THE RELATIONSHIP BETWEEN BOARD SIZE AND BOARD COMPOSITION ON FIRM PERFORMANCE: A STUDY OF QUOTED COMPANIES AT THE NAIROBI STOCK EXCHANGE.

BY

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DECLARATION

THIS RESEARCH IS MY ORIGINAL WORK AND HAS NOT BEEN PRESENTED FOR THE AWARD OF A DEGREE IN ANY OTHER UNIVERSITY.

SIGNED ..... DATE 20/09/2016

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THIS RESEARCH HAS BEEN SUBMITTED FOR EXAMINATION WITH MY APPROVAL AS THE UNIVERSITY SUPERVISOR.

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DEDICATION

To my sons, David, Samson and Rabala who were a source of inspiration during my time of study.

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May god bless you all abundantly.

ABBREVIATIONS

CEO	Chief Executive Officer.
CME	Capital Markets Authority.
COB	Chairman of Board
NSE	Nairobi Stock Exchange.
PSCGT	Private Sector Corporate Governance Trust.

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ABSTRACT

There is no gainsaying of the fact that corporate governance structure of a firm has critical impact on the responsive ability of a firm to external factors that impinge on performance. Well governed firms have been noted to have higher firm performance. Though corporate governance is multi-dimensional, this study examined the relationship between board size and board composition on performance measured by Tobin Q and ROA of non-financial listed firms on the Nairobi Stock Exchange. Annual data covering 2000-2002 was used.

The findings suggest that the size of the board of directors is an independent corporate governance mechanism. This implies that any relationship between board size and firm valuation is indeed casual. However in contrast to previous studies, there was no significant relationship between board size and firm valuation. On average, firms choose their number of board members just optimally. The mean board size was found to be 7.18 and the maximum was fifteen with a deviation of 2.85.

It was also evident from the sample that most firms in Kenya adopt the two-tier board structure where the positions of board chairman and CEO are occupied by different personalities thereby reducing the agency cost. The firms are of similar sizes indicated by their asset base, fixed assets forms a major component of their total assets and that most of the firms depend on debt financing as compared to equity financing.

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SECTION ONE- INTRODUCTION

1.1 BACKGROUND

The board of directors plays an important role in the governance of corporations, it is generally acknowledged that the legal and contractual settings as well as the structure and activities of the board of directors have an impact on the firm performance.
All directors are elected each year at the annual general meeting to serve until the next annual meeting. The board seeks members from diverse professional backgrounds who combine abroad spectrum of experience and expertise with a reputation for integrity. The basic responsibility of a director is to exercise his/her business judgment and act in what he/she reasonably believes to be the best interest of the company and its shareholder. In discharging that obligation a director should be entitled to rely on the honesty and integrity of the company senior executives and the company outside advisers and auditors.

The characteristics of corporate governance are the board size, board composition and whether the CEO is also the board chairman. There is a view that large boards are better for corporate governance because they have arrange of expertise to help make better decisions and harder for a powerful CEO to dominate. However, recent thinking has leaned towards smaller boards. Jensen(1993) and Lipton & Lorsch (1992) argue that large boards are less effective and are easier for a CEO to control. When a board gets too big, it becomes difficult to co-ordinate and process problems. Smaller boards also reduce the possibility of free riding by individual directors, and increase their decision taking processes.

The issue of whether directors should be employees of/or affiliated with the firm(inside directors) or outsiders has been well researched , yet no clear conclusion has been reached. On the other hand, inside directors are more familiar with the firm's activities and they can act as monitors to top management if they perceive the

opportunity to advance into positions held by incompetent executives. Outside directors may act as "professional referees" to ensure that competition among insiders stimulates actions consistent with shareholders value maximization (Fama 1983). John and Senbet(1998), argue that boards of directors are more independent as the proportion of their outside directors increases. A number of empirical studies on outside directors support the beneficial monitoring and advisory functions to firm shareholders.

Monks and Minow (2001) describe the main function of board as follows "the existence of boards, is based on the premise that they oversee management, select executives who will do the best job and tell them when they don't''. In addition they are not permitted to become intimately involved in the running of the company. That is directors do not manage their company first hand and their main role is to remove undesirable managers and appoint desirable ones.

Mululu(2005) , the study found out that the frequency of board meetings is related to the number of corporate governance variables, such as the board size, the number of executive directors, number of total shares held by largest shareholders, the number of shares held by unaffiliated block holders, the number of percentage of shares held by officers and directors and the number of other directorship held by outside directors. From the study there was evidence that the number of board meetings decrease with the board size.

According to the study by Mwangi(2004), the board size average was eight members and the outside representation constitutes about 71.23%. It was also noted that the larger the board the higher the number of outside directors. The empirical finds of the study was consistent with the implications of the agency theory literature and it was consistent with board composition studies in considerably larger countries such as the US and UK, where the emphasis on the role of independent outside directors has been part of the corporate environment for relatively much longer amount of time.

1.2 Statement of the Problem

While the primary responsibility of board is to ensure that the corporation management is performing its job correctly, actually achieving this in practice can be difficult. In a number of "corporate scandals" one notable features revealed in subsequent investigations is that board were not aware of the activities of the manager that they have hired and the true financial state of the corporation. Cases of corruption and failure of companies in Kenya have attracted debate in many legal and business sectors. The cases include the Goldenberg scandal, Uchumi supermarkets and Euro Bank. The development and promotion of corporate governance practices require investment in financial and human resources, thus the monitoring role of the board of directors should be recognized as crucial in corporate governance. Shareholders appoint directors and entrusting them to run the company more efficiently. Directors can make good decisions if they are provided with timely and correct information by the management.

In Kenya corporate governance has been gaining roots in response to initiatives by some stakeholders such as the Nairobi Stock Exchange (NSE) in collaboration with the Capital Markets Authority (CMA) to address corporate governance in Kenya. Again there have also been other initiatives designed to address corporate governance issue in the country. For instance, a study, conducted and launched by Private Sector Corporate Governance Trust (PSCGT) pointed out that there is an increasing acceptance of good corporate governance practices by companies in the country.
Not withstanding the above developments it must be indicated that more formal corporate governance structure, and institutions are relatively not widespread though number of laws provide for governance structures for companies in Kenya. These laws include:

The companies Act (CAP 486), which provides for governance of all companies in Kenya.

The Capital Markets Authority in the exercise of the powers conferred by the CMA Act(CAP 485A) issues the guidelines for observance by public listed companies, in Kenya in order to enhance corporate governance practices, by such companies.

In the companies Act, there is deliberate attempt to streamline corporate practices in the country. For instance the Act stipulates a minimum of two directors for a company with no ceiling on the maximum number whilst the Capital Market Authority (CMA) listing regulations are silent on board size. With regards to board composition, there is no requirement under the companies Act for the appointment of independent directors neither is there a provision for the balance of executive and non-executive directors. However, there is allowance for the interest of different stakeholders to be represented on aboard. This is however a requirement under the CMA Act. Developing countries such as Kenya are now increasingly embracing the concept of governance knowing that it leads to sustainable growth.

Previous research done on corporate governance and firm performance in Kenya include a study of corporate governance by Jebet(2001) in which she set to determine the existing corporate governance structures in publicly quoted companies in Kenya. Other research studies conducted in the area of corporate governance and board of directors are: Mululu(2005), the relationship between the board activity and firm performance; Kitonga(2002), on the need for corporate governance audit in Kenya; Mwangi(2003), on determinants of corporate board composition in Kenya-an agency perspective.

Considering the important role the directors play in creating value for the shareholders of corporations, this paper proposes to study the relationship between Board size and composition on firm performance.

1.3 Objectives of the Study

1. The effect of the board size on the firm performance.
2. To determine how the composition of the board of directors affect the firm performance.

1.4 Importance of the Study

This study is expected to benefit the following

(1) The Investors and Shareholders will be able to know which board structure directors is suitable for the company, and to what extend does the company need the executive and non-executive directors. It will also assist them in determining the company performance in comparison to the board size and board composition.

(2) It will also assist researchers who want to carry out further research in the area and look into other board attributes like the ownership structure and the compensation of the directors.

(3) The management will also find the study to be useful in that they will be able to advice the board accordingly on the firm performance. Managers are the stewards of the companies charged with the responsibility of maximizing the wealth of its shareholders.

(4) The research will offer the government and other regulatory bodies the basis for the assessment and refinement of board size and board composition that may help improve the efficiency of the corporate governance and when formulating guidelines on the board .

SECTION TWO: LITERATURE REVIEW

2.1 Corporate Governance and Firm Performance

The concept "corporate governance" has attracted various definitions. Metrick and Ishii (2002) define corporate governance from the perspective of the investors as "both the promise to repay a fair return on capital invested and the commitment to operate a firm, efficiently given investment". The implication of this definition is that corporate governance has an impact on an investment Cadbury Committee (1992) defines corporate governance as "the system by which companies are directed and controlled" Zingales (1998) also defines a governance system as "the complex set of constraints that shape the ex-post bargaining over the quasi rent registered by the firm".

According to Mayer (1997), corporate governance is concerned with ways of bringing the interest of investors and managers into line and ensuring that firms are run for the benefit of investors. Corporate governance is concerned with relationship between the internal governance mechanisms of corporations and society's conception of the scope of corporate accountability (Deakin and Hughes, 1997). It has also been defined by Keasey et al (1997) to include the structure, processes, cultures and systems that engender the successful operation of organizations. Corporate governance is also seen as the whole set of measures taken within the social entity that is an enterprise to favour the economic agents to take part in the productive process, in order to generate some organizational surplus, and to set up a fair distribution between the partners, taking into consideration what they have brought to the organization. It may be stated more generally that different systems of corporate governance will embody what are considered to be legitimate lines of accountability by defining the nature of the relationship between the company and key corporate constituencies. Thus, corporate governance systems may be thought of as mechanisms for establishing the nature of ownership and control or organizations

within an economy. In this context, "corporate governance mechanisms are economic and legal institutions that can be altered through the political process – sometimes for the better (Shleifer and Vishny, 1997).

The impact of regulation on corporate governance occurs through its effect on the way in which companies are owned, the form in which they are controlled and processes by which changes in ownership and control take place (Jenkinson and Mayer, 1992). Ownernship is established by company law, which defines property rights and income streams of those with interests in or against the business enterprise (Deakin and Slinger, 1997). Corporate governance describes how companies ought to be run, directed and controlled (Cadbury Committee, 1992). It is about supervising and holding to account those who direct and control the management.

Previous empirical studies have provided the nexus between corporate governance and firm performance (Yermack 1996). Cohen &Ferrell (2004) have shown that well governed firms have higher firm performance. The main characteristic of corporate governance identified in these studies include board size, board composition, and whether the CEO is also the board chairman.

2.1.1 The Corporate Debate

During the late 1950s a number of large UK companies failed, some of them as a result of large-scale travel by directors. These companies include Polly Peck and Maxwell Communications. The failures were largely attributable to lack of accountability and commitment from the companies Board of Directors and management.

To ensure the achievement of the Corporate set objectives and minimize the failure of firms, new standards setting regimes for both financial accountability and reporting were set up, they include.

1. The Cadbury Report (Committee on the financial accountability of corporate bodies)
2. The Greenbury Report (Directors' remuneration)
3. The Hampel Report.

2.1.2 The Cadbury Report (Committee on the financial accountability of corporate bodies)

The Cadbury committee was set up in 1991 to examine the reporting and control functions of Board of Directors and the role of auditors and shareholders. The committee concentrated on the financial aspects of corporate governance.

Compliance with the code of best practice was voluntary. However, the London Stock Exchange (LSE) listing rules requires UK – incorporated listed companies to include a statement as to whether they had compiled with the standards in their annual financial statements. Non-compliance had to be explained.

Broadly the Cadbury report covered the following:

1). The board must meet regular, have a formal agenda, encourage openness etc.

2).Reporting and disclosure (including disclosure of director's remuneration packages, involvement and on internal control systems)

3).Membership of the Board with effective division of responsibility (combination of executive and non-executive directors)

4).Independence of the Board (no financial connection with the company except fees and shareholdings

5).Separate audit and remuneration committees be established and service contract over three years be approved by shareholders and be made up entirely of independent directors;

6).Audit committee must meet with the external auditors at lease once a year and without executive directors;

7).Fees for independent directors should the time they spend on the company business;

8).The directors should state in the financial report that the company is a going concern, report on the effectiveness of the company's system of internal control.

2.1.3 The Greenbury Report (Directors' remuneration)

This report was a response to the increasing public concern that financial statements still did not adequately reflect companies' directors and management remuneration.

The report set out a code of best practice in determining and accounting for director's remuneration. The detailed provisions were prepared with large companies mainly in mind, but the committee stated that the principles apply equally to small companies.
All listed companies registered in UK were required to comply with the Greenbury code from 1995 onwards. They had to include a statement about their compliance in the annual reports to shareholders or in the annual report of the remuneration committee. Any areas of non-compliance were to be explained and justified.

2.1.4 The Hampel Report

While both the Cardbury and Greenbury reports concentrated on preventing abuses, the Hampel report is concerned with the positive contribution which corporate governance can make.
Throughout, it aims to restrict the regulatory burden facing companies and substitute broad principles where practical. Each company's circumstances are different. A 'one – size – fits – all" approach to corporate governance issues is not appropriate. Instead, each listed company is required to introduce corporate governance practices which suites it's position and disclose the same in it's annual financial report a narrative explaining how the broad principles of corporate governance have been applied.
The general message of Hampel report is that a board need not approach various corporate governance requirements in a compliance mentality: the-so called "tick box" approach. Good corporate governance is not achieved by satisfying a checklist. Directors must comply with the substance as well as the letter of all best practice pronouncements.

2.1.5 Corporate Governance Practices in Kenya

The Capital Markets Authority (CMA) developed, and gazetted in May 2002, the guidelines for good corporate governance practices for listed companies in Kenya in response to the growing importance of governance issues both in emerging and developing economies and for promoting growth in domestic and regional capital markets. 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 investor's rights.

CMA developed the guidelines by taking into account the work which had been undertaken extensively by several jurisdictions through many task forces and committees included but not limited to the United Kingdom, Malasia, South Africa, Organization for Economic Corporation and Development (OECD) and the Commonwealth Association for Corporate Governance.

Prior to CMA's promulgation of the guidelines for good corporate governance, the Private Sector Corporate Governance Trust, Kenya, had in November 1999 issued a code of best practice for corporate governance in Kenya. Most of the provisions in this code were incorporated in the CMA's guidelines.

Manyuru(2005), the study looked at the extent corporate governance cut across the industries and it was established that all the four sectors scored highly. The results indicated that Agricultural sector exhibited a high positive correlation between performance and corporate governance . Finance and Investment sector also showed a high correlation.

2.2 The Functions of the Board.

In theory and law a variety of functions of corporate boards have been identified. For example the CMA authority has listed eight such functions. They are:

(1) To define the company's mission, its strategy and objectives.

(2) To oversee the corporate management and operations.

(3) To identify the business opportunities.

(4) To develop appropriate staffing and remuneration policy.

(5) To review the adequacy and integrity of the company internal controls.

(6) To establish and implement a system that provides necessary information to the shareholders.

(7) To monitor the effectiveness of the corporate governance practices.

(8) To take into consideration the interests of the company's stakeholders in its decision making process.

The functions can be grouped into two broad categories.

Control functions. They give the board wide ranging formal powers to control the organization and determine its performance. The functions include selecting the C.E.O., exercising direct control during periods of crisis, reviewing managerial decisions and performance. In fact, virtually, every state's corporate law prescribes that business affairs of a corporation shall be managed by or under the directions of the company's board. The board may or may not have time or technical knowledge of the business to literally control management decisions. However, it has power to constrain the key decisions and set limits within which the management will act (Herman, 1981; Mizruchi, 1983).

Service functions. They refer to the service rendered by board members. At least four service functions can be distinguished: co-opting external influencers in an effort to control an aspect of the external environment of the corporation; establishing contacts and raising funds; enhancing organizational image; and giving advice to a management (Mintzberg, 1983).

2.2.1 The Weaknesses of the Board

Despite the fact that corporate boards are assigned key positions in the business and social scene, efficiency of the boards has long been questioned. Mace (1971) accomplished a study demonstrating that the board's participation in directing the corporation was minimal. He found that the directors were generally selected by the C.E.O and they did not usually ask the C.E.O to resign for unsatisfactory performance. Directors did not ask discerning questions, did not select the C.E.O except in crises, and did not establish corporate objectives, policies and strategies.

Clendenin (1972) concluded that most boards make exhaustive evaluation of the operating performance only during periods of crisis and at all other times they content with a superficial review of the performance. In a similar vein Boulton (1978) found that the board's review of performance in most companies is minimal and is intended to meet the minimal requirements of the law.

The so-called weak boards are viewed as weak because their performance is deficient in control or service control or both. How might one explain the apparent discrepancies between the functions prescribed in theory, law, and the ones obtained in practice?

Koontz (1967) identified six reasons for the existence of weak boards, in general. The six are:

(1) Corporate board members and company executives alike misunderstand the position of the board. Directors sometimes forget that they are in fact the company's top executive group. Corporate executives fail to recognize the potential contribution board members can make.

(2) Insiders desire for independence. Due to the stockholder apathy and a lack of organization and power inherent in the control of the proxy machinery, power shifts to insiders and they may not want an effective board.

(3) Boards are creatures of the C.E.O.s. Because of the insider control and apathy of stockholders, the C.E.O recruits and select directors he can work with.

(4) Shortage of competent directors. Shortage of competent directors leaves management with no practical alternatives but to appoint insiders or persons with close ties to the company.

(5) Time commitment. Directors cannot spend large amounts of time preparing for board meetings and, boards, comprised of a majority of outsiders tend to be weak.

(6) Failure to operate efficiently and effectively. Incomplete information, ill-prepared project proposals submitted to boards and a lack of clear order of priorities among the items of board discussion result in ineffective board meetings.

In addition, Mintzberg (1983) argues that broads are really places where internal and external coalitions meet face to face. Structure and functioning of boards are influenced by power politics and boards act like many other coalitions. The complex network of power relations in a corporation determines the effectiveness of its board.

The posture that a board chooses to take is determined, among other factors, by the structure of external groups, dependence of the company on its directors, the directors' knowledge of the company's operations, and the general health and conditions of the company (Zald, 1969). For example, in a publicly held company, the board may be used as a tool to control its external environment; in a closely held company the board may control the company rather closely; in a company that is facing financial or personnel crisis the board may temporarily assume the control function.

A number of corporate board deficiencies identified by Mace (1971) and Boulton (1978), among others, probably still exist (Levy, 1981). Therefore, it is not surprising that pressures have been developing over recent years to hold the corporate boards formally responsible for the performance of the companies they are supposed to govern.

2.2.2 The Corporate Reform Movements.

Changing stockholder role. The rise of the large institutional investor has brought to many companies holders of large blocks of stocks. The investors are inclined to closely scrutinize company operations and hold boards responsible for corporate performance.

Growing awareness of board responsibilities. A series of precedent setting court actions involving corporate boards have steadily pushed board members individually and collectively to take on greater responsibility – perhaps more responsibility that they might be willing to assume otherwise.

2.3 The Size of the Board and Firm Performance

The number of directors is a relevant feature that can have much to do with board monitoring and control activity. Whereas the ability of the board to monitor can increase as more directors are added, the benefits can be out weighed by the costs in terms of the poorer communication and decision-making associated with lager groups (Lipton and Lorsch, 1992; Jensen, 1993), along with the fact that the CEO can be more likely to control the board of directors.

The empirical evidence supports this last assertion by showing an inverse relationship between firm value and the size of the board after controlling for the size of the firm, its age and growth opportunities (Yermack, 1996; Eisenberg *et al.*, 1998). Yermack presents evidence that small boards of directors are more effective, and that companies with them achieve higher market value. Furthermore, financial markets react positively to announcements of board downsizing, while announcements of higher number of directors usually reduce equity value. However, it is not a linear reaction. The lager the board, the smaller the negative effect of an additional director.

In other words, the companies most affected by this problem are small and medium-sized firms, whereas large companies, in spite of its negative effect, do not suffer the problem to such an extent.

2.3.1 Large Board Size

Resource dependence theory has been the primary foundation for the perspective that large boards will be associated with higher levels of firm performance (Alexander, Fennell, & Halpern, 1993; 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).

Pfeffer (1972, 1973) and Provan (1980), 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. Birnbaum (1984), 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. Research on board interlocks may also provide a rationale for expecting larger boards to be associated with positive corporate outcomes (e.g., Bazerman & Schoorman, 1983; Burt, 1980). There is some evidence, for example, that board interlocks are associated with effective capital acquisition (Burt, 1983; Mizruchi & Stearns, 1988).

The expertise-counsel account of board service suggests that directors may provide CEOs with advice of a quality unobtainable from other corporate staff (e.g., Zahra & Pearce, 1989). Lorsch and MacIver reported 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 to be effective directors. CEOs understand the complex problems of running a major enterprise and, it is argued, provide the best counsel and advice. The 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 and Maclver, 1989). A larger board with more CEO members then may offer an exceptional level of high quality advice and counsel to a CEO.

2.3.2 Small Boards Size

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".

Although we are unaware of research especially addressing group dynamics and boards, there is extensive work that may inform concerns about large board size Ellis and Fisher (1994).

Group cohesiveness is another construct that may have application for boards of directors. Cohesiveness, which may be facilitated by having fewer group members, has been related to performance. Evans and Dion (1991), relying on a meta-analysis, reported to a positive association between group cohesion and performance. Arguably, smaller boards would on average, have more group cohesiveness (Lipton, 1992).

Also, largeness can significantly inhibit a board's ability to initiate strategic actions (Goodstein et al., 1994). This idea is consistent with the more general view that larger boards may be less participative, less cohesive, and less able to reach consensus. Judge and Zeithaml (1992), reported that larger boards were less likely to become involved in strategic decision making. Goodstein and Colleagues (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 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). In fairness, however, others have expressed diametrically opposed opinions of the likely power relationship between CEOs and large boards.

It has also been suggested that larger boards developed factions and coalitions that lead to group conflict; such dynamics may embitter the process of reaching consensus (Goodstein et al., 1994). Notability, some observers have suggested that a tendency likely associated with group conflict might jeopardize the very existence of a firm (Daily & Dalton, 1994; Sutton & Callahan, 1987).

A host of theory-driven rationales thus suggest a relationship between board size and firm performance, but the literature provides no consensus about the direction of that relationship.

2.4 The Composition of the Corporate Board

On the basis of their participation firm management, directors are usually divided into insiders (those who are directors and managers at the same time)
And out sider's (non managers directors), since they can have quite different behavior and incentives. Although both groups have some advantages and disadvantages most authors are in favour of outsider- directors dominated boards. In the option of these authors, non manager directors provides superior performance benefits to the firm as a result of their independence from their firm management(Baysinger and Butler, 1985).

However, insider directorship (directors being managers at the same time) has also been justified on the basis for the better knowledge this kind of directors has about the company at the industry where company operates, so that their experience can improve firm performance (Baysinger and Hoskisson, 1990; Bhagat and black, 1998) There is also an intermediate position taken by the some authors who have not found any conclusive evidence. For instance Hermalin and Weisbach (1991) find no relationship between firm performance and board composition, despite having found close relationship with ownership structure. Moreover Rosenstain and Wyatt (1997) reveal that adding an insider director to an outsider-dominated board improves shareholder wealth, and so does adding an outsider director. Finally, three recent studies suggest that firms in the high percentage of independent directors may perform worse (Yermack, 1996; Agrawal and Knoeber, 1996; Klein, 1998).

2.4.1 Executive and non-executive Directors

Through the issue of whether directors should be employees of or afflicted with the firm (inside directors) or outsiders have been well researched, yet no clear conclusion

is reached. On the one hand, inside directors are more familiar with the firm's activities and they can act as monitors to top management if they perceive the opportunity to advance into positions held by incompetent executives. One the other hand, outside directors may act as "professional referees" to ensure that competition among outsider stimulate actions consistent with shareholder value maximization (Fama, 1980). John and Senbet (1998), argue that boards of directors are more independent as the proportion of their outside directors increases. Though it's been argued (Fama and Jensen 1983, Baysinger and Butler 1985, Baysinger Hoskinsson, 1990, Baums 1994) that the effectiveness of the board depends on the optimal mix of inside and outside directions, there is very little theory on the determinants of an optimal board composition (Hermalin and Weisbach 2002).

A number of empirical studies on outside directors support the beneficial monitoring and advisory functions to firm shareholders (Brickley and James 1987) showed that the market rewards firms for appointing market directors. Brickley et al (1994) found a positive relation between proportion of outside directors and the stock-market reaction to poison pill adoptions.. However, Forsberg (1989) found no relation between the proportion of the outside directors and various perfoemance measures. Hermalin & Weisberch (1981) and Bhagat and Black 2002 found no significant relationship between board competition and perfomance.

Yarmack (1996) also showed that, the percentage of outside directors does not significantly affect firm performance.. Argawal and Knoeber (1996) suggest that boards expanded for political reasons often result in too many outsiders on the board, which does not help performance.

Considerable attention has been given to the role of boards in monitoring managers and in removing non-performing CEOs. Jensen (1993) voices his concern that a lack of independent leadership makes it difficult for boards to respond to failures in top management team. Fama and Jensen (1983) voices his concern that a lack of independent leadership makes it difficult for boards to respond to failure in top management and decision control in one individual reduces board's effectiveness in monitoring top management.

2.4.2 The CEO duality and firm performance

Relating CEO duality more specifically to firm performance, researchers however find mixed evidence. Daily & Dalton (1992) find no relationship between CEO duality and performance in entrepreneurial firms. Brickley et.al (1997) show that CEO duality is not associated with inferior performance.

John and Senbet (1998) provide a comprehensive review of the stakeholders' theory of corporate governance. The main issue raised in the theory is the presence of many parties with competing interests in the operations of the firm. They also emphasized the role of non-market mechanisms such as the size of the board, committee structure as important to firm performance. Jensen (2001) critique the stakeholder theory for assuming single-valued objectives. They thus purpose an extension of the theory called an enlightened take holder theory. However, problems relating to empirical testing of the extension have limited its relevance (Sanda et.al 2003).

Corporate governance generally refers to the set of mechanisms that influence decision made by managers when there is a separation of ownership and control. As discussed above, some of the conventional variables used as measured of corporate governance are board size composition and CEO duality.

2.4.3 The global movement towards outside directors

The report on the Financial aspects of Corporate governance issued by the Cadbury Committee recommended among other things that boards of publicly traded U.K companies include at least three outside directors. Although these recommendations have not been legislated, the committee was appointed by the government and the recommendations have been adopted by the LSE. Between publication of the

Cadbury Report and December 2000, at least 18 other countries witnessed publication of similar reports. The introductory statement in the Handbook for Issuers on the Copenhagen Stock Exchange (2001) offers up a justification for this global movement.

Initially the corporate Governance debate arose partly in response to pressure from the increasingly prevalent institutional ownership, and partly in response to financial scandals at the end of the 1980s. The Cadbury Report contained a number of specific recommendations regarding good corporate governance also called 'best practice' or 'code of conduct'. The aim was to meet the demands of the institutional owners and to prevent new business and financial scandals... The debate has more recently moved from primarily being driven by a wish to stimulate 'owner activism' and increase the supervision of management.

In that spirit, in 1993 the Swedish Shareholders Association established guidelines for boards of publicly-traded Swedish corporations that closely mimicked this of the Cadbury committee. In 1994, the Committee Report on Corporate Governance in South Africa recommended that publicly-traded companies have at least 2 outside and outside directors and, in 1995, the Bosch, committee Report on corporate Practices and conduction Australia prescribed that, for listed firms, a majority of the board be outsiders and at lease one-third be independent

In 1998, the Report on Desirable Corporate Governance issued by the Confederation of India Industry promulgated that for large firms at least 30% of the board comprise outside directors unless the chairman of the board is also CEO in which case the fraction of outsiders should be at least 50'; the report on the roles, duties and responsibilities of the Directors of listed companies issues by the stock exchange of Thailand mandated that board of exchange-listed firms have at least 2 outside directors and the Report on Corporate Governance forBelgian listed Companies adopted by the Brussels Stock Exchanges specified that the board consist of a majority of outsiders.

In 1999, at least six countries witnessed the issuance of mandates and/or guidelines for board composition: In Korea, the code of best practice for Corporate Governance, backed by the Korean Stock Exchange, Recommended that financial institutions and large public corporations have at least 3 outside directors and gradually increase the ratio of outsiders to greater than 50% in Malaysia a Report on Corporate Governance issued by the High Level Finance Committee and, in France, the Vienot Report on the Boards of Directors of listed companies in France—proposed that one-third of the board comprise independent outside directors with no fewer than 2 outsiders; in Mexico, the Code of Corporate Governance prepared for listed companies recommended that at least 20% of the board be outsiders; and finally in Greece, the Principles of corporate Governance issued by the Capital Market Commission and in Brazil, the Code of best Practice of Corporate Governance issued by the IBGC, recommended that outsiders comprise at least 50% of the board.

Table1: Overview of previous literature on board size.

	Sample	Board Size	Dependent Variable	Findings
Yermack (1996)	Panel of 452 large US firms (1984 – 1991)	4 to 34 Mean: 12.25 Median: 12	Tobin's Q	• Significant negative effect of board size • Smaller boards fire CEO's more frequently • CEO compensation less performance dependent if board size large • Large changes in board size (>3) have significant price impact.
Huther (1997)	US electricity companies	3 – 16 Mean: 9	Total Variable costs	• Significant cost increasing impact of board size
Eisenber, Sundgren and Wells (1998)	785 small Finnish firms (1992 – 1994)	Mean: 3 .7	Industry effect adjusted ROA	• Significant negative effect of board size • Bad performance implies larger board changes
Conyon and Peck (1998)	2886 firms from UK, 360 from France, 186 from Netherlands, 132 from Denmark, 126 from Italy (1990 – 1995)	Means: UK 8.5 France: 10.5 Netherlands: 10.3 Denmark: 10.7 Italy: 11.8	ROE, modified Tobin,s Q	• Negative board size effect in all equations • ROE: significant negative board effect in 3 countries. • Tobin's Q: significant negative effect in 2 countries.
Postma, van Ees and Sterken (2003)	94 Dutch firms (1996)	Mean 4.95 Median: 5	Market-to book ratio	• Negative board size effect.
Loderer and Payer (2002)	Panel of 169 Swiss firms	Means: Between 10.5 and 8.5 (depending on year) Medians: between 7 and 9 (depending on year	Tobin's Q	• Significant negative relationship between board size and Tobin's • Committee work has no impact of firm value; thus new interpretation – large boards is a sign of bad overall governance system

SECTION THREE: RESEARCH METHODOLOGY

3.1 INTRODUCTION.

This chapter is concerned with the various steps that will facilitate execution of the study to satisfy the study objectives.

These include: population, data collection and data analysis.

3.2 POPULATION

The population of the research will consist of the companies quoted at the Nairobi Stock Exchange over the period of the study 2000 to 2002. The use of the listed firms is due primarily to data availability and reliability because these are required by law to provide end of year financials.

The choice of companies listed in N.S.E. will give this study a chance to look at all sectors of the economy, expect that banks and other financial institutions are excluded because of their huge debt structure which is very much different from other firms, consistent with studies by Faccio and Laster (2000). Also financial companies operate under the Banking Act, which compels them to have certain corporate governance structures, including ownership which non-financial companies are not obliged to have. Financial companies are also closely monitored by the Central Bank of Kenya in order to safeguard depositors' funds and this may influence performance of these companies. The relationship between corporate governance and performance may therefore be difficult to determine.

3.3 DATA 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 NSE and the information on board size, board composition; director share ownership and

CEO duality were extracted. Information on debt, total assets, and firm performance were calculated using information from the same financial statements.

3.4 DATA ANALYSIS

The methodological approach used in most previous work examining the impact of corporate governance on firm performance variables utilizes a multiple regression model, thus the Tobin's Q (Q), a commonly used market measure will be applied. The Q is calculated as the market value of the firm at financial year end divided by the book value of equity at the financial year end (Short and Keasey, 1999). This ratio provides a measure of management's ability to generate a certain stream of income from an asset base and is, therefore an indication of management performance. As in Short and Keasy (1999) intangible assets, is eliminated in calculating the book value of equity in order to eliminate differences resulting from diverse accounting treatments of intangible assets such as brand names and patents.

The four corporate governance mechanisms which will be used are the board size, ownership structure ,outside representation on the board and debt. The first step is to test whether there is any interdependency among these variables. The board size is included to examine whether it constitutes an independent governance mechanism, or whether it is simply related to the other mechanisms, but with no independent impact on other firm characteristics.

The first regression equation contains BOARDSIZE as the independent variable and it refers to the number of directors on the board of the company.
Assuming that all relations are linear then we have:

$$BOARDSIZE_i = \alpha_0+\alpha_1.OUTSIDE_i +\alpha_2.LEV_i +\alpha_3.OWNERSHIP_i +\alpha_4.SIZE_i +\alpha_5.GOV_i +\alpha_6.ROA_i +\alpha_7.IND_i +e_i$$

Large firms naturally have larger boards hence we expect a positive relationship between BOARDSIZE and SIZE, where SIZE is measured as the natural logarithm of total sales. The dummy variable GOV is one if the state owns more than 5% of the firm's equity, and zero otherwise. These variable accounts for the possibility that political influences lead to larger boards with a disproportionate number of government representatives. As stated by by Yermack(1996), small boards could contribute to better performance, or companies might adjust board size in response to past performance in order to increase managerial capacity.To capture possible relationships between operating performance and board size, the current year ROA is included. This variable is defined as the operating income over total assets. To control for industry effects, an industry dummy, labeled as IND is used. The industry classification is from the NSE.

The extent of outside membership on the board is measured as OUTSIDE, i.e the percentage of board seats held by non-officers and members without relationship to the founding family(if any). This is the dependent variable which will form the second equation.

$$OUTSIDE_i=\alpha_0+\alpha_1.BOARDSIZE_i+\alpha_2.LEV_i+\alpha_3.OWNERSHIP_i+\alpha_4.CEO_i$$
$$+\alpha_5.ROA_i+\alpha_6.GOV_i+\alpha_7.IND_i+e_i$$

A dummy variable called CEO as a control variable is used. It will be one if the the CEO is also the Chairman of the Board and zero otherwise. Being a CEO and the Chairman of the Board at the same time alleviates coordination and communication problems. On the other hand, a major conflict within the boardroom is between the CEO and the directors. The CEO has the incentive to capture the board so as to ensure that he can keep his job and increase the other benefits he derives from being the CEO. Directors have the incentives to maintain their independence and monitor the CEO. Shivdasani and Yermack(1999) suggest that a situation where the CEO is also the COB leads to concentration of power and election of less independent board members. To control for government ownership ,the GOV is included.

The third internal governance mechanism is the firm leverage, denoted by LEV, is the ratio of total(non-equity) liabilities to total assets.

$$LEV_i=\alpha_0+\alpha_1.BOARDSIZE_i+\alpha_2.OWNERSHIP_i+\alpha_3.OUTSIDER_i+\alpha_4.SIZE_i$$
$$+\alpha_5.AGE_i+\alpha_6.GROWTH_i+\alpha_7.IND_i+e_i$$

GROWTH, is the average annual sales growth and AGE is the number of years since inception as a private limited company. This is consistent with Jensen's(1986) free cash-flow hypothesis, where mature firms with substantial cash-flows use more debt to discipline managers. To control for industry effects the industry dummies, labeled as IND, is also included.

The other external governance mechanism is the ownership structure and it is the percentage of cumulated voting rights exercised by large investors with more than 5% of voting rights. For firms with unitary shares , this is equivalent to the percentage of actual stockholdings.

$$OWNERSHIP_i=\alpha_0+\alpha_1.BOARDSIZE_i+\alpha_2.LEV_i+\alpha_3.OUTSIDE_i+\alpha_4.SIZE_i$$
$$+\alpha_5.RESTR_i+\alpha_6.GROWTH_i+\alpha_7.IND_i+e_i$$

RESTR is a dummy variable that is one if the firm has different share categries with different voting rights and hence deviates from the one share-one-vote principle.

In the final regression equation the cross-sectional relationship between the mechanisms and firm valuation is examined and it is measured by TOBIN's Q.
A Tobin's Q ratio greater than 1 indicates that the firm has done well with its investment decisions i.e, it has invested in positive net present value projects. In contrast, a value of Tobin's Q lower than 1 indicates that the company not earn its firm the cost of capital with its investment projects.

$$Q_i=\alpha_0+\alpha_1.BOARDSIZE_i+\alpha_2.LEV_i+\alpha_3.OUTSIDER_i+\alpha_4.OWNERSHIP_i$$
$$+\alpha_5.SIZE_i+\alpha_6.GROWTH_i+\alpha_7.ROA_i+\alpha_8.IND_i+e_i$$

Table 2 : Summary of variables

Dependent variables	
Tobin's Q	Ration of market value to book value of assets. Market value of assets is computed as market value of equity plus book value of assets minus book value of equity
BOARD SIZE	Number of directors on the board of the company
OUTSIDER	Outsider membership on the board, measured by the percentage of board seats held by non-officers without relationship to the founding family (if any)
LEV	Leverage, measured as the ration of total (non-equity) liabilities to total assets
OWNERSHIP	Percentage of cumulated voting rights exercised by large investors with >5% of voting rights
Independent variables	
SIZE	Firm size, measured by the natural logarithm of sales
GOV	Dummy variable = 1 if state owns >5%
ROA	Ration of operating income and total assets (return on an assets)
AGE	Number of years since inception as private limited company
RESTR	Dummy variable = 1 if the firm has different share categories with different voting rights attached, = 0 if otherwise
CEO	Dummy variable = 1 if the CEO is also COB, = if otherwise
GROWTH	Average annual growth of sales over the past three years (2000 – 2002)
IND	The industry a firm belongs as per the summary of NSE.

3.4.1 COMPANY SIZE

Company size may affect firm performance through different avenues. First, large companies may be able to easily generate funds internally, and also to access funds from external sources. This allows large companies to easily make investments into profitable projects. The availability of external funding implies that large companies are able to procure foreign currency and secure critical raw materials.

Second, a given economies of scale associated with company size, large companies may be able to create entry barriers which may lead to better performance.

3.4.2 GEARING RATIO

Gearing may also influence firm performance. Debt holders have incentives to exert significant influence over the behavior and actions of managers.

Stiglitz (1985) states that control over management actions is more effectively exercised by debt holders than by shareholders. In Kenya , the source of external debt financing is mainly from banks. These institutions have incentives to monitor managers to ensure that they adhere to debt covenants. This is perhaps particularly more critically in a crisis situation such as in Kenya, since there is a danger that poor performing companies are more likely to liquidate. Debt may also be a signal by managers that they have bonded themselves to achieve the cash flows to meet the repayment. (Jensen, 1986: Short and Keasy, 1999). Thus debt may resolve the conflict of interest between shareholders and managers as it helps in reducing shirking by managers therefore increase firm value.

The industry in which the company operates may also influence firm performance. Short and Keasy, 1999 found that industry sector is significant determinant of firm performance. The reason for this being that performance may be influenced by the sensitivity of certain industries to macroeconomic, as well as to political factors.

SECTION FOUR: DATA ANALYSIS AND FINDINGS

4.1 Data Analysis and Discussion

Of the firms studied, the mean board size was 7.18 suggesting that firms in Kenya have relatively moderate board sizes. With a maximum of thirteen and deviation of 2.85, the implication is that firms in Kenya have relatively similar board sizes. This is essentially good for firm performance according to researchers such as Jewen (1993).

However, there are pronounced differences between firms with and without government influence. Specifically, there are nine firms in the sample where some state authority owns more than 5% of the firm's equity. On average, board size for these firms is 9.77. The difference in board size is statistically significant. The average value of Tobin's Q is 0.52, the median 0.32. This indicate, that Kenyan firms on average, does not invest in positive NPV projects.

On the average, most of the firms appear not to be doing well with regards to Tobin's Q as a performance variable. By implication most of the firms do not break even on this front. While the maximum performance is about 4.75, the minimum performances is -0.15. With regards to return on assets (ROA), there is a wide deviation between the firms. Showing a mean performance of 4.8%, the maximum of 20.8% and the minimum of -11.5% with a relatively high deviation of 7.6% between the firms.

Table 3 Descriptive Statistics

Variable	Board size	Outsider	Ownership	Gov	Lev	Tobin q	ROA
Mean	6.18	4.55	0.79	0.25	0.47	0.52	0.048
Median	8.00	4.50	0.78	0.00	0.39	0.32	0.035
S.D	2.85	2.72	0.12	0.44	0.19	0.79	0.076
Max./Min.	15/3	10/2	0.98/0.54	1/0	0.80/ 0.07	4.75/ -0.15	0.208/ -0.115

Lipton and Lorsch (1992) and Jewen (1993) argue that for aboard size beyond seven or eight the benefits of increasing monitoring capacities is outweighed by such costs as slower decision making. 78.9% of the firms in the sample have a board size equal to or less than eight. Figure 1 shows the values of Tobins, Q for companies sorted by size. There is no obvious relationship between the two variables i.e in a univariate analysis larger board sizes are not associated with lower valuations. This is a sharp contrast to the results in Yermack (1996) for US data. Plotting board size against average Tobin's Q, he find that Tobins Q values decline almost monotonically over the range of board size. For board sizes, below six, however, he also reports no consistent association between board size and firm value. In contrast, Eisenberg Sundgren and Wells (1998) prevent a figure with a negative relationship between the two variables for their sample of finish firms, even though average board size is only 3.7.

Figure 1: Tobin's Q and board size

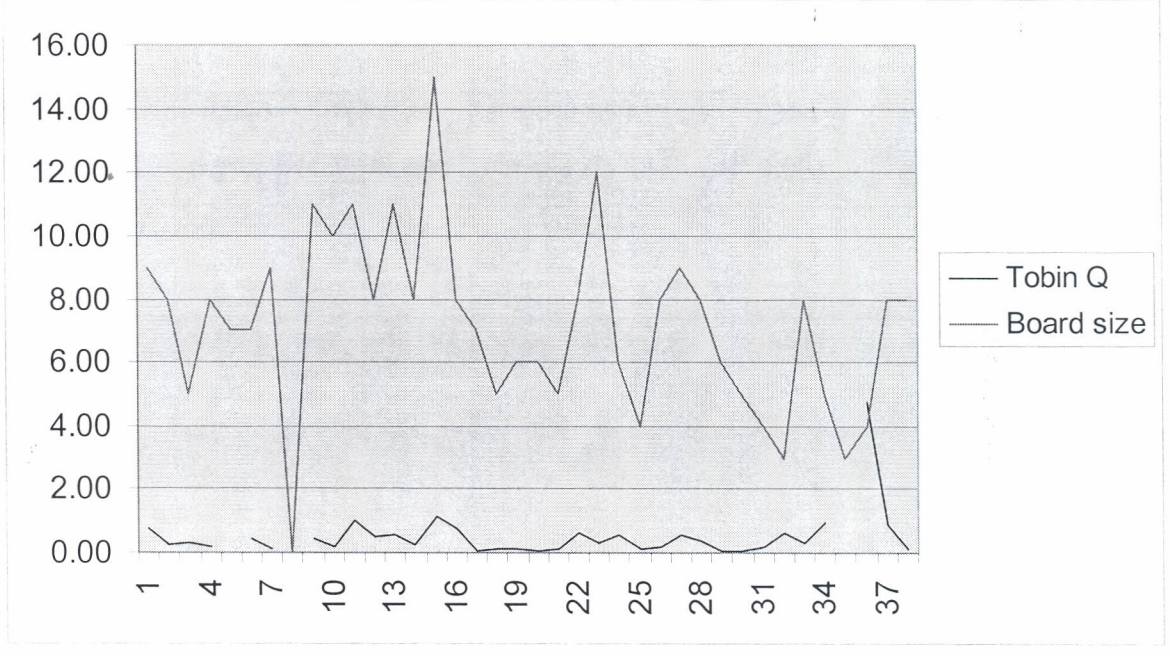

Table 3 further shows that the average of outsider is 4.55 (0.63), which is in contrast to the results of Yermack (1996). The larger boards are correlated with a greater proportion of outside directors, but this is a weak correlation. The relationship strengthens if the natural log of proportion of outside directors is taken. Also the proportion of outside directors is positively correlated with the firm size as measured by assets and revenue, but not with market capitalization. Greater level of diversification is not associated with a higher proportion of outside directors. With respect to the chairman, there is a notable lack of CEO duality. Interestingly, having an independent chairman is related to a larger board size and a higher proportion of outside directors and is associated with larger companies. He reports a lower value of 0.54 for US firms.

The average leverage ratio (LEV) is 44% and the average of ownership is 0.79

Table 4: Correlation matrix between the governance mechanisms

	Board size	Tobin Q	Lev	Ownership %	Outside directors %
Board size	1	-0.063	0.298	-0.279	0.094
Tobin Q	-0.063	1	0.050	0.314	-0.191
LEV	0.298	0.050	1	-0.051	0.154
Ownership %	-0.279	0.314	-0.51	1	-0.311
Outside Directors	0.094	-0.191	0.154	-0.311	1

4.2 Correlation Coefficients Between Tobin's Q and the four Governance Mechanisms.

All correlations are relatively small; expect the correlation between board size and LEV (0.298), and Tobin Q and ownership (0.314). The controlling variable are gathered from different sources. Size is measured as the natural logarithm of sales in 2002. Growth is defined as the average annual sale, growth over the past three years (2000 – 2002). For the firms, which went public after 2000, average sales growth since IPO was used. ROA is defined as the ratio of operating income to total assets, where operating income is measured as of end 2002. Total assets and book equity are simple averages of the respective starting ending values. The corresponding list of firms with voting restriction, for the variable RESTR can directly be found in the NSE.

4.3 Relationship among the governance mechanisms

Under this section 1 describe the empirical results i.e examining the interdependencies among the four governance mechanism, and extend the simultaneous system of equations and analyze the relationship between firm valuation and the governance mechanisms.

4.3.1 Dependent variable Tobin Q

The regression results show the relationship between Tobin q (Q) and the governance variables. The result clearly indicates that there exists a mixed result between the governance variables and this performance variable.

Table 5: Dependent variable: Tobin Q

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
(Constant)	2.989	3.149		.949	.352
Board size	-.011	.112	-.036	-.101	.921
LEV	.929	.962	.186	.966	.344
Outside Directors	.072	.154	.188	.470	.643
Ownership %	.020	.015	.296	1.390	.178
Size	-.200	.165	-.437	-1.217	.236
Growth-3 years sales average	.000	.000	.300	.979	.338
ROA	4.157	3.158	.292	1.316	.201
IND	-.442	.222	-.444	-1.988	.059

The results support the studies by Jensen (1993), Lipton and Lorsih (1992), Yermack (1996), the study shows that there is no relationship between the size of the board and the firm performance, thus board size is not highly significant in explaining Tobin's q for firms in Kenya.

The board composition has a positive relationship with Tobin's Q implying that when there are more external board members, performance of the firm tend to be better. This supports other empirical studies by Weisbach (1988) that outside director support is beneficial in the monitoring and advisory functions to form shareholders. Market, also reward firms appointing outside directors. However, this is not consistent with the findings of Agrawal & Knoeber (1996) who suggest that boards expanded for political reasons of ten results in too many outsiders on the board which does not help performance.

The study also suggests that the size of the firm has a negative impact on Tobin's q. This could however, be explained by the fact that the size of the firm measured by its asset base does not necessarily enhance performance if this is not put to efficient use. The implication therefore is that most firms in Kenya are not utilizing their size to enhance their performance. However, the contrary results obtained from the asset structure suggest that, the more fixed assets there are the better the performance of

Tobin's q. Firms that mostly have huge proportions of debt in their assets portfolio perform better. The significantly positive regression coefficient for total debt implies that, an increase in the debt position is associated with increase in performance. The results conform findings by Hadlock & James (2002), who found out that profitable firms use more debt. Again, this suggests that profitable firms depend more on debt as their main financing option. Studies by Fama and Jensen (1983) have asserted that the effectiveness of a board depends on the optimal mix of inside and outside directors. A situation where the CEO doubles as the board chairman leads to conflict of interest and increases agency costs as pointed by Fama & Jensen (1983) who argue that concentration of decision making and control in one individual reduces board's effectiveness in monitoring top management thereby having a negative impact on profitability. It was noted that the one-tier board structure type leads to leadership facing conflict of interest and agency problems.

4.3.2 Dependent Variable Board size

The board size is positively related to outside directors, leverage, ownership, GOV and ROA. It suggests that firms should have larger board sizes, especially when considering ROA. This contradicts findings made by researchers such as Jewen (1993) and Lipton & Lorsch (1992). In the light of the foregoing analysis, should boards thus be increased indefinitely? The fundamental problem is really to have an optimal board size for effective performance of firms in Kenya. The issue of optimal board size has come up in other studies, but have not really been dealt with thoroughly and thus have left it determinants largely unidentified.

Table 6: Dependent variable: Board Size

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	-2.337	2.525		-.925	.364
Outside Directors	1.029	.159	.842	6.480	.000
LEV	1.793	1.665	.113	1.077	.292
Ownership %	.051	.027	.232	1.885	.072
Gov	1.068	.876	.179	1.220	.234
ROA	3.538	6.156	.078	.575	.571
Tobin Q	-.223	.386	-.070	-.577	.569
IND	-.320	.493	-.101	-.649	.523

4.3.3 Dependent variable outside Directors

An important attribute of board composition is the distribution of members according to their primary allegiance, which may be either to shareholders (outside) or manager. In this respect, the governance literature suggests that an inside director, either a top executive or important shareholder.

The results shows that board composition is positively related to ROA implying that, the more outsiders there are on aboard, the better the performance. The regression results also indicate that the board size is positively related to the outside directors. The more there are outside directors, the larger the board size. Surprisingly, the results further indicate that when a CEO doubles as the board chairman, performance improves.

Table 7: Dependent variable: Outside Directors

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	4.519	1.789		2.526	.019
Board size	.635	.104	.776	6.111	.000
LEV	-.667	1.306	-.051	-.511	.614
Ownership %	-.050	.020	-.278	-2.514	.019
CEO	.294	.856	.046	.344	.734
ROA	1.844	4.391	.050	.420	.678
IND	-.013	.403	-.005	-.032	.975
Gov	.178	.711	.036	.251	.804

4.2.4 Dependent variable leverage

The asset structure, the size of the firm and the debt structure are all positively related to Tobin Q. by implication, the findings suggests that forms in Kenya rely on debt, with a huge composition of fixed assets in their portfolio tend to perform better likewise firms that have more debts in their capital structure. Thus firms in Kenya should lean towards having more debts and increase in size to enjoy economies of sale. The results are presented in the table below.

Table 8: Dependent variable: Leverage

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	.167	.683		.245	.808
Board size	.028	.025	.443	1.130	.270
Ownership %	.000	.003	-.013	-.056	.956
Outside Directors	-.035	.034	-.450	-1.035	.311
Size	.011	.035	.125	.331	.743
Age	-.002	.002	-.201	-.987	.334
Growth-3 years sales average	.000	.000	.166	.534	.598
IND	.008	.041	.038	.186	.854

SECTION FIVE: CONCLUSION

5.1 Summary and Conclusions

The importance of corporate governance cannot be over-emphasized since it enhances the organizational climate for the internal structures and performance of a company. Indeed, corporate governance brings to bear through external independent directors, new dimension for effective running of a corporate entity thereby enhancing a firm's corporate entrepreneurship and competitiveness.

The study examined the relationship between some measures of corporate governance such as board size, board composition, and CEO duality and firm performance of listed non-financial institutions in Kenya. The banks and other financial institutions were excluded due to their huge debt structures. The mean board size for the sample was found to be 7.18 and the maximum of fifteen and a deviation of 2.85. This is a consistent with the study of Mwangi (2004) who found out that the average board size was eight members and the outside representations constitutes about 71.23%. With regards to board composition, the mean ratio of about 63% implies the use of more outside directors on the board in the overall sample. It was also evident from the sample that most firms in Kenya adopt the two-tier board structure where the positions of board chairman and CEO are occupied by different personalities thereby reducing agency costs. The firms were of similar sizes indicated by their asset base, fixed assets forms a major component of their total assets and that most of the firms depend largely on debt financing as compared to equity financing.

The regression results further shows that board size is negatively related to Tobin's Q and ownership but positively related to leverage and outside directors. Like other studies, the findings of the study support the fact that a two-tier board structure enhances firm's performance, though it insignificantly has a positive impact on ROA. The separation of board chairman and chief executive officer positions minimizes the

tension between managers and board members thus influencing positively the performance of firms in Kenya.

The study also shows significantly that the more fixed assets there are in a firm's assets portfolio, the better the performance. Firms also resort to debt financing and they also perform better.

In the light of the foregoing analysis it is obvious that there is relatively mixed results regarding corporate governance and performance. It must however, be stated that this is consistent with other studies. However, for efficient performance of firms the adoption of the two-tier board structure and maintaining smaller board sizes that hooves around seven members is critical.

Corporate governance embraces a broader set of variables, such as economic and legal environment, progressive practices, existence of internal control measures, ownership and compensation structures within an institution, the nature and quality of information flow and the level of involvement of staff in the day to day decisions of corporate entity.

5.2 Limitations of the Study

1. The study only concentrated on the quoted companies at the NSE, thus the unquoted companies were not covered.
2. There was limitation of time to undertake the study.
3. Unavailability of data. There were companies whose data were unavailable. The sample taken did not include all the companies quoted at the NSE.
4. The number of quoted companies quoted at the NSE are small compared to other studies carried out in developed stock exchange markets.
5. There was possible omission of governance variables that may be relevant in

performance equation or with strong relations to other governance mechanisms. The extent to which some firms rely on subordinate debt may help them reduce agency problems between managers and shareholders, and possibly rely less on other governance mechanisms. Therefore, the system of of equations may be misspecified.

5.3 Suggestions for further research and recommendations

This study concentrated on the efficiency of board size and board composition on firm performance and the performance was measured by Tobin Q and ROA. The findings of this study suggest possible trails for future research. Other areas which researchers can consider are:

1. The study on firms from other possible regulated industries, such as airline companies, media companies, banking and financial institutions.
2. The effect of board size and board composition on the firm performance using other accounting measures.
3. The effect of the board characteristics on the firm performance considering the unquoted companies.
4. The optimal mix among the corporate governance variables and the firms performance.

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Table 9. Summary of the Firms

	2000	2001	2002
Total listed	49	50	50
Less: Financial Companies	11	11	11
Less Companies with no data	6	6	5
Final Sample	32	33	34

Table 10: Listed Companies and Corporate Governance Variables

	Board Size	Age	Year listed	CEO	Outside directors	Outside directors %	Ownership	Gov.	Restr
Brooke Bond	9	30	1972	0	7	77.78	93.45	0	0
Kakuzi	8	51	1951	0	3	37.5	67.58	0	0
Rea Vipingo	5	6	1996	0	4	80	69.8	0	0
Sasini	8	37	1965	0	6	75	76.53	0	0
Car & General	7	66	1936	0	5	71.43	87.67	0	0
CMC	9	52	1950	0	7	77.78	63.98	0	0
Kenya Airways	11	6	1996	0	9	81.82	60.27	1	0
Marshalls	10	48	1954	0	6	75	89.41	0	0
Nation Media	11	29	1973	0	10	90.91	64.23	0	0
TPS Serena	8	5	1997	0	6	75	78.62	0	0
Uchumi Supermarkets	11	10	1992	0	9	81.82	68.44	1	0
Athi River Mining	8	5	1997	0	5	62.5	78.72	1	0
Bamburi Cement	15	32	1970	0	9	60	92.53	1	0
BAT	8	33	1969	0	6	75	85.31	0	0
BOC	7	33	1969	0	5	71.42	80.57	0	0
Carbacid	5	30	1972	0	3	60	73.05	0	0
Crown-Berger	6	10	1992	0	5	71.43	76.6	0	0
Dunlop	6	28	1974	0	4	66.67	80.36	0	0
EA Cables	5	29	1973	0	4	80	81.97	0	0
EABL	12	30	1972	0	7	58.33	67.66	1	0
Firestone	6	8	1994	0	4	66.67	88.94	0	0
Kenya Oil	4	43	1959	0	3	75	88.96	0	0
Mumias Sugar	8	1	2001	0	7	87.5	54.32	1	0
KPLC	9	30	1972	0	8	88.89	63.16	1	0
Total Kenya	8	14	1988	0	4	50	98.8	0	0
Unga Group	6	31	1971	0	5	83.33	70.77	1	0
A Baumann	5	54	1948	0	3	60	78.08	0	0
City Trust	4	52	1950	0	2	50		0	0
Eaagads	3	30	1972	1	2	66.67	95.18	0	0
Kapchorua	5	30	1972	1	4	80	95.25	0	0
Limuru Tea	4	35	1967	1	2	50	91.97	0	0
Standard Newspaper	8	48	1954	0	3	37.5	94.08	0	0
Williamson Tea	8	30	1972	1	6	75	68.15	0	0

Table 11: Listed Companies and Tobin Q

	IND	LEV	Operating Income 000	ROA	SIZE	Turnover	Growth (3yrs sales average)	TOBIN Q
Brooke Bond	1	0.253	217,603.00	0.035	22.170	4,251,285.00	4,246,792.00	0.76
Kakuzi	1	0.364	8,471.00	0.003	20.802	1,082,190.00	1,181,976.00	0.26
Rea Vipingo	1	0.47	47,108.00	0.057	20.317	65,380.00	619,995.00	0.32
Sasini	2	0.169	-68,415.00	-0.031	20.559	848,445.00	913,510.00	0.18
Car & General	2	0.467	20,074.00	0.034	19.895	436,741	433,294.00	0.44
CMC	2	0.065	241,150.00	0.054	22.239	4,552,390.00	4,296,321.00	-0.13
Kenya Airways	2	0.667	1,059,000.00	0.048	23.949	225,165,000.00	21,723,333.00	0.44
Marshalls	2	0.708	1,799.00	0.002	21.077	1,424,543.00	1,472,406.00	0.22
Nation Media	2	0.381	637,200.00	0.176	22.135	4,103,400.00	3,554,933.00	1.02
TPS Serena	2	0.539	168,987.00	0.080	21.095	1,450,158.00	1,442,969.00	0.50
Uchumi Supermarkets	2	0.645	80,206.00	0.032	22.795	7,936,755.00	7,706,377.00	0.57
Athi River Mining	3	0.39	82,136.00	0.058	20.842	1,126,195.00	916,847.00	0.23
Bamburi Cement	3	0.322	2,083,000.00	0.138	23.033	10,073,000.00	8,892,333.00	1.13
BAT	3	0.389	1,310,423.00	0.208	22.967	9,422,530.00	10,227,318.00	0.75
BOC	3	0.263	154,990.00	0.121	20.363	697,504.00	368,391.00	0.06
Carbacid	3	0.45	78,859.00	0.103	18.977	174,433.00	183,107.00	0.15
Crown-Berger	3	0.4	93,412.00	0.107	20.810	1,090,626.00	1,045,293.00	-0.15
Dunlop	3	0.448	21,812.00	-0.156	18.034	67,919.00	73,103.00	0.07
EA Cables	3	0.286	-4,954.00	-0.015	19.777	33,008.00	381,808.00	0.10
EA Portland	3	0.75	212,934.00	0.029	21.889	3,207,060.00	3,098,244.00	0.63
EABL	3	0.434	3,400,411.00	0.188	24.046	27,734,679.00	26,665,541.00	0.34
Firestone	3	0.274	310,834.00	0.122	21.730	2,736,739.00	2,831,856.00	0.60
Kenya Oil	3	0.514	679,174.00	0.155	23.312	13,317,933.00	10,281,040.00	0.15
Mumias Sugar	3	0.468	104,552.00	0.011	22.783	7,847,233.00	7,253,274.00	0.19
KPLC	3	0.565	-2,849,116.00	-0.091	23.934	24,807,649.00	25,520,213.00	0.54
Total Kenya	3	0.489	604,776.00	0.099	23.514	69,261,258.00	19,124,797.00	0.39
Unga Group	3	0.373	-135,858.00	-0.043	22.428	5,500,307.00	6,490,593.00	0.08
A Baumann	2	0.136	-51,494.00	-0.115	18.541	112,749.00	113,131.00	0.08
City Trust	2	0.069	7,283.00	0.035	16.029	9,145.00	11,394.00	0.20
Eaagads	1	0.237	6,391.00	0.032	18.222	82,037.00	69,190.00	0.62
Express Kenya	2	0.706	-32,908.00	-0.036	22.003	3,595,292.00	3,382,171.00	0.32
Kapchorua	1	0.232	-18,019.00	-0.028	19.76	383,334.00	357,942.00	0.93
Limuru Tea	1	0.387	4,082.00	0.088	17.68	47,654.00	49,792.00	4.75
Standard Newspaper	2	0.798	14,550.00	0.02	21.00	1,321,611.00	1,196,902.00	0.90
Williamson Tea	1	0.289	-38,300.00	-0.016	20.073	1,010,236.00	1,103,643.00	0.11

APPENDICES

APPENDIX 1:

LIST OF COMPANIES

Main Investment Market Segment

Agricultural
Brook Bond Ltd.
Kakuzi Ltd
Rea Vipingo Plantations Ltd
Sasini Tea and Coffee Ltd.

Commercial and Services
African Lakes Corporation PLC
Car and General (K) Ltd
CMC Holdings Ltd
Hutchings Biemer Ltd
Kenya Airways Ltd
Marshalls (E.A.) Ltd
Nation Media Group
Tourism Promotion Services Ltd.
Uchumi Supermarket Ltd

Finance and Investment
Barclays Bank Ltd
C.F.C. Bank Ltd
Housing Finance Co. Ltd
I.C.D.C. Investment Co. Ltd
Jubilee Insurance Co. Ltd
Kenya Commercial Bank Ltd
National Bank of Kenya Ltd
NIC Bank Ltd
Pan African Insurance Ltd.
Standard Chartered Bank Ltd.

Industrial and Allied:

Athi River Mining
B.O.C. Kenya Ltd.
Bamburi Cement
British American Tobacco Kenya Ltd
Carbacid Investments Ltd
Crown Berger Ltd
Dunlop Kenya
E.A Cables Ltd
E.A. Portland Cement Ltd
East African Breweries Ltd
Firestone East African Ltd
Kenya Oil Company Ltd
Mumia Sugar Compay Ltd
Kenya Power and Lighting Ltd
Unga Group Ltd.

Alternative Investment Market Segment:

A.Baumann and Company Ltd.
City Trust Ltd
E.A. Packaging Ltd
Eaagads Ltd.
Express Ltd.
Williamson Tea Kenya Ltd
Kapchorua Tea Company Ltd
Kenya Orchards Ltd
Limuru Tea Company Ltd.
Standard Newspaper Group

APPENDIX 2

COMPANIES THAT CONSTITUTE THE CALCULATION OF NSE 20 SHARE INDEX.

Unilever Tea Kenya Limited

Williamson Tea Kenya Limited

Kakuzi

Sasini Tea and Coffee Limited

Kenya Airways Limited

TPS – Serena

Nation Media Group

Barclays Bank (K) Limited

Diamond Trust Bank Kenya Limited

Kenya Commercial Bank Limited

Standard Chartered Bank Limited

Bamburi Cement Limited

British Oxygen Company Kenya Limited

National Industrial Credit Bank Limited

East Africa Breweries Limited

Sameer East Africa Limited

Kenya Power and Lighting Company Limited

Total Kenya Limited

APPENDIX 3: LEETER OF INTRODUCTION

Dear sir/madam

RE: Request for Research Information

I am a postgraduate student at the faculty of commerce, University Of Nairobi, As part of my MBA (Finance) course requirements, I am undertaking a research project that seeks to establish. **THE RELATIONSHIP BETWEEN BOARD SIZE AND BOARD COMPOSITION ON FIRM PERFORMANCE .A STUDY OF QUOTED CAMPANIES AT THE NAIROBI STOCK EXCHANGE.**

To fulfill information requirement for my study I intend to collect secondary data from your institution. The information requested is needed for purely academic purposes and will be treated in strict confidence, and will not be used for any other purpose other than for my research.

I would be most grateful if you can allow me access to all the relevant information pertinent for this research. Any addition information you might consider necessary for this study is most welcome. I appreciate your assistance in accessing the much-needed information.

Yours sincerely,

OKIRO K.O

Supervisor
Mr.Luther Otieno

DEPT. OF ACCOUNTING
U.O.N