Ghana through examining 120 SMEs in the Accra Tema and Kumasi and established that although most of SME stakeholders in Ghana had heard about Corporate Governance, the actual adherence to corporate governance principles is very low. Majority of the SMEs reviewed by Dzigba (2015) did not have board committees while those that had boards had an average of between 2 to 4 member boards. The study concluded that corporate governance practice among SMEs in Ghana is very low.

A study done in South Africa aimed at analyzing and evaluating perceptions towards SME owner/managers and their consequences, on the survival and growth of SMEs. Primary data was collected from 9 provinces of South Africa, and 180 participants as samples. The research findings indicate that most respondents believed that the growth and survival of SMEs is, due to the lack of business leadership and poor Corporate Governance. In addition, respondents agreed that SME owners/managers are just average entrepreneurs, as they do not have leadership qualities or skills and that Corporate Governance does not exist in many SMEs, particularly in South Africa.

1.1.3 Board composition of SMEs

The board of directors lies at the center of the firm's internal governance mechanisms and it is also a formal organizational unit in the first line of defense to protect the shareholders' interests from being sub utilized by managers (Daily, 2003). In addition, the board of directors can help minimize the expectation gap between stakeholders and the board of directors (Brennan, 2006). Brennan & McDermott (2004), Matolcsy et al. (2004) and Peasnell et al. (2006) suggest that independent directors can monitor company managers more efficiently, thereby reducing the agency costs arising from the divergence between ownership and control rights. Shivdasani (1993), Brickley et al. (1994) and Yermack (1996) find that the firm's performance (value) and the fraction of outside independent directors on the board are positively correlated.

Daily (1999), Zahra and Pearce (1989) and Young et al. (2001) suggest that the appointment of independent directors on the board and the duality of the CEO positions are key factors in improving the effectiveness of the monitoring and service functions of the board. Fosberg (2004) finds that a dual leadership structure will increase the debt used by a firm. Fairchild and Li (2005) find that directors in managerial positions can improve a firm's financial performance.

1.1.4 Ownership Structure of SMEs

Fama & Jensen (1983) suggest that block-holders are more effective in monitoring the company than small shareholders. Shleifer and Vishny (1986) further propose that external large shareholders can limit the scope of managerial opportunism, thereby reducing the costs of conflicts between managers and shareholders. In addition, Brailsford et al. (2002) argue that if external large shareholders can actively monitor managers' behavior, it will be more difficult for managers to adjust the debt ratios to serve their own interests. Moreover, Fosberg (2004) suggests that the monitoring by large shareholders can effectively prevent the firm from choosing a suboptimal capital structure, thereby reducing the agency problem.

In addition, directors designated by the financial institution can provide professional financial or investment advisory services to firms (Schneider, 2000). Therefore, it can be regarded as a sign of a guarantee, allowing the monitoring costs to benefit from economies of scale, reducing entry barriers to the capital market (Fama, 1985), and thereby reducing the firm's capital costs (James, 1987). Chaganti & Damanpour (1991) and Bathala (1994) find that institutional shareholders prefer low debt financing. In addition, Firth (1995) suggests that institutional shareholders can safeguard the rights and interests of shareholders by restricting managerial behavior.

Friend & Hasbrouck (1988), Firth (1995), Berger et al. (1997), Al-Fayoumi, and Abuzayed (2009) find that managerial shareholdings are negatively related to firm's debt in order to reduce the bankruptcy risk. Fosberg (2004) further finds that the firm's financial advantage is negatively correlated with CEO shareholdings but positively correlated with director shareholdings. McConnell and Servaes (1995) suggest an inverted U-shape relationship between managerial ownership and the debt.

Family shareholders are more concerned about the firm's future growth and survival (Schneider, 2000). Since the interests of the firm are aligned with the interests of the family, the family shareholders have greater incentives to monitor the operations of the family business. Anderson et al. (2003) suggest that family firms have a stronger incentive to improve the firm's operating performance and reduce operating risks. Setia-Atmaja et al. (2009) find that family-controlled firms prefer to use leverage instead of monitoring the independent directors and, therefore, debt is an effective governance mechanism, which can reduce the equity agency problem.

When the ownership is concentrated, the interests of controlling shareholders and the firm are aligned. However, if the control rights diverge from the cash flow rights, the agency problem between controlling shareholders and minority shareholders will become more severe and will have a negative impact on firm value (Harris and Raviv, 1988). Du and Dai (2005) and Chong (2010) find that the divergence of shareholders' control rights from cash flow rights will increase the risk- taking in firm's capital structure decisions.

1.1.5 Presence of Audit committee in SMEs

SMEs that are incorporated as companies will need to take cognizance of the Companies Act requirements relating to the audit committees appointment, composition and duties. In addition, it is recommended that all companies should establish an audit committee and define its composition, purpose and duties. SMEs are required to establish an audit committee through statute and who do not decide to do so voluntarily, should implement and carry out the core functions of an audit committee within the Board.

According to the Cadbury Report (1992), the establishment of an independent audit committee is important to improve the quality of financial statements. The presence of an audit committee within a firm stands as a key aspect of internal corporate governance. In most of the times, the composition of audit committee provides strict control and monitoring to avoid financial fraud or misstatement by engaging external auditors' services, and thus leading to high audit fees. DeAngelo (1981) argues that the work of an auditor is to find any financial misstatements. Therefore, having an audit committee with independent directors will eventually lead to improve external audit quality, and in turn, to minimize the risk of having financial misstatements and fraud, causing audit fees to increase. Empirical evidence demonstrates that audit committee independence is positively related to audit fees. Beasley et al. (2000) detect that firms with low audit independence are likely to experience higher financial fraud. Similarly, Abbott et al. (2003) argue that audit independence enhances financial reporting. This implies that the higher the percentage of independent members on the audit committee, the higher will be the demand for audit work from external sources, and in turn, the higher will be the audit fees. Hence, we argue that there is a positive relationship between audit independence and audit fees, which supports the demand side approach of audit fees. Al-Najjar (2015) supports the importance of audit committee independence in the listed UK SMEs and includes it in his corporate governance index.

Audit diligence is measured as the number of audit meetings held in a year. It is argued that frequent audit meetings will result in better auditing processes (Raghunandan et al., 2001). Hence, for an audit committee to be more effective and functioning properly, it has to meet more frequently. Empirical studies posit that audit diligence is positively associated with audit fees. For example, Abbott et al. (2003) demonstrate that audit committees with frequent meetings (meet four times in a year) result in proper financial accounts. In other words, the more audit meetings, the higher the likelihood for firms to demand more audit assurance, for a better financial process, thus leading to high audit fees. However, they report no significant evidence of the relationship between audit meetings and audit fees. On the other hand, Goodwin-Stewart and Kent (2006) detect a positive relationship between audit meetings and audit fees. Research in SMEs context employs audit meetings as a key governance tool (see, for example, Al-Najjar, 2015).

About 2.2 million Small and Medium Enterprises (SMEs) in Kenya have closed their businesses in the last five years (2011 – 2016) (SME survey, 2016). The survey further posits that the average failure period is 3.8 years and that most of the businesses that went out of operations were in motor vehicles and motor cycles repair, wholesale and retail trade sectors that accounted to 73 per cent of the total closure. According to the report, 29.6 per cent of closure by SMEs is attributed to shortage of operating funds caused by decreasing in income, increase in firm operating expenses and increase in losses incurred. Majority of the SMEs that failed faced challenges in raising finances, which is attributed to them relying on traditional sources of financing that revolved around personal savings and loans from friends and family. Most banks are known to be unwilling to extend credit to SMEs. Scholars suggest that it is because of lack of proper governance systems and managerial competencies in the SME sector (Gockel and Akoena, 2002). Thus, it is essential that SMEs adopt good corporate governance mechanisms enhance performance, given that this would have major implications for sourcing finances by the sector.

1.1.6 Legal and Policy Frameworks of SMEs in Kenya

The SME industry has remains very crucial to the developing of Kenya and as such, policy provisions remains fundamental in propelling the SMEs towards self-sustenance hence realization of their full potentials especially in relation to boosting the country's economic development (Wanjoi, 2010). Through legal and policy frameworks, the Kenyan government has made some strides towards supporting governance among SMEs. The government implemented the two acts which are the Micro-Finance Act CAP493D (2006) and the SACCO Societies Act CAP 490B (Act 14 of 2008). The Micro-Finance Act (2006) was enacted to regulate and license SMEs while the SACCO Societies Act (2008) was enacted to license and supervise SACCOs. The two acts were established to offer effective regulatory framework to SMEs to enhance governance (MSME survey, 2016).

There is also the Micro and Small Enterprises Act No. 55 of 2012 whose mandate is to formulate, review, monitor and evaluate the implementation of policies and programs for the governance of SMEs (Ong'olo & Awino, 2013). There is also the formulation of other programme and institutions to support various aspects of SMEs including governance. These include, Assistance to Micro and Small Enterprises Programme (ASMEP), Micro Small and Medium Enterprise (MSME) Competitiveness Project and the Department of Micro and Small Enterprise Development (DMSED) (MSME survey, 2016).

1.1.7 SMEs in Kenya

On Local Perspective view, in 2015 the contribution of the SMEs in Kenya to the economy was about Sh1.6 trillion which represents about 28.5 per cent of the total count of the whole economy which is Sh5.6 trillion (Kangethe, 2016). Despite this huge contribution and a crucial role that the SMEs play, majority do not stay long in business. According to a survey by the Kenya National Bureau of Statistics (2016), 2.2 million Small and Medium Enterprises (SMEs) in Kenya have gone out of business in the last five years (2011 – 2016). The report posit that majority of SMEs failed at the age of 3.8 years. The report further suggested that most of the businesses that went out of operations were in motor vehicles and motor cycles repair, wholesale and retail trade sectors that accounted to 73 per cent of the total closure (KNBS, 2016). Given the crucial role SMEs play in an economy such as driving innovations and employment-creation among others, understanding the ways to enhance their operational performance is crucial thus, this study will examine whether corporate governance mechanisms have an effect on the SMEs operational performance.

1.2 Problem Statement

The concept of governance among firms has made a huge contribution to the development of developing countries. Thus, understanding and appreciating the importance, the nature and the impact of effective governance is crucial for a country's stability as well as social and economic growth. According to Afande (2015), governance can assist the SMEs largely through promoting stronger internal auditing, enhancing better management practices, thus increasing the opportunities for growth. McGee (2008) suggested that owners, directors and the management of SMEs have started to realize that having good corporate governance mechanisms in place is beneficial to their firms.

The choice of SMEs sector was reached at for various reasons. Majority of research on corporate governance mechanisms adopted by firms is based on large corporations and not SMEs (Afande, 2015). In Kenya, there is a high rate of failure by SMEs and the limited literature that has been reviewed does not focus on establishing whether the SMEs fail due to lack of governance or related problem. The uniqueness of the SME's sector also arises from the fact that the SMEs sector is one of the important sectors to the Kenya's economic development but the sector is faced with many challenges. Although there is increasing awareness of corporate governance concerns, little empirical evidence that focuses on corporate mechanisms and the performance of SMEs in the emerging economies. In Kenya, there exists sparse literature that links corporate governance and operational performance in SMEs.

Several studies have been done to review the relationship between corporate governance mechanisms and the performance of SMEs. For instance, Aksoys & Bozkus (2008) studied the impact of corporate governance on Accounting measures of financial performance, Credit usage and trade openness in Turkish SMEs firms. Taylor (2013) assessed the effects of corporate governance mechanisms on the performance of publicly traded SMEs in developing economies. Locally, Maranga, (2014) examined the effect of corporate governance on financial performance of SMEs in Kenya as of December 2013 in Nairobi County. Afande, (2015), sought to examine the financial performance and extent of adoption of corporate governance practices of SMEs in Kenya. Njagi (2016) examined the relationship between corporate governance practices and the financial performance of top 100 SMEs in Kenya.

Most of the literature reviewed on this area of knowledge is based on SME financial performance and not their operational performance, which brings a gap in knowledge. Some are based on developed countries that cannot be used to represent the same in developing countries such as Kenya, for instance Aksoys & Bozkus (2008) is based on Turkish SMEs. These make the corporate governance mechanisms and the operational performance of the SMEs in Kenya a unique component of review in this study.

According to Cho and Kim (2003), organization would enhance their corporate governance, when the firm performance is poor because changes in corporate governance structure are expected to bring positive result on their operational performance and hence a competitive advantage. Competitive advantage is the extent to which an organization is able to create a defensible position over its competitors. It comprises capabilities that allow an organization to differentiate itself from its competitors and is an outcome of good corporate governance. Core, Guay, and Rusticus (2005) find that firms with poor shareholder rights as measured by G-Index have significantly negative operating performance but the market is not surprised by the negative performance of poorly governed firms. These make the corporate governance mechanisms and the operational performance of the SMEs in Kenya a unique component of review in this study.

1.3 Research Objective

1.3.1 General Objective

The general objective was to determine the effect of corporate governance mechanisms on the operational performance of SMEs in Nairobi.

1.3.2 Specific Objectives

The specific objectives achieved by this study were;

i. To examine the influence SME board on the operational performance of the SMEs in Nairobi.
ii. To establish the effect of board roles on the operational performance of the SMEs in Nairobi.
iii. To determine the effect of Board competency on the operational performance of the SMEs in Nairobi.
iv. To establish the effect of audit committee on the operational performance of the SMEs in Nairobi.

1.4 Research Questions

i. Does the existence of a formal board influence the operational performance of an SME?
ii. Do board roles influence the operational performance of the SMEs in Nairobi?
iii. How does board competency influence the operational performance of the SMEs in Nairobi?
iv. What is the effect of audit committee on the operational performance of the SMEs in Nairobi?

1. 5 Significance of the Study

The findings of this study would be of great importance to several stakeholders. These included the government and other regulators, the management of the SMEs, researchers and academicians. The different levels of management of the SMEs in Kenya including the policymakers would acquire valuable information on corporate governance mechanisms. They would also adopt the findings of the study to equip them with knowledge and skills on responsible corporate governance, which will enhance improved operational performance of the SMEs.

The study would also enrich scholars and academicians with information with regard to correlation between corporate governance and operational performance of SMEs. Lastly, the study findings would form basis of further research and point of reference to the future researchers.

1.7 Scope of the Study

This study narrowed its scope to determining the effect of corporate governance mechanisms on the operational performance of SMEs in Kenya. The geographical scope for the study was SMEs operating within Nairobi's Central Business District (CBD) and the period of study was May 2019. The reason for the choice geographical area is that most of the SMEs are highly concentrated in this Nairobi CBD.

1.8 Definition of terms

1.8.1 SMEs

Small and medium-sized enterprises (**SMEs**) are non-subsidiary, independent firms, which employ less than a given number of employees. This number varies across countries. The most frequent upper limit designating an **SME** is 250 employees, as in the European Union. The term "SME" encompasses a broad spectrum of definitions. The definition varies from country to country. Generally, these guidelines are based upon either headcount or sales or assets. For example, the Inter-American Development Bank defines SMEs as having a maximum of 100 employees and less than $3 million in revenue. For small enterprises, it is from 10 to 50. For medium enterprises, it is from 50 to 100. SME is terms used differently in different countries.

1.8.2 Corporate Governance

A large number of definitions of corporate governance have been advanced through the years. The traditional definition is related to the protection of shareholder‟s interests Tirole (2001) and has roots in the issue of separation between management and control. Monks and Minow (1995) maintain that corporate governance studies the relationship among various participants in determining the direction and performance of corporations. Bauer et al., (2004) defined Corporate governance as the process and structure used to direct and manage business affairs of an entity/firm towards enhancing prosperity and corporate accounting with the ultimate objective of realizing shareholders long-term value while taking into account the interest of other stakeholders. Corporate governance may thus be perceived as the set of interlocking rules by which corporations, shareholders and management govern their behavior.

CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction

Corporate governance is the system of rules, practices and processes by which a firm is directed and controlled. Corporate governance involves the processes and structures put in place to safeguard the welfares of the stakeholders.

This chapter presents a discussion of the related literature on the effect of government mechanisms on the operational performance of SMEs, which is presented by different scholars, researchers, authors and analysts. This chapter covers the theoretical review, the empirical review, critique of existing literature, followed by the conceptual framework of the study and then the research gaps that exist in the literature are reviewed.

2.2 Theoretical Review

Scholars to try to explain the importance of governance and its effect on firm performance have put corporate governance theories forward. This study's theoretical review was based on two theories, which include; Agency theory and Stewardship theory.

2.2.1 Agency Theory

Jensen & Meckling (1976) put the Agency theory forward. The theory was developed to try to explain the relationship between the principals such as the firm's shareholders and the agents for instance the firm executives and managers. In this relationship, the shareholders as the owners of the organization, hires the agents to perform the work of managing the organization on their behalf (Clarke, 2004). This is also referred as delegation of work. According to this theory, after delegation, the agents can be self-interested in decision making instead of acting in the best interest of the shareholders or the principals as expected (Padilla, 2000). The agent may focus on self-interests, have opportunistic behavior and fall short of congruence with the aspirations of the principal. According to Holmstrom and Milgrom (1994), the agents focus on investments that have high return and a fixed wage without any incentive payments.

The challenges of agents are the ones that lead to the development of the agent theory which sort to separate ownership and control of firms (Bhimani, 2008). The theory suggested that the agents should be controlled by rules that are made by the principal which are aimed at maximizing shareholders value. This is because when left alone, managers sometime give their interest a priority over the shareholder's which brings about a conflict. The shareholders thus must incur some costs to monitor and direct the managers. However, some authors suggest that this will only help to provide a fair assessment, but it does not minimize or eradicate misconduct among firms. Thus, the theory reviews the relationship between the ownership and the management structure. The theory can also be used to align the goals of the management with the ones of the owners. It relates to a specific type of agency relationship that exists between the shareholders and directors/management of a company. The shareholders, true owners of the corporation, as principals, elect the executives to act and take decisions on their behalf. The aim is to represent the views of the owners and conduct operations in their interest. Despite this clear rationale of electing the board of directors, there are many instances when complicated issues come up and the executives, knowingly or unknowingly, take decisions that do not reflect shareholders' best interest. In the dynamic business environment, agency theory of corporate governance has garnered a lot of attention and is seen and evaluated from different points of view.

The Agency theory was criticized by Donaldson (1990) on various ground for instance, the grounds that it dominates in terms of methodology individualism, it has narrow defined motivation model, it disregards other research and for its regressive simplification. The agency theory states that the presence of an audit committee within the board of directors is sufficient to ensure the reliability of financial statements. Simple agency theory implies that, principals do not trust agents to provide them with reliable and relevant information, therefore they will hire in external experts, who are independent of these agents. This, however, introduces the concept of auditors as agents of principals, which leads to new concerns about trust, threats to objectivity and independence. This theory is however relevance to this study for its suggestion that effective monitoring of corporate governance practices like auditing among SMEs that would ensure that the management acts in the best interest of the shareholders would in turn enhances the performance of SMEs.

2.2.2 Stewardship Theory

The steward theory states that a steward protects and maximizes shareholders wealth through firm Performance. Stewards are company executives and managers working for the shareholders, protects and make profits for the shareholders. The stewards are satisfied and motivated when organizational success is attained. It stresses on the position of employees or executives to act more autonomously so that the shareholders' returns are maximized. The employees take ownership of their jobs and work at them diligently.

It is a theory that has been credited to organizational behavior scholars in the past 20-25 years, but it has been expressed and practiced in different forms for much longer than that. Certainly, Dodd, in his writings of the 1930s and in his famous public debates with Berle, posited some views that can be seen as similar to, or consistent with, stewardship theory. During the period from the 1920s to the early 1970s directors in the US and the UK, while practicing what is generally known as "managerialism," widely regarded themselves as stewards (Stout 2013) and acted in line with a broad stewardship approach.

Stewardship theory is presented as an alternative (some might say "complementary") to agency theory. Unlike agency theory which focuses on control and conflict, stewardship theory emphasizes co-operation and collaboration (Sundaramuthy and Lewis 2003), and provides a non-economic premise for explaining relationships.

The stewardship theory holds, essentially, that directors act as stewards and will not be concerned about fostering their own economic interests, as agency theory holds, but will be willing to act in the best interests of their company, and they will act in a way that leads to collectivist/organizational utility rather than self-serving benefits. In working towards organizational ends the personal needs of directors are fulfilled (Sundaramuthy and Lewis 2003; Kluvers and Tippett 2011). Thus, directors acting as stewards are concerned about acting honorably and "doing the right thing" (Stout 2003, 8). Stewardship theory is marked by the idea of service for others and not self-interest (Block 1993). Some commentators go further and say that the theory "assumes a commitment to the welfare, growth and wholeness of others…" (Caldwell & Karri 2005, 255).

This theory was however relevant to this study for suggesting that the firm management as stewards of the organization protects and maximizes the wealth of the shareholders which in turn enhance firm performance.

2.3 Empirical Review

This study's empirical literature presents the findings of other studies on the effect of government mechanisms on the operational performance of SME's. This section presents past studies and their findings according to the objectives. These include; the existence of a formal board, board roles, management competency and audit committee.

2.3.1 Formal Board Existence and Operational Performance

Corporate governance debates have largely focused on the existence of a formal board and the powers of the Board vis-à-vis the discretion of top management in decision-making processes. According to Abor and Adjasi (2007), the existence of a board in SMEs induces rapid growth strategies for rapid profits however; it requires the firm to go public to acquire larger finances. Thus, an effective board is required for a firm to smoothly transition from small to medium and finally large company. Existence of the board of directors makes available one type of internal control mechanism that balances the interests of multiple stakeholders and deals with some problems of corporate governance. Existence of a formal board also ensures effective monitoring which enables safeguarding invested capital given its legal authority to hire, fire, compensate and advise top management on behalf of shareholders.

Cheng (2011) examined the impact of the corporate governance mechanism on firm performance. The researchers employed measure such as return on assets, stock return and Tobin's Q to measure firm performance. The researcher's results indicate that firm performance is in negative and significant relation to board size, CEO duality, stock pledge ratio and deviation between voting right and cash flow right. On the other hand, firm performance is in positive and significant relation to the existence of the board, its independence and insider ownership.

Younas (2013) investigated the impact of prior year firm's performance on subsequent year firm's corporate governance mechanism. The researchers used existence of the board, its size, CEO–Chairman combined structure and audit expenditure as a firm level corporate governance mechanism. The analysis consists of panel data of fifty-two companies listed on Karachi Stock Exchange covering the period from 2006 to 2010. The researchers tested the hypotheses using fixed effect model and random effect model. The researchers found out that prior year, firm's performance had positive relationship with the existence of the board and the size of the board but negative relationship with audit expenditure and that any change in prior year firm's performance causes change in CEO duality.

Wanjiru (2013) investigated the effects of Corporate Governance on the financial performance of listed companies at the NSE. Specifically, the study examined existence of the board, board size, board composition, CEO duality and advantage and how they affect the financial performance of companies listed at the NSE. Firm performance was measured using Return on Assets (ROA). The study adopted a descriptive research design. Both descriptive and inferential statistics were used. The study found that a strong relationship exists between the Corporate Governance practices under study and the firms' financial performance. There was a positive relationship between existence of the board, its composition and firm financial performance. However, the most critical aspect of board composition was the experience, skills and expertise of the board members as opposed to whether they were executive or non-executive directors. Similarly, leverage was found to positively affect financial performance of insurance firms listed at the NSE. On CEO duality, the study found that separation of the role of CEO and Chair positively influenced the financial performance of listed firms. None of the studies determined the effect of existence of a formal board on the operational performance of SMEs in Kenya.

2.3.2 Board Role and Operational Performance

The board of directors is appointed to run the day to day activities of the firm on behalf of the shareholders thus it is accountable to the shareholders and each year the firm holds an annual general meeting (AGM) at which the directors provide the report on the performance of the firm to shareholders and also submit themselves to the shareholders for re-election (Brefi Group, 2016). Understanding the roles and mandates of the board should be the first task when the board is appointed. According to IFC Corporate Governance (2016), the most important roles of a well-organized board of directors are to set the overall strategy of the firm, which involve; overseeing the management performance; and ensure that an appropriate corporate governance structure is in place, including a robust control environment, sufficient disclosure levels, and an adequate minority shareholders' protection mechanism. The time and effort allocated by the board to each of these roles depends on the size and complexity of the business. The board is also responsible for taking corrective actions to ensure that the firm accomplishes the set goals, however Denis (2001) posits that suggests that sometime there exists a formal board but there are no sufficient incentives to influence the board partake its job properly.

Researchers such as Forbes and Milliken (1999), Johannisson, Huse (2000) as cited by Voordeckers, Gils, and Heuvel (2007) argue that firm boards have a more important role in SMEs than in larger corporations. Among SMEs, boards add value through board roles including arbitration (Whisler 1988), general and technical advice and counsel (Ward and Handy 1988), strategy development and control (Gabrielsson & Winlund, 2000), ensuring that the management is disciplined (Johannisson & Huse, 2000) and networking (George, Wood & Khan 2001). Neubauer and Lank (1998) as cited in IFC Corporate Governance (2016) suggested that in addition to strategy and oversight, other main tasks that are assigned to the board of directors include, ensuring that financial resources are available, securing the succession of senior management, reporting to the owners and any other parties that are interested and also ensuring the firm's risk management systems and internal controls are adequate.

Core, Holthausen, and Larcker (1999) as cited by Yacuzzi (2007) examine the effects of the "busyness" of directors on the effectiveness of corporate governance. The study defined the directors to be busy when they serve on more than three boards while employed full time and more than six boards if they are retired. They researchers reported that boards with busy directors tend to have excessive CEO compensation and imply that these busy directors do not perform their roles effectively to make substantial contributions to effective corporate governance. A study by Fich and Shivdasani (2006) on busy boards and the firm's operating performance established that that busy boards are associated with weak corporate governance and that firms with busy boards show poor performance in their operations which was shown by lower operating returns on sales, low market-to-book value ratios, low lower asset turnover ratios and lower returns on assets.

Iturralde, Arosa and Maseda (2012) examined the relationship between board demography and company performance and between the board members working style and board task in small and medium-sized enterprises (SMEs). The study used variables such as board size, board composition and control roles, board members working style, leadership structure and board activity and the performance of SMEs. The study used data from a sample of 307 Spanish SMEs. The researchers established that there is a negative relationship between the proportion of outside directors and the board size on firm performance. On board members working style, the study established a negative impact with the presence of outsiders and a positive relationship between board service role and board tenure. On board control role, the researchers found a negative relationship with CEO tenure.

However, none of the studies determined the effect of board roles and mandate on the operational performance of SMEs in Kenya, which leaves a gap in the literature.

2.3.3 Audit Committee and Operational Performance

The audit committee plays a major role in corporate governance regarding the organization's direction, control, and accountability. As a representative of the board of directors and main part of the corporate governance mechanism, the audit committee is involved in the organization's both internal and external audits, internal control, accounting and financial reporting, regulatory compliance, and risk management.

The audit committee operates as a representative of the board of directors from whom it receives its powers to perform its corporate governance responsibilities which include overseeing and monitoring the organization's financial reporting, disclosure, internal and external audit, internal control, regulatory compliance, and risk management activities; this applies to public, private, and mix sectors, as well as some non-governmental and not-for profit organizations. Several Previous studies have indicated that the monitoring role of audit committees is a key element in corporate governance, helping to control and monitor managers' practice (Campbell and Mínguez-Vera 2008; Afify 2009). Furthermore, audit committees can improve the quality of financial reporting and decrease audit risk, thereby improving the quality of reported earnings (Contessotto and Moroney 2014; Abernathy 2015). Therefore, audit committees play an important role in overseeing and monitoring a company's management, with the aim of safeguarding the interests of the owners (Kallamu and Saat 2015). It is recognized that an effective audit committee focuses on enhancing company performance and competitiveness, particularly in a changing business environment, which is beyond the control of the company (RamCharan 1998; Cravens and Wallace 2001; Herdjiono and Sari 2017). An effective audit committee is expected to emphasize optimization of shareholders' wealth and prevent managers' maximization of their personal interests (Wathne and Heide 2000; Bansal and Sharma 2016).

The audit committee provides the board of directors with necessary advices and recommendations which include ensuring: that the respective organization complies with relevant regulations and ethical principles and standards; that the internal auditors are independent and competent; that the financial statements have been prepared correctly and accurately; and that the compensations paid to the organization's executives were according to fairness and professionalism (Basuony 2014).

Several studies have been conducted on the audit committee responsibilities on corporate governance. Cooper and Lybrand (1995) found that audit committee responsibilities revolved mainly in the areas of financial reporting, auditing and overall corporate governance. Kiema (2015), conducted a study of influence of internal audit independence on the financial performance of SMEs in Mombasa county, the study revealed that in most organizations, internal auditors were not fully recognized for their roles and therefore the level of internal audit independence was found to be relatively weak and in some cases non-existence.

However, just a few of the studies determined the effect of audit committee on the operational performance of SMEs in Kenya that leaves a gap in the literature.

2.3.4 Board Competence and Operational Performance

Board managerial competence originates from knowledge. According to Bozbura (2007), the rise of knowledge on economy and socio-economic transformation of the societies have made it to be a fundamental means through which wealth and prosperity are acquired. According to Muller and Turner (2010), competencies are a combination of individual's knowledge, personal characteristics and abilities that would enable them perform specific duties, activities or tasks. The concept board management competency has been a subject of continuous debate for some time due to the need for firms to acquire managers with skills that would enable the firm to survive competition (Crawford, 2005). According to the MSME survey (2016), the management of SMEs in Kenya lack the capacity, competence and maturity to compete at regional and global level.

Knowledge plays a big part in leveraging the firm's resources effectively and efficiently which appears to be a crucial issue in order to gain the competitive advantage and the sustainability and development of the societies. The knowledge is viewed as the key factor that enhances the firm performance in the long run (Tat & Haze, 2007). Over time also asserts that there has been a shift from task-based approaches to competency-based approaches in the knowledge economies (Clardy, 2008). Therefore, the popularity of board management competency has gained a special concern from both practitioners and academicians. Board Management competency can contribute to organizations knowledge base and increase the knowledge utilization capability of an organization and thus increasing performance. Recent research in this area of knowledge, clarified that individual competency is an area of research attracting efforts to leverage personal development, knowledge generation (Abou-Zeid, 2002), hence development.

Several researchers have evaluated the effect of board managerial competencies on firm performance. A study by Krajcovicova, Caganova and Cambal (2012) established that the 4 pillars on which effective managerial skills are based include; knowing the organization, managing resources, leading and managing people and communicating effectively. A study by Blum (2014) on the competencies of effective managers established six managerial competencies that enhance managerial effectiveness that in turn is said to enhance firm performance. These are proficient communication skills, provision of high high-impact performance feedback, understand the needs of different generations and adapt accordingly, focus on employee career development needs, advocating for firm changes necessary for developing and keeping top talent and maximizing of the leadership strengths.

Fatoki (2014) examined the effect board managerial competencies specifically education and experience on the performance of immigrant owned SMEs in South Africa. The study employed a survey design. The study data was collected using self-administered questionnaire. The data was analyzed through descriptive statistics and the Chi-square test of independence. The researcher established that there is a relationship between owners' education and performance. The study also found that work experience had a positive effect on firm performance through establishing that managers with work experience prior to starting business significantly perform better than those without prior experience. The researchers thus recommended that SME managers should improve their level of education and experience thus it would enhance the performance of their organizations.

Gokkaya and Ozbag (2015) determined the relationship between core competence, innovation and firm performance in Turkey. The study proposed three empirical determiners, which included uniqueness, inimitability and extendibility. The researchers also sort to help leaders and managers enhance firm performance by means of improving their core competencies and innovation. The study established that all the three dimensions of core competence; uniqueness, extendibility and customer value; are significant in explaining innovation, which also has significant effects on firm performance. Hawi, Alkhodary and Hashem (2015) examined managerial competencies and organizations performance in airline sectors in Jordan. The researchers used a sample drawn from 4 big airlines organizations in Jordan. The study hypotheses were tested over a Mach data set that included 62 managers. The researchers established that all the managerial competencies under review; problem solving, customer focus, leadership and strategic competency had a positive impact on the performance of the airline sectors in Jordan. However, none of the study examined the effect of board competence on the operational performance of SMEs in Kenya, which leaves a gap in the literature.

2.4 Critique of Existing Literature

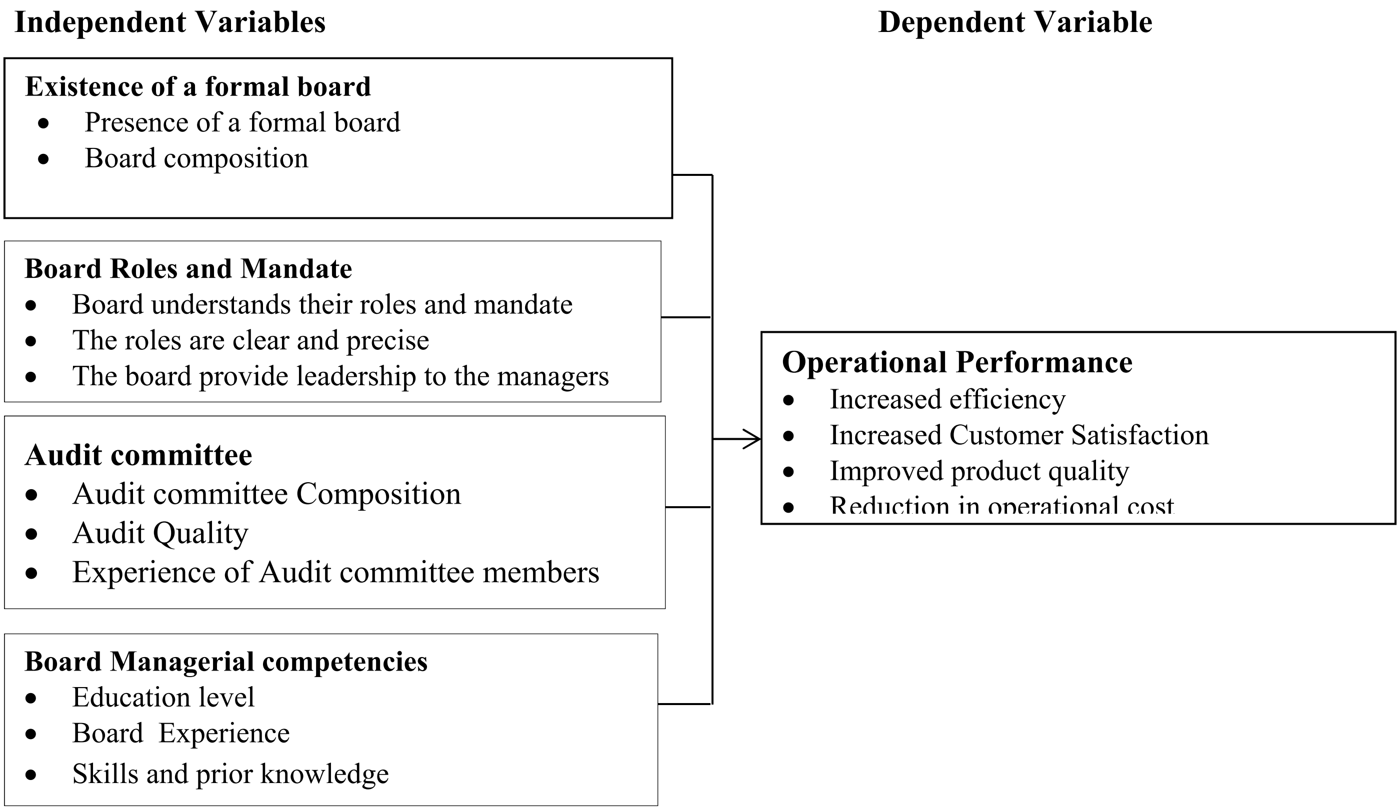
On theoretical review, the theories reviewed have different perceptions and focus on corporate governance. For instance, Agency theory focuses on mangers concentrating on their own interests and not those of shareholders, Stewardship theory emphasizes on firm managers as stewards of the organization while the Resource Dependence theory on the other hand concentrates on firm boards as managers of SME environment. Thus, the theoretical review is criticized based on lacking a common understanding on corporate governance among the SMEs. This is so because the theories do not view effective corporate governance as triggered by one aspect such as monitoring the shareholders, the competencies of the management or the experience that the directors have thus a conflict arises between them.

The literature reviewed is also criticized based on not bringing out well the mechanisms of effective corporate governance since scholars suggest different determinants however common among them are; the existence of a formal board, board roles and mandate, management competency and audit committee. According to our limited review of literature, we could not find a single study, which narrowed their scope to specific corporate governance mechanisms of existence of a formal board, board roles and mandate, audit committee and managerial competencies and operational performance of SMEs in Kenya. The studies reviewed is that most of the researches were limited to the largest, actively traded organizations that are found in developed economies many of which obviously have board in place and also show little variation in their management competencies and compensations and board structure and also measure performance as market value.

2.5 Conceptual Framework

The conceptual framework is given by the dependent and the independent variables. This study's dependent variable was the operational performance of SMEs in Kenya while the independent variables include corporate governance mechanisms. These include; existence of a formal board, board roles and mandate, audit committee and managerial competencies. As shown below;

Figure 2.1: Conceptual Framework



Existence of a formal board has been found by various scholars to positively affect firm performance although the studies did not focus on the operational performance of SMEs in Kenya. However, this study determined whether the existence of a formal board had an effect on the operational performance of SMEs in Kenya. Board roles and mandates have been reviewed by various scholars who have suggested that firm boards have a more important role in SMEs than in larger corporations through performing roles such as networking, arbitration, general and technical advice and counsel, strategy development and control and ensuring that the management is disciplined. The scholars did not however determine whether the roles have an effect on SMEs performance. This study however established whether board roles and mandate have an effect on the operational performance of SMEs in Kenya.

Many scholars to affect the firm performance had also identified the nature of the audit committee but although the studies did not focus on how it influence the operational performance of the SMEs in Kenya. This study therefore sought to establish the correlation of audit committee and the operational performance.

Board Managerial competencies have been found to be a very important aspect of corporate governance however many scholars have not reviewed whether this affects the operational performance of SMEs. This study however established whether board managerial competencies have an effect on the operational performance of SMEs in Kenya. The performance of SMEs in Kenya has been shaky with most of them going out of business within the first three years due to high costs, poor operational performance and other factors. This study therefore determined the effect of governance mechanisms on the operational performance of SMEs in Kenya.

2.6. Summary of the literature and Knowledge Gaps

Based on the pertinent literature reviewed, the focus of the studies is identified and knowledge gaps highlighted which informed the current study. The study therefore attempted to address these gaps with the view to contributing to the corporate governance and operational performance. Table 2.1 summarizes the gaps and how they were addressed in the study.

Table 2. 1 knowledge Gaps

Researcher (s)	**Focus**	**Knowledge Gap**	**Current Study**
Kyondu (2012)	The study examined the effect of corporate governance on the performance of state corporations in Kenya	Use of homogenous population makes generalization of the results questionable	The target population for the study was narrowed down to a specific region thus making the research more represented
Mwamburi (2017)	The effect of corporate governance practices on the financial performance of the insurance companies in Kenya	The study did not address the issue of audit committee and the impact on performance	Being addressed by objective four of the current study.

Ochieng (2011)	The relationship between corporate governance practices and performance of commercial banks in Kenya	The study did not focus on the managerial competency of the members	Objective three of the current study addressed this.
Opondo (2012)	Impact of corporate governance practices on operating Performance of the unlisted financial institutions in Kenya	The study did not focus on the board roles and attributes of the institutions	This was addressed by objective two of the current study
Raissa (2014)	The effect of corporate governance on the financial performance of commercial banks in Rwanda	The study target population was homogenous making generalization of the results	This was addressed by the current study where the target population was narrowed down

2.7 Literature Summary

This chapter reviewed the literature on the effect of corporate governance on the operational performance of SMEs. The review comprised the theoretical review where three theories were reviewed, empirical review that was reviewed according to the objectives of the study, the critique of the existing literature that the research will fill, and the conceptual framework. The review was based on the research problem under study. Most of the literature that was reviewed found a positive relationship between corporate governance mechanisms and firm’s performance. The theories reviewed advocate for an increase in performance of firms with good corporate governance mechanisms put in place.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This study aimed to determine the effect of corporate governance mechanisms on the operational performance of SMEs in Kenya. The chapter was divided into various sections. These include the research design, study population, sampling design and technique, sample size, data collection procedure and instrument, data analysis and ethical considerations.

3.2 Research Design

Dul and Hak (2008) defined research design as “an arrangement of conditions for collection and analysis of data in a manner that aims to combine relevance with the research purpose”. According to Mugenda and Mugenda (2003), research design refers to the structure, plan and strategy to be adopted in order to answer various research questions. This study employed a descriptive survey research design. Descriptive research design was adopted since it allowed the researcher to describe the population of interest. In this study, the phenomenon was the effect of corporate governance on the operational performance of the SMEs in Kenya. Descriptive survey was done by collecting data by way of interviews or administering questionnaires to a sample of the target population under study.

The design also allowed the researcher to study how corporate governance mechanisms affected the operational performance of SMEs in Kenya. This enabled the researcher to understand how corporate governance mechanisms affected the operational performance of SMEs in Kenya.

3.3 Population of the Study

Target population refers to the total number of respondents in a field that the researcher is interested in Kothari, 2004). Mugenda and Mugenda (2003) on the other hand described a target population as the population to which the research findings was generalized. The target population for this study was the SMEs operating Nairobi’s CBD as at the end of 31 December 2016. According to the Ministry of Industrialization and Enterprise Development (2015), there was around 20000 retail SMEs in Nairobi CBD but only 500 were sampled.

3.4 Sampling Design and Technique

According to Manion (2001), the quality of any research is influenced by the appropriateness of methodology, instrumentation and suitability of the sampling strategy that has been adopted. Mugenda and Mugenda (2003) define sampling as "the process of selecting a number of individuals for a study in such a way that the individuals selected represent the large group from which they were selected". This study used simple random sampling to come up with a representative sample.

3.5 Sampling Size

Researchers such as Babbie (2005) states that sample size for descriptive studies should be between 10%-30% of the population. Mugenda and Mugenda (2003) cites a sample size of 10% of the total population as an adequate representative sample for a descriptive study whereas Neuman (2003) considers 10%-20% as being an adequate sample for a descriptive study. The sample size for this study was calculated using the Yamano Taros formula (Israel, 2012) as shown below:

$$n = \frac{N}{1+N(e)^2}$$

Where: n = sample size

N = population size

e = is the level of precision ±10 (sampling error of 90 % confidence level)

Therefore: $$n = \frac{500}{1+500(0.10)^2}$$

= 83 (83 respondents) which represents 16.6% of the target population.

3.6 Data Collection Procedure

This study used primary data that was collected by use of semi-structured questionnaires. The questionnaires were administered to the target population through "drop-and-pick-later method". The "drop-and-pick-later method" was preferred because it ensured adequate time for the respondents to fill-in the questionnaires. The respondents of the study comprised the managers in each of the 83 selected SMEs.

3.7 Data Collection Instruments

The preferred data collection instruments for this study was the semi-structured questionnaires. The questionnaire was the preferred data collection instrument since it allowed a standardized procedure of primary data collection. The questionnaire contained both closed-ended and open-ended questions. The questionnaire was structured in three sections as follows: Section A had questions on general demographics about the respondent; Section B comprised questions on the corporate governance mechanisms while Section C contained questions on operational performance.

3.7.1 Validity

According to Ogula (1998), data validity refers to “the measure of research instrument’s accuracy when measuring variables of the study”. Data validity was used to indicate whether the research instrument really measured what it purported to measure. The researcher piloted the research instrument. Piloting was done in order: to clarify the wording and grammar of the research instrument; to avoid misinterpretations; to avoid research bias; detect ambiguity in the questions and to pick out any other issues in advance before deploying the instrument to the respondents. Piloting was done by subjecting 6 questionnaires to peer-review. This ensured the validity of the data collected.

3.7.1 Reliability

Mugenda & Mugenda (2003) defined data reliability as the consistency of the research findings if the same data was subjected to repeated trials. A research instrument is deemed reliable if it outputs consistent results even after repeated trials. Reliability analysis using Cronbach's Alpha was carried out in order to establish the internal consistency of the questionnaire. Cronbach’s Alpha co-efficient of $\alpha \geq 0.7$ was considered to be the minimum requirement for an internally consistent research instrument.

Data reliability is a state that exists when data is sufficiently complete and error free to be convincing for its purpose and context. In addition to being reliable, data must also meet other tests for evidence. It also relates to consistency and repeatability of the results. In this case, the reliability of the measurement scales was assessed by computing Cronbach’s alpha coefficient. The results of the reliability tests are presented in the table below.

Table 3. 1 Reliability statistics

Section of Questionnaire	Variable	Number of Items	Cronbach's Alpha	Remarks
Section B 8	Existence of Formal board	7	0.734	Reliable
Section B 9	Board Roles & Mandate	7	0.861	Reliable
Section B 10	Audit committee	7	0.752	Reliable
Section B 11	Board Competency	7	0.841	Reliable
Section C 12	Operational Performance	6	0.738	Reliable

Reliability Statistics

Cronbach's Alpha	N of Items
0.939	34

From the table above, the highest reliability was observed in board roles and mandate at 0.861 followed by Board competency at 0.841 while the lowest alpha was observed in existence of Formal board, which was 0.734. From the results of the table above, it was evident that the data was reliable which indicated a high level of internal consistency (The closer the coefficient is to 1.0, the greater is the internal consistency of the items (variables) in the scale).

3.8 Data Analysis

The collected questionnaires was sorted for completeness and then serialized in preparation for coding. Once coded, the responses were keyed into a statistical package and analysed. Descriptive statistics such as mean scores, standard deviation and frequency distribution were used to analyze the quantitative data collected using closed-ended questions. Descriptive statistics was used since because it helped in describing variables in central tendency and dispersion. The study findings were presented using bar charts, pie charts and frequency tables. Regression analysis was used to establish the relationship between the dependent and the independent variables.

The following regression model was used to establish the effect of corporate governance mechanisms on the operational performance of SMEs in Nairobi.

$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$

Where:

Y – Operational Performance (Dependent variable)

X_1- Existence of a formal board

X_2- Board Roles

X_3- Audit committee

X_4- Board competency

β_0 - Is the constant of the model

β_1- β_4 – Are the regression coefficients

ε – Stochastic error term estimate

T-tests was used to test the statistical significance of the relationship between corporate governance mechanisms and the operational performance of SMEs. The computations were done at 95% confidence interval. Therefore, the p-value was tested at 5%. The fitness of the model to the data was tested through Analysis of Variance (ANOVA) using the level of significance of F statistics at 5%.

3.9 Ethical Considerations

According to Cooper and Schindler (2008), ethics refers to "the norms or standards of acceptable behaviour that dictate choices about our moral behaviour especially on how we relate to each other". Ethics in research ensures that nobody suffers adverse consequences or is harmed in the course of the research exercise. Further, Mugenda and Mugenda (2003) observed that protecting the welfare and rights of the respondents is the main ethical consideration for the researchers. To ensure the privacy of the participants in this research, the researcher sought approval from Strathmore University and NACOSTI. Further, the data collected was to be used for academic purpose only.

CHAPTER FOUR: DATA ANALYSIS AND FINDINGS

4.1 Introduction

This chapter presents data analysis, presentation and discussion of the research findings guided by the research objectives of the study. Descriptive statistics was used to evaluate the data where by frequencies and percentages were determined. The objective of the study was to determine the effect of corporate governance mechanisms on the operational performance of small and medium enterprises in Nairobi County, Kenya. The chapter starts with the response rate of the questionnaires followed by demographic characteristics of the respondents and the company.

4.2 Response Rate

The target population for the study was 83 SMEs within Nairobi CBD. The key respondents comprised the production managers, operations managers, marketing managers and human resource managers. Out of 83 questionnaires administered, 80 questionnaires were duly filled and returned. However, 3 questionnaires were incomplete and therefore not used in the analysis. The received questionnaires response from the 80 firms represented a response rate of 96.4 %.

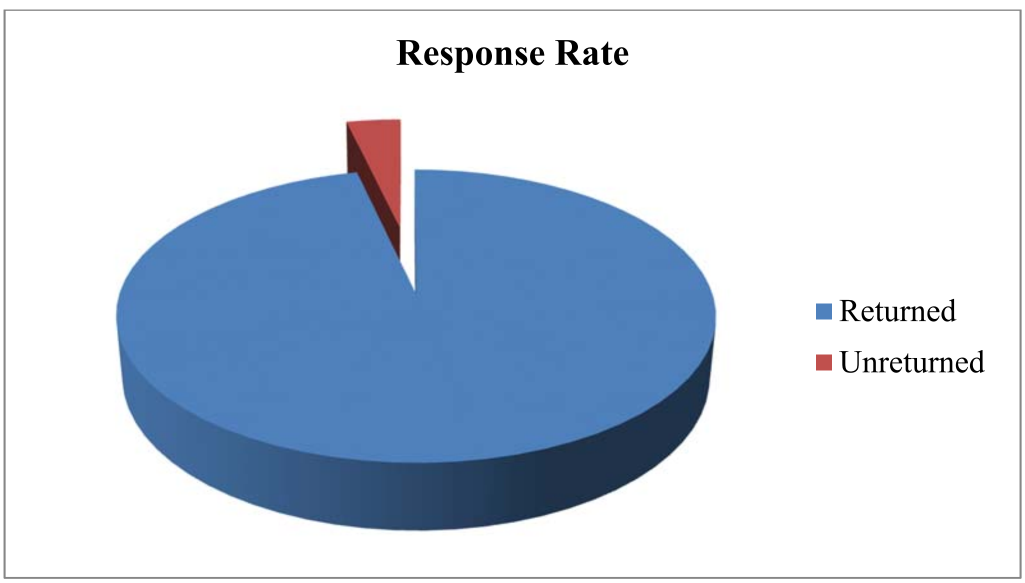


Figure 4.1 Response Rate

Source: Primary Data (2019)

4.3 Demographic characteristics of the respondent and company

4.3.1 Respondent Characteristics

Table 4.1 below shows results of the respondent demographic characteristics, the male gender category formed the majority of the respondents with 56.3 percent while Female category represented 43.7 percent. The study conducted on respondent age showed that most of the respondents are youth (young people) below the age of 35 years with a cumulative percentage of 61.3 as shown on the table 4.1; this implies that young people run most of the SMEs.

The study conducted to seek the highest level of education attained by the respondent showed that the highest population of the respondents was Bachelor's degree holders at 31.3 percent followed by Masters Holders at 28.8 percent. The smallest percentage of 7.5% was observed from respondents with O-level qualification. This therefore implies that majority of the SMEs are managed by university graduates.

On the designation of the respondent, a study was sought to establish the position held by the respondent in the company. The frequency distribution of the respondents by designation is presented in the table 4.1 below. From the results of the table 4.1, its evident that majority of the respondents were Production managers who represented 31.3 per cent followed by Operations manager with 30 per cent. The marketing managers represented 27.5 per cent and the least percentage of 11.3 was recorded from human resource managers.

Table 4.1 Demographic characteristics of the Respondent

	Gender of the Respondent		
	Gender	**Frequency**	**Percent**
Valid	Male	45	56.3
	Female	35	43.8
	Total	**80**	**100.0**
	Age of Respondent		
	Age	**Frequency**	**Percent**
Valid	20-25 Years	5	6.3
	26-30 Years	16	20.0
	31-35 Years	28	35.0
	36-40 Years	21	26.3

	41-50 Years	10	12.5
	Total	**80**	**100.0**
	Education Level of the Respondent		
	Education Level	**Frequency**	**Percent**
Valid	Secondary	6	7.5
	Diploma	16	20.0
	Bachelor	25	31.3
	Masters	23	28.8
	PHD	10	12.5
	Total	**80**	**100.0**
	Designation of the Respondent		
	Designation	**Frequency**	**Percent**
Valid	Human Resource Manager	9	11.3
	Marketing Manager	22	27.5
	Operations Manager	24	30.0
	Production Manager	25	31.3
	Total	**80**	**100.0**

Source: Primary Data (2019)

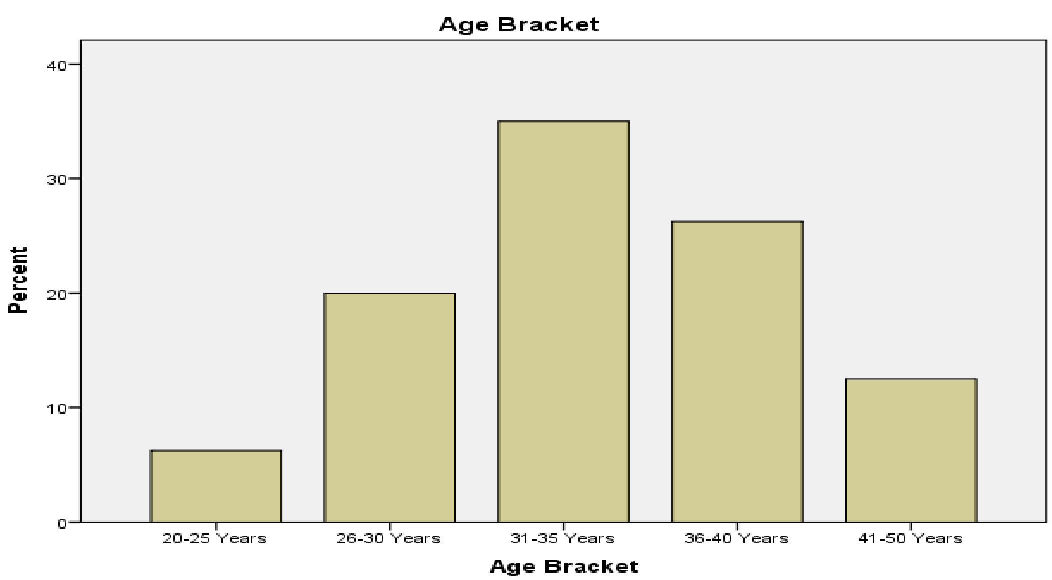


Figure 4.2 Age Bracket

Source: Primary Data (2019)

4.3.2 Company characteristics

This study was sought to establish the duration of operation of the company and the size of the company in terms of number of employees in the company. From the findings on table below,

It is evident that majority of the business operations of the SMEs have been in existence for between 1-10 years with a cumulative percentage of 86.3 percent. Businesses, which existed for more than 10 years, represented the smallest percentage of 3.8.

On the size of the company, as per the results in table below, it is evident that 77.7 percent of the companies had less than 50 employees, 15 percent had between 51 and 100 employees whereas 7.5 percent had employees above 100. The results findings imply that majority of the companies are relatively small with less than 50 employees.

Table 4.2 Demographic characteristics of the Company

Duration of operation			
No of Years		Frequency	Percent
Valid	Less than 1 year	8	10.0
	1-5 Years	46	57.5
	6-10 Years	23	28.8
	Above 10 Years	3	3.8
	Total	**80**	**100.0**
Size of the Company			
No of Employees		Frequency	Percent
Valid	1-10	9	11.3
	11-20	9	11.3
	21-30	15	18.8
	31-40	18	22.5
	41-50	17	21.3
	51-100	12	15.0
	Total	**80**	**100.0**

Source: Primary Data (2019)

4.4 Descriptive Statistics for Corporate Governance

The study was conducted to find out the effect of corporate governance mechanisms on the operational performance of SMEs in Nairobi. The respondents were asked to rate the extent to which the mechanisms of Corporate governance influence the level of operational performance of their companies. The measurement scale consisted of 34 items measured on a five –point likert type scale ranging from 1=not at all to 5 = very large extent. Mechanisms of corporate governance were defined by four (4) constructs namely: Existence of a formal board, board roles and mandate, audit committee and board competency. The aggregate score of corporate governance mechanisms was computed as an average of the mean score for the four constructs. The statements with high mean indicated that the respondents agreed (> 3.00) whereas the statements with a low mean is a true indication of respondents' disagreement (< 3.00).

Standard Deviation (SD) as a measure of dispersion summarizes how far away from the mean the data values are (Cooper and Schindler, 2006).Small SD (< 1) implies that most of the sample means are closer to the mean and a good estimator of the population mean whereas a large SD (1>) indicates that the sample mean is a poor estimator of the population mean simply because the data values are spread over a large set of values.

The results of the seven items on existence of formal board are presented in the tables that follow.

4.4.1 Mean and Standard Deviation of Existence of Formal board

The respondents were asked to rate the extent to which formal board as a mechanism of corporate governance influences the level of operational performance of their companies. The measurement scale consisted of seven items measured on a five –point likert type scale ranging from 1=not at all to five = very large extent. Data was collected using items on a five-point statement measured on likert-type scale from which the composite index was computed. The composite index or measure of formal board that was used in regression analysis was computed by first obtaining the aggregate of each construct or item of the formal board and then dividing by total number of respondents (N) to get mean of each construct, then an average mean score was obtained by dividing sum of means by the number of items in the independent variable (in this case 7 items that constitute formal board).

Table 4.3 Mean and Standard Deviation of Existence of Formal board

Descriptive Statistics			
	N	Mean	Std. Deviation
Presence of a formal board	80	3.04	1.107
Board Composition	80	2.80	1.163
Board Size	80	2.76	.903
Experience of board Members	80	3.21	1.177
Board skill level	80	3.13	1.095
Board Leadership(Duality)	80	2.90	1.218
Valid N (list wise)	80		
Average Mean Score		**2.97**	

Source: Primary Data (2019)

From the results on the table above, the item with the highest mean was experience of the board members with a mean score of 3.21 (SD = 1.177), followed by the level of the board skill with mean score of 3.13 (SD = 1.095), presence of formal board had a mean score of 3.04 (SD = 1.107). From the results, majority of the respondents agreed that experience of board members plays a great role in the firm operational performance. The existence of a formal board had an average mean score of 2.97 which clearly indicates that the formal board existence moderately influence the operational performance of the SMEs.

4.4.2 Mean and Standard Deviation of Board Roles

The respondents were asked to rate the extent to which board roles and mandate as a mechanism of corporate governance influences the level of operational performance of their companies. The measurement scale consisted of seven items measured on a five –point likert type scale ranging from 1=not at all to five = very large extent. Data was collected using items on a five-point statement measured on likert-type scale from which the composite index was computed. The composite index or measure of board roles that was used in regression analysis was computed by first obtaining the aggregate of each construct or item of the board roles and then dividing by total number of respondents (N) to get mean of each construct, then an average mean score was obtained by dividing sum of means by the number of items in the independent variable (in this case 7 items that constitute board roles).

Table 4.4 Mean and Standard Deviation of Board Roles

Descriptive Statistics			
	N	Mean	Std. Deviation
Board understands their roles and mandate	80	2.96	1.195
The roles are clear and precise	80	3.15	1.045
The board provide leadership to the managers	80	3.16	1.141
The roles evolve as the business grows	80	2.95	.940
The board provides strategic directions to the business	80	3.10	1.337
The board collectively represents all shareholders	80	3.04	1.107
Board promote transparency and efficiency	80	3.21	1.198
Valid N (list wise)	80		
Average Mean Score		**3.08**	

Source: Primary Data (2019)

From the results on the table above, it is evident that the respondents agreed that the board roles and mandate moderately influence the operational performance of their companies. The average mean score of this corporate governance mechanism was 3.08. The construct with the highest mean score was item on board promoting transparency and efficiency with 3.21 (SD = 1.198), followed by the board provide leadership to the managers. The lowest mean score of 2.95 (SD = 0.940) was recorded on item about the roles evolving as the business grew. From the above findings, we can deduce that board transparency and efficiency plays a very vital role in the firm's operational performance. Therefore, from the results on the findings, board roles and mandate are crucial for the operational performance of small and medium enterprises.

4.4.3 Mean and Standard Deviation of Audit Committee

The respondents were asked to rate the extent to which audit committee as a mechanism of corporate governance influences the level of operational performance of their companies. The measurement scale consisted of seven items measured on a five –point likert type scale ranging from 1=not at all to five = very large extent. Data was collected using items on a five-point statement measured on likert-type scale from which the composite index was computed. The composite index or measure of audit committee that was used in regression analysis was computed by first obtaining the aggregate of each construct or item of the board roles and then dividing by total number of respondents (N) to get mean of each construct, then an average mean score was obtained by dividing sum of means by the number of items in the independent variable (in this case 7 items that constitute audit committee).

Table 4.5 Mean and Standard Deviation of Audit Committee

Descriptive Statistics			
	N	Mean	Std. Deviation
Existence of Audit committee	80	3.10	1.143
Composition of the committee	80	3.19	.982
Size of the audit committee	80	2.93	1.077
Audit quality	80	3.33	1.077
Appointment of the Committee	80	3.01	1.037
Experience of the committee members	80	3.29	1.160
Audit Diligence (No of audit meetings yearly)	80	3.23	1.055
Valid N (list wise)	80		
Average Mean Score		**3.15**	

Source: Primary Data (2019)

The results in the table above show that the average mean score of audit committee is 3.15, which indicate moderate influence of the mechanism on the operational performance. The audit committee construct with the highest mean score was audit quality with mean score of 3.33 (SD = 1.077), followed by the experience of the audit committee members with mean score of 3.23 (SD = 1.055) whereas the size of the audit committee had the lowest mean score of 2.93 (1.077). From the above results, it is evident that quality of audit by committee, experience of the committee members and the number of audit meetings per annum are very important in determining the operational performance of business enterprises. The overall mean score clearly indicates that the respondent agreed that audit committee plays a major role in the operational performance of business enterprises.

4.4.4 Mean and standard Deviation of Board Competency

The respondents were asked to rate the extent to which board competency as a mechanism of corporate governance influences the level of operational performance of their companies. The measurement scale consisted of seven items measured on a five –point likert type scale ranging from 1=not at all to five = very large extent. Data was collected using items on a five-point statement measured on likert-type scale from which the composite index was computed. The composite index or measure of board competency that was used in regression analysis was computed by first obtaining the aggregate of each construct or item of the board competency and then dividing by total number of respondents (N) to get mean of each construct, then an average mean score was obtained by dividing sum of means by the number of items in the independent variable (in this case 7 items that constitute board competency).

Table 4.6 Mean and standard Deviation of Board Competency

Descriptive Statistics			
	N	Mean	Std. Deviation
Education level	80	3.16	1.152
Managerial Experience	80	3.23	1.169
Skills and prior knowledge	80	3.33	1.053
Ability to co-coordinate business activities	80	3.29	1.182
Ability to Budget the available resources	80	3.21	1.076
Ability to articulate ideas and opinions	80	3.33	1.123
Communication Competencies	80	3.23	1.190
Valid N (list wise)	80		
Average Mean Score		**3.25**	

Source: Primary Data (2019)

The results on the table above indicates that all the board managerial competency constructs had moderate influence on the operational performance of the SMEs as per the respondents. Managerial experience and ability to articulate ideas and opinions had mean scores of 3.33 and standard deviation of 1.169 and 1.123 respectively. Board competency had an average mean score of 3.25, which indicates that it is an important mechanism of corporate governance, which moderately influences the operational performance of SMEs.

4.4.5 Mean and Standard deviation of Operational Performance

For operational performance, the measurement scale consisted of 6 items measured on a five – point likert type scale ranging from 1=not at all to 5 = very large extent. The composite index for operational performance was computed by first obtaining mean of every construct, this was done by obtaining sum of all values of each construct and then dividing with the number of respondents. The aggregate mean of the six items was then divided by 6 to obtain the single composite index.

Table 4.7 Mean and Standard deviation of Operational Performance

Descriptive Statistics			
	N	Mean	Std. Deviation
Increased efficiency	80	3.33	1.003
Increased Customer Satisfaction	80	3.35	.995
Improved product quality	80	3.54	.980
Reduction in operational cost	80	3.20	.960
Increased capacity utilization	80	3.39	1.085
Increased sales	80	3.39	1.025
Valid N (list wise)	80		
Average Mean Score		**3.37**	

Source: Primary Data (2019)

The results on the above table show the performance parameters which were used to rate the operations of respondents business. From the results, it is evident that the respondents moderately rated the parameters. Improved product quality had the highest mean score of 3.54 (SD = 0.980), followed by increased capacity utilization and increased sales with mean score of 3.39 and standard deviations of 1.085 and 1.025 respectively. The results findings indicate that all the parameters moderately affect the operational performance of businesses in a positive way.

4.5 Overall correlation Analysis

A correlation analysis of all the study variables was carried out to determine the relationships that existed between them. The summary of the correlation findings was presented in the table below.

Table 4.8 Correlation Matrix

Correlations						
		OP	AC	BC	BR	FB
OP	Pearson Correlation	1				
	Sig. (2-tailed)					
AC	Pearson Correlation	.347**	1			
	Sig. (2-tailed)	.002				
BC	Pearson Correlation	.384**	.927**	1		
	Sig. (2-tailed)	.000	.000			
BR	Pearson Correlation	.449**	.701**	.760**	1	
	Sig. (2-tailed)	.000	.000	.000		
FB	Pearson Correlation	.437**	.692**	.730**	.912**	1
	Sig. (2-tailed)	.000	.000	.000	.000	
**. Correlation is significant at the 0.01 level (2-tailed).						

Source: Primary Data (2019)

Where:

OP = Operational Performance

AC =Audit committee

BC = Board Competency

BR = Board Roles

FB = Formal board

The results from the correlation analysis show a moderate positive linear and significant correlation between operational performance and board roles and mandate r =0.449, $p<0.05$.

This therefore implies that unit increase on the board roles and mandate result in 0.449 increase on the operational performance of the firm.

Similarly a moderate positive linear and significant correlation existed between operational performance and formal board r = 0.437, $p<0.05$, this implies that unit increase on formal board result in 0.437 increase of operational performance of the firm.

A weak positive linear and significant correlation existed between operational performance and audit committee r =0.347, $p<0.05$ which was also the case for board competency r = 0.384, $p<0.05$.

4.6 Regression Analysis

Since the study correlation revealed existence of statistically significant relationships, a multiple regression was conducted to establish the level of the relationships. The results of regression analysis are presented in table 4.9 below.

Table 4.9 Regression analysis table

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.549[a]	.301	.264	.41217

ANOVA[a]						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	5.497	4	1.374	8.089	.000[b]
	Residual	12.742	75	.170		
	Total	18.239	79			

Coefficients[a]						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.955	.467		4.189	.000
	Audit Committee	.198	.077	.303	2.582	.012
	Board Competency	.197	.097	.240	2.020	.047
	Board_Roles_Mandate	.185	.075	.243	2.471	.016
	Formal Board	.057	.076	.076	.754	.453

Source: Primary Data (2019)

From table 4.10 above, R=0.549 represents the simple correlation; therefore there existed a moderate positive linear relationship between mechanisms of corporate governance and operational performance.

From the results on table 4.10, R^2=0.301 which indicates how much of the total variation in the dependent variable can be explained by the independent variables. In this case, mechanisms of corporate governance explained 30.1% of the variability in operational performance and 69.9% variation in operational performance being explained by other factors not captured in this study.

From the Analysis of variance (ANOVA) table which examine whether there exist significant differences between the study variable means, the findings show that $F (4, 75) = 8.089$; P value = 0.000, the F value was above 2 and P value less than 0.05 therefore meaning the variables were statistically significant. This is evident in the ANOVA table 4.10.

Table 4.10 also shows the beta coefficients of constructs that constitute the independent variables (corporate governance) that predict the dependent variable (Operational Performance).

The regression model equation can be represented as shown below.

$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$

$Y = 1.955 + 0.057 (X_1) + 0.185(X_2) + 0.198(X_3) + 0.197(X_4)$

Where:

Y – Operational Performance (Dependent variable)

X_1- Existence of a formal board

X_2- Board Roles and Mandate

X_3- Audit committee

X_4- Board Managerial competencies

The regression equation above has established that holding all other factors constant (no mechanisms of corporate governance practises) operational performance of SMEs in Nairobi would be 1.955. The findings presented also that taking all other independent variables at zero, a unit increase on formal board would lead to 0.057 increase on Operational performance of the SMEs, a unit increase on board roles and mandate would lead to 0.185 increase on SMEs operational performance. Also according to the equation, a unit increase on the audit committee would lead to 0.198 increase on the firm's operational performance and lastly a unit increase on board competency would lead to 0.197 increase on the operational performance of the firm. It is therefore evident that all the independent variables are significant to the model except formal board whose p-value is greater than the 0.05. The overall model was statistically significant ($F = 8.089$, $P< 0.05$). From the above regression model, the study found out that the adoption of corporate governance practices enhances the operational performance of the SMES in Nairobi Kenya. This therefore means that the independent variables in this model contributes to 30.1% of the operational performance of the SMEs in Nairobi County while other factors and other random variations not studied in this study contributes 69.9% of the operational performance of the SMEs in Nairobi.

This was consistent with the studies reviewed earlier. The findings agree with Belkhir (2006) in literature who conducted a research on board composition and bank performance. The result showed that the larger the board size the lesser the performance of the organization. This also agrees with a study by Qin (2007) who asserts that firms with higher quality of earning are more associated with audit committee members who have accounts training. Audit committee with high frequency of training in accounts usually has significant impact on returns on equity and return on asset and hence organizational performance.

Accordingly, Oyoga (2010) in his findings concluded that good corporate governance practices would lead to higher financial performance in Kenya in his study of corporate governance and firm performance.

CHAPTER FIVE: DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

In this chapter, the researcher discusses the findings of the study, draws conclusions and makes recommendations. The discussion is presented based on the study objectives. Afterwards, conclusions to the research questions are drawn in view of the discussions. The chapter ends by highlighting recommendations and suggestions for further research.

5.2 Discussion of the findings

The main purpose of this study was to determine the effect of corporate governance mechanisms on the operational performance of firms in Nairobi County. In order to achieve the above objective, a conceptual model was developed and tested guided by the four specific objectives of the study.

5.2.1 Formal board and Firm operational performance

The first objective was to examine the influence of the existence of SME board on the operational performance of the SMEs in Nairobi. Regression analysis was used to test this relationship. Regression results revealed a positive relationship with Pearson correlation, which is significant. The findings indicate that the relationship between operational performance and formal board indicated a positive correlation. From the research findings, board composition is one of the most debated issues for the majority of research efforts on boards. Studies on board composition classify board of directors as either insiders (those who are directors and managers at the same time) or outsiders (non-managers directors). Most of the corporate governance codes require boards of directors to have a combination of inside and outside directors. On the size of the board, the study on corporate governance shows that it is not clear about the effect of the size of the board on firms' operational performance. From the research findings, it is evident that the abilities of the board can increase as more directors are added, however, as board increases in size; they also become less effective because the coordination and process problems overwhelm the advantages from having more people to draw on. Therefore, the effect of board size on operational performance is a trade-off between benefits and drawbacks and hence a non-linear relationship between the size of the board and operational performance is expected.

This therefore implies that presence of SME board has a significant contribution to the firm operational performance. These findings are consistent with previous empirical studies. Studies by Belkhir (2006) in literature review who conducted a research on board composition and bank performance, the result showed that the larger the board size the lesser the performance of the organization. The study suggested that as board size increased beyond a certain point, inefficiencies outweighed the advantages of having more directors.

5.2.2 Board Roles and Firm Operational performance

The second objective was to establish the effect of board roles on the operational performance. The results revealed that roles of the board have a moderate positive relationship with operational performance of the firm, which was evident from the correlation matrix, which was significant. From the research findings, the majority of the respondents agreed that the SME board should understand their roles and mandate. Each member of the board should clearly understand their duties and responsibilities to avoid duplication and thus enhance efficiency and effectiveness in execution of processes within the firms. The majority of the respondents also agreed that the board should promote transparency and efficiency to ensure proper operational performance of the SMEs is realized. The research findings also clearly demonstrated that majority of the respondents agreed that the board should provide proper leadership to the managers of the SMEs, this implies that decision making process should be business of the firm board which should then be escalated to managers and other stakeholders.

From the regression analysis, a unit of board roles and mandate contributes to 0.185 increase of the operational performance of a SME. These findings are consistent with prior empirical studies. Musyoki (2008) in the study on relationship between board committees and financial performance of companies, in his findings found that the mandate of board members is positively correlated to the financial performance.

5.2.3 Board managerial competency and Firm Operational performance

The third objective was to determine the effect of board managerial competency on the operational performance of SMEs. From results of regression analysis, it was evident that board competency had a moderate positive relationship with the firm operational performance which was significant. From the research findings, it is evident that the level of education of the board members plays a great role in the operational performance of firms. Majority of the respondents agreed that education plays a great role in the operational performance of enterprises. Majority of the respondents also agreed that knowledge and skills are very vital in the management of SMEs, the managerial board therefore should comprise members who are knowledgeable and have skills for handling management issues with maturity. The research findings also indicated that majority of the respondents agreed that board members of the SMEs should be able to articulate ideas and opinions, so as to influence innovation and competitive advantages for the good operational performance of the firms.

These findings also are consistent with other empirical studies. According to Kazdova (2008), the combination of knowledge, skills and other personality's characteristics that are necessary for the effective performance of the organization are very crucial in a board competency model. This therefore implies that education level, experience of managerial board members, knowledge and skills are very crucial in determining the firm's operational performance.

5.2.4 Audit Committee and Firm Operational performance

The fourth objective was to establish the effect of audit committee on the operational performance of the SMEs. From regression analysis results, confirmed that presence of audit committee had a moderate positive relationship with the firm operational performance, which implies that the relationship is significant. This therefore implies that, excellent audit committee influences the operational performance in a positive way. Gabliela (2016) analysed the effect of audit committee characteristics on firm operational performance and found that frequency of audit committee meetings have significant positive relationship with firm operational performance. The level of activity of an audit committee has been recommended as important to enhance its effectiveness in improving operational performance. It can be concluded that regular meetings of audit committee could help reduce agency problems and information asymmetry of a firm by providing fair and timely information. The findings also revealed that the size of audit committee have different effects on the firm operational performance. For instance, increased number of members is argued to provide more effective monitoring and thus improve on firm operational performance whereas on the other hand, large audit committees may lead to inefficient governance. The findings of this study lend support to previous studies. Studies by Ruto (2015) that examined the relationship between audit committee effectiveness and financial management in government ministries in Kenya established that audit committee membership composition contribute most to the financial management followed by audit committee independence. This therefore implies that audit committee as a mechanism of corporate governance plays a major role in the operational performance of a SME. The size of the audit committee, the number of audit committee meetings and experience of the committee plays major role in operational performance of organization.

On the operational performance parameters, the respondent rated them high, which is an indication that, there are increased efficiency, customer satisfaction, improved product quality and increased sales most probably because of good corporate governance practices adopted by the firms.

5.3 Conclusions

The main purpose of the study was to establish the effect of corporate governance mechanisms on the operational performance of SMEs in Nairobi county and the outcome of the study reveals that the different corporate governance practices adopted by the firms have positive correlation with the firms operational performance, and therefore the performance of a firm with good governance is thus expected to be excellent in its operations. From the research findings, it can be concluded that the SMEs appreciate corporate governance mechanisms and their role to enhance operational performance yet majority of the firms have not been able to adopt the mechanisms since most still consider the mechanisms applicable to large and established companies. Those adopting the mechanisms have not fully incorporated them, citing issues of size, limited finances and strict government regulations as their limitations.

What is quite important and significant to all business entities is to incorporate and accept good corporate governance mechanisms and practices, by doing so, the firms operational performance will be greatly improved and thus achieving their organizational goals and objectives.

5.4 Limitations of the Study

Although the study was successful, it was faced by few challenges. Firstly, some respondents did not fill the questionnaires for fear of not exposing their firms' information, which they termed as confidential. Secondly, some of the questions on the questionnaires were left unanswered, which affected the outcome of the study. Finally, time and resources were limited

The study variables were measured on a five –point likert scale ranging from 1=not at all to 5 = very large extent. One of limitations of this scale is its inability to measure true attitudes of the respondents.

5.5 Recommendations

Based from the drawn conclusions from 5.3, the researcher recommended that there is need for firms in Nairobi county to incorporate good corporate governance practices which will greatly help improving firms performance not only in their operations but also financially. In addition, creation of awareness about importance of good corporate governance to all levels of firms' management, this way; employees will have positive attitudes to these mechanisms of governance. Due to the findings above, the research proposes that business leaders, managers should invest more resources in training and development of their staff in the field of good corporate governance. In addition, government policy should be present to give support on corporate governance by imposing rules and regulations.

5.6 Suggestions for further Research

The study findings serves as a reference point to those who would wish to further do research on effect of corporate governance mechanisms on operational performance on Kenyan firms. Many studies establishing the linkage between corporate governance and operational performance are based on measuring the quality of governance based on a measure of good corporate governance. Typically such a measure is based on identifying desirable traits for good governance, based on a normative feel of what is good, and then measuring how individual firms compare against these benchmark traits. Such an approach is based upon the assumption that the desirable good governance characteristics are universal and can be commonly applied to all companies who can achieve good governance standards by following a common set of desirable standards.

Given that, an organization's strategy has a very significant effect on its operational performance; researchers into corporate governance must consider other key systemic factors in their studies. Such studies need to go beyond merely studying the impact of simplistic, structural factors like board attributes or shareholder rights on organizational operational performance and should be able to account for multiple, systemic and multi-dimensional influences on corporate performance which are related to the organization

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APPENDICES

Appendix I: Research Questionnaire

This questionnaire seeks to collect data on the effect of corporate governance mechanisms on the operational performance of SMEs in Nairobi. Kindly fill in the questionnaire. Any information availed will be treated with utmost confidentiality and shall be used for academic purposes only. Your identity shall not be revealed.

SECTION A: GENERAL INFORMATION

1. Gender

Male [ ] Female [ ]

2. Age Bracket in years

20-25	[ ]	26-30	[ ]
31-35	[ ]	36-40	[ ]
41 -50	[ ]	51 and Above	[ ]

4. Highest level of education

Secondary [ ]

Diploma [ ]

Bachelor [ ]

Masters [ ]

PhD [ ]

Any other (Specify) …………………..

5. What position do you hold in this organization?

……………………………………………….

6. How long has the business been in operation?

Less than 1 year	[ ]	1 - 5 years	[ ]
6 – 10 years	[ ]	Above 10 years	[ ]

7. Size of the business by number of employees

1-10 [ ]	11-20 [ ]	21-30 [ ]
31-40 [ ]	41-50 [ ]	51- 100 [ ]
Above 100 [ ]		

SECTION B: MECHANISMS OF CORPORATE GOVERNANCE

8. To what extent does existence of a formal board influence your level of operational performance? Tick as appropriate using the following Likert scale of 1-5 where: 1= No Extent; 2= Little Extent; 3= Moderate Extent; 4= Great Extent; 5=Very Great Extent.

Existence of a Formal Board		**1**	**2**	**3**	**4**	**5**
1.	Presence of a formal board					
2.	Absence of a formal board					
3.	Board composition					
4.	Board size					
5.	The experience of board members					
6.	Board skill level					
7.	Board Leadership (Duality)					

How else does existence of a formal board influence your level of operational performance?

____

9. To what extent does board roles influence your level of operational performance? Tick as appropriate using the following Likert scale of 1-5 where: 1= No Extent; 2= Little Extent; 3= Moderate Extent; 4= Great Extent; 5=Very Great Extent.

Board Roles and Mandate		**1**	**2**	**3**	**4**	**5**
1.	Board understands their roles					
2.	The roles are clear and precise					
3.	The board provide leadership to the managers					
4.	The roles evolve as the business grows					
5.	The board provides strategic directions to the business					
6.	The board collectively represents all shareholders					
7.	Board promote transparency and efficiency					

How else does board roles and mandate influence your level of operational performance?

____

10. To what extent does Audit committee influence your level of operational performance? Tick as appropriate using the following Likert scale of 1-5 where: 1= No Extent; 2= Little Extent; 3= Moderate Extent; 4= Great Extent; 5=Very Great Extent.

Audit Committee		**1**	**2**	**3**	**4**	**5**
1.	Existence of Audit committee					
2.	Composition of the committee					
3.	Size of the audit committee					
4.	Audit quality					
5.	Appointment of the Committee					
6.	Experience of the committee members					
7.	Audit Diligence (No of audit meetings yearly)					

How else does Audit committee influence your level of operational performance?

____

11. To what extent does Board managerial competency influence your level of operational performance? Tick as appropriate using the following Likert scale of 1-5 where: 1= No Extent; 2= Little Extent; 3= Moderate Extent; 4= Great Extent; 5=Very Great Extent.

Board Managerial Competency		**1**	**2**	**3**	**4**	**5**
1.	Education level					
2.	Managerial Experience					
3.	Skills and prior knowledge					
4.	Ability to co-coordinate business activities					
5.	Ability to Budget the available resources					
6.	Ability to articulate ideas and opinions					
7.	Communication Competencies					

How else does board managerial competency influence your level of operational performance?

____

SECTION C: OPEARTIONAL PERFORMANCE

12. To what extent do you rate the operational performance of your business based on the following performance parameters? Tick as appropriate using the following Likert scale of 1-5 where: 1= No Extent; 2= Little Extent; 3= Moderate Extent; 4= Great Extent; 5=Very Great Extent.

Performance Parameters	**1**	**2**	**3**	**4**	**5**
Increased efficiency					
Increased Customer Satisfaction					
Improved product quality					
Reduction in operational cost					
Increased capacity utilization					
Increased sales					

Thank you for participating in this study.

Appendix II: List of SMEs in Nairobi CBD

1. Napro Industries Ltd
2. Polygon Logistics Ltd
3. North Star Cooling Systems Ltd
4. Ravenzo Trading Ltd
5. Care Chemists
6. Isolutions Associates Ltd
7. Valley Hospital Limited
8. Soloh Worldwide Inter-Enterprises Limited
9. Super Broom Services Ltd
10. Well Told Story Limited
11. Novel Technologies Ea Ltd
12. Melvin Marsh International Ltd
13. Polucon Services (K) Ltd
14. Specicom Technologies Ltd
15. Manix Ltd
16. Software Technologies
17. Vinep Forwarders Limited
18. Prafulchandra & Brothers Ltd
19. Amex Auto & Industries Ltd
20. Sheffield Steel Systems Limited
21. Vivek Investments Ltd
22. Bluekey Seidor (K) Ltd
23. Skypex Supplies Ltd
24. Pathcare Kenya Limited
25. Orange Pharma Limited
26. Pinnacle Kenya Travel Ltd
27. Superior Homes (K) Limited
28. Furniturerama Limited
29. Bagda S& S Auto Spares Ltd
30. Nairobi Enterprises Ltd

31. Express Company Limited
32. Gina Din Corporate Communication
33. Zaverchand Punja Ltd
34. Patmat Bookshop Ltd
35. Executive Healthcare Solutions Ltd
36. Elite Tools Ltd
37. Bimas Kenya Ltd
38. Mandhir Construction Limited
39. Hotel Waterbuck Limited
40. General Automobile Corp
41. Economic Industries Ltd
42. Waterman Drilling Africa Ltd
43. Ndugu Transport Co Ltd
44. Fayaz Bakers Limited
45. Mpps Ltd
46. Trident Plumbers
47. Riley Paluon Security Ltd
48. Maroo Polymers Ltd
49. Total Solutions Ltd
50. Oil Sealsandbearings Centre Ltd
51. Palmhouse Dairies Ltd
52. Sensations Limited
53. Computer Pride Ltd
54. General Cargo Services Ltd
55. Varsani Brakelinings Ltd
56. Typotech Imaging Systems Ltd
57. Philafe Engineering Ltd
58. Mic Global Risks Insurance Brokers Ltd
59. Synergy Gases (K) Ltd
60. Machines Technologies Ltd
61. Orbit Engineering Ltd

62. Zen Garden Limited
63. Norda Industries Limited
64. Astral Industries
65. Warren Enterprises Ltd
66. Xtreme Advenures Ltd
67. Ideal Manufacturing Co. Ltd
68. Canon Aluminium Fabricators Ltd
69. Master Fabricators Ltd
70. Specialized Aluminium Renovators Ltd
71. Hydro Water Well K Ltd
72. Roy Transmotors Ltd
73. Hipora Business Solutions
74. Nationwide Electrical Industries Ltd
75. Allwin Packaging Intl Limited
76. Impax Business Solutions
77. Synermedica (Kenya) Limited
78. Synermed Pharmaceuticals (K) Ltd
79. Uneek Freight Services Ltd
80. Sollatek Electronics (K) Ltd
81. Avtech System Ltd
82. Specialised Hardwares
83. Smart Brands Limited

Appendix III: Letter of Introduction

Strathmore University

Office of Graduate Studies

The effect of corporate governance mechanisms on the operational performance of small and medium-sized enterprises in Nairobi.

The Respondent,

Dear Sir/Madam,

<u>Re: Request for Research Data</u>

My name is Moses Ranka, a Master of Business Administration student at Strathmore University. In partial fulfilment of the master's degree programme, I am required to carry out a research project and write a dissertation on a contemporary subject within my field of specialization. Among other activities, the project involves data collection and analysis. I hereby request to gather information to be used in this research in your firm. The information obtained will be used for this academic purpose only and will be kept confidential. The result of the survey will not disclose any individual, company name or information in any way.

If you have any further questions about this study, you may contact me directly via my email address mranka207@gmail.com

Thank you very much for your time and cooperation.

Sincerely, Moses Ranka

Appendix IV: Nacosti

Standard Chartered Bank - Online Banking -Local Funds Transfer - Successful   Inbox ×

Ibanking.KE@sc.com <Ibanking.KE@sc.com>   Fri, May 24, 10:59 AM
to MRANKA207@GMAIL.COM

Dear Customer,

Your local funds transfer request with the following details has been processed successfully

Reference Number : KE-013-190524-105751671-892127-187
Transfer From :HIFADHI CURRENT ACCOUNT,XXXXXXXXX3400,KES
Beneficiary Details : National Commission for Science Te,XXXXXX2547,KES
Beneficiary Country (Country of Residence) : KENYA
Beneficiary Address : Nairobi
Beneficiary Bank : KCB BANK KENYA LIMITED
Transfer Type : PESALINK
Remittance Amount : KES 1,000.00
Debit Amount : KES 1,000.00
Indicative Exchange Rate : 1.000000000
Charges to Debit : KES 40.00
Transfer Reference (Purpose of fund Transfer) : Application fee for Moses Ranka Application fee for Moses Ranka
Transfer Date : 24/05/2019
Status : Successful
Reject Reason : N/A

NACOSTI ORIS SYSTEM   Inbox ×

NCST Online Research Information System <oris@oris.nacosti.go.ke>   May 24, 2019, 10:41 AM
to me

Thank you for applying for ***Research (Masters)***.Your application will be processed upon receipt of **Kshs 1000** .Kindly use the following bank details to make the payments.

Bank	Kenya Commercial Bank
Branch	Kipande House-Nairobi
Account No:	**11 04 16 25 47**
Account Name:	**National Commission for Science, Technology and Innovation**
Swift Code	KCBLKENX

OR

Bank	NIC Bank
Branch	Town Centre
Account No:	**10 01 46 73 75 OR US Dollar Account for Non Kenyans**
Account Name:	**National Commission for Science, Technology and Innovation**
Swift Code	NINCKENA

Appendix V: Ethics Clearance Certificate

Final Decision Certificate

This document certifies that the study:

"THE EFFECT OF CORPORATE GOVERNANCE MECHANISMS OI

Principal Investigator: Mr. Ranka, Moses Nkoidilla
Reference number: SU-IERC0480/19

Was reviewed and received the following status:
"done"
Additional Comments: Final decision: **approved**
Comments sent:

Reviewer #1:
'Well done on the study. Kindly take note of typos in the budget and include a