A SURVEY OF THE IMPACT OF DIVERSIFIED BOARDS ON THE VALUE OF FIRMS QUOTED IN THE NSE

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DECLARATION

This management research project is my original work and has not been presented for a degree in any other University.

Signed:... Date: ...24/11/08...................

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This management research project has been submitted for examination with my approval as University supervisor.

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DEDICATION

To my late mother who taught me to stand strong against any challenge and inspired me to have a burning desire to succeed. To my sponsor Susan Lyall, who without her financial support it would have been difficult to complete the program.

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ABBREVIATION

CBK - Central Bank of Kenya

CEO - Chief Executive Officer

CFO - Chief Financial Officer

CMA - Capital Markets Authority

NSE - Nairobi Stock Exchange

BOD - Board of Directors

SOX -Sarbanes Oxley Act

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ABSTRACT

The study sought to examine the impact of the diversified boards on the value of firms quoted in the NSE. The period covered in the study was six years between Jan 2002 to Dec 2007. Secondary data was used and was obtained from the NSE database, websites, and the prospectus of all quoted companies. Data was analyzed using the Multiple Regression Model. This helped determine the impact of diversified boards or otherwise on the value of the firm. The dependent variable was firm value and it was measured using ROE. The independent variables were board characteristics (age, gender, independence, experience, and board size).

The study found that diversified boards account for 21.2% of the variance in firm value as measured by return on equity. The correlation coefficient was 0.460 which indicates that the correlation is moderately low but positive. The study failed to establish a significant relationship between firm value and board diversity. The significance of the F statistic (sig. = 0.301) revealed that a lot of the relationship is explained by chance. The most significant board feature that affects firm value was gender followed by board size. Age was the third significant feature that affects firm value. Individually, the show that age has a negative influence of the value of firms. Board size was also found to have a negative influence on firm value. Expertise and gender were also found to have a negative influence on firm value. However, independence has a positive influence on firm value.

The study concludes that highly diversified boards in terms of gender, age, expertise, size, and independence positively impact on the value of firms in Kenya. This evidence concurs with other studies done in other countries which found that diversified boards positively influence performance of firms. It is recommended that during the composition of board, several issues need to be looked into. The diversification parameters of size, age, gender, expertise, and independence should be carefully looked into so as to balance the board since more of some of the features may have negative impact on firm values. Independence is very important and all boards should always strive to be independent.

CHAPTER ONE: 1.0 INTRODUCTION

1.1 Background

The creation of a Limited liability Company implies the separation of ownership between management and shareholders. The latter elect a board of directors who are charged with the core responsibility of safe guarding their (shareholders) interest; i.e. value creation. The election of the board of directors is governed by the provisions in the company's article of association (charter) which defines the regulations governing the relationship between the directors and shareholders of a company. Together with the Memorandum of association, these two articles form the constitution of the company, Fama et al, (1983). Monks et al, (2001) describes the main function of the board as follows; "the existence of the board is based on the premise that they oversee management, select executives who will do the best job for the company".

In theory and in law a variety of functions of the corporate boards have been identified by the Capital Market Authority (CMA) as a unit that performs the following functions; defines the company's mission, its strategy and objectives, oversees the corporate management and operations, identifies business opportunities, develops appropriate staff and remuneration policies, reviews adequacy and integrity of the company's internal controls, monitors the effectiveness of the corporate governance practices, and takes into consideration the interest of the company's stakeholders in its decision making process, Okiro, (2006).

These functions can be grouped into two broad categories;

Control function; This gives the Board wide ranging formal powers to control the organization and determine its performance. This involves selecting the CEO, exercising direct control during periods of crisis, reviewing managerial decisions and performance. The board may not have time (may be due to size) or technical knowledge (experience and expertise) to literally control the management decisions. However it has powers to constrain the key decisions and set limits within which the management will act – Hermalin et al, (2000).

Service function; These functions includes; Co-opting external influence in an effort to control an aspect of the external environment of the company, establishing contacts and raising funds, enhancing organizational image, and advising the management, Mintzberg, (1983).

Despite the fact that the boards are assigned key positions in the business and social scene, efficiency has long been questioned due to their diversity, Mace, (1971). Mace accomplished a study demonstrating that the board participation in directing the corporation was minimal. The directors were generally selected by the CEO and they didn't usually ask the CEO to resign for unsatisfactory performance.

In the modern capital markets the performance of the board is evaluated on the basis of the value created or destroyed by their decisions. Some boards perform better than others i.e. they enhance shareholders' wealth, Huse et al, (2004). Certain diverse characteristics may be associated with high or low performance of the board. As a result, the impact of board diversity in today's business environment is being discussed and addressed in the academic, business and investment spheres. Many theories and hypotheses on board diversity have been tested to determine its impact on a corporation's productivity and the bottom line. Some theorize that it positively influences corporate environments and key value drivers in a significant way. Others theorize that you cannot unequivocally determine a causal link between board diversity and firm value since numerous other variables may also contribute to improved performance. Whether there is a valid connection or not between corporate governance and firm performance, requires further examination. As such, this study begins to test board diversity, corporate governance and firm value.

The value of the firm refers to the market capitalization of a firm's equity plus the market value of the firm's debt. The value of the assets that are non core are excluded from the final calculation. Understanding the value of the firm is both critical to the investors and managers. Investors will be able to know the factors that create the value for the firm and to understand the causes of changes of stock prices from time to time. The managers can invest, finance and make dividend decisions that create value if they understand the value of the firm. The board governs these decisions made by managers.

Board diversity refers to wide-ranging distinctiveness inherent in members comprising the board. This degree of differences includes; race, nationality, educational qualification, expertise & experience, age, gender, insider/outsider directors (independent), board size, and CEO duality. These distinctive characteristics will to a large extent influence the decision making by the board hence firm value. The issue of cohesiveness, debate and conflict among the board will be influenced by these inherent characteristics, Bohren et al, (2006).

The ineffectiveness of the board can be attributed to certain key factors, Koontz, (1967). This includes; corporate board members and company executives alike misunderstand the position of the BOD and sometimes forget that the latter are the company's top executive group, insider desire for independence - this is due to the stockholders' apathy and power inherent in the control of the proxy machinery. This makes insiders reluctant to have an effective board, BOD are creatures of the CEOs due to insider control and apathy the CEO recruits and selects directors to the board that he/she can work with, shortage of competence directors - this leaves management with no particular alternative but to appoint insiders or persons with close ties to the company, time commitment, and failure to appoint effective and efficient members.

In the USA and Europe for instance, the public demand for more board diversity in corporations, TIAA-CREF, (1997). Thus, TIAA-CREF, one of the largest pension funds in the U.S. and an opinion leader in corporate governance, argued nine years back that boards should be filled by "qualified individuals who reflect diversity of experience, gender, race and age" TIAA-CREF, (1997).

Outside the USA, a fierce debate has emerged in the Nordic countries concerning the pros and cons for increased gender diversity and about the potential role of regulators in achieving it. This makes the region particularly interesting for empirical testing on the effect of board diversity, Bohren et al, (2006). Furthermore, the political implications vary extensively across the region. In Norway the equity argument has become law, and Norwegian public firms The "ASA"-firms are required to have a 40% minimum board representation (among shareholder appointed board members) from each gender by the end of 2006. If an individual company does not meet this requirement within due time, forced deregistration of the firm will result. A similar law was proposed in Sweden, but the change of government in the fall of 2006 led to a withdrawal of the proposed law. Such a law has been advocated by the CMA in Kenya. The implementation of the same law by CMA has been a key challenge, Okiro, (2006).

Board composition has been found to play a substantial role in corporate performance surrounding events where agency costs between shareholders and managers are severe, Barnhart et al, (1994). Greater diversity in outside directors' principal occupations increases the tendency of corporations to use greenmail, suggesting that diversity fragments the board and provides insiders with greater degree of control. Weisbach, (1988), finds that CEO turnover is more highly correlated with firm performance in corporations having a majority of outside directors than in those with insiders. Hermalin and Weisbach, (1988), find that outsiders are more likely to join a board after a firm performs poorly or leaves an industry.

Shareholders and investors have become increasingly concerned about the integrity of their investments. As such many are requiring diversity at the highest levels of an organization for viable investment opportunity. Thus, corporations are moving more strategically to respond to investor-standard strategies. For example, in 2005, Viacom, Inc. issued a *Board Diversity Resolution* "to ensure that every reasonable measure is taken to achieve board diversity." Included in the resolution is a commitment from the board that women and experienced candidates would be considered for nomination.

The empirical evidence on the performance effect of the board gender diversity is mixed. For example, one U.S. study identifies a negative relationship between the percentages of female directors and accounting performance, Sharader et al, (1997), and another study finds for Norwegian firms a negative relationship between female board membership and market-to-book ratio, Bohren and Strom, (2006). However, other studies find no relationship, Zahra and Stanton, (1988) or a positive performance effect from such female board membership, Carter et-al, (2003); Smith et al, (2005). There are number of possible explanations for the inconclusive empirical results. First, the studies are conducted in different countries and at different points in time, and the effect of board diversity might be contingent on the timing and the legal/cultural context which has only partly been addressed in the research design of past studies. Second, the effect of gender diversity might be a substitute for other aspects of board diversity, such as age and nationality diversity, which need to be part of the research design. Third, empirical testing of the performance effect of gender diversity is methodologically challenging.

When greater diversity is advocated for moral or political reasons it is still interesting to inquire how it is perceived by the stock market. Another motivation is that more empirical evidence is needed. A shortcoming of past research is the dominance of research on strictly Anglo-American markets (countries with a "market-based" system of corporate governance that emphasize shareholder primacy). The greater "stakeholder" orientation of corporate governance in Nordic firms might suggest that corporate boards, and thus board diversity, play a different and more significant role in these countries.

In the Nordic countries the management boards are surprisingly homogenous in terms of gender and nationality, whereas the age distribution is more diverse. The low level of board diversity in terms of gender and nationality in the Scandinavian countries seems puzzling given the participation of women in the workforce and the internationalization of the work force of Nordic firms, Bohren, (2006). It is particularly paradoxical that firms from these countries have lower level of board diversity than similar publicly traded firms in Anglo-American markets, Burke and Mattis, (2005), especially given the strong political emphasis on diversity among Nordic countries. Nevertheless, there are substantial differences in board diversity among the various companies. Board members tend to be older and less diverse in most countries. High gender diversity in some countries probably reflects political priorities. However, the very low fraction of women on some boards seems puzzling given the general perception of highly democratic nations. Apart from the differences between the countries, board diversity is influenced mainly by; Industry and Company size.

Contrary to a common popular myth, we must reject the notion that board diversity is lacking because of a self-selecting 'old boys' network. The number of board connections of the Chair (a closed network) and the average age (older) of the board do not influence board diversity, Mace, (1971). Larger boards tend to be more diverse in some countries. Age diversity appears to decrease with average age of board members, but this is believed to be attributable to more or less mandatory retirement ages. This suggests that increasing diversity of boards is no "quick fix" to enhance firm performance. However, we note that the greater board diversity of firms do not produce lower firm performance, which suggests that enhanced board diversity, as a deliberate choice or as forced by law, can be achieved without a negative effect on firm performance and shareholder return. But, in case it means an expansion of the size of the board, value destruction may follow because the issue of decisiveness might follow, Bohren, (2006).

In the aftermath of the large corporate scandals during the beginning of this decade (such as Enron and WorldCom in the US), a number of practitioners have called for more board diversity in order to enhance prudent firm practices. The key benefit attributed to board diversity includes; Improved monitoring of management through board independence, Enhanced innovation capability provided by the diverse team, better global understanding, and better understanding of diverse customer needs, Dalton et al, (1999).

1.2 Statement of the Problem

Corporate governance issues have attracted tremendous attention both in academic research and in practice in the last decade than any other time in the past. Shleifer and Vishny, (1997) define corporate governance as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment". John and Senbet, 1998 propose a more comprehensive definition that "corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected". Since corporate governance has to do with setting priorities, delegating power and organizing accountability, it receives high priority on the agenda of policymakers, institutional investors, companies and academics. Allegations of accounting fraud and corporate misdeeds at high- profile companies such as Enron, WorldCom, Tyco International, and Adelphia Communications, along with five of the ten largest bankruptcies in United States history, shock investor confidence and gave rise to widespread calls for the reform of corporate diligence, ethics, and contro1s. A legislative response to the corporate crisis came swiftly, in the form of the Sarbanes Oxley Act 2002 (SOX). Arguably the most far-reaching corporate reform legislation since the securities and Exchange Acts of 1933 and 1934, the Act was designed to increase the transparency, integrity, and accountability of public companies and, in turn, to combat the kind of corporate deceit that had given rise to the scandals and financial breakdown. With the enactment of the Act (SOX) 2002, Congress intended to pave the way for more effective monitoring of public companies, their employees, and their agents by enhancing the standards for corporate governance and disclosures. The perception that the recent wave of corporate scandals resulted not simply from a failure of laws and regulations, but also from a failure of behavior by corporate leaders and corporate attorneys, is reflected in the Act's attempt both to capture a broad range of behavior within its provisions and to foster greater self-policing of behavior not specifically captured within its provision.

Corporate governance codes, experts and activists view this issue in different perspectives. Some have long advocated changes in the board structure, which include among others, the appointment of independent directors, the installation of board committees in those areas where conflicts of interest might appear and a separation of the roles of CEO and chairman of the board, Van den Berghe and De Ridder, (1999). These structural measures are assumed to be important means to enhance the power of the board, protect shareholders' interest and hence increase shareholder wealth, Becht et al, (2002). However, financial economists are more concerned about the relationship between corporate governance and firm value i.e. shareholders wealth.

Corporate governance has many aspects and the latest entrant to this portfolio of concern is board diversity. The clamor for board diversity is partly attributed to the recognition of drastic changes in demographics and globalization, Monks et al, (2001). It has been theorized and empirically tested that board diversity, particularly gender and nationality improves board effectiveness hence firm value. Other diversity aspects like, education qualification, expertise, insider/outsider directors, board size, age and race have not collectively been tested to determine their influence on firm value.

A number of studies conducted in both the USA and Europe are largely inconclusive with some finding a positive relationship between board diversity and firm value. The research is not in the know of any similar study done in a developing country and Kenya in particular. However, research on board composition and their impact on firm value have been conducted but no conclusive evidence has been established to link the two on listed firms in the NSE Okiro, (2006) and Maina, (2005). Any research that will establish the existence of a positive relationship between board diversity and firm value will provide a good signal to shareholders on the composition of the board that should result to the greatest wealth impact.

The studies done by Okiro, (2006) and Maina, (2005) only focused on board composition (size) and its implication on firm value, though no conclusive linkage was found between board composition and firm value, numerous other board characteristics were left out that may have linkage with firm value. This paper filled in this gap.

The research study intended to establish the effect of board diversity on the firm value of quoted companies in the NSE.

1.3 Objectives of the study

The study intended to establish the composition of corporate boards, and determine the implication of a diversified board on the firm value of firms quoted in the NSE.

1.4 Importance of the study

Policy makers like Capital Market Authority, Central Bank of Kenya, and the Nairobi Exchange strive to implement corporate governance guidelines to enhance performance of companies in general and the growth of the economy. With findings from this study these institutions will be able to effectively implement these policies knowing the implication that board diversity has on governance.

1.4.1 To Management

Management help implement strategies formulated by the board of directors. Company management will find this study helpful in their appreciation of board diversity as well as to offer an insight into what other entities are doing about the same. It will enable them understand some of the reasons influencing company performance.

The explanations on the board diversity practices adopted by companies, can give guidelines to management as well as the government on how best to improve and maintain a high performance level in the companies and the best ways to achieve diversified board.

1.4.2 The Government

Companies operating a country cannot be ignored by the government of the day. This is as result of the crucial economic benefit these companies have to the well being of the economy. The success of these companies will therefore ensure improved economic growth. This study will offer an opportunity for review of board diversity in these firms. It will offer a window for possible amendments and / or adjustments to the legal framework or otherwise to facilitate a more beneficial and prudent management of government corporations by diversified boards hence improving economic growth.

1.4. 3 To Investors

Investors' need for prudent sources of information in order to make informed decisions has increased. The study intends to broaden the information available by establishing whether the diversity of the boards has any relation on the value of the firm. It will also ensure that the agency problem is understood and systematic ways of handling it are established.

1.4.4 Customers

The study intends to help customers understand the relationship between the quality of products and services provided by corporations and the diversity of the board who make strategic decisions to influence the quality and the price of these goods and services.

1.4.5 To Academicians

This study intends to broaden the knowledge base of the topical issue, and provide a basis for further research into the area of board diversity and firm value in different sectors.

CHAPTER TWO: 2.0 LITERATURE REVIEW

2.1 Introduction

In relation to a company, a director is an officer, that is, someone who works for the company; charged with the conduct and management of its affairs of the company, Alexander et al, (1993). A director may be an inside director (a director who is also an officer, manager, executive) or an outside, or independent director. The directors collectively are referred to as a board of directors. Sometimes the board will appoint one of its members to be the chairman of the board of directors.

Theoretically, the control of a company is divided between two bodies; the board of directors, and the shareholders in general meeting. In practice, the amount of power exercised by the board varies with the type of company. In small private companies, the directors and the shareholders will normally be the same people, and thus there is no real division of power. However, in large public companies, the board tends to exercise more of a supervisory role, and individual responsibility and management tends to be delegated downward to individual professional managers who deal with particular areas of the company's affairs, Fama et al, (1983).

During the late 1950s a number of large UK companies collapsed, some of them as a result of large scale travel by directors. These companies included Polly Peck and Maxwell Communications. These failures were attributed to lack of accountability and commitment from both the board and the management of the company. Though evidence of diversity in these boards were present, dismal performance from them were witnessed, Carter, (2003). To ensure the achievement of corporate set objectives and minimize failure of firms, new standards and regulations were put in place;

The Cadbury report 1992, titled financial aspect of corporate governance, sets out recommendations on the arrangement of company boards and accounting systems to mitigate corporate governance risks and failures. The report was published in 1992. The report's recommendations have been adopted in varying degree by the European Union, United States, and the World Bank.

The Greenbury report 1995 was a UK government report on corporate governance. It followed in the tradition of the Cadbury Report and addressed a growing concern about the level of director remuneration and its implication on performance.

The Hampel report 1998, the report emphasized principles of good corporate governance rather than explicit rules in order to reduce the regulatory burden on companies. The report recognized that good corporate governance will largely depend on the particular situation of each company. Unlike the Cadbury and Greenbury reports, the Hampel report favored greater shareholder involvement in company affairs. The report also made advances in the area of accountability and audit.

Abigail et al, (2007), made important findings using the input-output process approach to extract the significant variables from literature and integrate them into a research framework for studying board effectiveness. First, the diverging findings from different scholars have been attributed to the varying definitions and operationalization of the constructs used in empirical research. The earliest studies distinguished inside from outside directors and board composition was measured using three different approaches: (absolute) number of outsiders, industry inside-outside norm and outsider/insider proportion or dominance, Zahra and Pearce, (1989).

Researchers increasingly wanted to capture the independence of the outside directors and have been separating independent directors from interdependent or affiliated directors, who are considered to be characterized by a lack of independence. In such an approach, board composition has been operationalized by the independent/interdependent distinction or by the proportion of affiliated directors, Dalton et al, (1999). Although some scholars rely on market-based measures, research on boards of directors has been dominated by accounting measures, Dalton et al, (1998); Coles et.al, (2001). Performance measures rooted in financial accounting are being criticized because they; Are subject to managerial manipulation, undervalue assets, are influenced by accounting standards such as depreciation policies, inventory valuation and treatment of certain revenue and expenditure items, are affected by differences in methods for consolidation of accounts

Furthermore, a review by Johnson et al, (1996), has revealed a list of distinct financial performance measures on which empirical research has relied, emphasizing the fact that certain measures have additionally been adjusted to account for industry effects or risk in a different manner. Consequently, the variety in definitions and measures applied in empirical research makes comparison of studies difficult and may cause the inconsistent findings.

Second, it can be argued that the models used to study the relationship between the board of directors and firm performances are incomplete. The literature on boards of directors is characterized by a near universal focus on studying the direct effects of board characteristics on performance outcomes while ignoring the influence of potential intervening variables. In particular, Pettigrew, (1992) observed that in mainstream board research: "great inferential leaps are made from input variables such as board composition to output variables such as board performance with no direct evidence on the processes and mechanisms which presumably link the inputs to the outputs" (p.171). More and more, researchers hold this point of view and are convinced that it is necessary to go beyond the traditional direct approach to fully understand what boards of directors actually do, how they work, and derivatively, to what extent they affect performance Huse and Schoning, (2004); Finkelstein and Mooney, (2003).

In Kenya the CMA, (2005) decided to a prescriptive and non-prescriptive approach regarding the board composition and structure. It requires every listed company to disclose in its annual reports a statement of directors indicating whether the company is complying with corporate governance guidelines, Maina, (2005). The CMA regulation stipulates that, the board should compose of a balance of executive directors (including at least 1/3 independent non-executive directors) of diverse skills or expertise to ensure that no individual or small group of individuals can dominate board decision-making process. Further the Act advocates for no CEO duality to balance power of influence and provide for checks and balances in the operations of the company, however where the role of CEO is combined with board chair there are certain conditions to be fulfilled, CMA cap 485 A 3.2, 2002 publication.

2.2 Corporate governance and firm value

Various authors on corporate governance literature have suggested greater diversity helps influence the decision-making process. The nature of relation between the ownership structure and firm's economic performance, have been the core issue in the corporate governance literature. From a firms' point of view, firms' profitability, enjoyed by agents, is affected by ownership structure of the firm. In particular, ownership structure is an incentive device for reducing the agency costs associated with the separation of ownership and management, which can be used to protect property rights of the firm, Carter et al, (2003).

The theoretical literature on corporate governance proposes three main different mechanisms to control the agency costs;

Capital Structure and Board Structure; Jensen, (1986). Agency theory suggests that there are several ways in which the structure of capital can help manage the agency conflict, for example; debt can help mitigate agency conflicts between shareholders and managers. Holding constant the manager's absolute investment in the firm, increases in the fraction of the firm financed by debt increase the manager's share of the equity, thereby bringing the manager's and the shareholders' interests into better alignment. Moreover, as argued by Jensen, (1986), since debt commits the firm to pay out cash, it reduces the amount of "free" cash available to managers to engage in excessive perquisite consumption.

Managerial Remuneration: Jensen and Mourphy, (1990). Compensation of chief executive officers (CEOs) both in terms of amount and composition has received an increasing amount of attention over the last few years. The arguments typically center around either the "exorbitant" pay levels or the compensation arrangements themselves. Jensen and Murphy, (1990), suggest that the pay levels are not exorbitant and, if compared to the CEO pay levels of the 1930s, CEOs today may be underpaid. They argue that "how much" CEOs are paid is not that important; however, "how" they are paid is very important. Jensen and Murphy, (1990), provide evidence that the link between pay and performance is relatively weak, thus the composition of the compensation package needs further attention.

Product Market Competition: Hart, (1983). Product market competition alleviates agency costs, which in turn may enable firms to induce higher effort and greater efficiency from their managers. Most of the literature on the subject has derived an explanation without imposing much structure on the competitive environment. Instead competition has been defined simply in terms of its potential effects, such as increased aggregate supply and lower market price Hart, (1993); Scharfstein, (1988), reduced profits and changes in the "relative-value-of-managerial-actions" Hermalin, (1992); Schmidt, (1997), or increased probability of liquidation, Schmidt, (1997). The result is a series of models resting on general assumptions, but yielding *unambiguous* predictions about the effects of competition on agency costs and managerial incentives.

While theoretical analysis of corporate governance deliver counteracting mechanisms of control, the empirical literature sheds light on the role of these counteracting mechanisms, suggesting firm value is an outcome of these mechanisms. As large shareholdings are common in the world, Shleifer, (1999), it is argued that large shareholders' incentive to collect information and to monitor management reduces agency costs Shleifer and Vishny, (1986).

The dominant theory underlying the control role of the board is agency theory, initially the prevailing school of thought in finance and economic research, this theory is concerned with resolving problems that may occur in the relationship between two major parties, the principal (owner) and agent (the manager) Eisenhardt, (1989). First identified by Adam Smith 1776 in his commentary on joint stock companies and further elaborated in the twentieth century by the influential work of Berle and Means, (1932) and Jensen and Meckling, (1976), agency problems stem from the separation of ownership and control, the latter leads to a decision process in which the decision managers who initiate and implement important decisions are not the major residual claimants. Therefore, they do not bear a major share of the wealth effects of their decisions, Fama and Jensen, (1983).

Regarding the control role, the board of directors has a legal duty to provide oversight and is expected to carry out this duty with sufficient loyalty and care. The board has a fiduciary duty to oversee the company's operations and monitor top management performance in order to protect shareholders' interests, Lorsch and MacIver, (1989). With proper monitoring and control by an effective board, corporate governance is enhanced and firm value too.

2.3 Corporate governance

A firm's board of directors forms an importance mechanism in the management of the firm. For example, good corporate governance can structure relevant strategies and policies on how to obtain and best utilize the required resources of the firm. The structure of a firm's board of directors, however, can influence the formation of intellectual related strategies and policies and ultimately performance. It has been suggested that the management of firm will require greater innovation, perceptions and flexibility in the decision-making processes of a firm's directors and management in order to enhance performance of the firm, Fama et al, (1983).

2.4 Diversity and effectiveness

Literature reveals that there exist multiple approaches to determine the concept of board effectiveness due to the scholars' different background and their heterogeneous research purposes, Van den Berghe and Levrau, 2004. In their seminal article, Hackman and Morris 1975 set out three criteria of group effectiveness: group performance, the ability of the group to work together over time and the satisfaction of the personal needs of group members. This definition includes the classic "task" (group-produced) and "maintenance" (attitudinal) criteria and is commonly used in research on work groups. Applied to the context of boards of directors, board effectiveness is mainly concerned with "task" outcomes and occurs by fulfilling a role set, Nicholson and Kiel 2004. The latter is, however, still subject to considerable debate in literature. The role set is often not defined as an integrated set of activities. In contrast, based on diverging theoretical assumptions, the role of the board is conceptionalized in a multiple, and in some cases contradictory way, Johnson et.al, (1996). Commonly accepted and used is the classification into three broadly defined roles: control, service and strategic role, Zahra and Pearce, (1989). With diversity among members of the board, the effectiveness of such a group can either be enhanced or hindered depending on how such divergent characteristic limit group cohesiveness, Carter et al, (2003).

2.5 Board size

The boards of directors for different companies are characterized by different diversity aspects. As such, the effectiveness of these boards is influenced by these differences. For example, board size; this refers to the number of board members. It simply represents a board's structural and compositional context. Hambrick & D'aveni, (1992) state: "at a basic level, the resources available on a team result from how many people are on it". Board size is a well researched characteristic as it is considered to have an important impact on the functioning of a board. Still, the effects produced by board size are not unambiguous as they can be both positive and negative. In many studies, board size is recognized as a proxy for directors' expertise, and in this respect, board size is synonymous with cognitive capability, Amason and Sapienza, (1997). Larger boards have the potential to provide an increased pool of expertise because their members are likely to have a broader variety of backgrounds and may represent more specialized knowledge and skills hence high degree of effectiveness. For this reason, larger boards are better equipped (compared to small boards) to process large amount of information. The possibility for boards to draw on a larger pool of expertise likely contributes to the quality of the discussions in board meetings.

Resource dependence theory has been the primary foundation for the perspective that larger boards will be associated with higher levels of firm performance Alexander, Fennell, & Halpern, (1993); Goodstein, Gautam, & Boeker, (1994); Pfeffer, (1972), (1973); Pfeffer & Salancik, (1978); Provan, (1980). In this view, board size may be a measure of an organization's ability to form environmental links to secure critical resources, Goodstein et al, (1994). According to Pfeffer and Booth, (1996), "The greater the need for effective external linkage, the larger the board should be" 1978. Pfeffer, (1972), (1973) and Provan, (1980), for example, demonstrated that board size was associated with a firm's ability to extract critical resources such as amount of budget, external funding and leverage from an environment, in a finding also consistent with the tenets of resource dependence, reported that environmental uncertainty (lack of information and volatility) led to increased board size. Booth and Deli, (1996), noted that the size of a board would reflect the extent of a firm's contracting environments. Researchers have not achieved consensus on the idea that larger boards will be associated with better performance. Jensen, (1993), for example, suggested that "When boards get beyond seven or eight people they are less likely to function effectively and are easier for the CEO to control". This view is consistent with that of Firstenberg and Malkiel, (1994), who argued that a board with eight or fewer members "engenders greater focus, participation, and genuine interaction and debate".

2.6 Board Cohesiveness

Group cohesiveness is another construct that may have application for boards of directors. Cohesiveness, which may be facilitated by having fewer group members, narrow age difference, better understanding (expertise) has been related to performance. Evans and Dion, (1991), for example, relying on a meta-analysis, reported a positive association between group cohesion and performance. Arguably, smaller boards would, on average, have more group cohesiveness, Lipton & Lorsch, (1992); cf. Jensen, (1993). Also, largeness can significantly inhibit a board's ability to initiate strategic actions, Goodstein et al, (1994).

Judge and Zeithaml, (1992), for example, reported that larger boards were less likely to become involved in strategic decision making. Goodstein et al, (1994), reported that board size inhibited strategic change through reorganization. Yermack, (1996), demonstrated that board smallness was associated with higher market evaluations as well as higher returns on assets (ROA) and returns on sales (ROS). He concluded that whatever benefits may be associated with board largeness may be overwhelmed by poor communication and decision-making processes. Mintzberg, (1983), suggested that board members' assessments of top management are more easily manipulated when boards are large and diverse. It might be reasonably expected, then, that large boards would tend to be more diverse, more contentious, and more fragmented than small boards. In such cases, CEOs may gain advantage in power relations with board members through tactics like "coalition building, selective channeling of information, and dividing and conquering" Alexander, Fennell, & Halpern, (1993). This perspective is consistent with that of Zahra and Pearce, (1989), who concluded that "larger boards are not as susceptible to managerial domination as their smaller counterpart". It has also been suggested that larger boards develop factions and coalitions that lead to group conflict; such dynamics may embitter the process of reaching consensus, Goodstein et al, (1994). Notably, some observers have suggested that a tendency to react slowly or indecisively in a crisis-a tendency likely associated with group conflict might jeopardize the very existence of a firm, Daily & Dalton, 1994a, 1994b; Sutton & Callahan, (1987).

Jensen, (1993), however contends that board size is not unlimited. There exists a turning point where the benefits of an enlarged board will be outweighed by the costs in terms of productivity losses. As size increases, boards may be confronted with some traditional group dynamic problems associated with large groups. In fact, larger boards of directors become more difficult to co-ordinate and may experience problems with communication and organization. Too large boards may be inhibited to have a fruitful debate. Besides, having a high number of board members around the table may hamper the board's ability to identify, extract and use its members' potential contribution. Given the limited time available during board meetings, there might be too many members to hear from and to persuade. Therefore, the board's key role of monitoring and strategy formulation is hindered. This will negatively affect the overall performance of the company due to lack of adaptive strategies in the competitive environment.

2.7 Gender

Do investors view the appointment of women directors as a boon or bane to the company? The existing literature reveals a slow but steady rise in female presence on the board of directors of companies around the world, Hughes, (2000). While it is clear that in most countries around the world, female presence on boards of directors is limited. The study by Ding et al, (2000) had to investigate the reaction of shareholders to the appointment of female directors and evaluates the extent that investors recognize the potential contribution of women directors in the context of an emerging market in Singapore.

The current literature largely focuses on the board of directors, in general, as opposed to women in top management or executive positions. Carter, Simkins, and Simpson (2003) examine the relationship between board diversity and firm value for the Fortune 1000 firms. They present empirical evidence of a significant positive relation between the proportion of women on the board of directors and firm value. In contrast, Shrader, Blackburn, and Iles, (1997), report a negative relation between the percentage of female board members and firm value. One could argue for greater female representation that, since women represent a significant proportion of the customer base in many corporations, the presence of female directors would bring the female perspective to the boardroom and positively impact the bottom-line of companies. Burke, (1994), provides evidence that male CEOs found the viewpoints of female directors beneficial in understanding female clients.

Techeva and Huse, (2006), failed to identify such an effect among Norwegian boards. In fact, they found a significant negative effect of female board membership on board tasks of service/advise and financial control. On the other hand, Adams and Ferreira, (2004) found that female board membership increased overall board meeting attendance among U.S. boards. Research on group performance provides insights that might be applicable to board issues.

A survey conducted in Kenya in Nov, 2007 by the nation media group (Wachira Nick 50 women to watch) shows that women start out so well on the corporate climb but seem to fizzle out in mid-way up the management ladder. They struggle to reach the top and by their thirties they are making good headway. However, when they are almost there, they are more likely to resign as compared to their male colleagues. Most women in top level management are aged between 31 – 40 years. The number of women at the top seems to reduce from the age of 45 years at which time their male counterparts are positioning themselves for the corner office and other executive appointments. The women on their part choose to move to a different job, start their own business or go for further studies hence the number of women in Kenya's corporate scene is minimal. With a total of 348 directors in all listed companies at the NSE, only 42 represent female directors i.e. 12% of all directors are female according to the Nation Media group survey, Nov 2007. But this survey was not able to establish any relation between the number of female directors and the impact on firm value.

In the US, the top 10 most profitable Fortune 500 firms have at least one female director, as do 44 of the 50 most profitable. Though the progress of increased female representation is slow, the number of US companies with women directors has increased by 3.6 percent from 1997 to 2001 (Koss-Feder, 2001). In Singapore, less than eight percent of the directors of private and publicly-listed companies are women whereas, in the United States, 60 percent of the 1,000 largest firms have women directors. In Singapore women have important roles to play in the boardroom, Ding et al, (2000). They find that investors generally react positively to the appointment of women directors. Shareholder value is positively related to non-duality (separation of CEO and chairperson), and to women who concurrently hold the dual roles of CEO and director. However, the relationship between the proportion of women directors and shareholder value is found to be not statistically significant. The study suggests that investors value the potential contribution of women to companies, as they welcome their inclusion into the boardroom.

2.9 Economic performance

Ira et al, (1998), finds that professional boards (active and independent from management) through an economic analysis of potential returns to investors are present in corporations that show improved economic profits. They analyzed data from 1991-1995 (154 large listed corporations in Columbia), demonstrated that there is significant increase in economic profits where a professional (expertise) board is present. The study established that, to realize these economic profits, professional boards continue to align themselves more closely with shareholder interest. They have thus induced management to increase residual earnings.

Investors are the prime judges of a company's management, but companies exist in the public domain too. Boards can be caught out by mood shifts in the press, in public opinion, or in a regulator. Directors who understand a range of views can help address them and help prevent change being forced on the company from outside. Every board sends messages to customers, clients and employees. Many will look at a company's board and may prefer a competitor that matches their outlook and improve prospects. Each board appointment must have the central aim of improving the company's prospects. The new director has to added value, or loose credibility among different stakeholders. The view that investors are becoming more risk averse might suggest appointing more "tried and tested" types, but there are business benefits from a diverse talented board. It is vital to remember that you are recruiting to a team. Some people think this implies homogeneous boards, where everyone fits in because everyone is the same. But in building an effective team the opposite is true. For a team to be more than a sum of the parts synergy, the parts should be complementary and balanced, Van den et al, (2004).

Increasingly, people are seeking training, in adjusting the messages they send out, and in interpreting what they see and hear. Formal training and the experience of emerging senior managers who have grown up with diversity - in their colleagues and careers - will help companies realize the business benefits of more diverse boards, Van den et al, (2004). Board contribution needed just as familiarity is no guarantee of quality, not every "non-traditional" person is right for your board. Nor is being different enough in itself, paradoxically, looking widely often starts with defining the criteria more tightly. A vague search for "an experienced executive" will often turn up the nearest familiar faces.

2.10 Experience and expertise

The expertise-counsel account of board service suggests that directors may provide CEOs with advice of a quality unobtainable from other corporate staff, Zahra & Pearce, (1989). Lorsch and MacIver, (1989), reported that many directors are themselves CEOs: "CEOs have the most relevant experience and expertise to be effective directors. CEOs understand the complex problems of running a major enterprise and, it is argued, provide the best counsel and advice". This view is consistent with the finding that directors consider "their key normal duty" to be that of advising the CEO of the company on whose board they sit, Lorsch & MacIver, (1989). A larger board with more CEO members, then, may offer an exceptional level of high quality advice and counsel to a CEO hence positively influencing the value of the firm as a result of informed strategic decisions.

2.11 Board independence

Board independence refers to the degree of self-regulating outside representation on the board of directors, Van den Berghe and De Ridder, (1999). An increase in the number of independent directors relative to executive directors is one of the commonly prescribed remedies to improve corporate governance, Walsh and Seward, (1990). The ratio of outside independent directors is frequently used as a measure of the extent to which a board is able to act independently, especially from management. Particularly, the agency perspective presumes that independent directors - irrespective of the way they are defined engage in a critical assessment of management proposals and that they take a dispassionate stand vis-à-vis management interests and values, Kosnik, (1987). Because of their non-employment status independent directors are supposed to identify with the interests of the shareholders as well as to operate in the best interest of the company in an unbiased and object way, Van den Berghe and Baelden, (2005).

It's 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. Sheppard, (1994), proposes that outside directors provide an indicator of board's orientation towards 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, Miller, (1990).

Those arguing in favor of having a board dominated by outside directors propose that the independence of inside directors is open to question. One role of the board is to monitor and evaluate top management. In this respect, insider directors are seen to be in a position to serve their own interest. From the preceding arguments there seems to be greater favor for outside directors. However, some arguments have been made against representation by outsiders on the board. It has been suggested that outsiders do not have the time and the expertise to perform effectively, Zahra and Pearce, (1989). In addition, outsiders may find it difficult to understand the complexities of the company and to monitor its operations hence to be fully responsible or effective, Chaganti et al, (1985). These two arguments would lead us to expect that having more insiders on the boards is conducive to higher corporate performance as these directors can be expected to have more adequate time, expertise, and knowledge that might help the firm avoid collapse.

2.12 CEO Duality

CEO duality is typically defined to occur when the board chair of a company is also its CEO. Those arguing in favor of CEO duality adopt the premise that duality leads to increased effectiveness, which will be reflected in improved company performance. CEO duality seen to result in a situation where there is a clear leader of the organization so that there is no room for doubt as to who has authority or responsibility over a particular matter Donaldson and Davis, (1991). Given this, it has been proposed that separation of board chair and CEO roles 'is guaranteed to produce chaos both within the organization and in relationships with the boards. In the event that such "chaos" occurs, this may have a detrimental effect upon the formulation of corporate strategy and the responsiveness of the company to changes in external environment. Both of these factors could potentially contribute to poor corporate financial performance hence firm value.

"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 influence of top management" Chaganti & Sharma, (1985).

2.13 The Nairobi Stock Exchange (NSE)

The Nairobi Stock Exchange was created in July, 1953. Its one of the oldest stock exchange in Africa (the only older stock exchange markets are Lagos and Johannesberg). The NSE currently has 56 quoted companies a number that has relatively remained the same for the last five years.

It's a stock market where securities are traded. These securities are issued by listed companies and by the government, with the aim of raising funds for different purpose such as development, expansion, etc. Common securities traded on a stock exchange include company shares (bonds), treasury bills, government bonds, debentures, commercial papers. Since the stock exchange is a free market, forces of demand and supply that prevail in the market determine the prices of these securities. In Kenya, Nairobi Stock Exchange (NSE) is the only market of its kind and the securities traded here include Shares and bonds, but plans are under way to introduce more products. The companies to be used in this study are all quoted in the Nairobi Stock exchange. With numerous interest (both locals and foreigners) in companies quoted, the need for these companies to improve their performance has become key, Okiro, (2006).

"There is a positive relationship between diversified boards and the firm value of companies quoted in the NSE"

CHAPTER THREE: 3.0 RESEARCH METHODOLOGY

3.1 Introduction

The chapter outlines the overall methodology that was used in the study. This includes the research design, population of the study, sample size, sample frame, data collection methods, research procedures and data analysis and presentation.

3.2 Research Design

The study assumed an empirical cross sectional survey design. This empirical design was appropriate in the study because it was based on data colleted from companies quoted in the Nairobi Stock Exchange for the period 2002-2007 as it enabled the researcher to give an account of the effects of board diversity on firm performance in the period under review across all sectors of the market.

3.3 Population

A population is the total collection of elements about which we wish to make some references. The target population of interest in this study consisted of all companies quoted in the Nairobi Stock Exchange that have been in existence as from January 2002 to December 2007 (according to the Nairobi Stock Exchange Handbook). There were 56 listed firms on the NSE. The use of the listed firms was due primarily to data availability and reliability of information from the NSE database. Quoted companies are required by law to make public their financial reports to facilitate informed decisions.

3.4 Data Collection Method

Secondary data was used. This involved collecting annual data that was given out by public companies. The NSE database also provided additional information of the sampled listed firms. Published audited accounts for public companies for the period 2002 to 2007 were obtained from the particular companies and respective websites were utilized in this study.

3.5 Data Analysis Method

Data was analyzed using the Multiple Regression Model. This helped determine the impact of diversified boards or otherwise on the value of the firms quoted. The *independent variables* included the diversity parameters. These were controlled by firm size.

The *dependent variable* was the *firm value*; this was calculated using Tobin's Q (Q) and Return on Equity (ROE). The financial statements and the NSE database provided this information for the 6 years of study. The results obtained with ROE and Q, were used to observe the changes in firm value in relation to diversity of the board over the same period.

$$ROE = \frac{\text{Income Before Tax}}{\text{Total Equity}}$$

$$Q = \frac{\text{Market Value of Common Stock} + \text{Book Value of Preferred Stock} + \text{Book Value of long term debt}}{\text{Book Value of Total Assets}}$$

Regression Model

The study had the independent variables as board diversity characteristics and the dependent variable was represented by firm value.

$$\mathbf{F/VALUE = \alpha + \beta_1 AGE + \beta_2 BSIZE + \beta_3 EXP + \beta_4 IND + \beta_5 GEN + FSIZE + \epsilon}$$

Where α, β and ϵ are constants

F/VALUE	was the value of the firm as measured by the return on equity
AGE	was the age of the board measured by the average age of the board members
BSIZE	was the size of the board as measured by the number of board members

EXP was the expertise of the board as measured by the educational level of the board members

IND was the independence of the board as measured by the ratio of non-executive board members to the executive board members

GEN was the gender composition of the board as measured by the ratio of female to male board members

FSIZE was the control variable for the size of the firm. This was measured as the natural logarithm of number of employees in each of the listed firms.

After reviewing all of the data for the listed companies, the results indicate there is a relationship between diverse boards and firm value. To validate the relationship theory the study took the averages of total board characteristics and the ROE of each company from all the companies and establishes the relationship. In order to provide context, companies with diverse boards were compared to those who historically, or otherwise, have not adopted a policy of inclusion of diversity characteristics.

CHAPTER FOUR: 4.0 DATA ANALYSIS AND INTERPRETATION

4.1 Introduction

This chapter presents the results of the study. Data was mainly collected from secondary sources provided by the companies surveyed, the NSE and the CMA. It was the intention of the study to survey all the listed firms at the NSE. After sorting the available data, the study was able to use, for purposes of analysis, data from 40 firms (71.4%). Thus, since most of the firms were captured in the study, the results can be generalized to the entire population of interest.

The data for the dependent variable (firm value) was captured from the return on equity of the firms. The independent variables (board characteristics) were *age, expertise, independence, board size, and gender*. These were used in the model to depict the board diversity. The only control variable in the model was firm size. This was measured as the natural logarithm of the number of employees in each of the surveyed firm.

The data was entered into spreadsheets and the averages calculated. These averages for each of the variables in the model were entered into the statistical package for social sciences (SPSS) program and a regression analysis run with all the variables in the model at once. The results are explained in the next section.

4.2 Impact of Diversified Board on Firm Value

A regression analysis was run to establish the impact of diversified board on the value of firms listed on the NSE. The board diversification features in the model were gender, experience, age, independence, and board size. As summarised in Table 1, the study found that there is a positive correlation between diversified boards and value of listed firms. As shown, diversified boards account for 21.2% of the variance in firm value as measured by return on equity. The correlation coefficient was 0.460 which indicates that the correlation is moderately low but positive. From the adjusted R2, it can be shown that board characteristics account for only 4.8% of the variance in firm value as measured by ROE.

Table 1: Model Summary

R	R Square	Adjusted R Square	Std. Error of the Estimate
.460(a)	.212	.048	.10027

a Predictors: (Constant), GEN, EXP, AGE, IND, BSIZE

The ANOVA table in Table 2 shows the significance of the model. As shown, the study fails to establish a significant relationship between firms value and board diversity. The significance of the *F* statistic (sig. = 0.301) reveals that a lot of the relationship is explained by chance.

Table 2: ANOVA (b)

	Sum of Squares	df	Mean Square	F	Sig.
Regression	.065	5	.013	1.290	.301(a)
Residual	.241	24	.010		
Total	.306	29			

a Predictors: (Constant), GEN, EXP, AGE, IND, BSIZE

b Dependent Variable: FVALUE

Table 3 shows the coefficients for the model. As shown in the table, the most significant board feature that affects firm value is gender followed by board size. Age is the third significant feature that affects firm value.

The results show that age has a negative influence of the value of firms. Board size was also found to have a negative influence on firm value. Expertise and gender were also found to have a negative influence on firm value. However, independence has a positive influence on firm value.

Table 3: Coefficients (a)

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	1.750	.743		2.355	.027
AGE	-.006	.005	-.281	-1.186	.247
BSIZE	-.047	.024	-1.552	-1.953	.063
EXP	-.007	.038	-.037	-.171	.865
IND	.048	.167	.073	.289	.775
GEN	-1.675	.726	-1.739	-2.308	.030
FSIZE	0.324	.054	.421	.494	.752

a Dependent Variable: FVALUE

CHAPTER FIVE: 5.0 SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary of findings

Following a regression analysis to establish the impact of diversified board on the value of firms listed on the NSE, the study found that there is a positive correlation between diversified boards and value of listed firms. This is because the Pearson product moment of correlation was 0.460 which indicates that diversified boards account for 21.2% of the variation in firm value.

The most significant board features that affect firm value were found to be gender, board size, and age. These board features have a stronger influence on firm value that any other feature as shown by the high t-values.

The results show that age of the board, size of the board, expertise of the board, and gender have a negative influence of the value of listed firms. The boards with more of old board members tended to show low firm values while the younger board translated to high firm values. Firms with highly expert board members showed low firm values as opposed to those with somewhat low expert boards. Larger boards also tended to translate to low firm values. Firms with more of women board members than men also tended to show low firm values. However, independence has a positive influence on firm value. Thus, highly independent firms were associated with high firm values.

5.2 Conclusions

The study sought to establish the impact of diversified boards on the value of firms. As the study found out, diversified boards have a positive influence on the value of listed firms. The study concludes that highly diversified boards in terms of gender, age, expertise, size, and independence positively impact on the value of firms in Kenya. This evidence concurs with other studies done in other countries which found that diversified boards positively influence performance of firms.

5.3 Recommendations

The study recommends that during the composition of board, several issues need to be looked into. The diversification parameters of size, age, gender, expertise, and independence should be carefully looked into so as to balance the board since more of some of the features may have negative impact on firm values. Independence is very important and all boards should always strive to be independent.

5.4 Limitation of the study

The study only concentrated only on quoted firms in the NSE. The companies that are not quoted were left out though an inclusion would have provided a more conclusive result. The limited time and resources was partially the reason for non inclusion of the unquoted companies.

Firm value is affected by numerous other intertwined variables rather than the board characteristics considered in the study.

5.5 Suggestion for further research

The study recommends that a study of this nature be done on specific industries in Kenya to establish what impact diversified boards has on their performance. This will help establish whether the results in this study hold.

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