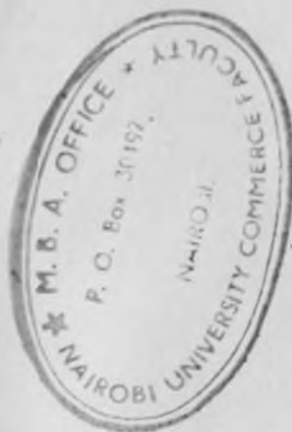


DETERMINANTS OF CORPORATE BOARD COMPOSITION IN KENYA: AN AGENCY THEORY PERSPECTIVE



BY

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2004

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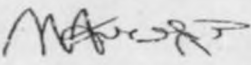
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A MANAGEMENT RESEARCH PROJECT SUBMITTED IN PARTIAL
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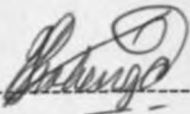
APRIL 2004

DECLARATION

This research project is my original work and has not been submitted for a degree in any other university.

Signed:  Date 02/05/04
Mercy W. Mwangi.

This project has been submitted for examination with my approval as university supervisor.

Signed:  Date 03/05/04

Mr. L. Lishenga
Lecturer, Department of Accounting.

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Mr. L. Lishenga
Lecturer, Department of Accounting.

DEDICATION

To my daughter, Judy and "little Kimmy" who were a source of inspiration during my time of study.

ACKNOWLEDGEMENTS

I give thanks to the Almighty GOD for making the whole programme a success.

Special thanks to my supervisor Mr. Lishenga, for invaluable guidance, contribution, support, advice and patience throughout this project.

Thanks to all my friends and colleagues for their input throughout the course period.

My most sincere and heartfelt gratitude to my family, Judy, shiko and "little Kimmy", for their love, support and prayers. To Judy your patience when mum took so long to finish her classes, the numerals long waits in the car, all the encouragement you gave, gave me the energy to keep on. To shiko though quite far your understanding and prayers keep me on. To, little Kimmy your sudden appearance in our lives gave a different perspective about life.

I register my appreciation to all those who, in one-way or other made a contribution to my life during this period.

ABSTRACT

An important aspect of research on corporate governance is the appointment of outside directors on boards in order to monitor the behavior of management. The purpose of this research was to seek the factors that determine the board composition as measured by the proportion of outside directors. The research adopted an agency theory perspective focusing on the impact of managerial ownership, structure of ownership, leadership structure of the board and board size.

Our basic methodology consisted of estimating a multivariate regression model. The dependent variable was the proportion of outside directors. The independent variables included variables to capture alternative corporate governance mechanisms (inside ownership, leverage, and ownership concentration), other board characteristics (board size and CEO duality), and potentially important control variables including company size and firm performance.

Overall we expected an inverse relationship between representation of outside directors on boards and alternate agency conflict controlling mechanisms.

The study was tested on 45 companies of the Nairobi stock exchange for the year 1st April 2002 to 31st March 2003.

The empirical findings of this study are consistent with the implications of the agency theory literature. We find that many results are consistent with board composition studies in considerably more developed countries such as the US and UK where the emphasis on effective corporate governance and the role of independent outside directors has been part of the corporate environment for a relatively much longer amount of time. Thus, there is evidence that many elements of the agency framework as it relates to board composition are applicable to different economic systems. The findings also reflect that corporate boards in Kenya are fully embracing the recommendations on good corporate governance as recommended by the guidelines issued by CMA in 2002

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Chapter One-Introduction

1 Background of the study

1.1 Agency Problem

In the corporate form of organization, Prevost et al (2002) notes that the separation of ownership from control results in potential agency conflicts stemming from divergence between managerial and shareholder interests. More specifically, the top management of a corporation is generally responsible for suggesting and implementing major policy initiatives, while equity holders who are the owners of the corporation and for the most part diffused; assume the bulk of the risk associated with those decisions. Because management does not bear a substantial portion of the wealth effects of their decisions, this leads to an agency problem between management and equity holders.

Separating ownership and control, forms the key component of agency theory, a 17th Century legal concept of the relationship of the servant (agent) to his master (principal). Initially it focused on the servant's duties to the master and later expanded to include the master's liability to third parties for wrongful servants' acts while working on the master's behalf. This legal concept has long recognized that agents may use their position to enhance their own self- interest to the principal's detriment.

The agency problem is a ubiquitous problem defying sectors, boundaries of any sort. It exists in the developed world where several researches have been undertaken.

In the 1930's, Berles and Means (1932) concluded that the separation of ownership induces potential conflicts between the interests of managers and stockholders. University of Chicago economist, Coase (1937) expanded this agency theory concept to a theory of the firm, viewing the firm as a nexus of contracts among individual managers—each acting to maximize his own economic self- interest.

Adam Smith (1776) recognized the potential conflict of economic self-interest between shareholders (principals) and managers (agents).

"The directors of such (joint stock) companies, however being the managers of other people's money than their own, it can both be well expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partner frequently watch over their own." Negligence and profusion therefore, must always prevail more or less in the management of the affairs of such a company" (Wealth of Nations, Book V, Ch.1).

Jensen and Meckling (1976), hereafter JM, later developed agency theory, defining its economic concept as a relationship where one or more persons (principals) engage another person (agent) to perform a service to the agent. Their analysis focused on the conflict of economic self-interest between an owner-manager and outside investors. Controlling the agent's (manager's) tendency to channel benefits to himself to the detriment of the principals' (outside shareholders') creates agency costs that are controlled by monitoring and bonding activities.

Helland and Sykuta (2003) in their recent study concluded that the agency conflicts arise in modern corporations` any time the manager's interests are not perfectly aligned with shareholders interest at the expense of shareholders and because the shares of most corporations are diffusely held, individual shareholders have little incentive to effectively monitor manager's behavior.

Agency theory is based on the notion that the delegation of managerial responsibilities by principals (owners) to managers requires the presence of mechanisms that either align the interests of principles and agents or monitor the performance of managers to insure that they use their knowledge and the firm's resources to generate the highest possible return for the principle. More specifically agency theory suggests that the best option for owners is to design contracts that align manager/owner interests. It is concerned with aligning the interest of owners and managers, and is based on the inherent premise that there is an inherent conflict between the interests of a firm owners and its management.

Kiel and Nicholson (2003) in their study concluded that, the clear implication from an agency theory perspective is that adequate monitoring or control mechanisms need be established to protect shareholders from management's conflict of interest- the so called agency costs of modern capitalism. Agency theory is therefore based on the premise that management action can be monitored through established governance structures.

Studies conducted by Mihnea and Roger (2002) recognized the primary monitoring mechanism available to organizational owners, as the board of directors, which is charged with insuring that CEOs and top management carry their duties in the best interest of owners. Within the agency theory the corporate board is thus seen as a key internal governance mechanism.

The role of boards is therefore critically tied to the imperfect agency relationship between shareholders and managers that are itself, a direct consequence of the modern corporate form.

To solve the agency conflict Fama and Jensen (1983) also suggests that the board of directors exercises control over manager's decisions on behalf of the shareholders thereby monitoring managerial behavior.

Hermalin and Weishback (2002) also assert that,
"Boards are a market solution to an organizational design problem an endogenously determined institution that helps you ameliorate the agency problems that plague any large organization."(P.9)

The empirical literature provides substantial evidence that boards play an important monitoring role. Lots of work has also been carried out in developing countries on the effectiveness of the board. Existing literature, which is largely empirical, grapples mainly with the following issues?

- How effective is the board performing its monitoring function?

- Does the board contribute to shareholder wealth?
- Does composition matter?
- How does the board interact with management?

Researchers have examined the issue of monitoring and control within a variety of contexts including the adoption of poison pill, (Davis, 1991), (Mallette and Foler, 1992), R&D spending, (Baysinger et al, 1991), and CEO succession, (Zajac, 1990). Herman (1981) and Kosnik (1987) noted that the theories differ significantly regarding their assessment of effectiveness of boards in performing this role.

1.2 Statement of the problem

For many decades now, the search for responsible company practices has become a characteristic for many companies. This has been as a result of recent business failures, which have occurred in the absence of any warnings. Stiles (1993) observed that the collapse today, results from lack of preventive measures within corporate control. Stockholders are interested in maximizing the value of the firm, while manager's objectives may also include enhancing personal wealth, job security and prestige i.e. the agency conflict. Senbet (1998) argues that the board of directors is presumed to carry out the monitoring function on behalf of the shareholders, because the shareholders would find it difficult to exercise control due to wide dispersion of ownership of common stock.

The problem however, remains: **How can boards mitigate the agency conflicts particularly when boards frequently consist of senior managers in the organization?**

A study by Fama and Jensen (1983) concluded that composition of the board of directors is a critical factor in establishing the effectiveness of the board as an objective monitor of management. In particular outside directors are seen as providing more independent shareholder monitoring.

In Kenya the agency problem remains a major problem more so because of our still budding institutions and structures, less entrenched transparency practices, low public awareness as well as undeveloped communication systems. How to constitute the board so that it effectively plays its oversight function on management (on behalf of shareholders) is a knowledge gap that this paper intends to contribute in its plugging.

Locally several studies have been carried out in the field of corporate governance (Wambua, 1999), (Mwangi, 2002), (Jebet, 2001), and (Mucuvi, 2002). The studies have emphasized on good corporate governance practices in various industries. The Capital Markets Authority (CMA) has recently issued guidelines on good corporate governance, which were effective on 14th January 2002. Recently the Center for Corporate Governance launched the Institute of Directors in a bid to help directors in Kenya as the country implements good corporate governance practices. No study however has been carried out on board of directors or the determinants of its composition in Kenya. This paper focuses on; **The Board of Directors, and the determinants of its composition in Kenya, from an agency theory perspective**, which is one of the governance mechanisms, which have evolved, designed to limit the scope of the agency problems.

1.3 Objectives of the study

The study will seek to satisfy the following objectives.

1. To collect evidence on the characteristic of board composition in Kenya.
2. To determine the relationship between effective board composition and certain corporate attributes.

1.4 Importance of the study

- ❖ The study will assist organizations in Kenya to determine their board composition.

- ❖ The study will be useful to the government bodies such as the capital market authority when formulating guidelines on board composition.
- ❖ For researchers and companies interested in effective governance practices the study's findings would be useful in determining whether one should focus on the common factors and/or certain country specific factors in establishing an optimal governance structure as it relates to board composition.
- ❖ Company directors: The management of publicly quoted companies in formulating guidelines on board composition.
- ❖ Investors: The study will assist investors in determining companies which are doing well as a result of good Board of directors composition.

Chapter Two- Literature Review

2.1 Agency problem

The modern public corporation is a relatively new organizational form in the history of societies, dating back to the beginning of this century. Its distinguishing characteristic is the separation of *ownership* of the assets of the corporation from *control* of those assets. While ownership of the assets is vested in the shareholders of the corporation, control over these assets is in the hands of professional managers of the corporation. Hence, managers take actions whose consequences are largely carried by the shareholders of the corporation.

To guard against failures, Fama and Jensen (1983) discovered that shareholders enact ratification, monitoring and sanctioning (reward and punishment) mechanisms. Mihnea and Roger (2001) went further and defined these mechanisms. Ratification mechanisms are mechanisms for validating the decisions of the agent, of giving final approval or veto for an initiative or directive or actionable plan of the agent. Monitoring mechanisms are mechanisms for observing, recording and measuring the output of the efforts and strivings of the agent. Sanctioning mechanisms are mechanisms for providing selective rewards and punishments (i.e. 'incentives') to agents for the purpose of motivating them to exert effort in directions that are aligned with the interests of the shareholders.

Jensen and Meckling (1976) define the agency relationship as a contract under which one party (the principal) engages another party (the agent) to perform some service on their behalf. As part of this, the principal will delegate some decision-making authority to the agent. Brennan (1995b) concludes that, these agency problems arise because of the impossibility of perfectly contracting for every possible action of an agent whose decisions affect both his own welfare and the welfare of the principal. Arising from this problem is how to induce the agent to act in the best interests of the principal. Managers bear the entire cost of failing to pursue their own goals, but capture only a fraction of the benefits.

JM (1976) argue that this inefficiency is reduced as managerial incentives to take value-maximizing decisions are increased. As with any other costs, agency problems will be captured by financial markets and reflected in a company's share price. Agency costs can be seen as the value loss to shareholders, arising from divergences of interests between shareholders and corporate managers. JM defined agency costs as the sum of monitoring costs, bonding costs, and residual loss. Monitoring costs are expenditures paid by the principal to measure, observe and control an agent's behavior. They may include the cost of audits, writing executive compensation contracts and ultimately the cost of firing managers. Certain aspects of monitoring may also be imposed by legislative practices. In the UK companies are required to provide statements of compliance with the Cadbury (1992) and Greenbury (1995) reports on corporate governance.

Given that agents ultimately bear monitoring costs, they are likely to set up structures that will see them act in shareholder's best interests, or compensate them accordingly if they do not. The cost of establishing and adhering to these systems are known as bonding costs. They are borne by the agent, but are not always financial. They may include the cost of additional information disclosures to shareholders, but management will obviously have the benefit of preparing these themselves. Since managers cannot be made to do everything that shareholders would wish, bonding provides a means of making managers do some of the things that shareholders would like by writing a less than perfect contract.

Despite monitoring and bonding, the interest of managers and shareholders are still unlikely to be fully aligned. Therefore, there are still agency losses arising from conflicts of interest. These are known as residual loss. They arise because the cost of fully enforcing principal-agent contracts would far outweigh the benefits derived from doing so. Since managerial actions are unobservable *ex ante*, to fully contract for every state of nature is impractical. The result of this is an optimal level of residual loss, which may represent a trade-off between overly constraining management and enforcing contractual mechanisms designed to reduce agency problems.

Within the agency framework agency conflicts arise from divergences of interest between any two parties to a contract within an organization. As a result, they are almost limitless in nature. Despite the existence of the agency problems, the modern corporation, with the diffused share ownership, which leads to such conflicts, has continued to be popular amongst both corporate managers and outside investor's alike. This could be attributed largely to the evolution of internal and external monitoring devices, which are aimed at controlling such problems. There does tend to be a degree of interaction between each type of mechanism within firms. Himmelberg et al (1999) argue that firms will tend to substitute various mechanisms depending on unobservable (to the econometrician) characteristics of the firm's contracting environment. Since this contracting nexus varies dramatically from one firm to the next, what is optimal for one need not be optimal for another?

Within this context, Agrawal (1987) argue that if one specific mechanism is utilized to a lesser degree, others may be used more, resulting in equally good decision-making and performance. Denis (2000) argues that two questions must be confronted when designing an effective governance mechanism. Firstly, does the mechanism serve to narrow the gap between managers' and shareholders' interests? Secondly, does the mechanism then have a significant impact on corporate performance and value? She also comments that where firms are all in equilibrium with respect to their governance mechanisms, then no meaningful relationship between any individual mechanism and performance will be seen to exist.

2.2 Suggested mechanisms for dealing with the agency problem

Research on corporate governance has identified a number of mechanisms intended to insure that management teams act in the best interests of shareholders. Alexander (1988) in his study identified them to include external mechanisms such as institutional ownership, large creditors, long-term relationships, debt financing, and the market for managerial labor, and internal mechanisms, which include managerial ownership, executive compensation and the board of directors. I will focus on only a few of them as follows:

❖ *The Managerial Labor Market*

Fama (1980) argues that corporate managers will be compensated in accordance with the market's estimation of how well they are aligned to shareholder's interests, based on prior performance with other companies.

❖ *Corporate Boards*

In theory, the board of directors is directly elected by shareholders at the company's annual general meeting (AGM). If these directors wish to stay in their jobs they should take decisions, which maximize the wealth of their shareholders. In their literature review, Hermalin and Weisbach (1987) contend that company boards have evolved as part of the market solution to the problem of contracting within organizations.

❖ *Corporate Financial Policy*

The financial structure and policy of companies may also have strong implications for agency controls. JM (1976) argue that the existence of debt reduces the amount of equity, and enables higher levels of insider ownership. Jensen (1986) also argues that the existence of debt in the firm's capital structure acts as a bonding mechanism for company managers. By issuing debt, and repurchasing equity, managers contractually bind themselves to pay out future cash flows in a way unachievable through dividends.

❖ *Blockholders and Institutional Investors*

Ordinary atomistic shareholders may not have the time, skill, or the interest to monitor managerial activities. Since they own a small portion of the total shares, the free-rider problem, means that it may not be in their best interests to monitor management while others will also derive the benefits from this.

The existence of large block investor(s) may overcome this problem, as they may have more skill, more time, and a greater financial incentive to overcome this free-rider problem and closely monitor management. In addition, such large shareholders may be able to elect themselves onto company boards, increasing their ability to monitor management. CEO's may also tend to voluntarily disclose information to block holders to reduce monitoring costs.

❖ *The Market for Corporate Control*

Takeovers may occur in relation to the earnings retention conflict between shareholders and management. Jensen (1986) argues that takeovers occur in response to breakdowns of internal control systems in firms with substantial free cash flows and organizational policies, which are wasting resources, in short, where management are using resources inefficiently. The market for corporate control can therefore serve to transfer control of the firm's assets to more efficient managers.

❖ *Managerial Remuneration*

The structure of executive compensation contracts can have a large influence in aligning the interest of shareholders and management. Compensation contracts, and their revision, represent a financial incentive for management to increase company value.

❖ *Managerial Share Ownership*

The final method of reducing agency conflicts is managerial share ownership. JM (1976) argued that as ownership of the company by inside managers increases, so does their incentive to invest in positive Net Present Value projects and reduce private perquisite consumption.

2.3 The corporate board as an agency conflict resolver.

Melvin A. Eisenberg (1972) corporate boards of directors are uniquely suited to perform monitoring functions. The monitoring function of central concern is "conflicts monitoring" or ways to prevent managers from opportunistically pursuing their own interests rather than the interests of shareholders. The board reform debate all over the world is focused on ways that board of directors can be made more effective at making managers accountable.

Schellenger and Wood (2001) conclude that the board of directors is by law the ultimate holder of authority granted to a corporation by its charter. It has the responsibility to manage or to direct the management of the corporation; it provides an additional check on managerial decisions. It represents a first line of defense against incompetent management. Within the context of monitoring the agency problem, the board of directors is a substitute

for equity ownership structure. Under corporate law virtually all management rights are assigned to directors and officers. The board of director's primary objective is to be the stockholders advocate. The board reviews and evaluates the performance of management in running the firm and is ultimately responsible for ensuring that shareholder wealth is maximized and agency problems are minimized.

Studies by Lorsch and MacIver (1989), Fox and Walker (2003) concludes that the agency theory identifies the corporate board as an important internal governance mechanism. The board of directors is positioned at the top of the corporate governance structure of the modern business corporation and fulfills three interrelated governance functions: compliance (ensuring the fulfillment of legal requirements), directing (determining the overall direction of organizations), and, monitoring (overseeing management).

While the board serves many important governance functions as noted above, Pearce and Zahra (1992), Zahra and Pearce (1989), notes that one of its key roles is that of providing oversight and control over the decisions of top management. In this control function, the board of directors is responsible for monitoring the strategic decisions of top corporate executives concludes (Andrews, 1971), (Demb et al, 1989). Indeed, as Dalton and Kesner (1987, p. 34) point out, "*It is the board of directors who have the fundamental charter at law to counsel, evaluate, and control company management.*" which creates employment risk for these executives. Agency theorists also suggest that the board of directors is in place to monitor and interpret the decisions of top managers and possibly intervene on behalf of shareholders. The monitoring role of the board of directors has long been recognized as a crucial component of corporate governance. Firms' board of directors primarily exists to resolve agency problems between shareholders and management (see JM, (1976)). A large literature has studied the monitoring role played by the board of directors and its impact on managerial incentives and firm performance. Rajesh K. A. & Dhananjay N. (2002), Eistenhardt (1989), Jensen and Meckling (1976) document that from an agency theory perspective, boards of directors are put in place to monitor managers on behalf of the shareholders.

2.4 Effectiveness of the corporate board.

Agency theorists acknowledge that boards will vary in their incentive to monitor on behalf of shareholders; as a result, incentives are an important precursor to effective monitoring. Board independence –the degree to which board members are dependent on the current CEO or organization is considered a primary incentive in that key to board monitoring. Boards consisting primarily of insiders or dependent outside directors are considered to be less effective at monitoring because of their dependence on the organization. Independent boards are thought to be the most effective at monitoring because their incentives are not compromised by dependence on the CEO or organization. From the viewpoint of the shareholder, the agency perspective on board composition, as Kiel and Nicholson (2003) concludes, primarily concerns creating independent boards or otherwise aligning the interests of directors with those of the shareholders to ensure effective monitoring of management.

In their studies Finkelstein and D'Aveni, (1994) argued that the same person should not hold the CEO and chairman roles simultaneously as this will reduce the effectiveness of board monitoring.

Literature has also uncovered a number of determinants of the effectiveness of the board. There is near consensus in the conceptual literature that effective boards will be comprised of greater proportions of outside directors. Studies by Lorsch and MacIver (1989), and Zahra and Peace (1989) concludes that effective boards are comprised of greater proportions of outside directors. Scholars such as Bacon and Brown (1973), Fristenberg and Malkiel (1980), approaching the board composition from the agency theory perspective typically, advocate for outside –dominance, i.e. outsiders should be in the majority on corporate boards. Mace (1986) and Patton (1987) concluded that an insider-dominated board cannot be trusted to police itself. Senbet (1998) assert, *"The board is presumed to be more independent as the number of outside directors increases proportionately"*. The standard view is that the degree of board independence is closely related to its composition.

2.4.1 Board Composition

According to Pearce and Zahra (1992), board composition refers to the number of director's hereafter "board size" and type of members as determined by the usual insider or outsider classification. Insiders are current members of top management team and employees of the company or its subsidiaries. Outside directors have no such association, but are further grouped as affiliated or non-affiliated (independent). Affiliated outsiders are not members of the current management or employees of the company but have close links with the firm as in the case of former executives or consultants. Non-affiliated outsiders are usually referred to as independent directors. They are recruited primarily because of their expertise, name recognition and skills. In theory these independent directors are not under the control of the company's executives.

Fama and Jensen (1983) in their research established that the composition of the board of directors is a critical factor in establishing the effectiveness of the board as an objective monitor of management, according to them, board composition refers to the relative numbers of inside (management) and outside (non-management) directors serving on the board. They argue that outside members of the board, those that are not employed by the organization nor have any other business ties to firm aside from their directorships, serves as the real monitors on the board since they have no affiliation with management.

The ability of a board to effectively monitor management has been directly linked by the empirical literature to board independence, where the degree of independence is in turn related to its composition. Other studies by Fama (1980); Weisbach (1988); and Zahra and Pearce (1989), concludes that board composition becomes significant as the primary responsibility in keeping the board independent depends on outside disinterested members of the board that are not directly beholden to management. As Fama and Jensen (1983, p. 315) argue, outside directors have a particular incentive to monitor managers on behalf of shareholders because their reputation, and in turn the value of their human capital, depends on their acumen as decision control specialists.

Agency theorists suggest that boards dominated by inside directors may be less vigilant monitors of management as these directors may intentionally provide self-serving accounts of managerial actions to enhance their status with the firm's chief executive officer (Eisenhardt, 1989); (Fama, 1980). By contrast, outside directors are thought to be vital to ensuring that an effective, impartial governance system is allowed to operate within the corporation since outside directors have more independence from management (Fama, 1980). Johnson et al (1993) suggest that outsider dominated boards, because of their greater objectivity in evaluating firm performance, will be inclined to support higher risk but potentially more rewarding strategies. Laszlo (2002) observes that outsider dominated boards tend to support the interests of shareholders.

A preference for outside dominated board is grounded in the agency theory. Outside directors, agency theorists contend, are able to separate functions and exercise decision control, since reputational concerns, and perhaps any equity stakes, provides them with sufficient incentive to do so. Corporate boards should act as monitors in disagreements amongst internal managers and carry out tasks involving serious agency problems, such as setting executive compensation and hiring and firing managers. Indeed, in the UK, the Greenbury (1995) report recommends that remuneration committees be comprised only of independent directors in order to increase their neutrality in this task.

Effective corporate governance by company boards requires both good information (provided by insiders?) and the will to act on negative information (provided by outsiders?). The positive role of outside directors on company boards with respect to particular discrete tasks has been explored with respect to disciplining poorly performing top management, such as Weisbach (1988), reducing top management's ability to block a takeover bid, the proportion of managerial compensation that is equity based, Mehran (1995), and reducing managerial opportunism in granting executive stock options, Yermack (1997), amongst others. However, Warner (1987) find that only prolonged poor performance leads to top management having shorter tenures within their positions. Denis and Denis (1995) find modest performance increases following top management turnover,

but find that such changes are precipitated by external control events rather than the composition of the company's board. Agrawal (1996) examine a range of governance variables within a simultaneous regressions framework and find that the proportion of outside directors on company boards is the only governance mechanism, which consistently affects corporate value. However, the relationship is negative, suggesting that the US firms have destroyed shareholder wealth by employing these directors.

Hermalin and Weisbach (1988) find no relationship between board composition and firm value. Perhaps most significantly, Denis (2000) discusses the important role of outsiders in 'crisis' situations such as those that would necessitate top management turnover. However, the role of such directors in the day to day running of a business is unlikely to be significant. Similarly, Hermalin and Weisbach (1988) present a model of the importance of outside directors, whereby their power is determined by the performance of the incumbent CEO. If this director is a 'star performer' then outside directors have very little power in controlling their actions, since shareholders perceive the top officer as being high quality. Outsiders are reliant on the CEO providing observable signals of poor quality to shareholders before they are able to intervene and appropriately discipline such managers.

Studies on the determinants of board composition have been carried out. Hermalin and Weisbach (1988) examined the reasons behind inside- and outside directors' departures (additions) from (to) boards. They concluded that changes in board composition are influenced by the CEO succession process and firm performance. More recent work by Rediker and Seth (1995) found a substitution effect between outside board representations and block shareholder equity stakes, managerial shareholdings, and stock ownership of inside directors.

Similarly, Bathala and Rao (1995) found support for the view that board composition is a substitute for alternative agency mechanisms. They also found that the proportion of outside representation on the board is positively related to institutional holdings and negatively related to growth, volatility, and CEO tenure.

Dalton and Kesner (1987), found that the pattern of relationships between board characteristics and the incidence of CEO duality are very similar respect to the US and UK boards. On the contrary, significantly fewer outside board members and fewer instances of CEO duality characterize Japanese boards.

Li (1994) found that outside proportion in the board is inversely related to inside ownership, bank ownership of equity, and board size. He also found that outside board membership is positively related to state ownership in the firm and CEO duality but is not affected by firm performance, leverage, or size.

Within an agency theory context, the determinants of board composition can be loosely categorized into three major areas.

First, board composition may be affected by alternative corporate governance mechanisms. The agency literature has identified a number of alternative control mechanisms, in addition to the board of directors, which can mitigate agency conflicts within the firm. Research on corporate governance has identified a number of mechanisms intended to insure that management teams act in the best interests of shareholders. These include external mechanisms such as institutional ownership, large creditors, long-term relationships, debt financing, and the market for managerial labour, and internal mechanisms, which include managerial ownership, executive compensation and the board of directors.

As JM (1976) show, principal-agent conflicts may arise because management is distinct from residual claimants; since managers do not bear the full costs of their decisions, the outcome is that managerial interests are not necessarily tied to those of shareholders. JM assert that increasing managerial ownership of equity can control these problems. Furthermore, in their article "Board composition in New Zealand: an agency perspective" Prevost et al (2002) found that capital structure and ownership concentration may also be useful in controlling agency problems both in the US and elsewhere. Thus, the proportion of outside directors on boards is likely to be interrelated with the extent that other

substitute corporate governance mechanisms are in place. However, the degree of substitutability between alternative governance mechanisms will depend, in part, on existing regulatory and institutional environments (Li, 1994). The more effective substitute corporate governance mechanism the less crucial the need for an independent board therefore the smaller the number of outside directors.

Second, a large literature has developed which attempts to relate the ability of boards to effectively monitor management to board-specific attributes. In particular, board size, board composition, and the extent to which CEOs are able to 'hand-pick' board members are characteristics, which have achieved a prominent role as likely determinants of the degree of the board's monitoring efficacy.

Finally, in their article "Board composition in new Zealand: An agency perspective" Prevost et al (2002) also found that board composition itself is also impacted by other control variables including firm size, future growth, extent of diversification, and firm performance.

2.4.2 Attributes determining board effectiveness.

Outsider Directors

Pearce and Zahra (1989) identified three sets of interrelated roles played by boards in modern organization, Service, strategy and control. In performing its control role the board attempts to align the interests of senior managers and those of the shareholders in order to minimize agency costs and protect shareholders interest. Several empirical studies have concluded that board composition determines board's power as an instrument of corporate control. The last two decades have witnessed increasing efforts to reform boards to make them a strong means of corporate governance. Schellenger et al (2001) observed that the bulk of these activities have focused on altering board composition, especially increasing the representation of outside directors. Herman (1981) concludes that, by increasing the representation of outside directors, independence of the CEO is enhanced, more objectivity is introduced into the boards proceedings and the level of board expertise

is increased. Overall, the vast majority of reports on corporate governance and text laws recommended a balance between executive and non executive directors, the former brings their perfect knowledge of the company's transaction and strategic orientation, and the latter their wide experience source of benchmarking.

Baysinger and Hoskinson (1991) concludes that, most corporate boards include some of the firm's top managers as well as directors from outside the firm and noted that the executive (inside) directors provide valuable information about the firm's activities while non-executive directors (outside) directors are expected to contribute both experience and objectivity in monitoring management decisions.

The guidelines issued on good corporate governance practices in Kenya recommend that boards of directors in Kenya should reflect a balance between independent directors, non-executive directors and executive directors. Independent and non-executive directors should reflect one third of membership of the board.

It is often proposed that inside (executive) directors cannot be relied on to impartially monitor their own performance. In contrast, outsiders are viewed as more independent and, therefore, impartial. Also, Sheppard (1994) proposes that outside directors 'provide an indicator of the board's orientation toward its external environment ... and thus its ability to respond to change'. The inability to respond to change is one of the major causes of corporate decline.

Outsider representation on boards has not been shown to be consistently associated with positive outcomes. For example, Boyd (1994) found that insider dominated boards had lower levels of CEO pay and Hill and Snell (1988) found outsider dominated boards to be associated with less research and development and more unrelated and overall diversification. As non-executive directors are more likely to be professional directors and on the boards of other companies, there is greater potential for conflicts of interest and anti-competitive behavior by these directors.

Several empirical researches, emanating principally from UK and US has attempted to evaluate the monitoring contribution of non-executive directors. The vast majority of these studies have focused on examining the value to shareholders of independent directors either in term of the impact on shareholder value or in situations where the interests of shareholders and managers are in conflict (executive compensation, executive turnover and takeovers). Concerning shareholders value, many researches have confirmed the positive impact on stock prices of the addition of outside directors; Rosenstein and Wyatt (1990) reported that announcements of outside directors and appointment are associated with positive excessive returns. On the other hand, Baysinger and Butler (1985) found that the proportion of outsiders had a positive but lagged effect on companies' accounting performance. A similar positive impact has been found by Pearce and Zahra (1992) and Dehaene, De Vuyst and Ooghe (2001) in Belgium.

Hermalin and Weisbach (1988) found that companies are more likely to replace executive directors with outsiders after periods of poor performance. The absence or weak association between board composition and firm performance must also be signaled (Fosberg, 1989); (Hermalin and Weisbach, 1991) and (Baghat and Black, 1998). In France, Alexandre and Paquerot (2000) have noted the absence of relation with the turnover of CEO. Besides, the behaviour of outside directors in the context of takeovers has been subject of study of many researches in order to have insights into the effectiveness of outsider monitoring. Byrd and Hyckman (1992) reported that in the case of acquisitions, bidding firms dominated by outside directors (board with more than 50% of outside directors) have higher announcement-date stock price reaction than other bidding firms. Brickley et al, (1994) studied the reaction of equity prices after the adoption of poison pills in US. They found that shareholder reaction is more positive when the board has a majority of outside directors compared to their counterparts having a majority of inside directors. According to Brickley et al (1994), this suggests that shareholders believe that such action is more likely to benefit them when outsiders have significant input into its implementation.

Another strain of research interested on the behavior of outside directors surrounds the replacement of CEO. Weisbach (1988) found that companies with outsider-dominated board are more likely to remove the CEO than firms with insider dominated board, and such changes tended to result in improved post turnover appointments. A positive association between the proportion of outsider and the replacement of poorly performing CEO has been also documented by Borokhovich (1996).

Regarding executive remuneration, Mehran (1995) found that companies with a majority of outside directors included a greater proportion of equity-based compensation of executives, which led to greater shareholder wealth. This result suggests that outsider act in the interest of shareholders. This idea is confirmed by Mayers et al (1997). In fact, Mayers et al (1997) found that higher proportion of independent directors is associated with lower executive remuneration. However, Boyd (1994) and Kren & Kerr (1997) found that the proportion of outside directors had little impact on the pay performance relationship in US, a finding confirmed by Cosh and Hughes (1997) in UK.

Overall, the available evidence confirms the importance of outside directors in the monitoring process of management, which is in line with the interests of shareholders. The evidence in the US by Bathala and Rao (1995), has generally been that outside board representation is a substitute for other corporate governance mechanisms as evidenced by the inverse relationship between outside board proportion and inside ownership, debt, and institutional and large block ownership

Inside ownership

Inside ownership refers to the proportion of equity held by insiders. JM (1976) note that as the proportion of equity held by the manager increases, his propensity to undertake excessive perquisite consumption declines thereby aligning managerial and shareholder interests. The monitoring role of external board members would be less critical for firms with higher proportions of inside ownership. Concerning managerial ownership, as the proportion of equity owned by the manager's increases, the agency conflict between managers and shareholders decreases concludes, JM (1976). Additionally, firms may

adopt means, which lead to increase management ownership. With having an increasing level of ownership, managers are encouraged to act as owner. In deed, managerial personal wealth is increasingly dependent on firm value, the cost of pursuing activities that do not increase shareholder wealth increase. These managers may have an incentive to accept these additional cost only if there is a significant personal benefit.

Mak and Li (2001) studied the determinants and interrelationships among corporate ownership and board structure characteristics using a sample of Singapore listed firms. They found that corporate ownership and board structure are related. Specifically, firms with higher managerial ownership tend to have lower proportion of outside directors. They signaled that these results are consistent with a substitute relationship between managerial ownership and the use of outsiders on the board. Studies by Rediker and Seth (1995), Prevost et al (2002) also confirm this idea.

Debt

In the agency framework, debt assumes a significant role in mitigating agency problems. Jensen (1986) argues that the contractual nature of debt reduces management's discretionary control over the firm's free cash flow and their incentive to engage in non-optimal activities. Grossman and Hart (1980) assert that debt forces managers to consume fewer perks and become more efficient in order to avoid bankruptcy, the loss of control, and loss of reputation. Harris and Raviv (1991), in a survey of the literature, observe that the evidence is broadly consistent with the view that debt can mitigate agency conflicts. On the other hand, increased leverage may be positively associated with the percentage of outsiders. As Li (1994) points out, increased debt may be used to finance external growth or diversification activities or internal development. The result, then, is an increased need for the expertise brought by outside board members and, subsequently, a positive relationship between the proportion of long-term debt and outside board representation.

Large shareholders or block holders

There is also a growing literature on the effect of **large shareholders or block holders** on mitigating agency problems in the firm. Beginning with the theoretical models postulated by Grossman and Hart (1980) and Shleifer and Vishny (1986), a large body of empirical

evidence has developed which shows that shareholder wealth increases when large blocks of equity are acquired by outside shareholders owing to their monitoring role. Recent work in this area includes Bethel, Liebeskind and Opler (1998) in the US and Craswell, Taylor and Saywell (1997) in Australia. Consistent with this view, Li (1994) finds that outside board proportion and ownership concentration are substitutes, i.e., are inversely related. When an individual shareholder own a large equity stake in a company, that shareholder has an increased incentive to monitor managerial behavior since he will receive a greater share of any benefits resulting from discouraging or detecting mismanagement (Schleifer and Vishny, 1986).

A number of recent studies provided evidence on the relation between outsider's representation on board and ownership structure. In fact, Li, (1994) found that outside board proportion and ownership concentrations are substitutes. Similarly, Rediker and Seth (1995) studied the link between the monitoring potential of the board of directors measured by the proportion of outside directors and both ownership of large external blockholder and managerial ownership. The author found that there is a negative association between outsider representation and blockholder ownership in large companies, which is not verified for small ones.

In the same line of spirit, Whidbee (1997) investigated the influence of ownership structure on the utilization of outsiders on boards. However, he found that there is a negative relation between managerial ownership and outsider representation on board, but a positive association between outsider's representation on board and the ownership of external blockholders, Which suggests that there is a relation of substitutability between outsider representation on board and the level of managerial ownership, which is not verified for the relation with ownership concentration.

Similarly, O'Sullivan (2000) found a positive association between ownership of external blockholders and the proportion of outsiders on board. He asserted that non institutional shareholders utilize their ownership holdings to ensure their interests are protected.

Overall, these results suggest that there is a substitution relation between ownership concentration and outsider representation. Hence, when the level of ownership concentration increases, the proportion of outsider in board decreases. High ownership concentration serves to insulate the firm from the disciplinary effect of an active takeover market, and it follows that outside director monitoring would take on an increased role in the absence of a credible threat of efficiency-enhancing takeovers.

Board characteristics:

Previous studies have identified three main characteristics of the board that affect its effectiveness in corporate governance. The **chief executive officer (CEO)** is likely to be the person with the most power and influence in the corporate governance process. Of particular relevance, is whether the same person holds the position of CEO and chairman of the board in a company. When a single individual wears the "hats" of both the CEO and chairman of the board (unitary leadership), managerial dominance is greatly enhanced since that individual is more aligned with management, than with stockholders (Mak and Li 2001). Having separate persons holding the CEO and chairman of the board enhances the monitoring ability of the board (Jensen, 1993).

O'Sullivan (2000) notes that, **CEO duality** is likely to erode the ability of external shareholders to appoint the desired level of non-executive director's representation on board of directors. The presence of CEO duality is associated with lower outside representation on the board of directors. CEO duality is typically defined to occur when the board chair of a company is also its chief executive officer (CEO). Arguments have also been made *against* CEO duality. In particular, it has been proposed CEO duality leads to a situation where the governance role of the board of directors is compromised. The argument is aptly put in the following quote by Mahajan and Sharma (1985):

"In a company where the chairman is also the CEO ... power concentrated in one individual and possibilities for checking and balancing powers of the CEO ... are virtually eliminated. In such a corporation, the board may not be able to function as an independent body - independent from the influences of top management."

Taking an agency theory perspective, Daily and Dalton (1985) propose that separating the roles of CEO and chairperson, reduces the opportunity for the CEO and inside directors to exercise behaviors which are self-serving and costly to the firm's owners.

It has also been proposed that the separation of CEO and board chair roles is necessary because one person cannot perform both roles effectively as both the chairman and CEO have a distinctive domain. A further argument for separating the roles of chairperson and CEO concerns the relative role expectations on each. In contrast to the CEO, who is involved in the day-to-day management of the company, the board chair is often involved in special planning assignments, in policy review and formulation and in public and stockholder relations. It is likely that, given his or her day to day executive commitments, the CEO will not be able to effectively perform the additional roles of chairperson, and a fortiori during times of crisis. Furthermore, some of the benefits, which the CEO can obtain from having a chairperson, will inevitably be absent when the roles are combined. Yet another proposed for the separation of CEO and chairperson roles is that – in the case of a poorly performing company it is not immediately clear what process would be relied on to remove CEO/board chair. This is because the CEO who is also board chair is assumed to have a board, which largely defers to him or her. Interestingly, research by Harrison, Torres and Kukalis (1988) indicates that it is more difficult to replace either the CEO or board chair when these roles are separated than when the two roles are held by one individual.

In Kenya, the capital markets authority guidelines on good governance practices recommend separation of the CEO and chairman position.

Hermalin and weisbach (1988) suggests that that the CEO plays a large role in choosing the board of directors. One concern particularly toward the end of his tenure is the choice of his successor. Grooming the next CEO is a major motive for adding insiders to the board. At the beginning of a new CEOS tenure a number of insider directors losing

candidates to become new CEO may leave, since they will not soon have another chance to become CEO. The new CEO will likely fill the vacant positions with outsiders as he will not be ready to start his succession plans and will not have as much freedom like an established CEO and will therefore appoint more outside directors to make the shareholders happy. CEO-founder- this refers to the situation where the CEO is also founder of the company. Boeker (1989) in their study found out that founders are shown to exhibit strong organizational influence. They are therefore likely to stack the board in their favor with insiders who are unlikely to be critical of their performance. (Prevost et al, 2002)

Board Size

In Kenya there is no requirement regarding board size imposed by the Nairobi stock Exchange (NSE). The guidelines issued by Capital Markets Authority on corporate governance, however recommends that the size of board should not be too large to undermine an inter-active discussion during board meetings nor too small such that the inclusion of wider expertise and skills to improve effectiveness of the board is compromised.

Jensen (1993) concludes that, large boards are "less likely to function effectively and are easier for the CEO to control. Yermack (1996) provides an empirical investigation of the performance effect of board size. His main finding is that there is a clear inverse relation between firm's market value and the sizes of board of directors. Therefore a board is effective in monitoring has a relatively small size. Concerning the effect of board size on the proportion of outside directors, Li (1994) found a significant negative relation between board size and outsider representation.

Because of disparity in the size of organizations, difference in the competitiveness of the markets, variance in both size and importance of the respective industry sectors and the nature of the organization (public, private, listed, not for profit etc.), there is not a convenient 'one size fits all' prescription for the size of the board. The appropriate sizing of the board is a function of the individual organization's need to respond to external

environmental dynamics as well as its need to address the dynamics of the internal issues it is experiencing. Too large a board can be dysfunctional (becoming prey to factional elements and agendas) to the point of destroying the board's cohesiveness, and as a consequence, its effectiveness. The board should have sufficient numbers and diversity to cover the required range of skills, experience and expertise required by the company. The differences in needs between companies, industry sectors, and markets could vary greatly.

Growth and profitability.

It has been argued that agency costs can be fairly high for growth firms as managers have greater flexibility with regard to future investments (Myers, 1977). As a result, firms with significant growth opportunities may be associated with greater proportion of outsiders on their boards. However, a case for an inverse relation between growth and outside board proportion can also be made. Bathala and Rao (1995) document an inverse relation between growth and outside proportion on the board. Bathala and Rao (1995), using arguments found in the management literature, suggest that investment decisions of high growth firms may be associated with greater uncertainties, require information that may be highly specialized, and decisions that are very subjective such that only insiders can properly assess the value of the investments. Since inside directors are expected to possess superior knowledge to assess such situations better than external directors, one would expect the top management of growth firms to prefer more internal directors on their boards. Consequently, if decision-making in high growth firms involves a great deal of subjectivity and strategic choices, top management of high growth firms may prefer more insiders on their boards. Consistent with this hypothesis, Bathala and Rao (1995) find that growth and outside board representation are negatively related in the US. Researches by Prevost et al (2002) and Li (1994) found positive relation between profitability and outsider representation on board.

Company Size

The influence of company size on the structure of corporate governance has been addressed in the governance debate. In terms of ownership and control, larger companies are expected to present increased difficulty for shareholders to exercise adequate monitoring of managerial behavior. Therefore as the company size increases, there is a

growing need for agency conflicts to be controlled either with outside directors and/or other governance mechanisms. Studies by, Mautz and Neary (1979); and Kesner (1988) conclude that larger firms, because of their greater visibility and prestige, may tend to have a larger proportion of outside board members. The log of total assets of the firm is used as a proxy for a possible size effect. From an agency theory perspective larger companies require a greater number of directors to monitor and control the firm's activities. (Kiel and Nicholson, 2002).

Business segments

Business segments are the number of business segments in which the firm operates. Increasing numbers of business segments adds a dimension of organizational complexity, which requires the expertise brought by a greater proportion of outside directors.

2.5 Overview of Corporate Governance in Kenya.

Corporate governance has never been so topical or important. The Enron failure together with other high profile corporate collapses has resulted in calls for better corporate governance, Kiel (2002). Thus, there is growing recognition around the world of the importance of corporate governance; in Kenya, we have recently become infatuated with the subject and the issues surrounding it such as accountability, controls, international best practice, disclosure, transparency and corporate reporting.

Why the interest? The watershed Cadbury Report of 1992 put corporate governance in the limelight, as it held up a Code of Best Practice for UK companies to aspire to in terms of enhancing the quality of their management and accountability to stakeholders.

Recent global and financial developments, including the crisis sparked by capital flight from Asia in 1997, led to introspection and scrutiny by governments and corporate regimes into what went wrong:

- What drove investors away? And
- What did companies do--or not do--to make them appear less than attractive to international money?

The realizations that perhaps the reporting regime in Asia was not speaking the same language as regimes elsewhere led to a search for a common understanding of what attracts investors and keeps them coming. In this, Asia was not alone. Russia; Italy and Kenya were amongst those who joined Malaysia, Japan and Singapore in seeking to undertake reform and create new and stronger regimes that would encourage and forge better corporate governance and better-governed companies in the Private Sectors. (Raslan, 2000)

2.5.1 What is corporate governance?

From a corporate perspective, governance means that companies should not only maximize shareholders wealth, but should balance the interests of shareholders with those of other stakeholders, employees, customers, suppliers, investors and commodities, in order to achieve long-term sustained value. From a public policy perspective, corporate governance is about managing an enterprise while ensuring accountability in the exercise of power and patronage by firms. The role of public policy is to provide firms with the incentives and discipline to minimize the divergence between private and social returns and to protect the interests of stakeholders. (Mensah, 2000)

The capital markets authority in Kenya looks at Corporate governance, as the process and structure used to direct and manage business affairs of the company 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. (CMA act)

There is not a universally accepted definition of corporate governance. Cadbury (1992) defines "corporate governance as the system by which companies are directed and controlled"

2.5.2 The importance of Corporate Governance

No matter what view of the corporate objective is taken, effective governance ensures that boards and managers are accountable for pursuing it. Effective corporate governance:

- ❖ Promotes the efficient use of resources both within the company and the larger economy.
- ❖ Helps ensure that the company is in compliance with the laws, regulations, and expectations of society.
- ❖ Provides managers with oversight of their use of corporate assets.
- ❖ Supports efforts to reduce corruption in business dealings, and
- ❖ Assists companies (and economies) in attracting lower-cost investment capital by improving both domestic and international investor confidence that assets will be used as agreed (whether that investment is in the form of debt or equity).

2.5.3 Development of corporate governance in Kenya.

Job K. Kihumba, the then Chairman of Private Sector Corporate Governance Trust traces the development of corporate governance initiative in Kenya, to a workshop on the Role of Non-Executive Directors, which was held in, Nairobi in November 1998. A second seminar in March, 1999 in Mombasa made important decisions one of which, was to create an interim committee with the mandate of doing all that was necessary to formulate a Code of Best Practice for Corporate Governance in Kenya and to co-ordinate, where applicable, with other efforts in the region and beyond for the purpose of improving Corporate Governance.

Several other seminars were held with a final one attended by representatives from over seventy corporate and other organizations on the 8th October 1999. Participants at function resolved, among other things:

- That the Code of Best Practice for Corporate Governance, as previously circulated and subsequently refined through expert input and comments from corporate respondents, be adopted, printed and circulated as a guide for Corporate Governance in Kenya.
- That there was an urgent need to establish a "Corporate Sector Foundation" to promote, co-ordinate and guide corporate governance in Kenya and

- That the steering committee be mandated to proceed to work on the implementation of this resolution.

Sam Nganga in his article notes that the Capital Markets Authority (CMA) has adopted a code of corporate governance derived from the OECD code. They revolve around these principles:

- **The rights of shareholders** (and others) to receive relevant information about the company in a timely manner, to have the opportunity to participate in decisions concerning fundamental corporate changes, and to share in the profits of the corporation, among others;
- ❖ **Equitable treatment of shareholders**, especially minority and foreign shareholders;
- ❖ **The role of stakeholders in corporate governance** should be recognized and established by law;
- ❖ **Timely and accurate disclosure and transparency** on all matters material to comp performance, ownership;
- ❖ **The responsibilities of the board:** The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and shareholders.

2.5.4 Challenges of the Kenyan Transition

Kenya like most African countries went through two decades of economic decline in the post-independence era. The traditions of rule of law, transparency, accountability and social justice, which underpin governance, both at the national and corporate levels are non-existent. In the 1990.s, Kenya embarked on economic reforms, driven by IMF structural adjustment programs. The development of a significant private sector, whether through a privatization of state enterprises or the emergence of new firms, although progressing at a rapid pace, is still very much at its infancy compared to the size of the private sector in most advanced market economies. Kenyan economy is very much

transition economy with special features, affecting the evolution of good corporate governance; there is excessive reliance on government, which provides a fertile ground for rent-seeking capital. Because of the transitional state of African economies and political systems, Kenya is ill-equipped to implement the corporate governance systems that have evolved over centuries in developed market economies. The constraints arise from the

- *Ownership structure*

In advanced economies, widely held public companies represent a significant part of the corporate sector. This is much less so in African economies. The number of listed companies on stock exchanges is low. More commonly, we have a dominance of state enterprises (even with privatization) or closely held family-owned and managed companies.

- *Less Competitive markets*

Firms are disciplined by competition. Competition creates incentives for insiders to enhance the value of the firm. In Kenya, the business environment lacks many of the elements needed for a competitive market. Rent seeking interferes with the ability of firms to be competitive.

- *Legal and Regulatory Systems*

Regulatory reform in transitional economies is a real challenge. Reform is strongly resisted by rent-seeking vested interests individuals, who have the most to gain if reforms stall halfway between the state-controlled economy of the past and a well functioning, open, and a well-functioning, open, and competitive market economy

These constraints have worked against the development of well-functioning securities, markets that could provide disciplinary role. Institutional investors are few and not strong enough to insist on fairness, efficiency and transparency.

Given the transitional nature of African economies, good corporate governance in Kenya like in all other African countries will be an outcome of an organic transformation of society from a controlled economy to a market-based economy, and from personalized and dictatorial political power to political systems that stress participation and accountability concluded Mensah (2000), thus a broad-based approach is needed to foster good corporate governance.

A Lot of developments have taken place in Kenya on the issue of corporate governance. In the academic world a several researches have been undertaken on the topic with different results.

Wambua (1999) in his research on corporate governance practices in the banking sub-sector noted that accountability requires some agent to monitor management performance because of the significant weaknesses noted among board of directors.

Mwangi (2002) on carrying out a survey on corporate governance practices among insurance companies found out that there appears to be a positive relationship between level of governance and ownership in as far as companies were categorized into local, foreign owned and financial performance depending on the type of business written.

Mucuvi (2002) found out that there is generally a high level of awareness about corporate governance among the motor industry, her results indicated that a large number of firms have taken deliberate steps to implement the corporate governance policies.

The capital markets authority, through gazette notice no.369 of 25th January 2002 issued **guidelines on corporate governance practices by public listed companies in Kenya**; this was in order to enhance corporate governance practices by such companies. These Guidelines came into effect on 14th January 2002.

2.5.5 What constitutes good corporate governance?

In its simplest form, good corporate governance is no more than effective and responsible management, with the directors of a company assuming stewardship and discharging their full responsibilities towards their various stakeholders. While most companies aspire to the best practices set out in the code, they may face certain challenges or issues like their readiness to adopt a "best-practice" culture, or inadequate resources in terms of directors able and willing to put in the commitment, which is clearly a prerequisite. Entrepreneur-driven companies are a key part of our economy, and these may regard the push for

corporate governance as a threat to entrepreneurial drive and spirit. A balance needs to be struck between good governance and effectiveness. The search for governance cannot, and must not, stifle creativity. Equally, companies must guard against the temptation to undertake "window-dressing" for disclosure in their corporate governance reports. As far as long-term investor confidence is concerned, disclosure is all very well, so long as what is disclosed is the truth. (Raslan, 2000).

Corporate Governance is increasingly recognized as an important element of sustainable private sector development, which in turn creates economic growth and employment, and therefore contributes to the alleviation of poverty. Strengthening corporate governance is critical to improving access to capital, ensuring appropriate risk management, increasing productivity and competitiveness and supporting the fight against corruption. In doing so, corporate governance assists in the strengthening of the overall international financial system and reduces the vulnerability of developing and emerging markets to financial crisis.

In Kenya the Capital Markets Authority has developed guidelines for good corporate governance practices by public listed companies in Kenya in response to the growing importance of governance issues both in emerging and developing economies and for promoting domestic and regional capital markets growth. It is also in recognition of the role of good governance in corporate performance, capital formation and maximization of shareholders value as well as protection of investors' rights.

These guidelines were developed taking into account the work, which had been undertaken extensively by several jurisdictions through many task forces or committees including but not limited, to the United Kingdom, Malaysia, South Africa and the Commonwealth Association for Corporate Governance.

The Capital Markets Authority has also supported development of a code of best practices for corporate governance in Kenya issued by the Private Sector Corporate Governance Trust, Kenya, whose efforts have also been useful in the development of the guidelines.

The objective of the guidelines was to strengthen corporate governance practices by listed companies in Kenya and promote the standards of self-regulation so as to bring the level of governance in line with international trends.

Good corporate governance practices must be nurtured and encouraged to evolve, as a matter of best practices but certain aspects of operation in a body corporate must of necessity require minimum standards of good governance. In this regard the Authority expected the directors of every listed company to undertake or commit themselves to adopt good corporate governance practices as part of their continuing listing obligations.

It was important that the extent of compliance with the guidelines should form an essential part of disclosure obligations in the corporate annual reports. It was equally important that disclosure of areas of non-compliance or alternative practices be made a part of the disclosure requirements.

The Capital Markets Authority also required issuers of securities through the capital markets such as bonds and commercial paper to comply with the guidelines. The issuer of the debt instrument will disclose in the information memorandum whether the Issuer is complying with the guidelines on Corporate Governance. Though the guidelines were developed for public listed companies and issuers of debt instruments in Kenya's capital market, Companies in the private sector were encouraged to practice good corporate governance.

Capital Markets Authority identifies a number of principles that are essential for good corporate governance practices. The following representing critical foundation for and virtues of good corporate governance practices:

❖ *Directors*

An effective board to lead and control the company and be accountable to its shareholders should head every listed company. The board of directors should assume a primary responsibility of fostering the long-term business of the corporation consistent with their fiduciary responsibility to the shareholders.

❖ **Role of Chairman and Chief Executive**

Every public listed company should separate the role of the chairman and chief executive in order to ensure a balance of power and authority and provide for checks and balances. No person shall hold more than two chairmanships in any public listed company at any one time.

❖ **Shareholders**

There should be shareholders participation in major decisions of the company. The board should therefore provide the shareholders with information on matters that include but are not limited to major disposal of company's assets, restructuring, takeovers, mergers, acquisitions or reorganization. The board should provide to all its shareholders sufficient and timely information concerning the date, location and agenda of the general meeting as well as full and timely information regarding issues to be decided during the general meeting;

❖ **Accountability and Audit**

The board should present an objective and understandable assessment of the company's operating position and prospects. The board should ensure that accounts are presented in line with International Accounting Standards. The constitution of audit committees represents an important step towards promoting good corporate governance.

Chapter Three- Research Design

3.1 Research Design

This chapter sets to explain the population of interest, the type of secondary data used, the sources of data, the techniques of analysis used and the data analysis. A multivariate regression model is estimated.

3.2 Population and sampling.

The population for the study was all the companies listed on the Nairobi Stock Exchange for year 1st April 2002 to 31st March, 2003. The sample for the study was generated from the companies listed on the Nairobi stock exchange as of March 31ST 2003, which had filed the financial statements for the current financial year.

3.3 Data description and collection.

Secondary data was utilized for the purpose of this study. The source of data was the Nairobi stock exchange (NSE). Financial statements were obtained from the Nairobi Stock Exchange and the information on board size, composition, director share ownership, the top ten shareholders, CEO duality as well as business segments were extracted. Information on the top ten not listed on the financial statement was obtained from the Nairobi stock exchange library. Information on debt, total assets, and firm performance were calculated using information from the same financial statements. Firm share prices at their respective year-ends were also obtained from the Nairobi stock exchange.

3.4 Techniques of Analysis.

Multiple regression analysis was undertaken to examine the determinants of effective board composition.

The dependent variable is the proportion of outsiders on the board.

The independent variables included variables to capture alternative corporate governance mechanisms (inside ownership, leverage, and ownership concentration), other board

characteristics (board size and CEO duality), and potentially important control variables, which included, profitability.

The model used was similar to the one in Prevost, et al (2002) but with the necessary adjustments and configurations to domesticate it to the Kenyan conditions and environment.

The model was as follows.

$$\text{OUTDIR} = a_0 + a_1 \text{INSOWN} + a_2 \text{DEBT} + a_3 \text{TOP10} + a_4 \text{BDSIZE} + a_5 \text{CEO DUALITY} + a_6 \text{PROFIT} + a_7 \text{LSIZE} + a_8 \text{BUSSEG} + a_9 \text{LEGIS} + e$$

Where:

1. The dependent variable, **OUTDIR**, is defined as the percentage of outsiders on the board. Outside directors as individuals who (1) are not an active or retired employee of the firm; (2) do not have close business ties (e.g. consultant, supplier, etc.) with the firm; and (3) are not representative of or appointed by a major shareholder of the firm. It proxies for effective board composition.
2. **INSOWN** refers to the proportion of equity held by insiders. **INSOWN** is measured as the proportion of stock held by the top management and directors of the company to total shares outstanding.
3. **DEBT** is defined as the long-term debt plus current liabilities divided by the book value of total assets.
4. **TOP10** is used to control for block holder monitoring of management by including the proportion of equity held by the top ten largest shareholders as an independent variable
5. **BDSIZE** refers to the total number of directors on the board.
6. **CEO_DUALITY** is a dummy variable that takes on the value one if the CEO is also the chairman of the board.
7. **LSIZE** is the log of total assets of the firm. It proxies for possible size effect. Larger firms, because of their greater visibility and prestige, may tend to have a larger proportion of outside board members.
8. **BUSSEG** is the number of business segments in which the firm operates. We hypothesize that increasing numbers of business segments adds a dimension of

organizational complexity, which should require the expertise brought by a greater proportion of outside directors.

9. **PROFIT:** Tobin's **q** ratio as one measure of firm performance will be used.

$$\text{Approximate } q = (\text{MVE} + \text{PS} + \text{DEBT})/\text{TA}$$

Where **MVE** is the product of a firm's share price and the number of common stock shares outstanding

PS is the liquidating value of the firm's outstanding preferred stock,

DE BT is the value of the firm's short-term liabilities net of its short-term assets, plus the book value of the firm's long-term debt.

T A is the total assets

Table 1

The table below lists the hypothesized relationship with dependent variable.

Independent variable	Measure (ratio)	Relationship with dependent variable	Reason for hypothesized relationship
INSOWN	Equity held by insiders divided by total equity	Negative	Monitoring role of external board members is less critical for firms with higher proportion of outside directors. As the proportion of equity owned by managers increase, the agency conflict decreases therefore the need for outside director's decrease.
DEBT	Long-term debt plus current liabilities divided by book value of total assets	Negative	Debt forces managers to consume fewer perks and become more efficient to avoid bankruptcy. This therefore acts as substitute governance mechanism to control the agency conflict.
TOP 10	Equity held by top 10 shareholders divided by total equity	Negative	When an individual shareholder owns a large equity in a company, that stakeholder has an increased incentive to monitor managerial behaviour. Therefore, outside board proportion and ownership concentration are

			substitutes.
BDSIZE	No. of directors on board	Negative	Large boards are less likely to function effectively and are easier for the CEO to control and for a dominant CEO to slant the board with more inside directors.
CEO_DUALITY	Dummy variable which takes on value one if CEO is also chairman	Negative	Dominant CEO are likely to entrench themselves by slanting boards with more insiders.
LSIZE	Log of total assets.	Positive	Larger firms will be expected to have a larger proportion of outside directors because of their greater visibility and prestige.
BUSSEG	No. Of business segments.	Positive	Increasing business segments brings in business complexity, which requires greater proportion of outside directors.
PROFIT	Tobin's $q = \frac{MVE + PS + DEBT}{TA}$	Positive	Growing and profitable firms will need outside directors who will bring in more expertise

3.5 Data analysis

There were 51 companies quoted at the stock exchange, as at 31 st March 2003, however only 45 companies had submitted their financial statements and these were the companies used in the study.

Details on all the variables for 45 companies were obtained and listed in a table as indicated on appendix 1. The means for each variable were calculated as indicated in table 2.

Computer software SPSS was used in determining the correlation matrix of all the variables as indicated in Appendix 2.

We also used the same software to get obtain coefficients of each variable and the significance of each variable. The F-test and Durbin Watson test were carried out to test the whole model using the same computer software SPSS. (See appendix 3.)

Chapter Four- Discussion of Results and Findings.

4.1 Introduction.

The aim of this study was to collect evidence on the characteristic of board composition in Kenya and to determine the relationship between effective board composition and certain corporate attributes. From an agency theory perspective, outside director's, proxies' effective board composition. The study focused on firms quoted at the Nairobi stock exchange as at 31st March 2003.

4.2 Discussion of Results

Table 2
Sample Descriptive statistics

	(Variables)									
	BDSI ZE	OUTDIR.	OUTDIR %	CEO DUALIT Y	INSOWN	TOP 10	DEBT	Total Assets(KSHS)	BUS SEG	Profit =Tobin' s Q
Mean	8	7.73	71.23%	NONE	.01 %	76.08 %	40.56 %	9,560.878,395	2.2	51.1 %

Notes:
OUTDIR is the proportion of independent outsider board members to total board size. INSOWN is the proportion of common shares owned by top management and directors. DEBT is the proportion of debt defined as long-term debt plus current liabilities to total Assets. TOP10 is the proportion of shares held by the 10 largest shareholders of the firm's equity. BDSIZE is the size of the board of directors. CEO_DUALITY is a dummy variable set equal to one if the CEO is also the chairman of the board, q Ratio is Tobin's q approximated by taking the sum of book value of long term debt, book value of net short term debt, and the market value of common equity divided by the book value of total assets. LSIZE is defined as book value of total assets. BUSSEG is the number of business segments in which the firm operates.

Table 2 provides descriptive statistics for the sample. The mean proportion of outside directors is 71.23 percent. A study carried out by Provost et al (2002) on boards in New Zealand had proportion of outside directors varying from 42.0 percent to 50.5 percent over a five-year period with a noticeable increase trend over time. In contrast, Li (1994) reports a mean of 58 percent for a sample of 390 firms in 10 industrialized countries. However, the percentages between countries in Li's study vary widely, from 83 percent in France to 9 percent in Japan.

The mean proportion of inside ownership (INSOWN) is .01 percent. This means that most of the quoted companies are not owned by the managers and inside directors. The case is different in New Zealand where the proportion varies from 14.9 percent to 19.0 percent, over a five-year period, (Prevost et al, 2002).

The proportion of debt to total assets (DEBT) is about 40.56 percent. This compares well with New Zealand.

The mean proportion of stock held by the top 10 shareholders (TOP10) is approximately 76 percent. This is in sharp contrast to the US market, where Demsetz and Lehn (1985) report, that the mean percentage of equity owned by the top 20 largest shareholders of a sample of 511 large US corporations is 37.66 percent. However it compares well with New Zealand, which has 73 percent. The tightly held nature of Kenyan firms is suggestive of a relatively inactive takeover market in which case the importance of outside director monitoring (as well as other alternative governance mechanisms) should presumably take on a greater role.

The typical board consists of eight members, which is considerably smaller than that observed in other countries; for example, Dalton and Kesner (1987) report a mean board size of 21.04 in Japan, 11.44 in the UK, and 12.96 in the US. However, this is consistent with board sizes in other relatively small countries; for example, Eisenberg, Sundgren and Wells (1998) report that the mean (median) board size of a large sample of firms in Finland is only three (3.7). Prevost et al (2002), report a board size of six in New Zealand.

None of the companies in the sample had the chairman being the same as the CEO. This is quite unlike, in other countries. Prevost et al (2002) in his study noticed that approximately a 33.3 percent of the sample exhibited CEO duality, which was similar to that reported in the Dalton and Kesner study for UK (30 percent) but higher than that found in Japan (11 percent) and markedly smaller than the US (82 percent). The mean firm

size (book value of total assets) is kshs 9.5 billion. Most of the companies tested were on average operating on 2.2 segments.

4.3 Board Characteristics

Table 3
Correlation Matrix for Kenyan Board Characteristics

	FIRM SIZE	NO. OF OUTSIDE DIRECTORS	BDSIZE	OUTDIR
FIRM SIZE	-			
NO. OF OUTSIDE DIRECTORS	.611**	-		
BDSIZE	.744**	.833**	-	
OUTDIR	.136	.615**	.095	-

Notes:

SIZE is defined as book value of total assets. Outside Directors is the number of independent outside directors. BDSIZE is the size of the board of directors, and OUTDIR is the proportion of independent outsider board members to total boardsize.

* Correlation is significant at the 0.05 level (2-tailed).

** Correlation is significant at the 0.01 level (2-tailed).

Table 3 illustrates the correlation coefficients of Kenya board characteristics. Greater numbers of outside directors are positively associated with board size. Firm size is also an important control variable with respect to these board characteristics; firm size is significantly positively correlated with the number of outside directors and board size.

Dalton and Kesner (1987) provided correlation statistics for board-specific attributes in Japan, the UK and the US, which serve as useful comparisons to our sample of Kenyan boards. Generally, their study reports broadly similar relationships for boards in the comparatively much larger UK and US markets. Prevost et al (2002) also report similar results in his study on New Zealand boards. In particular, firm size has the same positive relationship with the number of outside directors and board size. As with New Zealand, US, Japan and UK, the number of outside directors is directly correlated to the total number of directors and to the percentage of outside representation in all four countries.

The major difference between Kenya and these four countries appears to be associated with CEO duality. In Kenya, we noted that all boards looked at had different chairman and CEO while in New Zealand this variable is significantly negatively correlated with all four other attributes. In comparison, Dalton and Kesner (1987) report insignificant correlations with the other four board attributes in their three-country study.

4.4 Determinants of board composition.

The estimated model for the determinants of board composition in Kenya is as follows:

$$\text{OUTDIR} = -5.579 - 0.001\text{INSOWN} - 0.118\text{DEBT} + 0.034\text{PROFIT} - 0.355\text{TOP10} + 0.037\text{BUSSEG}$$

Table 4
Regression Estimates

INDEPENDENT VARIABLE.	
Intercept	-5.579
INSOWN	-0.001
BUSSEG	0.037
TOP10	-0.355**
PROFITQ	0.034
LSIZE	0.541**
DEBT	-0.118
F-VALUE	6.21
R	.704
R-SQUARE	.495
ADJUSTED R-SQUARE	.415
DURBIN WATSON	2.317
N	45

* Correlation is significant at the 0.05 level (2-tailed).

** Correlation is significant at the 0.01 level (2-tailed).

Table 4 presents the coefficients for the regression model and related statistics estimated using the regression analysis.

Consistent with the predictions of agency theory, the inside ownership variable, INSOWN, has a negative coefficient but is very not significant. Thus, low inside ownership is associated with a higher proportion of outsiders on the board. This supports the substitution hypothesis that board composition and inside ownership are substitute mechanisms in mitigating agency problems. The findings are also consistent with the US-based findings of Bathala and Rao (1995). While we do not have any comparable evidence for other countries, we surmise that this relationship may be suggestive of a reliance of outside directors as a substitute for inadequate inside ownerships in Kenyan companies.

We also find a substitution effect for the other internal agency control variable DEBT. The negative debt coefficient is consistent the evidence documented by Bathala and Rao (1995) but inconsistent with the findings of Li's (1994) and Denis and Sarin (1998) in the US. The external agency control variable, TOP10, is negative and significant. This is consistent with findings of Rediker and Seth (1995), Bathala and Rao (1995), and this may suggests a substitution effect between outside representation and block shareholders equity stakes. We therefore conclude that board composition is a substitute for alternative agency control mechanisms.

With respect to other board and CEO characteristics, the coefficient for BDSIZE highly positively correlated to outside directors and was dropped due to multicollinearity. Observations indicated that the larger the board the bigger was the number of outside directors. We also found out that out of the companies included in our sample there was no case where the CEO was chairman. Different people held the two positions. This is an indication of board independence. Guidelines issued by CMA have recommended that it is good corporate governance practice, that the two positions, be held by different people and the CEO to run the organization.

Turning to the other control variables, the measures of profitability, profit q-ratio, is positive but not significant. This is moderate evidence that higher proportion of outside membership on the board is positively associated with firm performance. This evidence is

consistent with results reported by Li (1994) for a sample of firms from the US and other developed economies. Firm size (LSIZE), has a positive coefficient that is significant. This is consistent with the positive coefficient reported by Bathala and Rao (1995) in the US. It also consistent with the findings of Li (1994), who finds that firm size, is on average positively associated with outside representation across the 10 countries in his study. The results differ from results by Prevost et al (2002) in his examination of board composition in New Zealand and also with the recent findings of Hossain, Cahan and Adams (2000) for New Zealand in their study relating board composition to investment opportunities. BUSSEG has a positive coefficient but is not significant.

Chapter Five –Summary Conclusions and Recommendations

5.1. Conclusions

Our findings indicate that board size in Kenya averages about eight members. The outside representation constitutes about 71.23 % on average. We also noted that the larger the board the higher the number of outside directors. In all the cases we found out that there is no CEO duality. Different people held the CEO and chairman positions.

The empirical findings of this study are consistent with the implications of the agency theory literature. We find that many results are consistent with board composition studies in considerably larger countries such as the US and UK, where the emphasis on effective corporate governance and the role of independent outside directors has been part of the corporate environment for a relatively much longer amount of time. Thus, there is evidence that many elements of the agency framework as it relates to board composition are applicable to different economic systems.

Our evidence from Kenya indicates that there are aspects of the board composition issue that are unique to different countries. Similar to UK, Japan, US-based research, we find that greater inside ownership is associated with lower proportion of outsiders on the board. This supports the notion that board composition and inside equity ownership are substitute mechanisms in controlling agency problems. In line with the agency expectations we also find that debt, and ownership concentration are negatively related to board composition, which suggests that debt, ownership concentration and board composition are viewed as substitute agency conflict controlling mechanisms in Kenya. This is quite different from findings in New Zealand by Prevost et al (2002), where he found out that debt and ownership concentration were positively related to board composition.

Contrary to my hypothesized relationship, we also found out that board size is highly positively correlated to outside representation, the bigger the board the higher the number

of outside directors. Our study finds that CEOs are separate from board chairs in all the companies looked at. This may explain the reason for my negative result. The CEO cannot slant the board with more inside directors because he is also not the chairman of the board. The findings may be a reflection that corporate boards in Kenya are fully embracing the recommendations on good corporate governance as recommended by the guidelines issued by CMA in 2002.

Among the remaining control variables, we find that business segment is positively related to outside representation, this means that as companies get into many different business segments they may require expertise and may therefore take on more outside directors. Firm size is also positively related to outside representation, this is consistent with the view that growing firms will require expertise which may be brought in by outside directors.

5.2 Limitations of the Study.

1. One of the limitations encountered was the presence of gaps in the data collected. The population was made up of the 51 listed companies but only 45 were left for the study.
2. The second limitation was the focus of the study. The study focused on the quoted companies. It did not look at the unquoted companies thus limiting the generalization of results.
3. Limitation of time available for research is yet another constraint. If more time were available one would have looked at data over a longer period of time for more meaningful relationships.
4. Thinness of the Nairobi stock exchange was yet another limitation. We have very few listed companies at the Nairobi stock exchange unlike exchanges in other developed countries and this limited the number of companies' looked at.

5.3. Recommendation for further study.

There is no literature on board composition in Kenya and a lot of research would therefore be necessary in the area.

The results of this study have identified evidence on the characteristics of board's composition in quoted companies in Kenya. It has also established the relationship between effective board composition and other corporate attributes in the same quoted companies.

It would be beneficial if research was carried out on;

1. Determinants of corporate board composition on unquoted companies.
2. Board composition and firm performance in Kenya.
3. Board Composition, Structure and Independence in Kenya.
4. Board Composition and CEO Compensation: evidence from Kenya.
5. Determinants of corporate Board composition, in different industries in Kenya.

APPENDIX 1

COMPANIES INCLUDED IN THE STUDY

Company	BDSIZE	OUTDIR	OUTDIR	CEO		TOP 10	DEBT	Total Assets (KSHS)	BUS SEG	Profit = Tobin's Q
				DUALITY	INSOWN					
1 Brooke Bond Kenya Ltd	9	7	77.78%	no	0.00%	93.45%	13.33%	6,227,163,000	1	29.69%
2 Kakuzi Ltd	8	3	37.50%	no	0.03%	67.58%	30.94%	2,823,822,000	5	34.23%
3 Nation Media group	11	10	90.91%	no	0.00%	64.23%	29.91%	3,613,400,000	5	54.63%
4 Firestone	6	4	66.67%	no	0.11%	88.98%	17.04%	2,548,682,000	2	54.58%
5 Jubilee Insurance	11	9	81.82%	no	0.00%	47.71%	10.59%	3,190,471,000	2	51.66%
6 Crown Berger	7	5	71.43%	no	0.00%	76.60%	28.62%	873,257,000	1	57.93%
7 NIC bank	9	7	77.78%	no	0.00%	36.23%	73.22%	9,329,282,000	1	47.63%
8 Standard Chartered Bank	10	4	40.00%	no	0.00%	78.40%	90.77%	61,650,128,000	1	60.13%
9 Kenya Commercial Bank	12	9	75.00%	no	0.00%	75.30%	91.18%	59,754,869,000	6	72.62%
10 Barclay Bank of Kenya	12	7	58.33%	no	0.00%	80.71%	88.37%	85,914,000,000	5	80.42%
11 HFCK	8	5	62.50%	no	0.00%	60.16%	90.28%	10,445,217,000	2	77.91%
12 National Bank of Kenya	10	7	70.00%	no	0.00%	73.00%	92.40%	25,230,980,000	1	89.23%
13 TPS Serena	8	6	75.00%	no	0.00%	78.62%	39.93%	2,122,792,000	1	53.49%
14 Bamburi	14	9	64.29%	no	0.00%	92.53%	14.96%	15,105,000,000	2	95.18%
15 East African Cables	6	4	66.67%	no	0.17%	81.97%	19.02%	330,539,000	1	2.84%
16 BAT	9	6	66.67%	no	0.00%	85.31%	25.01%	3,710,796,000	1	64.73%
17 Dunlop	6	4	66.67%	no	0.00%	80.36%	56.22%	225,808,000	1	10.77%
18 Total Kenya	8	4	50.00%	no	0.00%	98.80%	44.03%	6,108,924,000	1	47.96%
19 Athi River Mining	8	5	62.50%	no	0.00%	78.72%	28.01%	1,415,154,000	3	24.14%
20 Limuru Tea Company	5	2	40.00%	no	0.00%	91.97%	14.20%	46,483,000	1	453.94%
21 Diamond Trust	9	8	88.89%	no	0.00%	39.09%	79.77%	6,273,754,000	1	42.99%
22 CFC Bank	8	6	75.00%	no	0.00%	90.91%	79.93%	11,846,125,000	3	60.42%
23 Pan African Insurance	9	7	77.78%	no	0.00%	72.48%	17.38%	1,590,375,000	3	26.52%
24 Eaagad Limited	3	2	66.67%	no	0.00%	95.18%	7.68%	174,550,000	1	55.96%
25 CMC	9	7	77.78%	no	0.00%	63.98%	48.19%	4,457,162,000	5	-3.57%
26 Kenya Airways	11	9	81.82%	no	21.98%	60.27%	63.01%	24,255,000,000	3	52.40%
27 Uchumi Supermarkets	10	9	90.00%	no	0.00%	68.44%	81.53%	2,539,965,000	1	74.92%
28 Mumias Sugar	7	7	100.00%	no	0.00%	54.32%	26.72%	9,524,364,000	1	5.41%
29 Carbacid Investments	5	3	60.00%	no	10.17%	73.05%	1.11%	685,816,000	1	14.04%
30 Kenya Power & Lighting	9	8	88.89%	no	0.00%	63.16%	48.43%	31,353,095,000	1	25.63%
31 East African Breweries	12	7	58.33%	no	0.00%	67.66%	19.91%	17,297,637,000	4	23.44%
32 I C D C I	11	10	90.91%	no	0.02%	64.04%	2.90%	2,549,230,000	1	34.96%
33 Williamson Tea(k) Ltd	7	6	85.71%	no	0.00%	68.15%	17.42%	1,460,316,000	4	37.53%
34 Unga limited	6	5	83.33%	no	0.03%	70.77%	35.44%	3,089,719,000	2	88.37%
35 Car and General	7	5	71.43%	no	0.00%	87.69%	46.15%	595,333,000	2	43.34%
36 City Trust	3	2	66.67%	no	0.00%	92.33%	3.04%	208,582,787	1	1.57%
37 Kapchorua Tea Co Ltd	5	4	80.00%	no	0.00%	95.25%	11.96%	607,430,000	2	73.13%
38 Rea Vipingo	5	4	80.00%	no	0.00%	69.80%	19.56%	607,391,000	2	32.34%
39 Standard Newspapers	8	3	37.50%	no	0.00%	94.08%	79.76%	736,878,000	2	106.71%
40 Marshall East Africa	8	6	75.00%	no	0.00%	89.41%	79.10%	970,549,000	1	24.72%
41 East Africa Packaging	8	6	75.00%	no	0.00%	88.79%	72.61%	954,377,000	1	5.63%
42 A Baumann	5	3	60.00%	no	0.00%	78.08%	18.96%	383,438,000	4	-14.67%
43 BOC Kenya	6	5	83.33%	no	0.00%	80.57%	17.74%	1,277,058,000	2	1.45%
44 Sasini Tea	8	6	75.00%	no	0.00%	76.53%	6.07%	2,470,290,000	5	13.96%
45 Kenya Oil	4	3	75.00%	no	0.00%	88.96%	42.88%	3,664,326,000	1	8.41%
Averages	8	5.73	71.23%		.01%	76.08%	40.56%	9,560,878,395	2.2	51.1%

Notes:

OUTDIR is the proportion of independent outsider board members to total board size. INSOWN is the proportion of common shares owned by top management and directors. DEBT is the proportion of debt defined as long-term debt plus current liabilities to total Assets. TOP10 is the proportion of shares held by the 10 largest shareholders of the firm's equity. BDSIZE is the size of the board of directors. CEO_DUALITY is a dummy variable set equal to one if the CEO is also the chairman of the board, q Ratio is Tobin's q approximated by taking the sum of book value of long term debt, book value of net short term debt, and the market value of common equity divided by the book value of total assets. LSIZE is defined as book value of total assets. BUSSEG is the number of business segments in which the firm operates.

APPENDIX 2

Correlation Matrix for Kenyan Board Characteristics

		Bdsize	OUTDIR	OUTDIR %	INSOWN	TOP10	DEBT	LSIZE	BUSSEG	PROFIT Q
Bdsize	Pearson Correlation	1	.833(**)	0.095	0.089	.342(*)	.371(*)	.744(**)	.342(*)	0.011
	Sig. (2-tailed)	.	0	0.536	0.562	0.021	0.012	0	0.022	0.942
	N	45	45	45	45	45	45	45	45	45
OUTDIR	Pearson Correlation	.833(**)	1	.615(**)	0.124	.528(*)	0.225	.611(**)	0.232	-0.135
	Sig. (2-tailed)	0	.	0	0.415	0	0.136	0	0.124	0.376
	N	45	45	45	45	45	45	45	45	45
OUTDIR %	Pearson Correlation	0.095	.615(**)	1	0.052	.456(*)	-0.089	0.136	-0.057	.368(*)
	Sig. (2-tailed)	0.536	0	.	0.735	0.002	0.561	0.373	0.711	0.013
	N	45	45	45	45	45	45	45	45	45
INSOWN	Pearson Correlation	0.089	0.124	0.052	1	-0.164	0.018	0.127	0.028	-0.034
	Sig. (2-tailed)	0.562	0.415	0.735	.	0.281	0.907	0.404	0.853	0.824
	N	45	45	45	45	45	45	45	45	45
TOP10	Pearson Correlation	-.342(*)	-.528(**)	-.456(**)	-0.164	1	-0.168	-.358(*)	-0.133	0.177
	Sig. (2-tailed)	0.021	0	0.002	0.281	.	0.27	0.016	0.382	0.246
	N	45	45	45	45	45	45	45	45	45
DEBT	Pearson Correlation	.371(*)	0.225	-0.089	0.018	-0.168	1	.520(**)	0.024	0.052
	Sig. (2-tailed)	0.012	0.136	0.561	0.907	0.27	.	0	0.877	0.736
	N	45	45	45	45	45	45	45	45	45
LSIZE	Pearson Correlation	.744(**)	.611(**)	0.136	0.127	.358(*)	.520(**)	1	0.286	-0.178
	Sig. (2-tailed)	0	0	0.373	0.404	0.016	0	.	0.057	0.242
	N	45	45	45	45	45	45	45	45	45
BUSSEG	Pearson Correlation	.342(*)	0.232	-0.057	0.028	-0.133	0.024	0.286	1	-0.109
	Sig. (2-tailed)	0.022	0.124	0.711	0.853	0.382	0.877	0.057	.	0.475
	N	45	45	45	45	45	45	45	45	45
PROFIT Q	Pearson Correlation	0.011	-0.135	-.368(*)	-0.034	0.177	0.052	-0.178	-0.109	1
	Sig. (2-tailed)	0.942	0.376	0.013	0.824	0.246	0.736	0.242	0.475	.
	N	45	45	45	45	45	45	45	45	45

* Correlation is significant at the 0.05 level (2-tailed).

** Correlation is significant at the 0.01 level (2-tailed).

APPENDIX 3

REGRESSION MODEL OUTPUT

Variables Entered/Removed (b)			
Model	Variables Entered	Variables Removed	Method
1			Enter
a All requested variables entered.			
b Dependent Variable: OUTDIR			

Model Summary (b)					
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.704(a)	0.495	0.415	1.6973	2.317
a Predictors: (Constant), DEBT, INSOWN, BUSSEG, PROFITQ, TOP10, LSIZE					
b Dependent Variable: OUTDIR					

ANOVA (b)						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	107.333	6	17.889	6.21	.000(a)
	Residual	109.467	38	2.881		
	Total	216.8	44			
a Predictors: (Constant), DEBT, INSOWN, BUSSEG, PROFITQ, TOP10, LSIZE						
b Dependent Variable: OUTDIR						

Coefficients (a)

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	-5.579	4.711		-1.184	0.244		
	INSOWN	-3.49E-02	7.285	-0.001	-0.005	0.996	0.964	1.037
	BUSSEG	5.53E-02	0.181	0.037	0.305	0.762	0.895	1.118
	TOP10	-5.329	1.884	-0.355	-2.83	0.007	0.844	1.185
	PROFITQ	0.111	0.391	0.034	0.283	0.779	0.925	1.081
	LSIZE	0.716	0.202	0.541	3.551	0.001	0.573	1.744
	DEBT	-0.883	1.039	-0.118	-0.85	0.4	0.691	1.447
a Dependent Variable: NONEXEC								

Collinearity Diagnostics (a)

Model	Dimension	Eigenvalue	Condition Index	Variance Proportions						
				(Constant)	INSOWN	BUSSE	TOP10	PROFITQ	LSIZE	DEBT
1	1	4.871	1	0	0	0.01	0	0.01	0	0.01
	2	0.959	2.253	0	0.94	0	0	0.01	0	0
	3	0.606	2.835	0	0.02	0.05	0	0.81	0	0
	4	0.32	3.902	0	0	0.28	0	0.02	0	0.49
	5	0.22	4.701	0	0	0.55	0.03	0.09	0	0.17
	6	2.23E-02	14.788	0.02	0.03	0.07	0.78	0.03	0.04	0.11
	7	1.57E-03	55.665	0.98	0	0.05	0.19	0.03	0.96	0.22
A Dependent Variable: OUTDIR										

Residuals Statistics (a)

	Minimum	Maximum	Mean	Std. Deviation	N
Predicted Value	2.5833	8.3979	5.7333	1.5619	45
Residual	-3.4104	3.421	2.07E-16	1.5773	45
Std. Predicted Value	-2.017	1.706	0	1	45
Std. Residual	-2.009	2.016	0	0.929	45
a Dependent Variable: OUTDIR					

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