

**THE EFFECTS OF OWNERSHIP STRUCTURE, BOARD EFFECTIVENESS
AND MANAGERIAL DISCRETION ON PERFORMANCE OF LISTED
COMPANIES IN KENYA**

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**Thesis submitted in fulfillment of the requirements for the award of the degree of
Doctor of Philosophy (Ph D) in Business Administration, School of Business,
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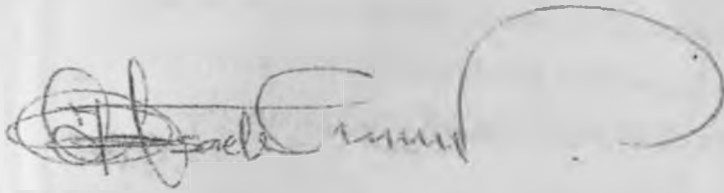


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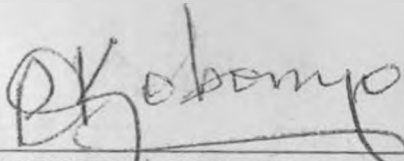
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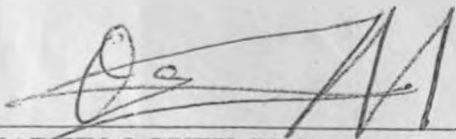


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DEDICATION

The thesis is dedicated to my mother, **Susana Sind nyar Obara**, who, although widowed in her early 40's without formal education or source of regular income, demonstrated exceptional tenacity and resilience in the face of deprivation to take me through school.

I pray to the Almighty God to grant her full life.

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It is my wish that this humble thesis will contribute in a small way to the already existing body of knowledge that can be tapped for the good of our beloved country, Kenya; our beloved continent, Africa; and our beloved, and the only World we know.

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LIST OF ABBREVIATIONS AND ACRONYMS

ACCA	-	Association of Chartered Certified Accountants
AIMS	-	Alternative Investments Market Segment
ANOVA	-	Analysis of Variance
BAT	-	British American Tobacco
BBK	-	Barclays Bank of Kenya
BODEFFECT	-	Board Effectiveness
CEO	-	Chief Executive Officer
CMC	-	Cooper Motors Corporation
CCGK	-	Centre for Corporate Governance in Kenya
CMA	-	Capital Markets Authority
CORPOWN	-	Corporation Ownership
DY	-	Dividend Yield
DV	-	Dependent Variable
EA	-	East Africa
EABL	-	East African Breweries Limited
FISM	-	Fixed Income Securities Market
FOMS	-	Futures and Options Market Segment
FORENOWN	-	Foreign Ownership
GA	-	General Assessment
GCGF	-	Global Corporate Governance Forum
GOVOWN	-	Government Ownership
ICDC	-	Industrial and Commercial Development Corporation
ICPAK	-	Institute of Certified Public Accountants of Kenya
IPAR	-	Institute for Public Analysis and Research
IV	-	Independent Variable
KENATCO	-	Kenya National Transport Company
KENYA-RE	-	Kenya Reinsurance Corporation
KCB	-	Kenya Commercial Bank
KNAC	-	Kenya National Assurance Company

KCC	-	Kenya Co-operative Creameries
KICOMI	-	Kisumu Cotton Mills
KENGEN	-	Kenya Electricity Generation Company
KMC	-	Kenya Meat Commission
KPLC	-	Kenya Power and Lighting Company
LA	-	Leadership Assessment
LC	-	Locus of Control
MANDISC	-	Managerial Discretion
MANDMAKI	-	Product of Managerial Discretion and Market Influences
MANDINTI	-	Product of Managerial Discretion and Internal Influences
MATINF	-	Market Influence
MIMS	-	Main Investments Market Segment
MA	-	Monitoring Assessment
MV	-	Moderating Variable
NBK	-	National Bank of Kenya
NSE	-	Nairobi Stock Exchange
OLS	-	Ordinary Least Square
OWNCONC	-	Ownership Concentration
PD	-	Perception of Discretion
PP	-	Perceived Power
PSCGT	-	Private Sector Corporate Governance Trust
PSICG	-	Private Sector Initiative for Corporate Governance
RA	-	Reporting Assessment
ROA	-	Return on Assets
ROE	-	Return on Equity
RIVATEX	-	Rift Valley Textiles
SA	-	Stewardship Assessment
UK	-	United Kingdom
USA	-	United States of America
VIF	-	Variance-Inflation Factor

ABSTRACT

The study investigated the effects of ownership structure, board effectiveness and managerial discretion on performance of listed companies in Kenya. Pertinent literature on corporate governance has paid much attention to effectiveness of the Board of Directors, to the exclusion of other vital organs and structures of governance such as ownership structure and management. The study therefore, sought to establish the role of these other organs alongside the Board in the overall governance of the firm, using Agency Theory as an analytical framework.

Ownership structure was operationalized in terms of ownership concentration (percentage of shares owned by the top five shareholders) and ownership identity (actual identity of shareholders: Government; Corporations/Institutions; managers/Insiders; Foreign; and Diffuse/Diverse). Board effectiveness was operationalized in terms of Leadership, Monitoring, Stewardship and Reporting, while Managerial Discretion was operationalized in terms of Locus of Control, Perceived Power and Perceived Discretion. Measures of performance used in the study were Return on Assets (ROA), Return on Equity (ROE) and Dividend Yield (DY).

All the fifty four companies listed at the Nairobi Stock Exchange were targeted for this study, but after eliminating five of them which were listed in 2006, and one that was on suspension from the bourse, forty eight companies were eligible, out of which forty two valid questionnaires were used. Both primary and secondary data were used in this study. The secondary data (financial performance and ownership concentration) were collected from the Nairobi Stock Exchange Handbook for 2006. On the other hand, primary data (ownership identity, board effectiveness and managerial discretion) were collected using a customized Brown Governance Evaluative Framework questionnaire.

The study was cross sectional design that utilized data for 2006 only. Both primary and secondary data were collected in 2008, although they related to 2006 because the data for 2007 was not ready by the time of data collection. Because of the time lag between 2006 and early 2008 when the data was collected, the researcher ensured that respondents were

chosen only from amongst those who were in the companies by 2006, and were well conversant with the issues being studied. In this regard, the respondents were purposively chosen from the ranks of Chief Executive Officer, Top Management and Line Management.

The study employed Pearson's Product Moment Correlation, Linear Regression, Logistic Regression, Moderation models, and Step-wise Regression and Hierarchical Change Statistics (i.e. ANOVA and F Tests) for data analysis and tests. The results of the study indicated that Ownership Concentration, Board Effectiveness and Government Ownership have significant negative relationships with firm performance. This is attributable to the excessive monitoring, control and ratification powers that principals wield over managers in such ownership arrangements, and this grossly emasculates managerial innovation and creativity, thereby compromising corporate performance. On the other hand, Foreign Ownership, Diffuse Ownership, Corporation Ownership, Manager Ownership were found to have positive relationship with firm performance, principally because these ownership scenarios afford managers sufficient discretion for innovation and creativity, which in turn translate to superior corporate performance.

The strength of the relationship between managerial discretion and firm performance was found to be moderated by internal influences (i.e. size, intangible assets and leverage) in terms of Return on Assets and Return on Equity, but not with respect to Dividend Yield. The relationship between managerial discretion and firm performance was moderated by market influences (i.e. managerial labor markets, product market and financial markets) only with regard to Dividend Yield, but not Return on Assets or Return on Equity. These results clearly indicate that market influences moderate the relationship with regard to the market-dependent performance indicator (DY), while internal influences moderate the relationship with regard to internal indicators (i.e. Return on Assets and Return on Equity). Using ANOVA and F-tests, the study showed that the relationship between Ownership Structure and firm performance was direct (i.e. not hierarchical through board effectiveness and managerial discretion).

The study had a number of implications both for theory as well as practice. First, the study found Agency Theory to be very robust as an analytical framework for corporate governance. Second, the Board of Directors, as the core of traditional corporate governance framework was found to be inadequate, and needs to be invigorated. Third, risk preference of shareholders is critical to corporate performance. Equally important is the fact that managerial motivation and entrenchment through executive share options and other perks improves corporate performance.

CHAPTER 1: INTRODUCTION

1.1. Background

The relationship between ownership structure and firm performance has become a key issue in understanding the effectiveness of alternative corporate governance mechanisms. Indeed, this relationship has been studied since the pioneering work by Berle and Mean (1932). Many researchers (Guner and Kursat, 1998; Jensen and Meckling, 1976; and Amoako, 2000) have recognized that organizations are an efficient form of enterprise that benefits both society and the corporations themselves. In Kenya, for example, IPAR (2000) posits that firms are the most formidable institutional framework for mobilization of resources necessary for capital accumulation and acceleration of wealth creation. It is, however, disheartening to note that corporate performance in Kenya has been dismal over the past one decade. According to NSE reports (2002, 2006), 15 per cent of all firms listed at the bourse between 1998 and 2006 reported accounting losses, and only about 38 per cent consistently paid annual dividends during that period. This trend of poor corporate performance is a threat to the expansion of the Kenyan economy as it sends negative signals to potential investors regarding the safety of their capital.

When investors buy shares in a company or purchase its debt securities, they must have faith not only that the company's financial statements have been prepared using high-quality accounting standards designed to accurately reflect the company's financial condition, but also in the relevant socio-political and economic fundamentals of the host country. Besides, investors need an assurance that there is in place effective corporate governance structure that can sustain superior performance and wealth-creation in line with owner preferences. Sarbanes-Oxley (2002) strongly argues that if investors do not have this confidence, they will insist on a risk premium for their investments. The cost of capital will increase for these companies, with the obviously negative impact on investment and other capital decisions (Ibid, pp.54).

As it becomes extremely time-consuming for investors to distinguish the good from the bad, they will tend to invest in other markets or perhaps not invest at all. This will

obviously deny the affected economies the much-needed financial resources for investment, capital accumulation and employment-creation. Different countries have responded variously to the problems of corporate governance, but what is significant is that there has been a global recognition of the need for reforms. This is critical, because simply fixing the problem in one market may lead to its reappearance in other markets.

The fundamental issue for investors and shareholders alike is, regardless of company or country, to maintain high standards—legal, regulatory and ethical—that breed trust and confidence. This becomes particularly important at a time when those who are entrusted with the stewardship of corporate resources can move capital around the world with great ease, courtesy of advancements in information and computer technology. Researchers (Donaldson, 2005; Sarbanes-Oxley, 2002) have demonstrated that capital will flee harsh environments that are unstable or unpredictable, whether that is due to lax corporate governance, ineffective accounting standards, a lack of transparency, or a weak enforcement regime.

It is therefore, incumbent upon investors and shareholders to ensure that companies are living up to their mandate, and embracing the spirit of wealth-creation for their owners. Only then will the place of companies and world's securities markets as an engine of prosperity be assured. Corporate restructuring has been considered as the panacea to corporate failure, and a precursor for the increased profitability and success of companies in Kenya. In its report on the performance of the Kenyan economy, IPAR (2000) concludes that a robust corporate sector is a necessary ingredient for economic performance.

Two competing approaches to corporate restructuring have been suggested, namely, the market approach and the ownership approach. The market approach is premised on the contention that if markets for products, factors of production and corporate control are put in place and given the requisite capacity to function well, corporate performance can be enhanced without dramatic changes in ownership. Proponents of the ownership approach on the other hand, argue that appropriate ownership structure and corporate governance is a necessary condition for firm efficiency and enhanced performance. Reflecting on the two

alternative views, and considering the varying levels of market inefficiencies, Xu and Wang (1997) have argued that developing countries that are still subject gross market inefficiencies should adopt the ownership approach. In Kenya, for instance, Jones and Cullis (1991) and Anyang' Nyong'o (2000) argue that macroeconomic performance is sometimes not explained by economic fundamentals but political whims, often rendering investment decision making difficult. This study adopts the ownership approach to explain the correlation between ownership structure and firm performance. In a nutshell, therefore, this study investigates whether corporate governance issues such as ownership structure, board effectiveness and managerial discretion, have significant effects on the performance of publicly listed companies in Kenya.

1.1.1. Corporate Governance

The concept of corporate governance has received a great deal of attention worldwide in both the private and public sectors over the last decade, mainly attributable to the high profile cases of corporate failures. According to Gomez (2005), Corporate Governance can be defined as the manner in which the power of a corporate entity is exercised in the stewardship of the entity's total portfolio of assets and resources with the objective of maintaining and increasing shareholder value while ensuring stakeholder satisfaction within the context of its corporate mission. In broad terms, therefore, corporate governance refers to the processes by which corporate entities are directed, controlled and made accountable. It encompasses the authority, accountability, stewardship, leadership, direction and control exercised in corporations (Gomez, 2005).

According to Maher and Andersson (1999), corporate governance not only affects microeconomic efficiency by facilitating the development and functioning of the capital market and resource allocation, but also impacts upon the behavior and performance of firms. In fact, with globalization and capital mobility, corporate governance has become an important framework for understanding competitiveness of countries and corporations (Ibid, 1999, pp.4). However, there is no single model of corporate governance that is universally applicable across countries. Corporate governance practices vary not only across countries, but also across industries and firms.

One of the most striking differences in corporate governance mechanisms across countries, however, is in the ownership and control of firms. According to Maher and colleagues (1999), systems of corporate governance can be distinguished according to the degree of ownership and control, and the identity of the controlling shareholders. While some systems are characterized wide dispersed ownership, others tend to be characterized by concentrated ownership or control. Either of these mechanisms presents their own unique corporate governance challenges. In dispersed (diffused) ownership, the basic conflict of interest is between strong managers and widely-dispersed weak shareholders who lack the motivation and wherewithal to monitor managers' actions. In concentrated systems, on the other hand, the basic conflict of interest arises between controlling shareholders (block holders) and weak minority shareholders (Ibid, pp.5).

Shleifer and Vishny (1997), argue that the effectiveness and form of different corporate governance systems may be influenced by a number of factors, including product market competition, the structure of capital and labour markets, and regulatory and legal environments. For example, as Mayer (1996) states that product market competition may be needed to encourage good corporate performance where there is limited competition in capital markets (e.g. lack of an active take-over market). It has also been suggested that competition in financial markets makes it difficult for firms to establish long term relationships with financial institutions (Chang and Wong, 2003).

There is sufficient empirical evidence to support the argument that much of the difference in corporate governance systems across the globe stem from varying regulatory and legal environments. According to Shleifer and Vishny (1997), the differences between corporate governance systems in the industrialized countries, while important, are relatively small compared to the collective difference between these countries and the developing countries. For example, in less developed countries, corporate governance mechanisms may be non-existent and, where they do exist, are often particularly weak and ineffective. However, even in rich industrialized countries, corporate governance problems can still act as a major impediment to economic growth. Therefore, understanding corporate governance and its effects can guide policy discussions, not only on the improvements in industrialized

countries' corporate governance systems, but also provide a basis for understanding the changes that may be required in other countries where corporate governance systems are severely underdeveloped (Barca, 1995; Zingales *et al*, 1995).

Researchers (Ezzamel and Watson, 1983; Baysinger, 1985; Hambrick and Abrahamson, 1995) have argued that an effective system of corporate governance helps to facilitate corporate decision-making and accountability, and enhances responsibility of the Board of Directors and managers. In fact, the Global Corporate Governance Forum (GCGF) notes in its mission statement that corporate governance has become an issue of worldwide importance. The corporation has a vital role to play in promoting economic development and social progress. The Centre for Corporate Governance in Kenya (CCGK, 2005) views corporate governance as the engine of growth internationally, and increasingly responsible for providing employment, public and private services, goods and infrastructure. The efficiency and accountability of the corporation is now a matter of both private and public interest and governance has thereby, come to the head of the international agenda.

The Commonwealth Association for Corporate Governance, in its guidelines, states that globalization of the market place within this context has ushered in an era where the traditional dimensions of corporate governance defined within local laws, regulations and national priorities are becoming increasingly challenged by circumstances and events having an international impact, and thereby bringing to the fore the need for a universal approach to the concept. Good corporate governance ensures that the varying interests of stakeholders are balanced; decisions are made in a rational, informed and transparent fashion; and decisions contribute to the overall efficiency and effectiveness of the organization. This approach ensures goal congruence between the stream of decisions made by managers, and the overall strategy of the organization (PSCGT, 2002).

To the extent that corporations are regarded as the most formidable institutional framework for mobilization of resources and capital accumulation, good corporate governance enhances socio-economic progress. In the liberalized global market, a country's capacity to create and produce wealth is closely related to the process by which corporate resources are

allocated, utilized and invested. Corporate decisions on production, employment and investment ultimately affect incomes, employment and social welfare. A country's capacity to effectively compete in the borderless and liberalized world market depends to a large extent on their ability to efficiently produce world class goods and services that can withstand international competition (Ibid, pp. 64).

Corporate competitiveness depends on the ability of the Boards of Directors to stimulate their organizations to generate innovative ideas, acquire and apply the knowledge and know-how to push and integrate their corporation into the competitive global market. Efficient corporations can only be established and developed within a framework of harmonious relationships among shareholders, board, managers and stakeholders. Indeed, a country that can not nurture efficient business enterprises will inevitably miss out on generation of wealth and employment opportunities (CCGK, 2005).

Arguably therefore, a country requires credible, stable and sustainable corporations in order to attract investments without which businesses will stagnate and collapse due to financial starvation. In a nutshell, the prosperity of corporations is a pre-requisite for economic growth, employment creation, taxes and development. In transitional economies such as Kenya, it is assumed that poor corporate governance mechanisms have posed a major impediment to improving the competitiveness of the firms. Better corporate governance, therefore, should lead to improved corporate performance and economic growth. In order to ensure this prosperity, corporations must reasonably adhere to the universal pillars of good corporate governance, namely, accountability; efficiency and effectiveness; probity (integrity and fairness); responsibility; and transparency (Ibid, pp. 25).

1.1.2. Development of Corporate Governance in Kenya

The formal Corporate Governance discussion (the manner in which the corporation is governed with the objective of maintaining and enhancing shareholder value) is a relatively recent phenomenon in Kenya, and may be traced back to 1998 when the first workshop was held in Nairobi to discuss the role of non-executive directors. Although this workshop was

sponsored and supported by leading organizations with specific interest in corporate governance in Kenya such as the Nairobi Stock Exchange (NSE), Capital Markets Authority (CMA), Institute of Certified Public Accountants of Kenya (ICPAK), and the Kenya Chapter of the Association of Chartered Certified Accountants (ACCA), with participation drawn from many leading corporate organizations, the organizers and sponsors had not anticipated that the effort would develop into a major initiative on corporate governance. Within a very short time, the idea of corporate governance was beginning to elicit tremendous interest, and permeated major corporations both in the private and public sectors. By the time the second workshop was held in Mombasa in 1999, it had become abundantly clear that the idea of corporate governance was already in vogue, and the meeting was geared to discuss major topics and principles of corporate governance in Kenya (PSICG, 1999). In fact, the introduction of the Sessional Paper No.1 of 1986 on "Economic Management for Renewed Growth", which had proposed far reaching reforms in economic and corporate governance mechanisms, could have acted as a watershed in the renewed interest in interrogating the existing governance frameworks in the country.

Kenya returned to multi-party system of political governance in 1991 after three decades of political agitation by the civil society and unofficial opposition that operated mainly in disguise to remove the increasingly draconian KANU regime. The decade of 1990's is therefore, very important in analyzing the governance system in Kenya. Political pluralism has thus spurred the resolve of Kenyans to participate more in governance, including the manner in which the assets of corporations and institutions are managed for sustainable socio-economic development. Increasingly, citizens have come to appreciate that governance is a vital ingredient in the maintenance of a dynamic balance between the need for order and equality in the society; the efficient production and delivery of goods and services; accountability in the use of power; the protection of human rights and freedoms; and the maintenance of an organized corporate framework within every citizen can fully contribute toward finding innovative solutions to common problems (PSCGT, 2002).

Although good corporate governance practices are not yet well entrenched in Kenya, there is tremendous effort being expended in that direction, with some positive results so far, not

least of them being the establishment of the Centre for Corporate Governance. This Centre has so far developed principles for corporate governance in Kenya, and also produced a Code of Best Practices for Corporate Governance. The Centre for Corporate Governance has already partnered with or affiliated with most major corporate governance organizations across the globe, and is in the process of building a body of knowledge and ideas that should address the needs of Kenyan corporate organizations. The Centre is also involved in studies and research in the critical areas that can help improve corporate governance for better national economic performance. As the Kenyan society gets more sophisticated, with increasing numbers accessing university education and exposure to international best practices, it is inevitable that this cream of society will continue to interrogate the existing corporate governance framework with a view to enhancing the capacity of both public and private corporations to deliver world-class services.

The growing interest in corporate governance in Kenya has been informed both by internal factors and external influences. In the face of major scandals leading to mismanagement of big corporations, especially state-owned ones such as Uchumi Supermarkets, Kenya National Assurance Company (KNAC), Kenya National Transport Company (KENATCO), African Tours and Hotels, Kenya Co-operative Creameries (KCC), Kenya Meat Commission (KMC), Rift Valley Textiles (RIVATEX), Kisumu Cotton Mills (KICOMI), it was inevitable that the wider society led by the civil society and mass media, would start questioning how these organizations were run.

There has been growing expectation in the recent times that corporate organizations, especially those in the private sector that are endowed with the requisite expertise, should take a more leading role in the debate and implementation of economic revival strategies. Not to be left behind are the shareholders, especially those in publicly-listed companies, who are becoming increasingly vocal, and demanding better transparency and disclosure of information from their directors. Besides, there has been increasing vigilance by the regulatory bodies, notably Capital Markets Authority and the Nairobi Stock Exchange which have made it a requirement for all publicly-listed companies to observe good corporate governance practices. With the privatization of economies globally, the quality of

governance at all levels is increasingly being seen as the key success factor in the performance of the economy and its institutions. The Private Sector Initiative on Corporate Governance in Kenya (PSICG, 1999) vindicates this position in their report on the divestiture program in Kenya.

1.1.3. Listed Companies in Kenya

Kenya has only one Stock Exchange, the Nairobi Stock Exchange (NSE). Dealings in shares and stocks started in Kenya way back in the 1920's when the country was still a British colony. There was however, no formal market, no rules and no regulations to govern stock broking activities. In the circumstances, trading took place on gentlemen's agreements in which standard commissions were charged with clients being obligated to honor their contractual commitments. At the time, stock broking was a sideline business conducted by accountants, auctioneers, estate agents and lawyers who met to exchange prices over a ⁴cap of coffee. Because these firms were engaged in other areas of specialization, the need for association did not arise.

In 1951, Francis Drummond, an Estate Agent, established the first stock brokerage firm in Kenya. By 1953, the London Stock Exchange accepted to recognize the setting up of the Nairobi Stock Exchange as their overseas stock exchange. Finally in 1954 the Nairobi Stock Exchange was constituted as a voluntary association of stock brokers registered under the Societies Act (it was transferred to the Companies Act with effect from 1991). Since Africans and Asians were not permitted to trade in securities until after the attainment of independence in 1963, the business of dealing in shares was then confined to the resident European community (NSE, 2006).

The Nairobi Stock Exchange has over the years grown into a modern and highly dynamic bourse, with an ever growing capacity for mobilization of the much-needed capital for economic development. The bourse attracts institutional as well as individual investors from Kenya and abroad. Expectedly, the Nairobi Stock Exchange has in place very strict and elaborate listing regime at the bourse, including disclosures, reporting obligations, financial requirements, records to be maintained, code of conduct, self regulation,

submission of annual budget, and other corporate governance requirements. The listing requirements, though strict and at times viewed as inhibitive, are necessary to ensure that only the best managed companies find their way to the Nairobi Stock Exchange. In a way, this strictness helps to create competition among companies, and in the long run, motivates them to improve on their corporate governance practices, and consequently contribute toward enhancing corporate profitability and wealth creation. Some investors, however, contend that the NSE has become a kind of cartel of a few stock brokers who determine the economic destiny of the country.

The most current register of companies at the Nairobi Stock Exchange indicates that there were fifty- four companies listed at the bourse by the end of 2006. These companies are typically owned by six categories of shareholders: the state, diffuse individuals, financial institutions, foreigners, managers and corporations. The Nairobi Stock Exchange operates under the supervision of a regulator, the Capital Markets Authority, which is a state corporation under the Ministry of Finance (Ibid, pp 8-9).

The main index at the Nairobi Stock Exchange is NSE 20-Share index which is determined on the basis of Geometric Mean of 20 Companies' prices. Delivery and settlement is done through the newly introduced electronic-based Central Depository and Settlement system. This system has been in place since November 2004, and to be able to trade, equity securities should be deposited with Central Depository and Settlement Corporation.

The tax law in Kenya has over the years, been amended in a bid to attract investors at the bourse. For example, currently withholding tax on dividend income is five per cent for locals, and ten per cent for non-residents. Capital Gains Tax remains suspended since 1985. Withholding Tax on interest income from listed corporate bonds and Government of Kenya Treasury bonds is fifteen per cent. For foreign investment holdings to be allowed to participate at the bourse, twenty five per cent of the issued share capital of a listed foreign company should be reserved for resident investors while the balance becomes a free float for all classes of investors.

In 2001 there was a fundamental reorganization of Kenya's capital markets into four independent market segments namely, Finance and Investment; Industrial and Allied; Commercial Services; Agriculture and Alternative Investment. In addition to these specific segments, Kenya has a vibrant Fixed Income Securities Market (FISM). As the capital market in Kenya matures, it is expected that the Futures and Options Market Segment (FOMS) will be a reality in the not-too-distant future. In terms of representation, Industrial and Allied segment has the biggest proportion of the NSE, accounting for 33.3 per cent, followed by Financial and Investment with 23.8 per cent. Industrial and Allied, and Commercial Services tie at 16.7 per cent each. The least represented is Agriculture with only 9.5 per cent representation at the Nairobi Stock Exchange.

In 2007, the Nairobi Stock Exchange experienced heightened activity as a result of the KShs. 50 billion (US \$ 714 million) Safaricom Initial Public Offer (IPO), arguably the biggest public offer ever in East Africa. The IPO elicited tremendous, and for several months before and after its introduction in the NSE, investors withdrew money from other counters with a view to take advantage of the once-in-a-lifetime offer. The peculiar investor behavior suffocated many companies of cash, and led to poor corporate performance. Ultimately, the IPO was oversubscribed, necessitating huge refunds to unsuccessful applicants. Since the NSE was not prepared for transactions of such magnitude, the bourse, investment banks and commercial banks that handled the applications came under scathing criticisms for their ineptitude. The last two years have witnessed the collapse of major players in the Nairobi Stock Exchange, including Nyagah Stock Brokers, a well established brokerage firm. The events are a pointer to some weaknesses in the governance mechanisms of the financial sector in Kenya, and should be investigated and remedied before the country begins to experience problems similar to those that led to the collapse of the mortgage business in the USA.

1.2. Statement of the Problem

The history of corporate governance systems is now well documented. According to Gomez (2005), the past one decade or so has however, witnessed significant transformations in corporate governance structures, leading to increased scholarly interest

in the role of board of directors in driving corporate performance. Arising from many high profile corporate failures, coupled with generally low corporate profits across the globe, the credibility of the existing corporate governance structures has been put to question. Recent research (Shleifer and Vishny, 1997; Shleifer, 2001; Jensen, 2000) has thus called for an intensified focus on board composition, accountability and responsibility.

The now well-publicized cases of Enron Corporation, Adelphia, Health South, Tyco, Global Crossing, Cendant and WorldCom, among others, have repeatedly been put forward as typical scandals that justify corporate governance reform and the need for new mechanisms to counter the perceived abuse of power by top management. Monks (1998) argues that the numerous cases of corporate failures are an indictment of the effectiveness of the board as an organ of corporate governance.

Initially, these financial scandals appeared primarily to be an American phenomenon, arising from overheated U.S. stock markets, excessive greed, and a winner-take-all mindset of the American society. Over the past ten years, however, it has become clear that the vice of managerial fraud, accounting irregularities and other governance abuses is a global phenomenon, afflicting many non-U.S. companies including Parmalat, Vivendi, Hollinger, Ahold, Adecco, TV Azteca, Royal Dutch Shell, Seibu, China Aviation, among other high profile cases. Related to these disclosures of alleged gross corporate malfeasance, there was also a more widespread erosion of standards throughout the global markets, with questionable and unethical practices being accepted. The net effect has been to undermine the faith shareholders and investors have in the integrity of the world's capital markets.

Researchers in corporate governance (Donaldson, 2005; Huse, 2005; Frentrop, 2003) have reported that there is still lack of concurrence on the ideal corporate governance structure that could safeguard shareholders' assets while promoting wealth creation ventures. The corporate governance debate has largely centered on the powers of the Board of Directors vis-à-vis the discretion of top management in decision making processes. Some researchers (Huse *et al*, 2005) have argued that the ever increasing complexity of the business environment calls for governors to acquire necessary competencies in their line of business.

For others, the evolution of the fiduciary economy puts pressure on boards, thus making them more accountable to shareholders (Huse *et al*, 2005). Still for others, the recent corporate scandals are a reflection of the excessive discretionary powers bestowed on top management. There is, therefore, an urgent need for firmer control of top management by an independent board. The conclusion that may be drawn from the on-going debate is that there is as yet no consensus on the ideal corporate governance structure.

The traditional approach to corporate governance has typically ignored the unique influence that firm owners exert on the board, and by extension, the top management, to behave or make decisions in a particular way. Consequently, studies on corporate governance (Cubbin and Leech, 1982; Monks, 1998; Jensen, 2000; Shleifer, 2001; Frentrop, 2003; Donaldson, 2005; Huse, 2005) have not comprehensively identified and dealt with the complexities that are inherent in corporate governance processes. Perhaps, this is where the greatest problem of corporate governance lies.

Owner preferences and investment choices are influenced by, among other factors, the extent to which they can take risks. To the extent that owners have economic relations with the firm, their priority would be to protect their interests even though this may lead to low investment returns, and generally low profitability. In this regard, Thomsen and Pedersen (1997) argue that banks which play a dual role as lenders and owners would not favor high risk ventures with great potential for returns since such a policy is inimical to loan repayment. Government may also play the dual role of regulator and owner. For each of these owners (stakeholders), preferences regarding company strategy will involve a trade off between the pursuit of shareholder value and other goals (Hill and Jones, 1982). All these issues have been ignored in the ongoing debate on corporate governance structure, and instead the role of the Board exalted as the panacea to all the corporate governance problems.

Thus, the corporate governance framework in its current form is evidently lacking in a monitoring system or contract, aligning the role of the firm owners, board of directors and managers' interests and actions within the wealth creation and welfare motivation of

stakeholders. This study, therefore, investigated the effect of ownership structure, board effectiveness and managerial discretion on firm performance, and has ultimately proposed a more vibrant conceptual framework that can help us better understand the corporate governance phenomenon. The proposed framework, hopefully, will help to forestall future cases of corporate malfeasance.

From the problem statement, the following broad research questions were raised: i) what is the relationship between ownership structure, board effectiveness and managerial discretion on firm performance?, ii) what are the internal and market influences that impact these relationships?

1.3. Objectives of the Study

The general objective of this study was to investigate the effect of ownership structure, board effectiveness and managerial discretion on corporate performance. From the general objective, a number of specific objectives were derived, namely, to: i) establish the relationship between ownership concentration and firm performance; ii) establish the relationship between ownership identity and firm performance; iii) determine the relationship between board effectiveness and firm performance; iv) determine the relationship between managerial discretion and firm performance when moderated by internal influences; v) establish the relationship between managerial discretion and firm performance when moderated by external influences; and vi) establish the nature of relationship (hierarchical or otherwise) between ownership structure and firm performance.

1.4. Significance of the Study

The study was aimed at developing a conceptual framework that should make us better understand the relationship between ownership structure, board effectiveness and managerial discretion on one hand, and firm performance on the other. Research has demonstrated a close link between good corporate governance practices and economic development (IPAR, 2000). However, researchers have not found any conclusive evidence on the relationship between specific organs of corporate governance and firm performance.

An equally important consideration for this study is the fact that pertinent literature appears to place the Board of Directors at the core of corporate governance mechanisms, a position that has been challenged following the numerous high profile cases of corporate failure across the globe. Last but not least, the bulk of the studies on corporate governance have been conducted within the developed country setting, thus rendering them inappropriate for wholesale application to the developing countries. It is against this background that this study was conceived to try and bridge the gap in literature, and to come up with results that are relevant within the context of the developing countries.

To this extent, the study will improve appreciation by policy makers and managers of corporate governance issues and mechanisms, especially their practical applications within a developing country context. More specifically, it will help us understand whether agency theory, as an analytical framework, can explain corporate governance practices in developing countries, or is irrelevant and should be replaced with a more vibrant theory of management; help shed light on how different ownership identities and levels of ownership concentration impact corporate performance; guide Boards of Directors to understand how to effectively discharge their mandate on behalf of the shareholders and other stakeholders; point out as to discretion that managers require for effective decision making in order to spur organizational creativity and innovation; help management in environmental analysis for purposes of understanding the internal and market factors that affect corporate decision making, and firm performance; and establish whether Return on Assets, Return on Equity and Dividend Yield are robust measures of firm performance.

The numerous cases of corporate malpractices in Kenya, including the giant Uchumi supermarkets, Kenya Co-operative Creameries and Kenya National Assurance Corporation over the last two decades, have been not only a great drain on the country's treasury, but also of great concern to stakeholders. Matters are even worse when one considers the fact that all the cases have been blamed on, among other factors, poor corporate governance practices, ineffective judiciary and outright moral hazard (Anyang'-Nyong'o, 2000). This study is therefore, crucial and timely as it seeks to provide insight into, and suggest

remedial measures to, the menace of corporate malpractices that is already taking monstrous proportions in Kenya.

CHAPTER 2: LITERATURE REVIEW

This chapter explores theoretical and empirical literature in the area of corporate governance. In this regard, the various theories of corporate governance are elucidated, and the choice of agency theory as an analytical framework is explained in details. The literature covers both the independent and dependent variables of this study, and attempts to bring to the fore the nature of the relationships among these variables as established by theory and empirical research. The relationships drawn from pertinent literature are then used to develop a conceptual model (Figure 1), from which the ten hypotheses tested in the study were drawn.

2.1. Theories of Corporate Governance

There are various frameworks for analyzing relationships among major players in corporate governance, the most notable of which are the agency theory, management theory, democratic theory, stewardship theory and stakeholder theory.

2.1.1 Agency Theory

Agency refers to the relationship between two persons, one of whom must be a principal (owner) and the other, an agent (manager). Agency theory therefore, is the theory that explains how best the agency relationship can be used for purposes of governing an organization (Brown Governance Inc; 2004). Agency theory was first articulated by Smith (1776). Essentially, what Smith said regarding corporate governance is that members of every social organization, from hunter-gatherer tribes to corporations, to nations rapidly specialize into groups depending on their competencies and expertise: principals (owners) are people with a knack for accumulating capital (wealth, resources) whereas agents (management) are people with a surplus of ideas to effectively use that capital and get things done, that is, create value (Ibid, pp. 264).

The principals and agents have specific core responsibilities which facilitate good governance of corporations. Principals are charged with three core responsibilities in

agency governance, namely to: select and put in place (elect, appoint) the governors (Board of Directors, Trustees); select and put in place the auditors (external, independent body that tests and reports on integrity of financial reporting and controls); and ensure that there is an effective governance system in place. The agents on the other hand, are responsible for day-to-day operations and activities throughout the organization (Sarbanes–Oxley, 2004). The division of responsibility, which is inherent in the agency governance mechanism, makes it possible for accountability to be achieved since the flow of power and authority is well defined and understood in the organization (Ibid, pp. 68).

According to the agency theory, the objective of the firm is to maximize shareholder wealth through efficiency. The criteria by which performance is judged in this model are profitability and shareholder value of the firm. Therefore, managers and directors have an implicit responsibility to ensure that firms are run in the interest of shareholders. The underlying challenge in the agency theory arises from the principal agent relationship occasioned by separation of beneficial ownership and executive decision-making.

According to Maher and Anderson (1999), it is the separation of firm ownership from its management that causes the behavior of managers to diverge from the profit-maximizing ideal. This happens because the interests and objectives of the principals (investors) and those of the agents (managers) differ when there is separation of ownership and control. Where the managers are not the owners of the firm, and neither bear the full costs of mismanagement, nor share in the residual income of the firm, there is a strong tendency of managers to engage in activities that enhance their private benefits from the firm at the expense of shareholders. Therefore, although investors are interested in maximizing shareholder value, managers may have other objectives such as maximizing their salaries, prestige, growth in market share, or an attachment to particular investment projects (Ibid, 1999, pp.6).

· 2.1.2. Management Theory

The proponents of management theory contend that the modern corporation is complete and, only sophisticated, experienced and professional management team can effectively

direct and control it. The private sector, particularly in industrialized economies, was dominated by a swing to management theory from about 1930s through to 1990s (Brown Governance Inc. 2004). This dominance has however, substantially diminished during the last decade of the 20th century as principals took more responsibility in the affairs of their companies.

Management theorists posit that agency theory was perhaps workable for the simpler, smaller corporations of Adam Smith's days, but in today's world, corporations are large, complex, multi-faceted entities that are challenging to direct and control (Brown Governance Inc: 2004). It is however, plausible to observe that under management theory, direction and control have been ceded by owners and boards (principals and governors) to the management team. The result is a breakdown in accountability as the correct separation of powers (division of duties) fails to occur. According to Cadbury and colleagues (2004), this arrangement vests immense discretionary powers on management who may misuse the powers to enhance their prestige and wealth at the expense of the principals.

There is no denying the fact that the modern organization is complex, but it is inappropriate in terms of accountability to allow managers inordinate discretionary latitude over both governance (direction and control) and day-to-day management. In fact, Adam Smith's position is that the more complex social organizations get, the more people need to specialize, to divide their labour in order to enhance efficiency and internal control. According to Cadbury and colleagues, (2004) boards (governors) are not given responsibility for governance because they understand the corporation any better than managers, but precisely because they are not the managers. It is argued that one of the reasons Japan has failed to completely recover from its economic troubles of the early 1990's is because of its continued adherence to management theory (Brown Governance Inc; 2004).

2.1.3. Stakeholder Theory

Stakeholder theory argues that every corporation was created not just to serve its shareholders, but a diverse range of people who have a legitimate stake in the organization's outcomes and performance, and indeed to serve a broad societal purpose (Cadbury et al, 2004). In this sense, the firm, according to stakeholder theory, is responsible to a wider constituency of stakeholders other than shareholders. Other stakeholders may include contractual partners such as employees, trade unions, financiers, suppliers, customers, and social constituents such as members of the community in which the firm is located, environmental interests, local and national governments, and society at large. This view holds that corporations should be socially responsible institutions, managed in the public interest. According to this theory, performance is judged by a wider constituency interested in employment, market share, and growth in trading relations with suppliers and purchasers, as well as financial performance (Maher and Anderson, 1999, pp. 9). Because of this, the board is selected to be as broadly representative of those stakeholders as possible. This way, the corporation benefits by adopting an all-inclusive decision-making process.

Diverse legitimate points of view and expectations have a direct voice around the boardroom table and influence the strategic direction and priorities of the corporation. The modern corporation is certainly more sensitive to matters of corporate social responsibility and the environment, since these issues are at the very heart of the society that gives the corporation the charter to operate. It is well understood that the corporation draws its inputs (including labor, raw materials, managers, finances) from the society, and sends back its products and/or services to the same society. It is therefore, inevitable that there be a perfect fit between the organization and its environment in order for symbiosis to be maintained.

The downside of the traditional stakeholder theory is that it is difficult, if not impossible, to ensure that corporations fulfill the wider objectives of all their stakeholders, and as such, the decision-making process is very slow. Inclusion of diverse voices necessarily means longer board meetings. Further, decisions are more often revisited. Even when a strategic

direction is approved, there is little or no board discipline in unifying behind it. Board members tend to act in their constituent's best interest, at times, at the cost of the corporation's best interests. In rejecting the Stakeholder theory, Blair (1995) argues that the idea failed to give clear guidance to help managers and directors set priorities and decide among competing socially beneficial uses of corporate resources, and provided no obvious enforcement mechanisms to ensure that corporations lived up to their social obligations. Another glaring deficiency of stakeholder theory is that managers or directors may use "stakeholder" interference reasons to justify poor corporate performance. As a result of these deficiencies, the stakeholder theory has not appealed much to academics, policy makers and corporate governance practitioners.

2.1.4. Stewardship Theory

Stewardship theory argues that managers are inherently trustworthy and not prone to misappropriate corporate resources (Donaldson, 1990; Donaldson and Davis, 1991, 1994). Donaldson and Davis (1994:159) appear to agree with the arguments of the stewardship theory that managers are good stewards of the corporation and diligently work to attain high levels of corporate profits and shareholder returns. The basis of this position is grounded in the need for corporate control.

Quite opposite to the agency theory however, Davis, Schoorman and Donaldson (1997) argue that stewardship theory would suggest that control be centralized in the hands of firm managers. It would appear that stewardship theory readily lends itself for application in motivation of top management. The theory, however, fails to take cognizance of the rampant cases of failures of managerial integrity (moral hazard) and managerial competence (adverse selection). This glaring omission makes stewardship theory inadequate as a framework for analyzing corporate governance mechanisms in the modern corporation.

The brief analysis of stakeholder theory, democratic theory, stewardship theory and management theory, reveals inherent weaknesses, particularly with regard to the crucial areas of control, monitoring and accountability structure. Agency theory, on the other hand,

appears to effectively mitigate all the glaring inadequacies of the other governance theories. The principles of agency theory are applicable not just to private sector firms, but to all social organizations. Public sector corporations, cooperatives, and mixed governance models can all benefit from the basic principles and lines of authority and accountability that are embedded in agency theory. Jensen and Meckling (1976), argue that there exist governance mechanisms by which to minimize conflicts arising from agency relationships in firms. Hence, agency theory lends itself as the most appropriate framework for analyzing the relationship between ownership structure and firm performance.

2.2. Agency Theory as an Analytical Framework

Agency theory is premised on the assumption that the interests of owners and managers are not perfectly aligned (Jensen and Meckling, 1976). Managers want to maximize their own wealth power and prestige while safeguarding their reputation, while shareholders want to maximize the value of their assets. These interests often collide. Contracts are mechanisms for resolving problems that arise from the imperfect alignment of interests. Hence, agency theorists speak of the modern corporation as a nexus of contracts (Jensen and Meckling, 1976).

The contracts delineate or specify agency relationships as follows: between shareholders (principals) and managers (agents), between debt holders (principals) and managers (agents), between shareholders (principals) and directors (agents) and between the directors (principals) and various board committees and task groups dealing with specified issues (agents). These contacts may be implicit or explicit. Implicit contracts are based on unspoken mutual expectations, cultural norms, individual roles, organizational 'common law' or 'culture.' Explicit contracts, on the other hand, are based upon written representations that are legally binding, such as corporate by-laws, shareholders agreements/resolutions, subscription agreements and employment contracts (Moldoveanu and Martin, 2001).

Agency theory is concerned with designing structural and behavioral measures that minimize inefficiencies in the contractual structure of the firm that arise from imperfect

alignment of interests between principals and agents (Moldoveanu & Martin, 2001). The elements of agency model of business relationships are decision rights, knowledge and incentives. Decision rights or the rights to exercise control over a particular asset, comprises two elements, namely; decision management rights (the right to initiate a decision and the right to implement that decision) and decision to control rights (the right to ratify or give approval for a decision). Decision control rights include decision monitoring rights (the right to measure the performance of the agent) and sanctioning rights (the right to reward or punish an agent according to the outcomes of his or her decisions). Both decision management rights and decision control rights can be of positive or negative kind. Positive decision rights are the rights to proactively propose or undertake a particular course of action. Negative decision rights, on the other hand, are the rights to veto, oppose or derail a particular course of action that is perceived to be inimical to the wealth creation motive of shareholders.

Knowledge is critical to the activities of the agent (and sometimes to those of the principal) (Jensen and Meckling, 1992). It is broadly divided into general and specific components. The general aspect is the kind that one can easily communicate or transfer, such as ideas and frameworks. On the other hand, specific knowledge is the kind that one cannot easily transfer or communicate, including specific circumstances of a particular event or that which cannot be codified at all. Typical examples of specific knowledge include how to persuade a particular person to give up her board seat through the use of inter-personal charm and knowledge of her psychology, or how to write a software program to perform a particular function, which, function cannot be codified as part of particular textbook or a course of learning (Jensen and Meckling, 1992).

Incentives (rewards and punishments) motivate the agent to act in a particular way, given a set of choices (Jensen and Meckling, 1976). Incentives are of two kinds, namely, pecuniary incentives and non-pecuniary incentives. Pecuniary incentives relate the observable effort level of the agent to a set of monetary rewards for the agent (such as salaries and bonuses), or a set of rewards that can easily be turned into monetary rewards (such as stock grants and warrant and option grants). Non-pecuniary incentives, on their part, relate the

observable effort level of the agent to a set of non-monetary rewards, such as intra-organizational power and prestige, perquisites and privileges and market-wide fame and reputation (Jensen and Murphy, 1990). The three elements of the agency model can be used together to better understand the potential problems and pitfalls of the modern corporation.

Failures of the agency relationship can result whenever managers make decisions for which they either do not have the right information to reach optimal conclusions (failures of competence, adverse selection) or where they have incentives to take actions that decrease value of the assets (moral hazard). In a nutshell therefore, agency failures occur whenever decision rights, the requisite specific knowledge and general knowledge (information) and incentives are not co-located in the same person (Moldoveanu and Martin, 2001). The biggest challenge facing the modern corporation is to develop an effective framework or mechanism for ensuring that the right people are hired for the right job, and that once on board, the managers have the necessary motivation and latitude to make the right decisions.

2.2.1. Agency Problem

At the center of the agency problem is the contention that separation of ownership and management gives rise to a conflict of interest between owners and managers (Jensen and Meckling, 1976). There is a chance that the professional managers governing the daily operations of the firm would take actions against the best interests of the shareholders. This agency problem stems from separation of ownership and control in the modern corporation (Berle and Means, 1932). The conclusion is that there needs to exist a monitoring system or contract, aligning the managers' interests and actions within the wealth creation and welfare motivation of stockholders (Fama and Jensen, 1983).

The agency type problems pervade all types of ownership structures albeit at different levels of severity. In diffusely owned firms, for example, the agency problem is more severe due to the apparent lack of capacity to collectively monitor the activities of managers. Agency type problems also exist in closely held firms because there are always only a few key decision makers (Jensen and Meckling, 1976). However, given the closely-knit ties between owners and managers in these firms, and given much closer monitoring,

agency problems in closely held firms, in relative terms, are less severe (Ibid, 1976). The presence of agency problems weakens the central thesis that modern diffuse ownership corporations are necessarily more efficient. For example, it is possible that in some business sectors, the costs of monitoring and bonding the managers would be excessive. It is also probable that in some cases the advantages of large-scale operations and professional management would be minor and insufficient to outweigh the expected agency costs (Xu and Wang, 1997). Nevertheless, given the historical trend towards disperse ownership structure, the hypothesis that diffusely owned firms perform better than closely held firms in an issue that requires more research (Xu and Wang, 1997).

Fama (1980) argues that an efficiently functioning managerial labour market with free flow of information will impose the necessary discipline on managers. Similarly, a market with properly functioning regulatory and supervisory systems will most likely impose corporate controls that serve as incentives for managers to act in the best interest of owners (Jensen and Ruback, 1983; Matin and McConnell, 1991). Grossman and Hart (1982), on the other hand, point out that if ownership is widely dispersed, no individual shareholder will have the incentive to monitor managers since each will regard the potential benefit to be too small to justify the cost of monitoring.

Alchian and Demsetz (1972) appear to concur with Jensen and Meckling (1976) in the latter's argument that in the absence of either appropriate incentives or sufficient monitoring, agents (managers) will be able to exercise their discretion to the detriment of owners (principals). What is not clear in the argument put forward by Alchian and Demsetz (1972) is whether, according to them, the existence of corporate controls and market efficiency occasion any impact or sanctions on managerial discretion.

In the context of the modern corporation, agency theory has been applied to the relationship between managers and shareholders within the framework of the organization. The traditional argument is that owners wish to maximize profits, but that their designated agents (managers) may have neither the interest nor the incentive to do so (Berle and Means, 1932). As such corporate performance depends in part on the ability of owners to

effectively monitor and control managers. The recent literature suggests that this argument on the short-run profit maximization motive of owners (principals) is sometimes simplistic and misleading.

The presumption that firm owners pursue short run profit motive at the expense of future performance of the organization implies that the owners are either ignorant of the potential dangers of short-run profit motivation or they are simply apathetic of the consequences (Cadbury and Dey, 2004). Either of the two presumptions would negate the going-concern principle of the modern firm. Besides, the shareholder profiles of firms are fast changing, with more and more educated people gaining control of firms. The effect is that the modern organization's stockholder profile comprises investors who are not only concerned with the firm's profitability, but are also cognizant of the need for sustainability of those profits (Cadbury and Dey, 2004).

It is, therefore, plausible to argue that as the society gets more educated, and investment minded people take up shareholdings in firms, the tendency for agency-related problems arising purely on the basis of short-run profit motivation of shareholders is minimized as strategic thinking gets entrenched among investors. At the same time managers are aware of the existence of potential take-over by other firms as well as competent managers who are waiting in the wings to replace them should they fail to deliver quality to shareholders. Hence, as the investing public becomes increasingly sophisticated, agency-related conflicts are minimized (Cadbury *et al*, 2004).

2.2.2. Agency Problems in the Modern Corporation

The modern corporation is a relatively new form of organization in the history of societies, dating back to the beginning of the 20th century (Moldoveanu & Martin, 2001). The most distinguishing feature of the modern corporation is the separation of ownership of assets from the control of those assets. While ownership of the assets is vested in the shareholders of the corporation, control over these assets is in the hands of professional managers of the corporation (Moldoveanu & Martin, 2001, *Ibid*). Hence the managers make decisions and take actions whose consequences are by and large, shouldered by shareholders of the

corporation. For this reason, managers do not always act as perfect agents of the shareholders.

There are types of managerial failures that hamper them from acting as perfect agents, namely; failures of managerial competence (genuine mistakes, miscalculations) that relate to unwitting mistakes in the course of managerial control and, failures of managerial integrity (moral hazard) that relate to willful behavior that negatively impact the value of the firm's assets (Fama and Jensen, 1983). To cushion the corporation against failures of either type, shareholders enact ratification, monitoring and sanctioning (reward and punishment) mechanisms. Ratification mechanisms relate to the process of validating the decisions of the agent, of giving final approval or veto for an initiative or directive or actionable plan of the agent.

Monitoring mechanisms are mechanisms for observing recording and measuring the output arising from the efforts and endeavors of the agent. Sanctioning mechanisms relate to those mechanisms for providing selective rewards and punishments to agents for purposes of motivating them to exert effort aimed at achieving goal congruence between managers' interests and wealth creation motives of the shareholders (Fama and Jensen, 1983). The board of directors of the modern corporation has fiduciary responsibility to enact these mechanisms, and the requisite legitimacy to monitor, ratify and sanction the decisions of the managers of the corporation. The role of the Board is therefore, inextricably tied to the imperfect agency relationship between shareholders and managers, that is itself a direct consequence of the modern corporation.

2.2.3. Possible Remedies for Agency Problems in the Modern Corporation

Agency theorists suggest three different principles for redressing inefficiencies of the modern corporation. Firstly, to align decision rights with the requisite specific knowledge useful in order to competently exercise those rights. This principle suggests that the decision rights should be cascaded in the organizational hierarchy to the lower levels at which they reside in the same people (managers or employees) that have the specific knowledge to competently use those rights. However, because general knowledge is easily transferable it is not necessarily required that decision rights and general knowledge be co-

located (Fama and Jensen, 1983). The second principle is to align incentives with decision rights. This principle suggests that the incentive packages given to board members, managers and employees match the level of responsibility allocated to these people (Jensen and Murphy, 1990). Thirdly, to design efficient monitoring mechanisms based on observable measures of performance, on which basis the rewards are offered. The effective implementation of efficient governance mechanisms critically hinge on the correct information on performance levels as well as the ability to undertake a proper assessment of the impact of the actions of an employee, manager or board member on the value of the firm (Jensen *et al*, 1990)).

There are however, two problems that hamper the implementation of these principles, namely, hidden information and hidden actions. The problem of hidden information relates to allocation of rewards and punishments in such a way as to motivate employees and managers to reveal the correct information that will make it possible to design an efficient performance based plan. The correct picture of a firm's performance is often blurred due to manager's tendency to over-estimate the budgets or when employees over-estimate the time it will take to complete a project. The right information is often hidden either by failures of integrity or by failures of competence (Arrow, 1985). Solving the hidden information problem requires the enactment of structural and behavioral constraints that make the people reveal more of the information required to adequately monitor their performance consistently.

2.3. Traditional Approach to Corporate Governance

The implications of corporate governance for firm efficiency and performance have been in the focus of scientific debate for at least seven decades after A. Berle and G. Means published their ground breaking work, *The Modern Corporation and Private Property* (Berle and Means, 1932). Since 1970s this relationship has traditionally been analyzed in the context of principal –agent relationship or between shareholders and managers (Kuznetsov and Murvyev, 2001). In companies, the agency relationship usually emerges as a result of diverse ownership, where several small shareholders are incapable of running their firm collectively and have to transfer their control rights to managers. In terms of the

agency theory, separation of ownership and control gives rise to agency costs, which are an additional over-heads to the corporation.

Due to the conflict of interest between principals and agents, there is a major risk that corporate resources will not be used to maximize shareholder wealth. As a result, corporate shareholders are in need of reliable mechanism of exercising control over management (Jensen, 1997). The efficacy of this mechanism however, depends on the extent to which it can be enforced by the shareholders. Due to free riding of small owners, managers of diffusely owned companies face little control and can easily use their discretion to pursue their own selfish objectives with little or no regard to shareholder wealth creation motives. These may include expropriation of investors' funds, building an empire or simply accumulating own wealth.

After Berle and Means' analysis, it has become fashionable to equate dispersed ownership structure with powerlessness in the face of managerial opportunism (Kuznetsov and Muravyev, 2001). According to this school of thought therefore, ownership concentration is the panacea to agency problems between owners and managers. The traditional thinking on corporate governance is heavily swayed by the view that large owners have stronger incentives and better opportunities to exercise control over managers than small shareholders. Moreover, some scholars argue that most corporate governance mechanisms used in the world can be viewed as examples of concentrated ownership (Shleifer and Vishny, 1997).

To summarize, the traditional approach views the main corporate governance problem as the conflict between managers with self-interest and weak dispersed shareholders.

2.4. Modern Perspective on Corporate Governance

In recent years the concept of corporate governance has undergone substantial changes. These changes were precipitated by the fact that the diffusely owned corporation, on which the corporate governance literature hinged, is becoming a rare phenomenon in the world (Bergloef and Von Thadden, 1999). In most of the world, the trend is towards relatively

concentrated ownership. Concentrated ownership of companies curtails, to a great extent, the ability of managers to act at their own discretion, and therefore, constrained to devising company strategies that are subject to the obligations which large shareholders impose on them. Consequently, the framework of corporate governance broadens to encompass relationships between managers, large stockholders and minority shareholders. Expectedly, the new framework introduces substantial complexity in the analysis of ownership structure-performance relationship.

Of particular importance is the realization that concentrated ownership has its costs. The costs may arise when large shareholders, capable of influencing corporate decisions directly, maximize value for themselves and deprive small owners of their part of residual income. This phenomenon, which has received much attention in literature, is referred to as "extraction of private benefits of control" (Barclay and Holderness, 1989). Other negative consequences of ownership concentration include raised cost of capital due to lower market liquidity or decreased diversification opportunities on the part of investors (Fama and Jensen, 1983). Besides, ownership concentration prevents additional monitoring of managers by the stock market, which is available in situations of diverse ownership with high liquidity of shares (Holmstrom and Tirole, 1993). Some recent studies point out that too high ownership concentration may lead to excessive monitoring of managers by shareholders which in turn can reduce manager initiative and innovative (Burkhart et al, 1996).

Hence, there is a trade-off between monitoring gains accruing from ownership concentration and potential gains arising from discretion accorded to managers through more diffuse ownership structures. In summary, the traditional approach, which focuses on minority shareholders' protection from managerial opportunism, is now considered too narrow. Its deficiencies are particularly obvious in applications to developing economies, where large strategic investors are the major players on the corporate governance scene (Berloef and von Thadden, 1999). On the other hand, the modern approach to corporate governance, which encompasses large shareholders, minority shareholders and managers,

has its inherent analytical complexity which calls for a more conceptually sound framework to understand.

2.5. Corporate Performance

The concept of firm performance has been interpreted variously. In applied studies, it is common to associate improvements in firm performance with increased profitability, higher efficiency and increased output (Ayres & Cramton, 1994). Assessing managerial performance is a difficult task. Typically, the capital market only has the current profit statement and other public disclosures with which to assess performance. These are inadequate measures of managerial quality since they ignore “soft issues” and strategic off-the balance sheet items in such as human resource development, expansion of production capacity and Research and Development whose return can only be realized in subsequent accounting periods (Cramton *et al*, 1994).

Extant research addressing governance structures has relied on accounting-based financial indicators (Finkelstein and D’Aveni, 1994; Ocasio, 1994), market-based indicators as well as combinations of both (Hoskisson et al, 1994; Johnson, Hoskisson and Hitt, 1993). The nature of a given financial performance indicator may be fundamental, as there is some disagreement regarding the extent to which any board or executive decisions might impact accounting versus market-based measures of financial performance.

According to Chakravarthy (1996), reliance on financial accounting measures has been frequently criticized. It has been argued, for example, that such measures (1) are subject to manipulation; (2) may systematically undervalue assets; (3) create distortions due to the nature of depreciation policies elected, inventory valuation, and treatment of certain revenue and expenditure items; (4) differ in methods adopted for consolidation of accounts; and (5) lack standardization in the handling of accounting conventions. Besides, financial accounting returns are difficult to interpret especially in the case of multi-industry participation by firms. It has been demonstrated, for example, that board members often compare firm performance relative to average industry performance when evaluating managerial decisions and performance (Morck, Shleifer and Vishny, 1989; Meindl, Ehrlich

and Dukerich, 1985). It is also notable that financial accounting measures do not normally account for shareholder investment risk. Fearing the loss of their jobs, managers might put too much emphasis on how their decisions influence short-term profits and other public disclosures. Managers thus have a tendency to act myopically (Scholes, 1994).

The emphasis on short-term performance is a common practice among executives. The danger is that current profits are over-valued by the market relative to strategic decisions that are likely to generate future profits. Hence, management will use a very high discount rate when making investment decisions. Good projects that reap their gains in the distant future will be ignored and bad projects with a short payback period accepted (Milgrom & Roberts, 2000). Researchers have however, relied on financial indicators of firm performance because they are readily available to the public.

The typical financial indicators that have been commonly used are Return on Assets (ROA) and Return on Equity (ROE) (Laffont, 1988; Demsetz and Villalonga 2001; Welch, 2003). Over-reliance on financial indicators to judge overall firm performance is often misleading especially if the firm in question has a lot of intangible assets component in its operations including human resources, Research and Development and other non-balance sheet assets. Hence, the need to pay attention to non-financial indicators of performance, or at least one that combines aspects of both, for a more comprehensive appraisal of firm performance cannot be overemphasized (Laffont, 1988).

Alternatively, market-based returns have a number of advantages. They do reflect risk-adjusted performance; they are not adversely affected by multi-industry or multinational contexts. The issue may, however, be that market-based performance indicators are often subject to forces beyond management control (Deckop, 1987; Hambrick and Finkelstein, 1995; Joskow *et al*, 1993). As there appears to be no consensus regarding the efficacy of reliance on one set of indicators, a combination of financial and market-based indicators is recommended in order to capture the issues that are under the control of management as well as those that are market-driven. For purposes of this study, Return on Assets and

Return on Equity will be utilized to gauge financial performance while Dividend Yield will serve as a market-based indicator since it is largely market-dependent.

2.5.1. Return on Assets (ROA)

Return on Assets is a useful indicator of how profitable a company is relative to its total assets. The ROA is calculated by dividing a firm's annual earnings by its total assets (Laffont, 1988). This ratio is an indicator of what the company can do with what it has got, i.e., how much profit it can achieve using one unit of assets that they control. It is an indication of how effective management is in utilizing the resources that it controls to make profits (Ibid, 1988). The higher the ratio the higher the profits generated per unit of assets. Return on Assets has proved to be a very useful number for comparing competing companies in the same industry. The number will vary widely across different industries. For example, capital-intensive industries (like railroads and steel structures) will yield a low return on assets, since they have to own such expensive assets to do business.

Labor-intensive companies (like software, job placement firms) will have a high ROA since their asset requirement is minimal (Scholes, 1994). ROA has been used widely in researches on corporate profitability, and found to be extremely robust. For example, Ezzamel and Watson (1993) used it to study organizational form, ownership structure and firm performance in the UK. Other researchers who have used ROA include Hambrick and Finkelstein (1987), Hambrick and Abrahamson (1995), Huff (1982), Heracleous (2001), Roe (1994), and Schleifer and Vishny (1986), all of whom were investigating various aspects of corporate governance, and their impact on corporate performance.

Return on Assets (ROA) is very relevant to the current study since it enables us to evaluate the result of managerial decisions on the use of shareholder assets which have been entrusted to them for stewardship and value creation. The major disadvantage of ROA as an indicator of profitability however, is that it ignores liabilities and non-balance sheet assets such as highly skilled human resources. It is, therefore, ineffective in skills-based industries with heavy investments in human resources and sophisticated Information Technology processes.

2.5.2. Return on Equity (ROE)

Return on Equity refers to the earnings generated by shareholders' equity over a period of one year. ROE stands as a critical weapon in the investor's arsenal if it is properly understood for what it is. It encompasses the three main levers which management can utilize to ensure health of the organization, namely, profitability; asset management; and financial leverage. By perceiving return on equity as a composite that represents the management team's ability to balance these three pillars of corporate management, investors cannot only get an excellent sense of whether they will receive a decent return on equity but also assess the management's ability to get the job done (Milgrom and Roberts, 2000).

Shareholders' equity is an accounting convention that represents the assets that have actually been generated by the business (i.e. total assets less total liabilities). A business that creates a lot of shareholder equity is a business that is a sound investment, as the original investors in the business will be able to be repaid with the proceeds that come from the business operations. Businesses that generate high returns relative to their shareholders equity are those that pay their shareholders off handsomely, creating substantial assets. These businesses are more than likely to be self-funding companies that require no additional debt or equity investments. One of the quickest ways to gauge whether a company is an asset creator or cash consumer is to look at the return on equity that it generates. By relating the earnings generated to the shareholders equity, an investor can quickly see how much cash is created from the existing assets.

Xu and Wang (1997) utilized ROE to study the relationship between ownership structure, corporate governance and corporate performance among the listed companies in China. Pfeffer and Salancik (1978) found ROE to be extremely handy as a measure of profitability when studying the impact of external control on profitability of USA companies. Levin (1982) utilized this tool to investigate the relationship between ownership and performance of large industrial firms in the USA. A good ROE is not only an indicator of what the management team has done with the investors' assets, but also points to good strategies that would probably ensure handsome returns on future. This, therefore, is a very

appropriate tool for the current study since it gauges the effectiveness of the corporate governance practices adopted by the company.

2.5.3. Dividend Yield

Dividend is a payment companies make to shareholders out of their excess earnings, usually expressed as a per-share amount. The expression “dividend yield” is however, used when comparing dividends of various companies, that is, the dividend amount divided by the stock price. Dividend yield helps the investors to appreciate the proportion of the purchase price the company will return to them in dividends (SmartMoney.com, 2005). Dividend yield is computed by dividing the annual dividend per share (current) by the current stock price (i.e. market price per share). Dividend yield is an easy way to compare relative attractiveness of various dividend-paying stocks. It tells an investor the yield he/she can expect by purchasing a stock. It also offers a basis of comparison between other investment vehicles such as Treasury Bills and Bonds, Corporate Bonds, Certificate of Deposit, Fixed Income securities and other such investment instruments.

Not all stocks pay dividends, nor should they. If a company is growing fast and can best benefit shareholders by reinvesting its earnings in the business or chooses to capitalize dividends, that is, what it should do for the sake of consolidating its future returns (Kennon, 2005). Still, many investors, particularly those nearing retirement, like a dividend both for the income and the security it provides. This analysis points to the often-ignored fact in investment practice, namely, that high dividend payout is not necessarily an indication of good corporate health, nor does low dividend or no-dividend indicate poor corporate performance.

Many studies dealing with corporate governance have often used Dividend Yield as a tool to cross check the overall health of companies. Among these studies are Demb and Neubauer (1992), Conforth (2001), Demsetz and Lehn (1985), Bhagat and Black (1999), Ayres and Cramton (1994), Baysinger and Hoskisson (1990), Fama and Jensen (1983) and Lewin and Stephens (1994), all of which found Dividend Yield to be extremely robust in establishing the market perception of a particular stock. On the other hand, Xu and Wang

(1997) found the tool to be inexact in emerging markets due to the political influences on the stock markets. To mitigate the political factor, this study will adopt the view that good, steady dividends over the study period, is a more reliable indicator of corporate health than spectacular oscillations in dividend and share price.

2.6. Ownership Structure and Corporate Performance

There is no well-established tradition of selecting specific measures for the analysis of ownership structure-performance relationship. In each case, the choice of these measures depends on availability of information and their appropriateness for specific research questions. For example, studies focusing on the impact of ownership concentration tend to employ the Herfindahl index or the equity stake of several largest investors, typically the top five shareholders (Demsetz and Lehn, 1985). Other researchers, especially those who investigate developing economies with low availability of data, use equity stake of the largest shareholder (Kapelyushnikov, 2000).

For purposes of this thesis, ownership structure was analyzed in two dimensions, namely: ownership concentration and ownership identity. Ownership concentration refers to the percentage of shares held by an owner relative to the total shareholding of the firm while ownership identity refers to the actual names of major shareholders (Ibid, 2000). According to Kuznetsov et al (2001), studies that use either ownership concentration or ownership identity alone cannot claim to have exhaustively analyzed the relationship between ownership structure and firm performance.

The literature on ownership concentration pays more attention to the ability of the owners to monitor and control managerial discretion, but fails to take into consideration the investment preferences of the owner(s) and how they affect the priorities and strategies of the firm. On the other hand, studies which use ownership identity may well be in a position to address the issues of risk aversion, wealth creation and shareholder value but dismally fail to pay attention to the powers to control and monitor management that are conferred by actual shareholding (Cubbin and Leech, 1983).

2.6.1. Ownership concentration and corporate performance

The effect of ownership concentration on company profitability has been studied since Berle and Means (1932). Other studies comparing profitability of manager- and owner-controlled companies, often categorized by the share of the largest owner, generally found a higher rate of return in companies with concentrated ownership (Cubbin and Leech, 1983). These studies, however, were seriously lacking a theoretical foundation. They neither used nor provided a theory of ownership structure and seemed to imply that shareholders could profit by rearranging their portfolios. This point was emphasized by Demsetz (1983) who argued theoretically that the ownership structure of the firm is an endogenous outcome of the competitive selection in which various cost advantages and disadvantages are balanced to arrive at an equilibrium organization of the firm.

Traditionally, concentrated ownership has been thought to provide better monitoring incentives, and lead to superior performance (Leech and Leahy, 1991). On the other hand, it might also lead to extraction of private benefits by the controlling shareholders at the expense of the minority shareholders (Maher and Andersson, 1999). The principal-agent model suggests that managers are less likely to engage in strictly profit maximizing behavior in the absence of strict monitoring by shareholders (Prowse, 1992; Agrawal and Knoeber, 1996). Therefore, if owner-controlled firms are more profitable than manager-controlled firms, it would seem that concentrated ownership provides better monitoring which leads to better performance.

Gugler (1999) provides a comprehensive survey of empirical studies of the effects of ownership concentration on corporate performance, beginning with the pioneering work of Berle and Means (1932) to more recent work by Leech and Leahy (1991), Prowse (1992), Agrawal and Knoeber (1996), and Ch0 (1998). Based on primary studies from the US and UK, he finds that although the results are ambiguous, the majority of studies find that firms with concentrated ownership tend to significantly outperform manager-controlled firms.

Demsetz and Lehn (1985) found no association between ownership concentration and profitability (return on equity) in large US companies when controlling for determinants of

concentration and other variables. According to standard agency theory (Shleifer and Vishny, 1997), the choice of a privately optimal ownership structure involves a trade off between risk and incentive efficiency. Other factors kept constant, larger owners will have a stronger incentive to monitor managers and more power to enforce their interests and this should increase the inclination of managers to maximize shareholder value. Generally speaking, however, the owners' portfolio risk will also increase the larger the ownership share. To the extent that companies differ in terms of firm specific risk, the privately optimal share of the largest shareholder (owner) will therefore, vary. Furthermore, the nature and complexity of activities carried out by individual firms may also vary, and so may the marginal effect of monitoring on the shareholder value of individual firms (Demsetz and Lehn, 1985).

Small shareholders may have an insufficient incentive to maximize total shareholder value because the control and monitoring gains from large block shareholdings are shared with other investors. And if one or a very small group of shareholders attempts to acquire a large ownership stake, the gains will largely be captured by the other shareholders who sell their shares at a premium reflecting increased demand for the shares and value of the firm. This in effect leads to a positive equilibrium effect of ownership concentration on company performance since companies with large owners will do better and since minority investors have insufficient incentives to change the ownership structure. But with increasing ownership shareholding, improved incentives will have less of an effect on performance if the marginal effect of monitoring effort is decreasing (Jensen and Ruback, 1983). Besides, a large ownership stake in a particular company indicates a less than fully diversified portfolio on the part of the owner so that the owner risk aversion may induce the company to trade off expected returns for lower risks. This is because a risk-averse investor, who has most of his investments in a particular line of assets, is always wary of the chances of his capital being substantially reduced or even wiped out in a hostile investment environment (Short, 1994).

Finally, the separation between ownership and management becomes blurred as ownership share increases with the added risk or owner "entrenchment" due to private benefits of

control (information advantages, perks, etc) (Ibid, 1994). From the above literature, and in accordance with Morck, Shleifer and Vishny (1988), the following hypothesis is suggested: There is a positive relationship between ownership concentration and firm performance.

2.6.2. Ownership Identity and corporate Performance

The pertinent literature on corporate governance pays much attention to the issue of shareholder identity (Shleifer and Vishny, 1997; Welch, 2000; Xu and Wang, 1997). The cited authors argue that the objective functions and the costs of exercising control over managers vary substantially for different types of owners. The implication is that, it is important, not only how much equity a shareholder owns, but also who this shareholder is, that is, a private person, manager, financial institution, non-financial institution enterprise, multi-national corporation or government. Investors differ in terms of wealth, risk aversion and the priority they attach to shareholder value relative to other goals.

Owner preferences and investment choices are influenced by shareholder interests that the owners may have in addition to their own interests (Cubbin and Leech, 1982; Nickel, 1997; Hill and Jones, 1982; Hansmann, 1988; 1996). To the extent that owners have their economic relations with the firm, conflicts of interest may arise. For example, banks may play a dual role as lenders and owners, government as regulators and owners (Thomsen and Pedersen, 1997). For each of these stakeholders, preferences regarding company strategy will involve a trade off between the pursuit of shareholder value and other goals.

A similar trade-off is implied for corporate owners such as multi-national parent companies that may want to sacrifice local profit maximization for global interest of the organization. Among the different ownership forms, managerial ownership seems to be the most controversial as it has ambivalent effects on firm performance. On one hand, it is considered as a tool for alignment of managerial interests with those of shareholders, while on the other hand, it promotes entrenchment of managers, which is especially costly when they do not act in the interest of shareholders (Mork *et al*, 1988; Stulz, 1988).

Thomsen and Pedersen (2000) posit that the relationship between ownership concentration (as a proxy for shareholder control over managers) and firm performance depends on the identity of the large (controlling) shareholders. One possible interpretation of this finding is that different types of shareholders have different investment priorities, and preferences for how to deal with managers' agency problems. The overall impact of managerial ownership on corporate performance depends on the relative strengths of the incentive alignment and entrenchment effects.

Regarding government (state) ownership, there is much more unanimity in the academic circles. State ownership has been regarded as inefficient and bureaucratic. De Alessi (1980, 1982) defines state-owned enterprises as "political" firms with general public as a collective owner. A specific characteristic of these firms is that individual citizens have no direct claim on their residual income and are not able to transfer their ownership rights. Ownership rights are exercised by some level in the bureaucracy, which does not have clear incentives to improve firm performance. Vickers and Yarrow (1988) consider the lack of incentives as the major argument against state ownership. Other explanations include the price policy (Shapiro and Willig, 1990), political intervention and human capital problems (Shleifer and Vishny, 1994).

State ownership of firms is not without some benefits to the society. Traditionally, public enterprises are called upon to cure market failures. As social costs of monopoly power become significant, state control seems to be more economically desirable as a way of restoring the purchasing power of the citizenry (Atkinson and Stiglitz, 1980). Generally speaking, however, empirical evidence suggests that public firms are highly inefficient in comparison to private ones (Megginson, *et al*, 1994), even in pursuing public interests. There are several reasons for such observed poor performance of state-owned firms.

According to Shleifer and Vishny (1994), state-owned firms are governed by bureaucrats or politicians that have extremely concentrated control rights, but no significant cash flow rights since all the profits generated by the firms are channeled to the government exchequer to finance the national budget. This is aggravated by political goals of

bureaucrats that often deviate from prudent business principles (Repei, 2000). Such enormous inefficiency of state firms has precipitated a wave of governance transformations in economies around the world in the last two decades through heightened privatization of state-owned firms.

In their analysis of political control of state-owned firms' decision making processes, Boycko, Shleifer and Vishny (1996) argue that transferring control rights from politicians to managers (i.e. increasing managerial discretion) can help improve firm performance largely because managers are more concerned with firm performance than are politicians. Banks and other financial institutions are most likely to be risk averse because of their concern with profit maximization. An organization that is heavily leveraged lacks the capacity to pursue risky investment options as these would jeopardize their chances of honoring loan repayment schedules, especially in loss making situations. Banks will also try to discourage further indebtedness as more loans might lead to liquidity problems and perhaps insolvency (Hansmann, 1988). Public companies, on the other hand, can support further indebtedness, if it promises to improve the financial position of the firm and shareholder value in the long-run.

Regarding diffuse shareholding, it is clear from the relevant literature on agency problem that this kind of ownership structure will not give adequate control to the shareholders due to lack of capacity and motivation to monitor management decisions (Jensen and Meckling, 1976). Hence the control of the firm reverts to underhand dealings aimed at augmenting their income. This insider dealing might compromise company performance. Manager/insider ownership, on the other hand, has attracted a lot of attention and interest for a wide variety of reasons. Much of the interest has focused on the potential for better economic performance, particularly through enhanced motivation and commitment from employees who have a direct stake in the residual income of the firm. Strong majorities of the public believe that manager-owners work harder and pay meticulous attention to the quality of their work than non-owners, and are more likely than outside shareholders to influence firm performance. There have also been social arguments for manager/insider ownership of firms, based on its potential to broaden the distribution of wealth, decrease

labor-management conflict, and enhance social cohesion and equality by distributing the fruits of economic success more widely and equitably (Gates, 1998).

The effect of foreign ownership on firm performance has been an issue of interest to academics and policy makers. According to Gorg and Greenaway (2004), the main challenging question in the international business strategy is the outcome gained from foreign ownership of firms. It is mainly accepted that foreign ownership plays a crucial role in firm performance, particularly in developing and transitional economies. Researchers (Aydin, Sayim and Yalama, 2007) have concluded that, on average, multi-national enterprises have performed better than the domestically owned firms. It is therefore, not surprising that the last two decades have witnessed increased levels of Foreign Direct Investments in the developing economies.

Two main reasons have been put forward to explain the phenomenon of high performance associated with foreign ownership of firms. The first reason is that foreign owners are more likely to have the ability to monitor managers, and give them performance-based incentives, leading the managers to manage more seriously, and avoid behaviors and activities that undermine the wealth creation motivations of the firm owners. The second reason is the transfer of new technology and globally-tested management practices to the firm, which help to enhance efficiency by reducing operating expenses and generating savings for the firm. This leads us to the hypothesis H_{2e}: Foreign ownership has a positive effect on firm performance.

2.7. Board Effectiveness and Corporate Performance

The Board of Directors, which is elected by the shareholders, is the ultimate decision making organ of the company (McDonald, 2005). The Board plays a major role in the corporate governance framework, and is mainly responsible for monitoring managerial performance, and achieving an adequate return for shareholders. The Board also acts as an intermediary between the principals (shareholders) and the agents (managers), ensuring that capital is directed to the right purpose (Brown Governance, 2004). In this role, the Board prevents conflicts of interest that may arise between managers and shareholders, and

balances competing demands on the corporation. When necessary, the Board also invokes its authority to replace the management of the corporation with new, presumably more efficient management that will maximize the firm's profits. Besides, the Board is responsible for reviewing key executive remuneration.

The Board also acts as the voice of the agents to the principals, articulating their ideas for uses of capital and making an accounting of the use of capital back to the principals (Brown Governance, *Ibid*, 2004). The Board, in exercising its business judgment, acts as an advisor to the top management and defines and enforces standards of accountability, all with a view to ensuring that top management execute their responsibilities fully and in the interest of shareholders.

The role of the Board has come under increasing scrutiny since the first wave of major corporate scandals broke, particularly, in the US (McDonald, 2005). Prior to the scandals, blame for corporate governance failures fell squarely on the CEO's shoulders (*Ibid*, 2005). In the recent past, investors have become increasingly skeptical about how well boards are running their companies. With more vigilance coming from stakeholders, directors are coming to grips with the need to play a hands-on role in maintaining the overall health of the enterprise for the benefit of its owners: the shareholders.

2.7.1. Board Composition

There is near consensus in the conceptual literature that effective boards are composed of greater proportions of outside directors (Lorsch and MacIver, 1989; Mizruchi, 1993; Zahra and Pearce, 1989). A preference for outsider-dominated boards is largely grounded in agency theory. Agency theory is built on the managerialist notion that separation of ownership and control, as is characteristic of the modern corporation, potentially leads to self-interested actions by those in control- managers (Eisenhardt, 1989; Jensen and Meckling, 1976). Agency theory is a control-based theory in that managers, by virtue of their firm-specific knowledge and managerial expertise, are believed to gain an advantage over firm owners who are largely removed from the operational aspects of the firm (Mizruchi, 1988).

As managers gain control in the firm, they may be able to pursue actions that benefit themselves and not the firm owners. The potential for this conflict of interest or battle for control necessitates monitoring mechanisms designed to protect shareholders as owners of the firm (Fama and Jensen, 1983; Jensen and Meckling, 1976; Williamson, 1985). One of the primary duties of the board of directors is to serve this monitoring function (Fama and Jensen).

According to the agency theory then, effective boards will be composed of outside directors. These 'outsiders' are believed to provide superior performance benefits to the firm as a result of their independence from firm management. Some empirical support has been found for this position. Ezzamel and Watson (1983), for example, found that outside directors were positively associated with profitability among a sample of U.K. firms. In an examination of 266 U.S. corporations, Baysinger and Butler (1985) found that firms with more outside board members realized higher returns on equity. Several other researchers have also noted a positive relationship between outside directors and firm performance (Pearce and Zahra, 1992; Rosentein and Wyatt, 1990; Schellenger, Wood and Tashakori, 1989).

Other researchers have, however, noted the potential benefits of inside directors (Baysinger and Hoskisson, 1990; Baysinger, Kosnik and Turk, 1991; Boyd, 1994; Hill and Snell, 1988; Hoskisson *et al*, 1994). Baysinger and Hoskisson (1990) have suggested that the superiority of the amount and quality of inside directors' information may lead to more effective evaluation of top managers' performance. Others have noted a positive relationship between inside directors and corporate R and D spending (Baysinger *et al*, 1991), the nature and extent of diversification (Hill and Snell, 1988) and CEO compensation (Boyd, 1994).

Consistent with stewardship theory, some researchers have found that inside directors were associated with higher corporate performance. For example, in an examination of Fortune 500 corporations, Kesner (1987) found a positive and significant relationship between the proportion of inside directors and returns to investors. The earlier work of Vance (1964,

1978) on corporate governance reported a positive association between inside directors and firm performance. Additionally, there is a stream of research which has found no relationship between board composition and firm performance (Chaganti, Mahajan and Sharma, 1985; Daily and Dalton, 1992, 1993; Kesner, Victor and Lamont, 1986; Schmidt, 1975; Zahra *et al* 1988).

2.7.2. Board Member Selection Criteria

Board members fulfill both the internal functions of monitoring and ratifying managerial decisions and providing conduits of trust and information for the firm in its external dealings. The board member selection criteria would ideally take into consideration these onerous responsibilities of the board. Particular attention should, therefore, be paid to the ability of the individual members of the board to appreciate the dynamics of the business environment, and provide leadership in real time. In this regard, care should be taken to constitute boards that are endowed not only with specific knowledge of a firm's technology and financial markets, but also general knowledge of corporate governance structures as well as overall appreciation of global business and financial trends.

In order to build and sustain a positive image of the organization, board members should be people who enjoy unquestioned industry-specific reputation, build individual networks across the industry, possess superior bargaining power and intellectual independence to competently monitor managerial performance and ratify managerial decisions (Zahra *et al*, 2005). This overview on board effectiveness, board composition, and board member selection criteria, among other things, demonstrates that there is little consistency in research findings to explain the most appropriate board composition that can ensure effectiveness, measured in terms of corporate performance. It however, helps us to appreciate the oversight role of the board as comprising four core responsibilities (Zahra, *Ibid*, 2005), namely, that sets the strategic direction of the organization (leadership); stewardship; monitoring; and reporting to the principals the results of using their capital. In addition, the modern Board must exhibit enthusiasm for creativity and innovation. This leads us to hypothesis H₃: Board effectiveness has a positive effect on firm performance

2.8. Managerial Discretion and Corporate Performance

Hambrick and Finkelstein (1987) have defined managerial discretion as the executives' ability to effect important organizational outcome; a function of the task environment, the internal organization, and the managerial characteristics.

While concurring with this definition, Hitt, Ireland, and Hoskisson (2003) specify factors affecting managerial discretion to include industry structure, rate of market growth, number and type of competitors, nature and degree of political, legal constraints, degree to which products can be differentiated, organizational characteristics of the manager. Hambrick and Abrahamson (1995) and Finkelstein and Hambrick (1990) posit that managerial discretion moderates the correlation between top management effectiveness and both strategic continuity and firm performance.

Agency theory hypothesizes that managerial discretion is related negatively to firm performance if managers use their discretion to pursue their own selfish objectives. According to Chang and Wong (2003), strategic management of managerial discretion is dependent, to a large extent, on a comparison of the objectives of controlling shareholders and those of managers. Although it is now a well established fact that managers may have self-serving objectives, there is no priori that restricting managerial discretion will better serve the goal of maximizing firm performance. When controlling shareholders also have self-serving objectives, increasing managerial discretion can be a useful way to partially protect the interests of investors, and improve firm performance (Ibid, 2003, pp. 4).

Typical agency theory views managerial discretion as an opportunity for managers to serve their own objectives rather than the objectives of their controlling shareholders. The controlling shareholders may develop various strategies to prevent managers from using their decision making discretion to pursue self-serving objectives at the expense of firm performance. These strategies would include doubling managers' compensation with firm performance (Jensen and Murphy, 1990), and establishing monitoring and bonding mechanisms to limit opportunistic actions by managers (Fama and Jensen, 1983). Such measures may discourage managers from pursuing their own goals even if they have the

discretion to do so. Furthermore, it may be in managers' best interest to maintain a certain level of firm performance because of both the discipline and opportunities provided by markets for their services, both within and outside the firm (Fama, 1989). Nevertheless, the core hypothesis within agency theory is that managerial discretion is negatively associated with firm performance if managers use their discretion to pursue self-serving objectives.

Many studies have examined the empirical relationship between managerial discretion and firm performance. Existing evidence about the relationship is however, inconclusive. Some studies (Williamson, 1963a; Palmer, 1973; Baysinger and Butler, 1985; Berger *et al*, 1997; Denis *et al*, 1997; Brush *et al*, 2000). Other studies find that managerial discretion is unrelated to firm performance (e.g. Chaganti *et al*, 1985; Demsetz and Lehn, 1985; Zahra and Stanton, 1988; Agrawal and Knoeber, 1996). The absence of a relationship is interpreted as evidence that various controlling shareholders have made optimal use of various mechanisms to control managers' agency problems and therefore, is considered to be consistent with agency theory's hypothesis. There are however, some studies (Kesner, 1987; Donaldson and Davis, 1991) that find a positive association between managerial discretion and firm performance.

While researchers have focused their efforts on identifying the indicators of discretion, they have not examined whether managers' perception of discretion vary within similar organizations and industries. Consequently, they also have not examined the sources of such variation. The goal of this study is to extend research on managerial discretion, and, more generally, to enrich our understanding of why managers and organizations may respond differently when confronted with similar strategic opportunities. Cognitively oriented studies have attributed managers' perceptions to industry conditions (Hambrick & Abrahamson, 1995) and organizational performance (Dutton and Duncan, 1987). These studies, have, unfortunately, not addressed the critical issue of managers personality characteristics; that is, whether the managers' actions are controlled by inner drive or some external influence (i.e. locus of control).

Rotter (1966) suggests that one's locus of control may affect the extent to which one perceives himself/herself to have discretion in a variety of situations. Locus of control reflects individual's generalized perceptions of the degree to which they control, or are controlled by their environment (Rotter, 1966). In fact, Rotter (1966) argues that the manager's perception of own discretion in decision making processes actually defines his/her perception of power relations within the organization.

"External" individuals tend to believe that the events in their lives are beyond their control; in their view, luck or destiny determine their fate. In contrast, "internals" tend to view their fate as primarily under their control (Milles, Kets de Vries and Toulouse, 1982). These perceptions tend to be communicated through informal channels or "body language" to the managers' subordinates, and they ultimately define the authority that managers actually wield over those subordinates.

2.8.1. Constraints on Managerial Discretion

According to the classical separation of ownership and control perspective, a dominant or majority shareholder has both the incentive and the ability to monitor management so that the firm is managed in a manner consistent with profit maximization. The incentive to monitor is high because the majority shareholder has a claim on all residual profit (Alchian and Demsetz, 1972), and the ability to monitor is high because the dominant shareholder can often control the Board of Directors (Tosi *et al*, 1989; Fama and Jensen, 1983; Salancik and Pfeffer, 1980).

On the other hand, agency theory is premised on the assumption that managers have non-profit maximizing objectives. Various studies analyzing managers' objectives make many different assumptions about these objectives. For example, Baumol (1959) assumes that managers have an incentive to maximize sales subject to the constraints of satisfactory profit, while Williamson (1963a, 1963b) assumes that managers have a positive preference for incurring staff expenses, acquiring bigger managerial emoluments, and increasing funds available for discretionary use. Some studies suggest that managers prefer a non-optimal

capital structure because such a structure enables them to pursue personal goals (Fama, 1980).

When the Board of Directors is under the control of a dominant shareholder, the cost of organizing a coalition to oppose existing management is avoided. In contrast, when shareholdings are widely diffused, neither the incentive nor the ability to monitor agents is present and so managers are afforded a greater degree of discretion that puts less pressure on them to maximize profits (and shareholder wealth). Thus concentrated ownership is a powerful restraint on managerial discretion. Research grounded in the separation of ownership and control thesis therefore typically makes the simplifying assumption that managerial discretion is essentially a function of ownership concentration. As such, individual, organizational and environmental factors other than ownership concentration that may impact upon managerial discretion are typically ignored (Hambrick and Finkelstein, 1987).

Nevertheless, even though modern corporations are often characterized by diffused ownership, managers are not necessarily able to engage in unethical discretionary behavior due to the monitoring and control role of boards of directors (Ibid, 1987). There are two broad sources of constraint on managerial discretion. These constraints may be classified as internal or external (Walsh and Seward, 1990).

Internal constraints largely emanate from the Board of Directors and are exercised on behalf of the shareholders (owners). These constraints reflect the composition and powers of the Board, including the ease by which shareholders can appoint or remove Board members, and the rules governing voting. External constraints, on the other hand, pertain to the role of markets in monitoring and disciplining managers. The mostly noted market-related constraints arise from managerial labour markets, product markets and financial markets (Jensen, 1989).

Managerial labor markets play a key role in influencing the behavior of managers. When the management of a firm is inefficient, or failing to maximize shareholder value, this

exposes the company to the threat of a take-over bid, with the consequential removal of inefficient management (Maher and Andersson, 1999). While up until now the market for corporate control has not been a key feature of corporate governance systems in developing countries such this is gradually beginning to change, as mergers and acquisitions are becoming more common (Ibid, 1999, pp.22).

According to Maher and colleagues (1999), product market competition can to some extent act to reduce the scope for managerial inefficiency and opportunism. This is because there are limited opportunities for supernormal profits and rent-seeking behavior when markets are competitive, forcing managers to enhance efficiency in order to survive. Competition also provides a benchmark by which the performance of the firm can be judged by comparing it with performance of other firms within the same sector.

Providers of capital tend to maintain complex and long-term relationships with the corporate sector. According to Blair (1995), the long-term relationships between banks and their corporate clients provide greater access to firm-specific information. Due to this disclosure, the bank-firm relationships reduce asymmetric information problems, enabling banks to supply more finance to firms at a lower cost, and thus increasing investment. In addition, bank-firm relationships increase monitoring, thus ensuring firms are run more efficiently (Ibid, 1995, pp. 25).

The modern corporation is increasingly experiencing extra-ordinary vigilance by a wide range of stakeholders who manifest themselves either directly or indirectly. Stakeholders place a lot of constraints on managerial consultations before major decisions are made. A Board that represents shareholder (or stakeholder) interests can effectively monitor managers by virtue of its proximity to sources of information. Also, because the Board is a relatively small body, monitoring costs are low (Kesner, 1987; Baysinger and Hoskisson; 1990; Baysinger, Kosnik and Turk, 1991).

Needless to say, the efficacy of internal constraints is dependent on the Board acting in the interests of shareholders (stakeholders), an assumption that may not always be justified

(Herman, 1981). Unless Board members are significant shareholders, their incentive to monitor is low and will not approach that of a dominant or majority shareholder. In contrast to the classical agency theory position, there is evidence to suggest that vigilant Boards comprising independent outsiders may have a strong incentive to monitor managers when they are shareholders. Further, even in the absence of share ownership, Board members have their personal reputations as directors at stake, which provides them with an incentive to be vigilant monitors (Fama and Jensen, 1983).

In countries where employees or other stakeholders are represented on the Board, the incentive as well as the ability of stakeholders to monitor can be quite high. Based on this logic, some organizations have developed executive share ownership programs for their higher-level management and Board of Directors. Under this plan, an employee, usually an executive manager or a member of the Board is given a certain number of shares of the company or an option to buy them from the market place. This way, the manager or the Board member gets a stake in the profits of the business (Muruku *et al*, 1999). The thesis is that it will be in the interest of the executive or board member to increase efficiency since that will result in increased stock prices, from which he also benefits.

An essential characteristic of internal constraints is that the responsibility for monitoring falls on insiders (e.g. owners or Board) who are directly charged with the responsibility for corporate governance. What is common to the external constraints is that they rely on a variety of markets or market-based measures to align interests and thus, when effective, render monitoring of managers unnecessary. In the case of external constraints, shareholders are essentially transferring monitoring responsibility to the markets. In the case of markets for corporate control, managers who do not maximize returns to shareholders will see their firms acquired and themselves displaced in favor of more proficient managers (Jensen, 1989).

2.9. Ownership Structure, Board Effectiveness, Managerial Discretion and Corporate Performance

Empirical researchers (Jensen and Meckling, 1976; Wang and Xu, 1997; Shleifer and Vishny, 1997; Monks, 1998; Jensen, 2000; Shleifer, 2001; Wirtz, 2002; Donaldson, 2005) have vindicated the long-held belief that there exists a relationship between ownership structure and firm performance. The researches have however, not reached conclusive evidence as to the nature of this relationship. There have been diverse and at times even contradictory results depending on, among other variables, the identity of the shareholders (owners) and the extent of ownership (ownership concentration).

It has been argued that ownership concentration has a direct and positive relationship with firm performance since the owners have the necessary motivation (as stakeholders in residual income) and the wherewithal to monitor corporate performance (Demsetz, 1983; Jensen and Ruback, 1983; Short, 1994; Shleifer and Vishny, 1997). On the other hand, different owners are known to have different levels of risk aversion and wealth creation affinity. When firm owners select people to represent their interests on the Board of Directors, the preferences and investment choices of the owners find expression through the Board. Hence, the interests of the owners more often than not influence corporate decisions and performance.

However, where directors are swayed by prudence or personal interests to act in disobedience to the owners, then agency conflict arises, and the defiant directors or the whole Board may be removed (Cubbin and Leech, 1982; Nickel, 1997; Hill and Jones, 1982; Hansmann, 1988; 1996). This argument is premised on the presumption that the owners have the ability to monitor and ratify Board decisions, a situation that is not always tenable given the large number of shareholders, lack of expertise and time that characterize shareholder participation in the modern organization. Ownership concentration may thus provide stronger motivation for the firm owners to keep abreast of Board processes and decisions, and strengthen the monitoring and ratification role more than would be possible in a diffuse/diverse ownership structure (Fama and Jensen, 1983; Williamson, 1985; Rosentein and Wyatt, 1990; Pearce and Zahra, 1992). The same argument has been

extended to explain the relationship between managerial discretion and corporate performance.

Where the Board is composed of members who have the requisite specific and general knowledge of the core business of the organization, the ability of that Board to monitor and ratify decisions of the management is enhanced. However, for the Board to be effective there is need for a reasonable proportion of outside directors with no direct dealings with the management (Eisenhardt, 1989; Lorsch, 1989). Empirical research has supported the positive impact of outside directors on superior performance (Ezzamel and Watson, 1983; Baysinger and Butler, 1985; Waldo, 1985; Fleischer, Hazard and Clipper, 1988; Pearce and Zahra, 1992).

Besides the internal monitoring that mainly emanates from the vigilant Board, firm size, leverage and idiosyncratic resources, the modern manager is also subject to external constraints that constrict his/her discretion in decision making. The most notable of these external constraints are managerial labour markets, product markets, financial markets and industry structure. The right balance of concentrated ownership, effective Board and external monitoring is expected to reasonably reduce the management's excessive discretion and insider dealings, and ultimately enhance corporate performance.

2.10. Summary of the Literature and Knowledge Gap

Pertinent literature has revealed that corporate governance systems are now well documented, together with the existing theories and analytical frameworks. Arising from the prevalent corporate failures across the globe, however, the credibility of the existing corporate governance structures have been put to question due to their inability to comprehensively explain the recent phenomenon (Gomez, 2005; Shleifer and Vishny, 1997; Shleifer, 2001; Jensen and Meckling, 2000). The need to explain the recent corporate failures in spite of the existing structures has led to renewed interest in the subject over the past one decade.

The traditional approach to corporate governance has tended to over rely on the monitoring and ratification powers of the board in relation to the discretion of top management in decision making processes (Huse, 2005; Donaldson, 2005; Frentrop, 2003; Monks, 1998). This approach to corporate governance has typically ignored the unique influence that firm owners exert on the board, and by extension, the top management, to behave or make decisions in a particular way. Owner preferences and investment choices are influenced by, among other things, the extent to which they can take risks, and the nature of economic relations that they have with the firm. These economic relations and risk taking behavior impact strongly on corporate performance (Cubbin and Leech, 1982; Hill and Jones, 1982; Fama and Jensen, 1983; Thomsen and Pedersen, 1997).

There is evidence from empirical research to vindicate the influence of firm owners on corporate performance. The available evidence has, however, failed to reach a consensus on the exact nature of the relationship between ownership structure, corporate governance and firm performance. Pedersen and Thomsen (1997) reported that banks that play a dual role as lenders and owners tend to be risk averse, whereas non-bank owners tend to accept more risk. Nickel (1997) found out that firms owned by government tended not to strictly implement government regulations on corporate governance. For that reason, the average corporate earnings from the public sector tended to be lower, on average, than those from the private sector. Morck, Shleifer and Vishny (1988) reported a significant relationship between owner preferences and firm performance. Cho *et al* (1996) concluded that firm performance affects ownership structure, but ownership structure does not affect firm performance among Chinese companies. Whereas Morck, Shleifer and Vishny (1988) established a significant positive relationship between outside owners and firm performance in the USA, Demsetz and Lehn (1985) found a non-significant relationship.

Whereas Demsetz and Villalonga (2001) found no significant relationship between insider (manager) ownership and accounting profitability, Welch (2004) reported a significant positive relationship among listed companies in Australia. Others who have found a positive significant relationship include Holdemess, Kroszner and Sheehan (1999) and Himmelberg, Hubbard and Palia (1998), and McConnell and Servaes (1990). Some

researchers have, however, found unclear results. Loderer and Martin (1997) for example, found that ownership does not predict performance, but performance is a negative predictor of ownership. Cho *et al.* (1998), on the other hand, established that performance affects ownership but, ownership by insider managers and directors does not affect performance of listed Chinese firms.

The conclusion that may be drawn from the pertinent literature is that the existing framework for analyzing corporate governance systems is inadequate, and has thus failed to explain the phenomenon of corporate malfeasance. Several researchers have identified ownership structure as the main missing link in the corporate governance framework. An attempt to resolve the missing link through empirical research has ended up with contradicting conclusions. Hence, there is need to continue with the research endeavors, particularly in the developing countries, in an attempt to obtain concrete evidence on the role of ownership structure in corporate governance. The relevant interrelationships among the corporate governance variables and their impact on performance, as revealed by the reviewed literature, are depicted in the conceptual framework (Figure 1).

2.11. Conceptual Framework

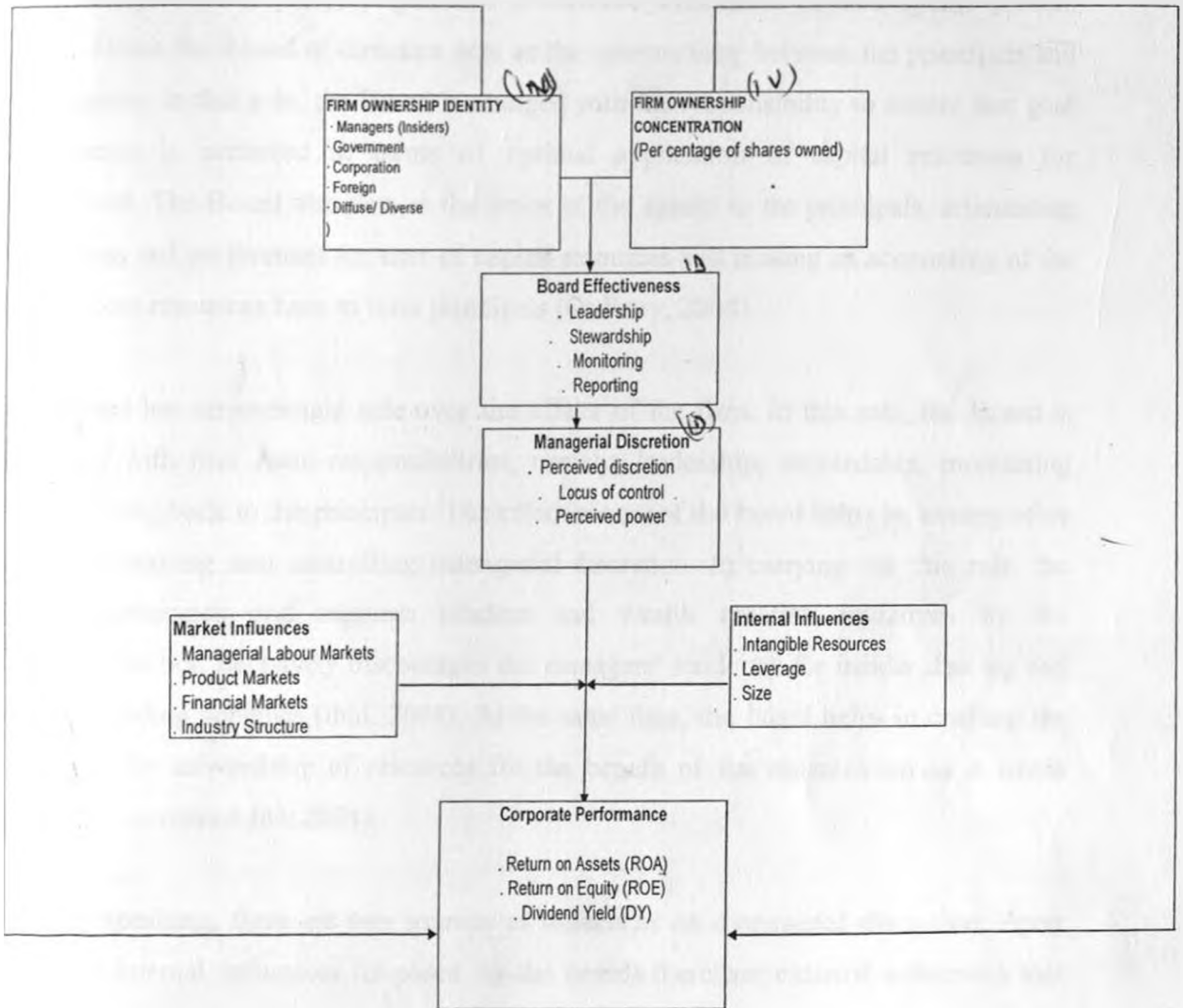


Figure 1: Corporate Governance Model

The variables that have been captured in the literature review, and relationships among them, have been integrated to constitute a conceptual framework presented as (Figure1). The framework is explained in this section. Agency problems arise when investment ideas and preferences of principals are at variance with those of their agents (Leech, 1986). Hence the board of directors acts as the intermediary between the principals and their agents. In this role, the Board is charged with the responsibility to ensure that goal congruence is achieved in terms of optimal application of capital resources for investment. The Board also acts as the voice of the agents to the principals, articulating their ideas and preferences for uses of capital resources and making an accounting of the use of these resources back to their principals (Cadbury, 2004).

The Board has an oversight role over the affairs of the firm. In this role, the Board is entrusted with four main responsibilities, namely, leadership, stewardship, monitoring and reporting back to the principals. The effectiveness of the board helps in, among other ways, monitoring and controlling managerial discretion. In carrying out this role, the board encourages and supports prudent and wealth creation initiatives by the management but, decisively discourages the managers' tendency for insider dealing and empire building schemes (Ibid, 2004). At the same time, the board helps in crafting the strategies for stewardship of resources for the benefit of the organization as a whole (Brown Governance Inc; 2004).

Broadly speaking, there are two sources of influences on managerial discretion. Apart from the internal influences (imposed by the board) there are external influences that pertain to the role of markets in monitoring and disciplining managers (Jensen, 1989). The most significant market-related constraints arise from managerial labor markets, product markets and financial markets. Managerial labor markets pose multi-dimensional threat to inept managers in the form of imminent take-over or absorption by better-managed firms, replacement of the management team or simply being black-listed.

The early literature on agency theory appears to stipulate that shareholders' interests can be protected because managerial incentives can be re-structured to bring about goal

congruence between managers' interests and the wealth creation motivation of the shareholders. As such, managers attempt to avoid poor performance due to the threat of dismissal and replacement by more competent managers, and as such, are stimulated to reach strong corporate performance as a result of the rewarding and incentive effects of the compensation contracts, and the disciplining role of the managerial labor markets (Holmstrom, 1982a; Murphy, 1986).

Evidently, most of the academic literature that exists on managerial labor markets appears to place more emphasis on managerial compensation at the expense of the disciplining role of the managerial labor markets, yet this is a crucial aspect of corporate governance. For instance, Bebchuk and Fried (2003) point out that executive compensation should be seen as a manifestation of agency problems rather than a solution if remuneration contracting is not embedded in a proper corporate governance system. Baysinger and colleagues (1991) found out that managers of poorly performing firms were three times more scared of strong managerial labor markets than those whose organizations had consistently reported superior performance.

Product markets are another key component of the firm's external environment. Firms produce goods and services in order to sell them to consumers. Badly managed firms have a tendency to be inefficient, leading to a pricing policy geared towards absorption of excessive costs of mismanagement. The result is that the products and services end up being priced higher than the industry average prices. Hence, such products and services gradually lose their market share, and, if this trend continues into the long run, the business becomes unsustainable and eventually closes down (Jensen, 1989). As providers of capital for operations and expansion, financial markets have the muscle to discipline managers who cannot honor their obligations to creditors and suppliers.

According to Chang and Wong (2003), there is absolutely no reason to worry about corporate governance issues since product market competition should provide incentives for firms to adopt the most efficient corporate governance mechanisms. Firms that do not adopt cost-minimizing governance mechanisms would presumably be less efficient, and

in the long run, would be replaced, that is, competition should take care of governance. This line of argument would oppose any external policy interventions on the grounds that at best they are unhelpful, and at worst, a distortion. Rather than justifying public intervention, the argument is that the resolution of governance problems should be left to market mechanisms. The recent developments in the managerial labor market, such as executive stock options and the market for corporate control (e.g. leveraged and management buy-outs) are seen as market responses to institutional deficiencies (Ibid, 2003, pp. 4).

While there are likely to be important interactions between product markets and corporate governance systems, market competition alone cannot solve the market failures arising from asymmetric information, hold-up and principal-agent problems that are at the core of the corporate governance problem. Market failures resulting in socially-inefficient outcomes are one of the strongest arguments in favor of policy intervention. For example, product market competition does not prevent managers from expropriating shareholders' rents, with the consequential effect of producing sub-optimal levels of investment.

Managerial ineptitude, more often than not, leads to poor financial management and erodes confidence of potential creditors (Brown Governance, Inc., 2004). These constraints impose on managers extra vigilance as they exercise their discretion. Other factors that moderate managerial discretion include intangible (idiosyncratic) resources, firm leverage, size, and industry structure. Demsetz and Villalonga (2001) found out that there was a significant positive relationship between corporate performance and intangible resources among American companies. Intangible assets are firm-specific characteristics that are unique to, and influence performance of an organization.

Resource Based View (RBV) holds that firms can earn sustainable supra-normal returns if and only if they have superior intangible resources that are protected by some form of isolating mechanism preventing their diffusion throughout industry (Miller, 2003). According to Wernerfelt (1984) and Rumelt (1984), the fundamental principle of the RBV is that the basis for a competitive advantage of a firm lies primarily in the

application of the bundle of valuable resources at the firm's disposal. To transform a short-run competitive advantage into a sustained competitive advantage requires that these resources are heterogeneous in nature and not perfectly mobile (Barney, 1991; Peteraf, 1993). Essentially, these valuable resources become a source of sustained competitive advantage when they are neither perfectly imitable nor substitutable without great effort (Hoopes, 2003; Barney, 1991). In a nutshell therefore, to achieve these sustainable above average returns, the firm's bundle of resources must be valuable, rare, imperfectly imitable and non-substitutable (Barney, 1991).

A valuable resource must enable the firm to employ a value-creating strategy, by either outperforming its competitors or reduce its own weaknesses (Barney, 1991, pp.99; Amit and Shoemaker, 1993). To be of value, a resource must be rare. In a perfectly competitive strategic factor market for a resource, the price of the resource will be a reflection of the expected discounted future above-average returns expected to accrue from its utilization (Barney, 1986a; Dierickx and Cool, 1989; Barney, 1991).

A resource is said to be in-imitable if that resource is controlled by only one firm, and it becomes a source of competitive advantage due to its non-availability to the firm's competitors (Barney, 1991, pp107). This advantage could be sustainable if competitors are not able to duplicate this strategic asset perfectly (Peteraf, 1993; Barney, 1986b). Even if a resource is rare, potentially value-creating and imperfectly imitable, an equally important aspect is non-substitutability (Dierickx and Cool, 1989; Priem and Butler, 2001a).

If competitors are able to counter the firm's value-creating strategy with a substitute, prices are driven down to the point that the price equals the discounted future cash flows from the use of the valuable resource (Barney, 1986a; Conner, 1991), resulting in zero economic profits. The above mentioned characteristics are individually necessary, but not sufficient conditions for a sustained competitive advantage (Dierickx and Cool, 1989; Priem and Butler, 2001a, p.25). Within the framework of the resource-based view, it is necessary that the four characteristics are displayed together in a firm to be a possible

source of a sustained competitive advantage (Barney, 1991, pp. 105-107). The observable measures of these intangible assets include research and development, skills, processes or assets a firm's competitors do not have and cannot copy at all. The inclusion of such variables allows one to show that a number of factors jointly affect firm performance (Villalonga et al, 2001).

Firm leverage refers to debt to equity ratio. It is necessary to keep this ratio at the optimal level since pecking order theory predicts a negative correlation between a firm's debt levels and corporate performance. When attempting to determine which is the best approach for financing their projects or needs, firms usually look at the accessibility of cash and its near future needs; look at the credit with the bank for short and long-term debt; and finally sell off non-core assets and equity (Pinder, 2007). Pecking order theory therefore, suggests that firms' capital structures are determined largely by needs for external financing. The theory predicts negative inter-industry correlation between profitability and debt-equity ratio, and negative share price reaction on an announcement of equity issue (i.e. information asymmetry). According to Peirson, Brown, Easton, and Howard (2003), leverage is investing debt in an effort to earn greater return than the cost of interest. When a company uses considerable proportion of debt to finance its investments, it is considered highly leveraged.

Leverage allows a firm to invest in assets that have the potential to generate high returns. Unfortunately, a highly leveraged firm brings about additional risk because if the investment does not bring the expected returns, the firm has to still pay the debt and interest. When a firm is leveraged it ultimately means that it depends somewhat on debt to finance its investments (Peirson *et al*, 2003). However, Mork (1988) reports a positive correlation between leverage and firm performance among financial institutions in America, leading him to conclude that firm leverage provides a measure of monitoring exerted by credit providers, which translate to superior corporate performance.

Providers of credit are an integral category of stakeholders in managerial decision-making process, not only to safeguard their funds, but also ensure that the decisions made

by management lead to firm expansion and hence more credit (Mork, Schleifer, and Vishny, 1988). Firm leverage therefore, constraints policy and strategy making process to the extent that the process might jeopardize loan repayment. Expensive and elaborate strategies are reconsidered in light of whether or not they lead to more exposure to risk (Demsetz et al, 2001). This notwithstanding, managers deal with leverage as part of their capital structure decisions, mainly a balancing act between financing needs of the firm and tax avoidance strategies (Ibid, 2001).

The decision to retain, reduce or expand firm size is a managerial decision, usually influenced by the need to reap maximum returns. However, once the decision on optimal size is made, the strategies and policies are crafted necessarily with reference to the size. While studying manufacturing firms in the USA, Chandler (1962), discovered that strategy of the organization influences structure, which in turn, affects size. The size of the firm helps in making such critical decisions as production Industry structure is another key moderating variable in so far as making of policies and strategies are concerned. Organizational policies, whether written or not, are the reference point on how the affairs of the organization are to be run for the sake of consistency in internal standards. Strategies, on the other hand, point to the direction that the organization needs to go in order to succeed.

Porter (1985) observes that industry structure has great influence on corporate performance. This is because the industry structure confers certain advantages and disadvantages to players, which do not necessarily affect firms in other industries. For example, the differences in the intensity of competition, maturity, existence of substitutes, threat of new entrants, power of buyers and suppliers may affect the level of profitability, growth and cash flow (Porter, 1985). It is also known that agency problems may be less severe in highly competitive industries.

Nickel (1997) found out that managers operating in intensely competitive industries in Europe have much larger latitude for decision making than their counterparts in less competitive industries. This, perhaps, is to enable the managers in the competitive

industries to quickly take advantage of opportunities that may be presented by the highly dynamic business environment. Factors like noise, dynamism and transparency may also vary by industry (Mifang and Simerly, 1985; Demsetz and Lehn, 1985; Zeckhouser and Pound, 1990). Industry structure and other factors influence managerial decision making processes regarding proactive and reactive policies and strategies. The type of strategies and policies that an organization makes, translate into firm performance that can be measured in terms of both financial as well as non-financial indicators (Ayres and Cramton, 1994).

The extent to which external and internal factors affect managerial discretion will depend on, among other factors, the manager's locus of control, perception of discretion and the amount of power that people perceive the manager to possess. The relationship between locus of control and how managers view their discretion is practically important to the extent that the variation in perceived discretion is systematically related to consequential managerial or organizational outcomes (Eisenhardt and Bourgeois, 1988). One such outcome is managerial power, defined as the ability to influence others. Managerial power is important because its use is especially likely at the strategic apex of the firm due to the ambiguity and uncertainty surrounding strategic issues (Eisenhardt and Bourgeois, 1988; Finkelstein, 1992; Tushman, 1977).

Child (1972) reported that managerial power is a positive predictor of managerial efficacy, the firm's strategic choices and performance among manufacturing firms in Europe. Noteworthy about the conceptualization of managerial power is that a manager must be able to recognize himself/herself, and be recognized by others, as powerful in order to influence these others (Pfeffer, 1981, 1992). This condition is significant since it conceptualizes managerial power as theoretically and practically distinct from perceived managerial discretion. For example, managers may perceive themselves as having much discretion and as powerful, they are not powerful (Pfeffer, 1992). Thus, managerial power is an interpersonal phenomenon, whereas perceived discretion is an intra personal phenomenon.

The relationship between locus of control and how managers view their discretion is both interesting and practically important to the extent that the variation in perceived discretion is systematically related to consequential managerial or organizational outcomes (Eisenhardt and Bourgeois, 1988). One such outcome is managerial power, defined as the ability to influence others. Managerial power is important because its use is especially likely at the strategic apex of the firm due to the ambiguity and uncertainty surrounding strategic issues (Eisenhardt and Bourgeois, 1988; Finkelstein, 1992; Tushman, 1977).

2.12. The Hypotheses

Table 2 presents a summary of objectives and corresponding hypotheses tested in the study. The hypotheses were deduced from the Corporate Governance Model (Figure 1) and the pertinent literature.

Table 1: Summary of Objectives and corresponding Hypotheses

OBJECTIVE	HYPOTHESES TESTED
1. To establish the relationship between ownership concentration and firm performance.	H₁ : There is a positive relationship between ownership concentration and firm performance.

<p>2. To establish the relationship between ownership identity and firm performance.</p>	<p>H2_a: Manager/Insider ownership has a positive effect on firm performance.</p> <p>H2_b: Government ownership has a negative effect on firm performance.</p> <p>H2_c: Ownership by corporations has a positive effect on firm performance.</p> <p>H2_d: Diffuse/Diverse ownership has a negative effect on firm performance.</p> <p>H2_e: Foreign ownership has a positive effect on firm performance.</p>
<p>3. To determine the relationship between board effectiveness and firm performance.</p>	<p>H3: Board Effectiveness has a positive effect on firm performance.</p>
<p>4. To determine the relationship between managerial discretion and firm performance when moderated by Internal Influences.</p>	<p>H4_a: The strength of the relationship between Managerial Discretion and Firm Performance depends on market influences.</p>
<p>5. To determine the relationship between managerial discretion and firm performance when moderated by external influences <i>market</i></p>	<p>H4_b: The strength of the relationship between Managerial Discretion and Firm Performance depends on internal influences.</p>
<p>6. To determine the nature of relationship (hierarchical or otherwise) between ownership structure and firm performance.</p>	<p>H5: The relationship between ownership structure and firm performance is hierarchical.</p>

2.13. Statistical Models

Theoretical models are used in research to demonstrate functional relationships that exist (if they do) among the variables. Specifically, these models enable the researchers to statistically determine the contribution made by the controllable (independent) variable on the dependent variable.

This study used Regression Analysis as follows:

Ownership Concentration and firm performance, (**H₁**)

$$Y_p = \alpha_c + \beta_c X_c$$

Where Y_p = Composite index of performance

X_c = Index of Ownership Concentration

α_c = Constant

β_c = Coefficient indicating influence of firm ownership concentration on performance.

Ownership Identity and firm performance (**H_{2a}, H_{2b}, H_{2c}, H_{2d}, H_{2e}**):

$$Y_p = \alpha_i + \beta_i X_i$$

Where Y_p = Composite index of performance

α_i = Constant

X_i = Index of Ownership Identity

β_c = Coefficient of identity and performance relationship.

Board Effectiveness and firm performance (**H₃**)

$$Y_p = \alpha_e + \beta_e X_e$$

Where Y_p = Composite index of firm performance

α_e = Constant

β_e = Coefficient Board Effectiveness on firm performance

X_e = Index of Board Effectiveness.

Managerial Discretion and firm performance (**H₄**)

$$Y_p = \alpha_d + \beta_d X_d$$

Where Y_p = Composite index of firm performance

α_d = Constant

β_d = Coefficient of influence Managerial Discretion on firm performance

X_d = Index of Managerial Discretion

Ownership Structure and Firm Performance (i.e. hierarchical relationship), **H₅**.

A multiple regression equation incorporating all the above variables was used.

$$Y_p = \alpha_o + \beta_c X_c + \beta_i X_i + \beta_e X_e + \beta_d X_d$$

Where: Y_p = Composite index of firm performance

α_o = Constant

β_c = Coefficient indicating influence of ownership concentration on firm performance.

X_c = Index of ownership concentration

β_i = Coefficient of indicating influence of ownership identity on firm performance

X_i = Index of identity on performance

β_e = Coefficient indicating Board Effectiveness on performance

X_e = Index of Board Effectiveness on firm performance

B_d = Coefficient of influence of Managerial Discretion on firm performance

X_d = Index of Managerial Discretion on firm performance

X_e = Index of Board Effectiveness

B_d = Coefficient of influence on managerial discretion

X_d = Index of Managerial Discretion

The statistical models explained above were utilized in both bi-variate and multivariate analyses of the study data.

CHAPTER 3: RESEARCH METHODOLOGY

3.1. Introduction

This chapter presents all the aspects of research methodology used in this study. These include research design, population of study, methods of data collection and the tests of reliability and viability for data collection instrument. Summaries of tests of multicollinearity and heteroscedasticity are given. In addition, the chapter explains how the study variables were operationalized.

3.2. Research Design

The study was conducted based on the positivist approach to research. The approach is based on objectivity, neutrality, measurement and validity of results. The roots of positivism lie particularly with empiricism, that is, all factual knowledge is based on positive information gained from observable experiences, and only analytic statements are allowed to be known as true through reason alone. Positivist approach seeks empirical regularities, which are correlations between variables (Lather, 1991; Sanguinetti, 1994). This does not need to be causal in nature, but it does allow laws to be defined and predictions made. The study of the effects of ownership structure, board effectiveness and managerial discretion on firm performance is a study that essentially seeks to establish possible relationships among these variables, and the strength of such relationships if they do exist.

As opposed to the phenomenological approach which does not begin from an established theory, and then proceeds to collect data to either vindicate or reject the theory, the study is designed to be empirical in nature, and proceeds from an established theoretical underpinning. The phenomenological approach typically seeks to obtain data, analyze it, and then make conclusions regarding the nature and strength of relationships among the variables based on empirical evidence. The study employed analytic rigor that minimized possibilities of multiple interpretations, bias or subjectivity. Previous studies have established that there exist relationships among the dependent and independent variables under investigation in the current study, but the nature and significance of these

relationships have varied depending on contexts and the nature of data collected. This study therefore, employed a quantitative/scientific approach to deal with this ambiguity within the Kenyan, and indeed, a developing country context. The positivist approach therefore, readily rendered itself for this kind of study.

The study was a cross sectional census survey, and targeted all firms listed at the Nairobi Stock Exchange. The listed companies are highly diversified in terms of sectors and attributes of the companies themselves. A survey was deemed appropriate for this study in order to bring out the unique industry influences that impact corporate governance and performance. Besides, some of the variables studied were quantifiable while others were not. Specifically, the financial statistics were extracted from the Nairobi Stock Exchange handbooks, but corresponding data for independent and moderating variables such as board effectiveness, managerial discretion, market influences and internal influences could only be meaningfully collected for the current period. This is why only one year's data (2006) was used. In any case, board compositions in Kenya keep changing within short periods, as they are constituted every three years, and in the case of private sector, nominees to the boards are subjected to Annual General Meetings for ratification.

3.3. Population of the Study

The relevant population for this study comprises all companies listed at the Nairobi Stock Exchange (NSE). According to the Nairobi Stock Exchange Handbook (2006), the total number of listed companies at the bourse is 54. However, five of the listed companies were not studied since they were listed in 2006, and preliminary review of their records revealed that they did not have most of the data required for this study. These firms are Eveready, KenGen, Scangroup, AccessKenya and Kenya Re-insurance Corporation. One company, Uchumi Supermarkets, was on suspension from the bourse at the time of the study. The study was therefore, designed to be a census survey of all listed companies excluding the six companies whose basis of exclusion are explained above. The exclusion of the six left a target population of forty eight firms. Out of the forty eight companies, a total of six did not respond, leaving forty two which were surveyed. This represents a response rate of 87.5 percent.

3.4. Data Collection

Both primary and secondary data were used for this study. The secondary data were extracted from the Nairobi Stock Exchange (NSE) handbook for 2006. The choice of 2006 was informed by the fact that performance statistics for 2007 had not been compiled by the NSE at the time of the study. The relevant secondary data included ownership identity and ownership concentration, and performance statistics as defined for purposes of the current study. The primary data were collected using a structured questionnaire. The researcher-administered questionnaire was developed in line with the Brown-Governance Evaluative Framework that has been utilized in the Cadbury Committee report on the Financial Aspects of Corporate Governance (1992), and Corporate Governance Guidelines (1994). The instrument utilized Likert-type statements anchored by a five-point rating scale ranging from *not at all (1)* to *very well (5)*. It is structured in accordance with the operational variables (Appendix 1).

In order to tap as much information on corporate governance as possible, the target respondents were categorized into three, namely, (i) Chief Executive Officer or his/her deputy (ii) Top Manager, and (iii) Line Manager. This approach was expected to enhance objectivity of the respondents at different echelons of decision making, and mitigate the possibility of one or some respondents not being conversant with all the corporate governance issues in the organization. Since some of the data and information on corporate governance relate to the past period 2006, care was taken to ensure that only those respondents who were in the company by that time completed the questionnaire.

3.5. Operationalization of the Key Study Variables

This section deals with how the key dependent and independent variables were operationalized in this study. The key independent variables used in this study were: Ownership Concentration; Ownership Identity (Manager/Insider, Government, Foreign, Corporation, and Diverse/ Diffuse); Board Effectiveness (Leadership, Monitoring, Stewardship, and Reporting); and Managerial Discretion (Locus of Control, Perceived Power, and Perceived Discretion). The key dependent variable is Firm Performance

measured in terms of Return on Assets (ROA), Return on Equity (ROE) and Dividend Yield (DY). The moderating factors are internal influences (i.e. intangible resources, size, and leverage) and market influences (i.e. managerial labor markets, product markets, financial markets and industry structure).

Table 2: Operationalization of Key Study Variables

VARIABLE	OPERATIONAL DEFINITION
<p>1. FIRM PERFORMANCE (DEPENDENT VARIABLE), Y</p>	<ol style="list-style-type: none"> 1. Return on Assets (ROA): Measured as Annual Net Income divided by Total Assets. 2. Return on Equity (ROE): Measured as Annual Net Income divided by Issued Shares. 3. Dividend Yield (DY): Measured as Annual Dividend per Share divided by Market Price per Share.
<p>2. INDEPENDENT VARIABLES, X</p> <p>A. OWNERSHIP STRUCTURE</p> <p>I. Ownership Concentration</p> <p>II. Ownership Identity</p>	<p>Percentage of total shares owned by a shareholder. Using Herfindahl Index which is an indicator of percentage of shares owned by the first five shareholders: 30% and above, concentrated; Less than 30%, diffuse/diverse.</p> <p>The actual identity of the shareholder:</p> <ol style="list-style-type: none"> 1) Foreown = Ownership by foreigners 2) Corpown = Ownership by Corporations

B. BOARD EFFECTIVENESS

I. Leadership

3) Govown = Ownership by Government

4) Divown = Ownership by diverse persons

- Clear distinction between agents and principals
- Clarity of vision and mission
- Strategic Plans
- Consensus among stakeholders
- Knowledge level of board members
- Clear procedure of selecting board members
- Clear communication channels

II. Stewardship

- Articulation of roles and responsibilities
- Management of assets and investments
- Clear mandate of the board
- Effectiveness of governance committees, including audit regime
- Capacity building initiatives and human resources development
- Harmony between board and management
- Culture of continuous learning and innovation

III. Monitoring

- Accuracy of information received by the board
- Timeliness of information
- Integrity of information
- Identification and management of strategic business risks
- Effectiveness of performance measurement system

<p>IV. Reporting</p>	<ul style="list-style-type: none"> ▪ Completeness and credibility of information to shareholders ▪ Timeliness of reports to shareholders ▪ Transparency of reports ▪ Customer Focus ▪ Employee focus ▪ Environmental, social and public responsibilities ▪ Communication with stakeholders ▪ Organization's reputation
<p>C. MANAGERIAL DISCRETION</p> <p>I. Locus of Control</p> <p>II. Perception of Discretion</p> <p>I. Perceived Power</p>	<ul style="list-style-type: none"> ▪ How confident managers are in decision making ▪ How clearly the results are related to managers' personal initiatives ▪ How effectively managers make decisions without external motivation or pushing ▪ How well the managers make decisions without supervision ▪ How knowledgeable the managers are in the business of the organization ▪ Board support of managers' decisions ▪ Transparency of management recruitment process ▪ Amount of power the managers have ▪ How powerful the managers are perceived by employees ▪ How powerful managers make independent decisions ▪ How effectively powerful managers get results from their

comprehension, meaning and clarity. The questionnaire was found to be valid save for a few minor corrections which were suggested by the respondents in the pilot study. The instrument was modified on the basis of the responses from the pilot tests. Cronbach's Alpha was used to test reliability of the instrument. A summary of the scores of the independent variables on the Cronbach's Alpha Reliability Coefficient is presented in table 3.

Table 3: Summary of Cronbach's Alpha Reliability Coefficient for Ownership Structure, Board Effectiveness and Managerial Discretion

Factor (Scale)	Number of Items	Cronbach Alpha
Board Leadership	13	0.82
Board Stewardship	12	0.79
Board Monitoring	9	0.89
Board Reporting	10	0.91
Perception of Discretion	4	0.86
Locus of Control	3	0.93
Perceived Power	4	0.89
Overall Assessment	18	0.87

The basis of interpreting the reliability of the scale in the current study was Cronbach's Alpha. The Alpha can take any value from zero (no internal consistency) to one (complete internal consistency). Nunnally (1978) suggested that as a rule of thumb, Cronbach's Alpha should not be lower than 0.7. In the case of the instrument for this study, the Cronbach's Alpha values for Board Leadership, Board Stewardship, Board Monitoring, Board Reporting, Perception of Discretion, Locus of Control, Perceived Power and Overall Assessment were all above 0.7 (Table 3). The data collection instrument is therefore, reliable and acceptable for the purposes of the study.

3.6.1. Test of Multicollinearity

Multicollinearity refers to excessive correlation of the predictor variables. When correlation is excessive (using the rule of thumb, $r > 0.90$), standard errors and beta coefficients become large, making it difficult or impossible to assess the relative importance of the predictor variables. Multicollinearity is less important where the research purpose is sheer prediction since the predicted values of the dependent remain stable, but multicollinearity is a severe problem when the research purpose includes causal modeling (Garson, 2008). The current study relied heavily on modeling to establish nature and strength of relationships between ownership structure, board effectiveness and managerial discretion on one hand, and firm performance on the other. The study relied on the most commonly used test statistics for multicollinearity, namely: tolerance and the variance-inflation factor (VIF). The results of the correlation values for the independent variables used are presented in Table 4.

Table 4: Correlation Results for Tests of Multicollinearity

Independent Variable	Analytical Tool	Boardeffect	Mandisc	Ownconc	Ownership Identity	Forenown	Instown	Govtown	Divown
Board Effectiveness	Pearson Correlation	1	.766(**)	-.021	.124	-.133	.126	-.221	.159
Managerial Discretion	Pearson Correlation	.766(**)	1	-.044	.134	-.082	-.025	-.033	.154
Ownership Concentration	Pearson Correlation	-.021	-.044	1	-.588(**)	.472(**)	-.038	-.060	-.542(**)
Ownership Identity	Pearson Correlation	.124	.134	-.588(**)	1	-.820(**)	.064	.230	-.872(**)
Foreign Ownership	Pearson Correlation	-.133	-.082	.472(**)	-.820(**)	1	.607(**)	-.241	-.484(**)
Institution Ownership	Pearson Correlation	.126	-.025	-.038	.064	-.607(**)	1	-.132	-.266
Government Ownership	Pearson Correlation	-.221	-.033	-.060	.230	-.241	-.132	1	-.106
Diverse Ownership	Pearson Correlation	.159	.154	-.542(**)	.872(**)	-.484(**)	-.266	-.106	1

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

Where:-

Boardeffect = Board Effectiveness

Mandisc = Managerial Discretion

Ownconc = Ownership Concentration

Forenown = Foreign Ownership

Instown = Institution Ownership

Govown = Government Ownership

Divown = Diverse/Diffuse Ownership

As can be discerned from Table 4, some variables were significantly correlated (boardeffect/mandisc, forenown/instown, diverseown/ownconc) while others had insignificant correlation (divown/govown, govown/ownconc, ownconc/boardeffect). The score 1 indicates perfect colinearity, which is found only when a variable is correlated with itself. Using the rule of the thumb (Garson, 2008) however, none of the independent variables used in the study had a correlation value of more than 0.9, suggesting that no multicollinearity was detected among the independent variables used in this study.

3.6.2 Tolerance and Variance-Inflation Factor (VIF)

Tolerance is $1 - r^2$ for the regression of an independent variable on all the other independent variables, ignoring the dependent variable. For example, regressing managerial discretion on ownership structure and board effectiveness would give an indication as to whether the variables are so closely correlated that they screen one another. The SPSS output gives as many tolerance coefficients as there are independent variables. The higher the inter-correlation of the independent variables, the more the tolerance will approach zero. If tolerance is less than 0.20, a problem with multicollinearity is indicated. When tolerance is close to 0.00, there is high multicollinearity of that variable with other independents and the beta coefficients will be unstable. The more multicollinearity there is among independent variables, the lower the tolerance, and the more the standard error of the regression coefficients. Tolerance is part of the denominator in the formula for calculating the confidence limits on the partial regression coefficient.

Variance-Inflation Factor is the reciprocal of tolerance. Therefore, when VIF is high there is high multicollinearity and instability of the beta coefficient, and vice versa. A variance inflation factor of more than 4.0 is an indication of high multicollinearity. Tolerance and VIF for the study independent variables are presented in the Coefficients (Table 5).

Table 5: Coefficients for Tolerance and VIF Tests

Model	Independent Variable	Colinearity Statistics	
		Tolerance	VIF
1	(Constant)		
	Board Effectiveness	.373	2.678
	Managerial Discretion	.403	2.481
	Ownership Concentration	.645	1.551
	Instown	.804	1.243
	Govown	.866	1.155
	Divown	.571	1.751

Using the $r < .20$ and $r > 4.0$ levels for the tolerance and VIF coefficients respectively, results in Table 5 suggest that there existed no multicollinearity problem among the independent variables used in this study.

3.6.3. Test of Heteroscedasticity

In regression analysis, heteroscedasticity means a situation in which the variance of the dependent variable varies across the data. Heteroscedasticity complicates analysis because many methods in regression analysis are based on an assumption of equal variances (Stewart, 2008). On the other hand, homoscedasticity means a situation in which the variance of the dependent variable is the same for all the data. According to Thompson (2000), homoscedasticity describes the consistency of variance of the error term (e , residual) at different levels of the predictor variable.

Guild and Fruchter (1978) explain homoscedasticity in terms of the standard error of estimate (of the regression line). The standard error of estimate is an index of the variance of measured values around each predicted value. The homoscedasticity assumption is more formally stated as $VAR(e_j) = \sigma^2$, that is, the variance of the error of residual term at each point j is equal to the variance for all residuals. The Gauss-Markov theorem states that when all the methodological assumptions are met, the least squares estimators of regression parameters are unbiased and efficient, that is, the least square estimators are said to be BUE: Best linear Unbiased Estimators (Thompson, 2000).

To perform this test the IV residual (ERR_1) was squared to obtain a second order variable ERR_12 (i.e. $ERR_{12} = err_1 * err_1$). Ordinary Least Square regression was used to generate new predictor variables (i.e. pre_1, pre_2 and pre_3). Since only Pre_3 was found to be a good predictor of the three, its square ($Pre_3 * Pre_3$) was used to generate a 2SLS forecast. To obtain the determinant statistics, this residual squared variable (err_12) was then regressed against the 2SLS forecasts (pre_32) and resultant t-ratio on the forecast variable given in Table 4 was used as the test statistic.

Table 6: Heteroscedasticity Determination Coefficients

Model	Un-standardized Coefficients		Standardized Coefficients	T-value	Level of significance
	B	Std. Error	Beta	t	Sig (p)
Constant	21.828	18.997	.071	1.042	.321
	7.650E-02	.015		.795	.589

a. Dependent Variable: ERR_12

The t-ratio on pre_32 is 0.795 with a p-value of 0.589; this is highly insignificant indicating the absence of heteroscedasticity.

Once the data was ascertained to have been collected through a rigorous process and the reliability and validity tests proved it capable of meeting the objective of the study, analysis of the data commenced.

CHAPTER 4: DATA ANALYSIS AND RESULTS

4.1. Introduction

This chapter presents a detailed description of the data, analysis and results, within the framework of the research questions, objectives and hypotheses. Detailed analysis and focused but brief discussions of findings are also presented. Analysis and interpretation of the results is based on the overall objective of the study which was to investigate the effect of ownership structure, board effectiveness and managerial discretion on corporate performance of companies in Kenya. Particular attention was paid to the specific research objectives. Central to this chapter is the presentation of the findings from the tests of the ten hypotheses that were drawn from the above study objectives and tested.

4.2. Data Analysis

This study targeted all the 54 firms listed in the Nairobi Stock Exchange, which were in operation in 2006. However, as already explained under section 3.2 (Population of Study), five of the firms were listed at the bourse in the course of 2006, and were therefore, expected to submit their first performance statistics in 2007. The five firms were rendered ineligible for this study on account of lack of the required data. Also excluded from this study was Uchumi Supermarket that had since been suspended from the bourse at the time of data collection. The criteria left us with 48 firms that were eligible for the study, out of which 42 were found to be valid for purposes of this analysis. This represents a response rate of 87.5 per cent. The results presented in this chapter are therefore, based on the responses received from the 42 firms. Data analysis was done at both bivariate and multivariate levels.

Bivariate regression analysis was conducted to test hypotheses H_1 , H_{2a} , H_{2b} , H_{2c} , H_{2d} , H_{2e} and H_3 . According to Coleman (2007) and Blalock Jr. (1999), bivariate analysis does not take into consideration other factors whose presence or absence can possibly affect the relationship between an independent and a dependent variable. The results obtained from bivariate analysis were mixed and thus were subjected to further scrutiny before conclusions could be made regarding either acceptance or rejection of the hypotheses.

Linear Regressions and Logistic Regressions were performed to overcome the shortcomings of bivariate analysis, and to subject the data to more rigorous tools in a bid to authenticate the results. Logistic Regression was applied to test the effect of independent variables on above-market average performance. This test was necessitated by the need to not only establish the relationship between independent variables and the performance indicator variables (i.e. ROA, ROE, and DY), but also to check whether that performance was below or above the market average. To use Logistic Regression, dependent variables (ROA, ROE and DY) were coded (1 if above market average, and 0 otherwise). This approach was used to compare the performance of the individual firms vis-à-vis other listed companies which were studied.

4.2.1. Profiles of the Listed Companies

4.2.2. Age of listed firms

A total of 42 out of 48 listed companies that were eligible for this study were surveyed. This represents 87.5 percent of the target population.

Table 7: Listing of Firms by Age

Age	Frequency	Percent
0-5 Years	1	2.5
6-10 Years	4	10.0
11-20 Years	8	20.0
21-30 Years	3	7.5
31-50 Years	19	47.5
> 50 Years	7	12.5
Total	42	100.0

Table 7 indicates that 67.5 percent of the companies that were trading at the NSE in 2006 had been listed for 21 years or longer. Generally, this is an indication that the companies themselves and the NSE had had a relatively high level of stability over time, thereby creating a sense of confidence in the operations of the bourse and the results of the study.

4.2.3. Distribution of Firms by Investment Market Segment

The NSE categorizes companies into five main investment market segments for purposes of listings. The differentiation is based on the unique attributes of each of the segments, and the need to develop products that address the unique opportunities and concerns of the investors (Table 8).

Table 8: Distribution of Firms by Investment Market Segments

Sector	Frequency	Percent
Agriculture Sector	4	9.5
Commercial Services	7	16.7
Financial and Investment	10	23.8
Industrial and Allied	14	33.3
Alternative Investment Market Segment (Aims)	7	16.7
Total	42	100.0

As shown in Table 8, firms in the industrial and allied sector represent a third (33.3 per cent) of all the firms listed at the NSE. The sector with the second highest representation is banking and insurance, accounting for nearly one quarter of all the firms. At 9.5 percent, the agriculture sector has the lowest presence which in part could be attributed to the risk levels arising from fluctuating performance in this sector owing to the vagaries of weather.

4.2.4. Classification of Firms by Predictor Variables and type of Investment Market

Regression analysis was conducted to establish the relative significance of the predictor variables in various investment segments as categorized by the NSE. This was necessary in order to determine the type of intervention measures that are relevant to various sectors of the economy.

The results in Table 9 indicate that when NSE listed firms were disaggregated by market segment, there were no significant differences in their mean scores for the four predictors

at $p < 0.05$. The large scores on F-ratios also indicate that there were no significant differences in the variances of the mean scores across the investment market segments.

Table 9: Regression Analysis of Response by Predictor Variables and Type of Investment Market Segment

Variable	Agriculture Sector	Commercial Services	Financial and Investment	Industrial and Allied	Alternative Investment Market Segment (Aims)	F-Value
Board Effectiveness						
Mean	192.25	184.1667	172.9	183.7143	176	.755
Median	203	185	174	176	176	
Managerial Discretion						
Mean	49.75	40	43.9	45.7857	43.4286	1.395
Median	52.5	39	43.5	44	44	
Ownership Concentration						
Mean	63.025	64.15	53.113	55.3792	71.0114	1.695
Median	62.95	67.5	51.045	60.08	72.2	
Firm Listing Age						
Mean	35	32	25.7	25.8462	39.7143	1.549
Median	37.5	33	23	33	34	

Table 9 is a summary of the relationships among predictor variables (Board Effectiveness, Managerial Discretion, Ownership Concentration and listing age) and firm ownership identity. The results indicate that there were no significant differences among firms owned by the government, foreigners, institutions and diverse individuals with regard to their mean scores on board effectiveness and managerial discretion. For example, diffusely-owned firms had the highest score on board effectiveness (mean=188.5714) and managerial discretion (mean=46.8571) compared to government owned companies with the lowest mean scores at 160 and 43.5, respectively.

On the other hand, foreign-owned companies had the highest mean scores on ownership concentration at 66.96% within the first five shareholders. The second highest level of ownership concentration was found within the institution-owned firms (58.55%). Lowest ownership concentration was found in the diversely-owned firms (40.40%). In a nutshell,

the ownership identity with the highest level of ownership concentration among the first five shareholders was foreign ownership while that with the lowest ownership concentration was diverse ownership category.

Table 10: Regression Results for the effects of Predictor Variables on Ownership Identity

Variable	Foreign	Institution	Government	Diverse	F-Value
Board Effectiveness (Score)					
Mean	178.2857	185.8	160	188.5714	1.15
Median	176	183	160	187	
Managerial Discretion(Score)					
Mean	43.9524	44.2	43.5	46.8571	.298
Median	44	44	43.5	44	
Ownership Concentration (%)					
Mean	66.962381	58.546	55.35	40.395714	6.529*
Median	68.4	62.04	55.35	39.83	
Firm Listing Age (Years)					
Mean	34.0476	29.7778	34	17.4286	2.66**
Median	34	34	34	12	

*p<0.01; **p<0.05

The findings presented in Table 10 indicate that if ownership concentration were to confer monitoring, control and ratification rights on the firm owners, then foreign and institutions-owned firms would be more likely to be subjected to influence from the owners (principals). In other words, managers and boards of listed foreign and institutions-owned firms were highly influenced by the shareholders in their decision-making processes.

Similarly, there were significant differences in firm listing age with foreign-owned firms having a mean listing age of 34 years (F=2.66, p<0.05) whereas diffusely-owned firms were significantly younger at a mean age of 17 years of listing. This finding can, in part, be attributed to the fact that up to the early 1990s state ownership of corporations was relatively high. The number of diversely-owned firms, therefore, began to rise when the Government started implementing the divestiture policy.

4.2.5. Type of Investment Market and Performance

There were significant differences among firms in their levels of Return on Assets (ROA) when categorized by investment type ($F=2.65, p<0.05$). As shown on Table 11, at a mean ROA of 17.27 per cent, firms in the Financial and Investment sector had better performance levels. Firms in the Industrial and Allied sector, and Commercial services posted second best aggregate performance in terms of ROA with a mean of 11.93 per cent and 11.83 per cent, respectively. At 7.38 per cent, firms in the Agricultural segment were placed third.

There were, however, no significant differences among firms in the different market segments in terms of their returns on equity (ROE) and dividend yield (DY) as performance indicators. Whereas firms in the Commercial Services (mean=17.32), Financial and Investment (mean =17.93), and Industrial and Allied (mean=16.57) were nearly at par in terms of ROE, firms in the Agriculture and Alternative investment market posted much lower ROE mean performance at 9.93 per cent and 3.87 per cent, respectively (Table 11).

Table 11: Results of Regression Analysis of Performance by Type of Investment Market Segment

Variable	Agriculture Sector	Commercial Services	Financial and Investment	Industrial and Allied	Alternative Investment Market Segment (Aims)	F-Value
Return on Assets (ROA) – (%)						
Mean	7.37	11.83	17.26	11.93	.73	2.652*
Median	7.30	10.19	16.49	9.37	3.76	
Return on Equity (%)						
Mean	9.93	17.32	17.93	16.56	3.86	1.617
Median	10.40	15.99	18.15	15.57	4.25	
Divided Yield (%)						
Mean	1.86	2.59	2.02	2.23	.74	.789
Median	2.16	1.8	2.05	1.97	.33	

* $p<0.05$

When firms were disaggregated by ownership category (Table12), no significant differences were found to exist in their performance levels in terms of ROA, ROE and DY. However, marginal comparisons of individual firm ownership category indicates that foreign and diversely owned firms appeared to post above average performances in terms all the indicators (ROA, ROE and DY) as shown by the respective mean scores (table 12)

Table 12: Results of Regression Analysis of the influence of Ownership Identity on Firm Performance

Variable	Foreign	Institution	Government	Diverse	F-Value
Return on Assets (ROA)					
Mean	11.3683	8.9433	5.7802	15.9147	.705
Median	13.3438	7.9954	5.7802	15.4759	
Return on Equity					
Mean	13.0520	12.0264	10.6902	22.1410	.976
Median	16.49018	10.6834	10.6901	19.9699	
Divided Yield					
Mean	2.5363	1.2300	1.4300	1.9742	1.155
Median	2.1400	1.4800	1.4300	2.4900	

Table 12 shows marginal differences in firm performance by ownership category. These differences are, however, consistent with the expectation that foreign-owned firms were likely to have several advantages over their competition as they benefit from internationally sourced expertise, large capital base and international tested management practices. A combination of all or some of these factors usually gives foreign multinationals an edge over competitors in the host countries. Diversely-owned firms, on the other hand, seemed to have slightly higher performance compared to institutions and government-owned firms.

Government owned firms posted the lowest performance levels in terms of ROA and ROE, a finding which is consistent with what most past studies have revealed (De Alessi, 1980, 1982; Vickers and Yarrow, 1988; Shapiro and Willig, 1990; Shleifer and Vishny, 1997). The relative low performance of government owned firms is in part attributable to

the political interference in the management of such firms leading to whimsical appointments of boards and managers who may be under no obligation to serve the commercial interests of the firms.

4.3. Tests of Hypotheses and interpretation of Results

This study had six objectives, out of which, a total of ten specific hypotheses were drawn and tested. This section therefore, presents the models used to test the hypotheses, and how the results were interpreted. There were broadly, two categories of hypotheses. The first category involved bivariate relationships, which were tested using bivariate models. The second category of hypotheses, on the other hand, involved combinations of predictor variables, and were tested using multivariate models. Given that bivariate analysis does not take into consideration possible effects of exogenous variables on the relationship that is being tested, it was necessary to apply more than one bivariate test to validate the results. Hence, the bivariate analytical tools used in this study were Pearson's Product Moment Correlation (PPMC), Logistic Regression and Linear Regression, and they were used to test hypotheses H_1 , H_{2a} , H_{2b} , H_{2c} , H_{2d} , H_{2e} and H_3 .

The results are organized by objectives.

4.3.1. Ownership Concentration and Firm Performance

The relationship between ownership concentration and firm performance was investigated by testing the null hypothesis H_1 .

Hypothesis H_1 : There is a positive relationship between ownership concentration and firm performance

To test hypothesis H_1 , Pearson's Product Moment Coefficient (PPMC), Logistic Regression and Linear Regression were used. Summary of the relevant correlation and regression results for the relationship between ownership concentration and the three indicators of firm performance (ROA, ROE, and DY) are presented in Tables 13, 14 and 15.

Table 13 Correlation Results for the relationship between ownership Concentration and Firm performance: PPMC

	ROA	ROE	DY
Pearson's r	-.028*	-.0301*	-.176
Asymp. Std. Error	.012	.011	.104
Valid Cases	40	40	37

*p<0.05

Table 13 indicates that there was a negative correlation between ownership concentration, and ROA and ROE at five per cent level of significance. As can be discerned from Table 13, there is a significant negative correlation between ownership concentration and ROA ($r=-.028$, $p<0.05$) and between ownership concentration and ROE ($r=-.030$, $p<0.05$). On the other hand, the relationship between ownership concentration and DY is negative but weak ($r=-.176$, $p<0.05$). This suggests that for the NSE listed companies, performance as measured by ROA and ROE declined with an increase in the ownership concentration, but the effect on DY was weak.

Table 14: Linear Regression Results for the effects of Predictor Variables on Firm Performance (Bivariate Relationships)

Indicator Variable	ROA	ROE	DY
Predictor Variable	Parameter Estimates (β)	Parameter Estimates (β)	Parameter Estimates (β)
Ownership Concentration			
Ownership concentration	-.761	-.645	-.888
Ownership Identity			
Foreign ownership	1.598*	1.218*	1.592*
Institution ownership	1.012*	.775	.826
Government ownership	-0.798	-0.616	-0.483
Diverse ownership	.946*	.789*	.723
Board Effectiveness			
Board effectiveness	-.557*	-.237*	-.111
Manager Ownership			
Manager/insider ownership	1.003	.792	.241

*p<0.05

The results of the Linear Regression presented in table 14 indicate that overall, ownership concentration was negatively and significantly related to all the three indicators of firm performance. This was evident from the beta coefficients and levels of significance of the relationships. The dependent variables: Return on Assets ($\beta = -.761, p < 0.05$), Return on Equity ($\beta = -.645, p < 0.05$) and Dividend Yield ($\beta = -.888, p < 0.05$) all recorded significant negative correlations with ownership concentration.

Table 15: Logistic Regression Results for the effects of Predictor Variables on Firm Performance (Above Market Average)

Indicator Variable	Column 1 ROA Above Market Average	Column 2 ROE Above Market Average	Column 3 DY Above Market Average
Predictor Variable	Parameter Estimates (β)	Parameter Estimates (β)	Parameter Estimates (β)
Ownership Concentration	-.360*	-.085	-.102*
Foreign ownership	6.436*	3.810	6.579
Institution ownership	4.888	2.595	3.120
Government ownership	-15.794	-17.778	-17.021
Diverse ownership	6.041*	5.038	3.718
Board effectiveness	-.033	-.042	-.035
Manager/ insider ownership	5.013	4.049	5.162

* $p < 0.05$

The results of the Logistic Regression tests (Table 15) indicate that there is a negative and significant correlation between ownership concentration and Return on Assets ($\beta = -0.360, p < 0.05$) and Return on Equity ($\beta = -.085, p < 0.05$).

The results for Dividend Yield ($\beta = -.102, p < 0.05$) were also negative but not significant. These results vindicate those of the Pearson's Product Moment Correlation tests which showed negative relationship between ownership concentration and firm performance. These results lead to a rejection of the hypothesis H_1 . The results mean that firms that are owned by few shareholders tend to perform relatively poorer than those owned by diverse shareholders.

The results for the negative relationship between ownership concentration and firm performance in terms of ROA and ROE are consistent with observations made by Short (1994). It is argued that a large ownership stake in a particular company may lead to risk aversion among the few dominating owners to induce the company to trade off expected returns for lower risks.

4.3.2. Ownership Identity and Firm Performance

The study considered five typical forms of ownership that are prevalent among the firms listed at the Nairobi Stock Exchange: Manager/Insider ownership; Government ownership; ownership by Corporations/Institutions; Foreign ownership; and Diverse/Diffuse ownership. Consequently, the hypotheses H_{2a}, H_{2b}, H_{2c}, H_{2d}, and H_{2e} were tested to establish the relationship between ownership identity and firm performance.

Hypothesis H_{2a}: Manager (Insider) ownership has a positive effect on firm performance

The Pearson's Product Moment Correlation was used to test this relationship. Results of Linear Regression (Table 14) and Logistic Regression (Table 15) were used to test the results obtained using the Pearson's Product Moment Correlation (Table 16).

Table 16: Correlation Results for the relationship between Manager/Insider Ownership and Firm performance: PPMC

Statistic	ROA	ROE	DY
Pearson's r	0.026*	0.038*	0.041*
Asymp. Std. Error	0.112	0.109	0.153
Valid Cases	40	41	38

*p<0.05

As can be seen from Table 16, there is a positive and significant relationship between level of manager (insider) ownership and firm performance in terms of Returns on Assets (r=0.026, p<0.05), Return on Equity (r=0.038, p<0.05) and Dividend Yield (r=0.041, p<0.05). These results imply that as the level of insider ownership increases, there is a corresponding positive rise in firm performance in terms of ROA, ROE and DY.

The results of Linear Regression tests in Table 14 indicate positive and significant relationships between insider ownership and Return on Assets ($\beta=1.003$, $p<0.05$) and Return on Equity ($\beta= .792$, $p<0.05$). The relationship between insider ownership and Dividend Yield was also positive but insignificant ($\beta=.241$, $p<0.05$). Similarly, the result of the Logistic Regression (Table 15) indicate positive and significant relationships between manager ownership and ROA ($\beta=5.013$, $p<0.05$), ROE ($\beta= 4.409$, $p<0.05$) and DY ($\beta = 5.162$, $p<0.05$). Overall, the results of bivariate regression analysis indicate a positive and significant relationship between manager ownership and ROA and ROE.

However, with regard to DY, the results indicate that although the relationship was positive, it was not significant. This apparent contradiction is attributable to the fact that most of the firms studied did not pay dividends during the year of study, and thus DY was not a robust indicator of firm performance. Notwithstanding the inconsistency in results attributable to DY, the results of Linear Regression and Logistic Regression appear to validate the results of Pearson's Product Moment Correlation, and thus lead to acceptance of the hypothesis **H_{2a}**. This finding means that large shareholding by the government leads to poor corporate performance.

Hypothesis H_{2b}: Government ownership has a negative effect on firm performance

This hypothesis was tested using the Pearson's Product Moment Correlation as shown in Table 17, and authenticated using Linear Regression (Table 14) and Logistic Regression (table 15). The results presented in Table 17 indicate that there is a significant negative relationship between government ownership and ROA ($r=-.017$, $p<0.05$), ROE ($r=-.058$, $p<0.05$) and DY ($r=-.077$, $p<0.05$). Generally, these results give a strong negative indication of the relationship between Government ownership of firms and performance of those firms.

Table 17: Correlation Results for the relationship between Government Ownership Firm Performance

Statistic	ROA	ROE	DY
Pearson's r	-0.017	-0.058	-0.077
Asymp. Std. Error	0.07	0.057	0.063
Valid Cases	39	40	37

*p<0.05

The regression results for the relationship between government ownership and firm performance using Linear Regression are presented on Table 14. Overall, the results indicate a significant negative relationship between Government ownership and all the dependent variables: ROA, ROE and DY). Specific beta coefficient scores and levels of significance obtained through Linear Regression are: ROA ($\beta=-.798$, $p<0.05$), ROE ($\beta=-.616$, $p<0.05$) and DY ($\beta=-.483$, $p<0.05$).

Similarly, Logistic Regression results (Table 15) indicate significant negative correlation between Government Ownership and firm performance as depicted by ROA ($\beta=-15.794$, $p<0.05$), ROE ($\beta=-17.778$, $p<0.05$) and DY ($\beta=-17.021$, $p<0.05$). This means that there is a very significant negative relationship between Government ownership and firm performance such that when Government shareholding increases, the firm performance deteriorates by almost a similar proportion. These results lead us to accept the hypothesis **H_{2b}**.

Hypothesis H_{2c}: Ownership by Corporations (institutions) has a positive effect on firm performance

This hypothesis sought to establish the nature and extent of the relationship between ownership of companies by other companies, and the performance of those companies in terms of Return on Assets (ROA), Return on Equity (ROE) and Dividend Yield (DY). The tests were conducted using Pearson's Product Moment Correlation, Linear Regression and Logistic Regression, and the results are presented in Table 18, Table 14 and Table 15, respectively. As can be discerned from Table 18, there is a significant

negative correlation between ownership by institutions and ROA ($r=-.016$, $p<0.05$), ROE ($r=-.014$, $p<0.05$) and DY ($r=-.029$, $p<0.05$).

Table 18: Correlation Results for the relationship between Ownership by Corporations (Institutions) and Firm performance: PPMC

Statistic	ROA	ROE	DY
Pearson's r	.016*	.014*	.029*
Asymp. Std. Error	.143	.140	.104
Valid Cases	39	40	37

* $p<0.05$

Results of Linear Regression (Table 14) indicate significant positive relationship between ownership by corporations and Return on Assets ($\beta=1.012$, $p<0.05$), and positive but relatively weak relationship for both ROE ($\beta=.775$, $p<0.05$) and DY ($\beta=.826$, $p<0.05$).

Similarly, the results of Logistic Regression (Table 15) indicate significant positive relationships between ownership by corporations and firm performance as depicted by ROA ($\beta=4.888$, $p<0.05$), ROE ($\beta=2.595$, $p<0.05$) and DY ($\beta=3.120$, $p<0.05$). Linear Regression and Logistic Regression results have validated the results of Pearson's Product Moment Correlation that there is a positive relationship between ownership by corporations and firm performance. Therefore, these results lead us to accept the hypothesis H_{2c} .

Hypothesis H_{2d} : Diffuse (Diverse) Ownership has a negative effect on firm performance

Pearson's Product Moment Correlation was used to test the relationship between diffuse/diverse ownership (i.e. large numbers of individuals holding small amounts of shares) and firm performance, and the results are presented in table 19. Further analysis was conducted using Linear Regression and Logistic Regression. The results presented in Table 19 indicate that there is a significant positive relationship between diverse ownership and ROA ($r=0.012$, $p<0.05$), and between diverse ownership and ROE

($r=0.023$, $p<0.05$). However, the relationship between diverse ownership and DY is positive but relatively weak ($r=0.061$, $p<0.05$).

Table 19: Correlation Results for the relationship between Diverse/Diffuse Firm Ownership and Firm Performance: PPMC

Statistic	ROA	ROE	DY
Pearson's r	0.012*	0.023*	0.061
Asymp. Std. Error	0.077	0.075	0.113
Valid Cases	39	40	37

* $p<0.05$

The results of the Linear Regression (Table 14) indicate a significant positive relationship between diverse firm ownership and ROA ($\beta=.946$, $p<0.05$), and between diverse ownership and ROE ($\beta=.789$, $p<0.05$). The relationship between diverse ownership and DY was however, positive but relatively weak ($\beta=.723$, $p<0.05$).

Similarly, the Logistic Regression results (Table 15) indicate significant positive relationship between diverse ownership and ROA ($\beta=6.041$, $p<0.05$), and ROE ($\beta=5.038$, $p<0.05$). However, the relationship between diverse ownership and DY ($\beta=3.718$, $p<0.05$) is positive but relatively weak. Overall, the results of Linear Regression and Logistic Regression appear to validate the results of Pearson's Product Moment Correlation that there is a positive relationship between diverse/diffuse ownership and firm performance. Both ROA and ROE indicate a significant relationship, but DY shows a consistently weak relationship for all the tests. This indicates that DY is not a very reliable measure of performance in the Kenyan context since most of the firms studied did not pay dividends in the year under review. The results of all the tests indicate a positive relationship between diverse ownership and firm performance, thus leading to rejection of the hypothesis H_{2d} .

Hypothesis H_{2c} : Foreign Ownership has a positive effect on firm performance

This hypothesis sought to establish the effect of foreign ownership of listed firms in Kenya on performance of those firms. The relationship was tested using Pearson's

Product Moment Correlation, Linear Regression and Logistic Regression, and the results are presented in Table 20, Table 14 and Table 15. The results of the tests using Pearson's Product Moment Correlation indicate significant positive correlation between foreign ownership and ROA ($r=0.044$, $p<0.05$), ROE ($r=.037$, $p<0.05$) and DY ($r=.041$, $p<0.05$).

Table 20: Correlation Results for the relationship between Foreign Ownership of firms and Firm Performance: PPMC

Statistic	ROA	ROE	DY
Pearson's r Value	.044*	.037*	.041*
Asymp. Std. Error (a)	.158	.141	.136
Valid Cases	39	40	37

* $p<0.05$

The results of the Linear Regression tests are presented in table 14. As can be discerned from table 14, there is a significant positive relationship between foreign ownership of firms and ROA ($\beta=1.598$, $p<0.05$), ROE ($\beta=1.218$, $p<0.05$) and DY ($\beta=1.592$, $p<0.05$).

Similarly, the results of Logistic Regression also indicate strong positive relationship between foreign ownership of firms and ROA ($\beta=6.436$, $p<0.05$), ROE ($\beta=3.810$, $p<0.05$) and DY ($\beta=6.579$, $p<0.05$). All the tests point to the fact that there is a significant positive relationship between foreign ownership of firms and firm performance, leading us to accept hypothesis H_{2c} .

4.3.3. Board Effectiveness and Firm Performance

Board effectiveness was operationalized in terms of: Leadership; Monitoring; Stewardship; and Reporting. The relationship between Board effectiveness and firm performance was investigated by testing hypothesis H_3 .

Hypothesis H_3 : Board Effectiveness has a positive effect on firm performance

Hypothesis H_3 was tested using Pearson's Product Moment Coefficient, Linear Regression and Logistic Regression, and the results are summarized in Table 21, Table 14 and Table 15, respectively. The scores on Board effectiveness were run on each of the

indicator variables as defined for purposes of this study. As can be seen from Table 21, there is a significant negative relationship between Board effectiveness and ROA ($r=-.014$, $p<0.05$), ROE ($r=-.026$, $p<0.05$) and DY ($r=-.011$, $p<0.05$). This is a pointer to the fact that the role of the Board of Directors is not critical for corporate performance in Kenya. Further analysis using Linear Regression and Logistic Regression were conducted, and the results presented in Table 14 and Table 15, respectively.

Table 21: Correlation Results for the relationship between Board Effectiveness and Firm Performance

Statistic	ROA	ROE	DY
Pearson's r value	-.014*	-.026*	-.011*
Assymp. Std Error	.143	.121	-.113
Valid Cases	41	42	38

* $p<0.05$

The Linear Regression results (Table 14) indicate significant negative correlation between board effectiveness and ROA ($\beta=-.557$, $p<0.05$), ROE ($\beta=-.237$, $p<0.05$) and DY ($\beta=-.111$, $p<0.05$). Similarly, the results of the Logistic Regression indicate significant negative relationships between board effectiveness and firm performance as shown by ROA ($\beta=-.033$, $p<0.05$), ROE ($\beta=-.042$, $p<0.05$) and DY ($\beta=-.035$, $p<0.05$). Overall, the results of Pearson's Product Moment Correlation tests, Linear Regression and Logistic Regression indicate significant negative relationship between board effectiveness and firm performance. This is a pointer to the fact that the Board has not played its rightful role in corporate governance in Kenya. These results lead to rejection of hypothesis H_3 .

4.3.4. Managerial Discretion and Firm Performance

Pertinent literature indicates that the relationship between managerial discretion and firm performance is moderated by both internal influences and market influences (Hambrick and Finkelstein, 1987, 1990; Hitt, Ireland and Hoskisson, 2003). Therefore, two hypotheses (H_{4a} , H_{4b}) were tested to deal specifically with internal influences and market

influences. The tests involved combining the predictor variables and the moderation factors to determine the product terms.

Multivariate analysis was used to test the relationships between combinations of variables and firm performance. This approach was relevant in testing the hypotheses H_{4a} , H_{4b} and H_5 . Hypotheses H_{4a} and H_{4b} were tested using moderation models. Hypothesis H_5 was tested using the step-wise regression approach. To cross-check the results, additional tests, mainly Change Statistics, were used. These included Analysis of Variance (ANOVA), adjusted R^2 , and F ratio. In an ANOVA analysis, the relationship between measures of the mean and the variance of the "random error" of each group provided the information needed to determine if the difference between the two is significant. R^2 was used to measure the changes on the predictor variables (ROA, ROE and DY) as a result of introduction of additional explanatory variables (Board Effectiveness and Managerial Discretion). More details on data analysis are provided under Summary of Tests and Measurement Criteria (Appendix 2).

4.3.4.1. Model Definition

The multivariate models used for data analysis are based on the hypothesized relationships between independent variables and dependent variables as specified for purposes of this study. The general form of the models used was:

$$\text{Firm performance} = b_1\text{OWNCONC} + b_2\text{FOREOWN} + b_3\text{INSTOWN} + b_4\text{GOVOWN} + b_5\text{DIVOWN} + b_6\text{BOARDDEFFECT} + b_7\text{MANDISC}$$

The independent variables were defined as:

$\text{OWNCONC} =$ Ownership concentration; a continuous variable representing the percentage of shareholding by the first five major shareholders. It is also referred to as Herfindahl Index (Jensen and Meckling, 1983).

OWNERSHIP IDENTITY=Actual identity of the shareholders of the firm. Ownership Identity of the firms as an independent variable was defined in four categories:

FORENOWN = Foreign ownership; a dummy variable coded (1= foreign owned; 0, otherwise).

CORPOWN = Institution ownership; a dummy variable coded (1= institution owned; 0, otherwise).

MANOWN = Ownership by Managers (Insiders); a continuous variable representing extent of ownership by managers.

GOVOWN = Government ownership; a dummy variable coded (1= institution owned; 0, otherwise).

DIVOWN = Diverse ownership; a dummy variable coded (1= diversely owned; 0, otherwise).

BOARDEFFECT = Board effectiveness; a continuous variable representing the total score for each firm on board effectiveness rating.

MANDISC = Managerial discretion; a continuous variable representing the total score for each firm on level of managerial discretion.

For specific firm performance indicators (ROA, ROE, and DY), the model equations were specified as follows:

$$\text{ROA} = b_1\text{OWNCONC} + b_2\text{FORENOWN} + b_3\text{INSTNOWN} + b_4\text{GOVOWN} + b_5\text{DIVOWN} + b_6\text{BOARDEFFECT} + b_7\text{MANDISC} .$$

$$\text{ROE} = b_1\text{OWNCONC} + b_2\text{FORENOWN} + b_3\text{INSTNOWN} + b_4\text{GOVOWN} + b_5\text{DIVOWN} + b_6\text{BOARDEFFECT} + b_7\text{MANDISC}$$

$$DY = b_1OWNCONC + b_2FOREOWN + b_3INSTOWN + b_4GOVOWN + b_5DIVOWN + b_6BOARDEFFECT + b_7MANDISC$$

4.3.4.2 Moderating Factors

Pertinent literature on corporate governance indicates that the relationship between managerial discretion and firm performance may not necessarily be the same for all firms (Chang and Wong, 2003; Denis *et al*, 1997; and Jensen and Murphy, 1990). Rather, the relationship may be contingent upon certain characteristics found within the organizations themselves (internal factors) and outside (market factors). The hypotheses H_{4a} and H_{4b} investigated the influences that market and internal factors exert on the relationship between managerial discretion and firm performance. The hypothesis H_5 , on the other hand, suggests that the relationship between ownership structure and firm performance is hierarchical, that is, through board effectiveness and managerial discretion. To test the extent of these hypothesized moderating influences, a general moderator effect model was used.

4.3.4.3. Moderating Factors in the Relationship between Managerial Discretion and Firm Performance

The general moderator effects are represented by the interaction of the independent variable (X) and the moderating factor (M) in explaining the dependent variable (Y). The following general regression equation was used to test the relationships:

$$Y = d + aX + bM + cXM + E$$

In the subsequent models, the interaction of X and M measures the moderation effect. The test of moderation is therefore operationalized by the product term XM, that is, the product between the independent variable and the moderator variable.

4.3.4.4. Moderation Analysis Models

Moderated multiple regression analyses were used to test the extent to which market influences moderated the relationship between managerial discretion and firm

performance. Linear-by-linear interaction terms were created by multiplying the proposed moderators by the independent variables (Stone & Hollenbeck, 1988). After entering the proposed main effects into the equation, the multiplicative terms were added. The regression weights for the multiplicative terms were then examined for significance.

4.3.4.5. Market Influences

These are external environmental influences that impact firm performance, and include managerial labour markets, product markets, capital markets and industry structure.

Hypothesis H_{4a}: **The strength of the relationship between managerial discretion and firm performance depends on market influences**

The hypotheses H_{4a} and H_{4b} were tested using the models explained below:

$$Y = d + aX + bM + cXM + E$$

The specific Equations are:

$$Y = d + aMANDISC + bMKTINFL + cMANDMKTINFL + E$$

$$Y = d + aMANDISC + bINTINFL + cMANDINTINFL + E$$

Where:-

<i>X</i> =	Independent Variable
<i>M</i> =	Moderating Factor
<i>XM</i> =	Product Term that explains the influence
<i>MANDISC</i> =	Managerial Discretion
<i>MKTINFL</i> =	Market Influence
<i>INTINFL</i> =	Internal Influence
<i>MANDMKTINFL</i> =	Product of Managerial Discretion and Market Influence
<i>MANDINTINFL</i> =	Product of Managerial Discretion and Internal Influence

Column I of Table 22 shows the results of the analysis for the moderating effects of market influences. As can be discerned from the table, market influences did not moderate the relationship between managerial discretion ($\beta = -.119$, $p > .10$) and firm performance in terms of ROA. The adjusted value of R^2 is $-.047$, indicating that a linear combination of the predictors explained only 4.7% of the variance in Return on assets (ROA).

Table 22: Regression results for the effects of Market Influence on the relationship between Managerial Discretion and Firm Performance

Predictors	Col. I Market Influence as Moderator ROA (β)	Col. II Market Influence as Moderator ROE (β)	Col. III Market Influence as Moderator DY (β)
Managerial Discretion	.980	.237	1.598*
Market Influence	4.605	.170	1.884*
Market Influence x Managerial Discretion	-.119	-.356	-1.985*
F (full model)	.412	0.289	1.249
R^2	.033	0.023	0.099
Adj. R^2	-.047	-0.056	0.020

Standardized regression coefficients

* $p < .05$

The β for the relationship between the independent predictor variable (Managerial Discretion), the moderator variable (Market Influence) and their product term (Market Influence x Managerial Discretion) were insignificant at the 5 per cent level (i.e. $p > 0.05$). The above results lead to the deduction that the strength of the relationship between managerial discretion and ROA did not depend on market influences. Similarly, results in column II show that the relationship between managerial discretion and ROE did not depend on market influences.

On the other hand, results in column III (Table 21) indicate that market influences had a significant effect on the relationship between managerial discretion and firm performance as measured by Dividend Yield. These results lead us to accept the hypothesis H_{4a} for DY but reject it for ROA and ROE.

4.3.4.6. Internal Influences

These are internal organizational factors that influence managerial decision making processes, and include leverage, size and intangible resources.

Hypothesis H_{4b}: **The strength of the relationship between managerial discretion and firm performance depends on internal influences**

The hypothesis was tested using regression and moderation models, and the results are presented below.

Table 23: Regression Results for the Moderation effects of Internal Influences on the relationship between Managerial Discretion and Firm Performance

Predictors	Col. I Internal Influence as Moderator ROA (β)	Col. II Internal Influence as Moderator ROE (β)	Col. III Internal Influence as Moderator DV=DY (β)
Managerial Discretion	-.426	-.134	.041*
Internal Influence	-.348	.177	.058*
Internal Influence x Managerial Discretion	1.258	1.005	.047
F (full model)	1.244	.835	1.553
R ²	.094	.063	0.121
Adj. R ²	.018	-.013	0.0429

*p<.05

Results in Table 23 indicate that internal influences had a significant moderating effect on the relationship between managerial discretion and ROA, ROE and DY at 0.05 level of significance (ROA: β =1.258; ROE: β =1.005; DY: β =0.041). The study results therefore, support the hypothesis H_{4b} that the strength of the relationship between managerial discretion and firm performance depends on internal influences. These results imply that internal influences moderate the effect on the relationship between managerial discretion and firm performance as measured by Return on Assets, Return on Equity and Dividend Yield.

4.4. Hierarchical Relationships between Ownership Structure and Firm Performance

This objective was aimed at establishing whether the relationship between ownership structure and firm performance was direct or hierarchical. The objective was investigated by testing hypothesis H₅.

Hypothesis H₅: The relationship between Ownership Structure and Firm Performance is Hierarchical (i.e. through Board Effectiveness and Managerial Discretion)

The hypothesis was tested using step-wise regression method as explained below.

4.4.1. Hierarchical order of variables

To analyze the expected hierarchical relationship between the three predictor variables (ownership structure, board effectiveness and managerial discretion) and the criterion variables (ROA, ROE and DY), hierarchical regression analysis was used. In the current study, it was theorized that the increase in the variance in firm performance proceeded from ownership concentration through board effectiveness to managerial discretion.

4.4.2. Return on Assets (ROA)

This section presents analysis for the determination of hierarchical relationships between the predictor variables: ownership structure, board effectiveness and managerial discretion and Return on Assets as a measure of firm performance.

Table 24: Results of the Hierarchical Regression Analysis

Model	r	R Square	Adjusted R Square	Std. Error of the Estimate	Change in R Square	Change in F
1	.280(a)	.079	.054	10.7735659	.079	3.159
2	.295(b)	.087	.036	10.8736776	.008	.322
3	.296(c)	.088	.009	11.0235732	.001	.028

a: Predictors: (Constant), Ownership Concentration (Ownconc)

b: Predictors: (Constant), Ownership Concentration, Board Effectiveness (Ownconc, Boardeffect)

c: Predictors: (Constant), Ownership Concentration, Board Effectiveness, Managerial Discretion (Ownconc, Boardeffect, Mandisc).

4.4.3. Model Results in Table 24

Model 1: R square = .079, indicating that ownership concentration (predictor variable) alone accounts for about 8 % of the variance in ROA.

Model 2: R square = .087. This is higher than the value of R^2 model 1 by 0.008 (i.e. $0.087-0.079$). The change in the value of R^2 in model 2 indicates that board effectiveness (a predictor variable) accounts for 0.8% of the variance in ROA after controlling for ownership concentration (i.e. $R^2=0.079 + 0.008 = 0.087$). Therefore, the incremental value to the variance in ROA is 0.008.

Model 3: R square = .088, showing that R^2 has increased by 0.001 from 0.087 in model 2 to 0.088 in model 3. This demonstrates that the predictor managerial discretion accounts for 0.1% of the variance in ROA, after controlling for ownership concentration and board effectiveness (i.e. $R^2 = .079 + .008+ .001= .088$).

Overall, about 9% of the variance in the criterion variable (ROA) was explained by ownership concentration (8%), Board effectiveness (0.8%) and managerial discretion (0.1%).

4.4.4. Hierarchical Change in Predictor Variables with respect to ROA

As shown in Table 24, the change in R square associated with the predictor variable in each question was very small. This means that the predictor variables (ownership structure, board effectiveness and managerial discretion) were not good predictors of the criterion variable (ROA) for firms in this study.

Table 25: Change Statistics from the Results of Hierarchical Regression Analysis for Variables associated with ROA

Model	r	R Square	Std. Error of the Estimate	Change Statistics			
Number	Value	Value	Value	Change in R Square	Change in F	df1	df2
1	.280(a)	.079	10.7735659	.079	3.159	1	37
2	.295(b)	.087	10.8736776	.008	.322	1	36
3	.296(c)	.088	11.0235732	.001	.028	1	35

Entering the predictor variable (ownership structure) first, resulted in an R square of .079, which was statistically significant (F Change= 3.159). Adding board effectiveness increased the R square by 0.8%, which was not statistically significant (F Change= .322). Adding managerial discretion in step 3 increased the R square by an additional 0.1%, which was also not statistically significant (F Change = .028). Change in F ratio in model 1 was significant, suggesting a strong effect of ownership concentration on firm performance. However, in model 2 and model 3, change in F value was insignificant, suggesting infinitesimal hierarchical impact of the predictor variables.

4.4.5. Results of the Analysis of Variance (ANOVA) for ROA

The foregoing hierarchical links were further analyzed using Analysis of Variance (ANOVA) statistical technique to check for the reliability of the results obtained using regression analysis. The results are presented in table 26.

Table 26: ANOVA Results for Change in F ratio with respect to ROA

Model	Type of Test	Sum of Squares	df	Mean Square	F
1	Regression	366.662	1	366.662	3.159
	Residual	4294.580	37	116.070	
	Total	4661.242	38		
2	Regression	404.715	2	202.357	1.711
	Residual	4256.527	36	118.237	
	Total	4661.242	38		
3	Regression	408.071	3	136.024	1.119
	Residual	4253.171	35	121.519	
	Total	4661.242	38		

a: Predictors: (Constant), Ownership Concentration (Ownconc)

b: Predictors: (Constant), Ownership Concentration, Board Effectiveness (Ownconc, Boardeffect)

c: Predictors: (Constant), Ownership Concentration, Board Effectiveness, Managerial Discretion (Ownconc, Boardeffect, Mandisc).

d : Dependent Variable: ROA

From the results shown in Table 26, it is evident that all the F ratios for the three models are significant, suggesting a hierarchical relationship between ownership structure and firm performance as measured by ROA. The study therefore, supports hypothesis H₅ which states that the relationship between ownership structure and firm performance as measured by ROA is hierarchical.

Model 1

About 7.9% of the variance in the criterion variable ROA) is accounted for by ownership structure. The first model, with only one predictor variable (i.e. ownership structure) resulted in an F ratio of 3.159 at $p < .05$. This indicates a significant effect on the variance in ROA. The results are presented in Table 26.

Model 2

Approximately 8.7% of the variance in the criterion variable (ROA) is accounted for by ownership structure and board effectiveness. The second model, with two predictors (i.e. ownership structure and board effectiveness) resulted in an F ratio of 1.711 at $p < .05$, suggesting a significant effect on the variance in ROA. The details are in table 26.

Model 3

About 8.8% of the variance in the criterion variable (ROA) is accounted for by all three predictors (ownership structure, board effectiveness and managerial discretion). The third model, which includes all three predictors, resulted in an F ratio of 1.119 at $p < .05$. This indicates a significant effect of the predictor variables on the variance in ROA. Table 26 captures this data in a comprehensive manner.

4.4.6. Return on Equity (ROE)

This section presents results of hierarchical regression analysis for relationships between the predictor variables: ownership structure, board effectiveness and managerial discretion, and Return on Equity. These results are presented in table 27.

Table 27: Regression Results for the effects of the Predictor Variables on ROE

Model	r	R Square	Std. Error of the Estimate	Change in R Square	Change in F
1	.301(a)	.091	13.1200958	.091	3.787
2	.303(b)	.092	13.2892111	.001	.039
3	.303(c)	.092	13.4715041	.000	.005

4.4.7. Model Results for ROE

As shown in table 27, $R^2=0.091$ in model 1. This means that ownership concentration (predictor variable) alone accounts for about 9% of the variance in ROE. In model 1, $R^2=0.092$, indicating an increase of 0.001 (i.e. $0.092-0.091$). These statistics imply that board effectiveness alone accounts for 0.1% of the variance in ROE after controlling for ownership concentration. In model 3, $R^2=0.092$. This is higher than the 0.091 in model 1, and equal to 0.092 in model 2. This implies that managerial discretion (predictor variable) does not account for any variance in ROE, even after ownership concentration and board effectiveness were excluded from the model, leaving only managerial discretion. As shown in table 27, about 9.1% of the variance in the criterion variable (ROE) was explained by managerial discretion (9%), internal influences (0.1%) and

market influence(0.0%).

4.4.8. Incremental Change in ROE attributable to each Predictor Variable

The table 28 presents ROE model results. As can be discerned from the table, there is a significant positive change in F ratio associated with ownership concentration as predictor variable in the first model ($F=3.787$, $p<.05$). On the other hand, board effectiveness ($F=0.039$) and managerial discretion ($F=0.005$) were not significant and therefore, not good predictors of the criterion variable (ROE). This implies that the relationship between ownership structure and firm performance is not mediated by board effectiveness and managerial discretion.

Table 28: Results of Hierarchical Regression Analysis for Variables associated with ROE

Model	R	R Square	Std. Error of the Estimate	Change Statistics			
				Change in R Square	Change in F	df1	df2
1	.301(a)	.091	13.1200958	.091	3.787	1	38
2	.303(b)	.092	13.2892111	.001	.039	1	37
3	.303(c)	.092	13.4715041	.000	.005	1	36

a: Predictors: (Constant), Ownership Concentration (Ownconc)

b: Predictors: (Constant), Ownership Concentration, Board Effectiveness (Ownconc, Boardeffect)

c: Predictors: (Constant), Ownership Concentration, Board Effectiveness, Managerial Discretion (Ownconc, Boardeffect, Mandisc).

4.4.9. Results of the Analysis of Variance (ANOVA) for Change in ROE resulting from Predictor Variables

Analysis of Variance (ANOVA) was used to corroborate the results of the hierarchical regression analysis for the effect of the three predictor variables (i.e. ownership concentration, board effectiveness and managerial discretion) on corporate performance.

The results are presented in Table 29.

Table 29: ANOVA Results for Change in F ratio for ROE Criterion Variable

Model	Type of Test	Sum of Squares	df	Mean Square	F
1	Regression	651.955	1	651.955	3.787
	Residual	6541.203	38	172.137	
	Total	7193.158	39		
2	Regression	658.842	2	329.421	1.865
	Residual	6534.316	37	176.603	
	Total	7193.158	39		
3	Regression	659.827	3	219.942	1.212
	Residual	6533.331	36	181.481	
	Total	7193.158	39		

a: Predictors: (Constant), Ownership Concentration (Ownconc)

b: Predictors: (Constant), Ownership Concentration, Board Effectiveness (Ownconc, Boardeffect)

c: Predictors: (Constant), Ownership Concentration, Board Effectiveness, Managerial Discretion (Ownconc, Boardeffect, Mandisc).

As can be seen in table 29 (model 1), 9.1% of the variance in ROE is accounted for by ownership structure. The first model included one predictor variable (i.e. ownership concentration), and resulted in an F ratio of 3.787 at $p < 0.05$ level of significance. The implication is that ownership concentration had significant effect on the variance in performance as measured by ROE. Model 2 shows that approximately 9.2% of the variance in ROE is accounted for by ownership concentration and board effectiveness. These statistics indicate that ownership concentration and board effectiveness together had a significant effect on the variance in ROE ($F=1.865$, $p < 0.05$). The third criterion with three predictor variables (ownership concentration, board effectiveness and managerial discretion) also showed a significant effect on the variance in ROE ($F=1.212$, $p < 0.05$).

Based on the results presented in Table 29, this study concluded that there was hierarchical relationship between ownership structure, board effectiveness and managerial discretion. The study therefore, supports H_5 which states that the relationship between ownership structure and firm performance as measured by ROE is hierarchical.

4.4.10. Dividend Yield (DY)

This section presents results of hierarchical analysis of the relationships between the predictor variables: ownership concentration, board effectiveness and managerial discretion and divided yield. The results are presented in Table 30 and Table 31.

Table 30: Regression Results for the effects of the Predictor Variables on DY

Model	r	R Square	Std. Error of the Estimate	Change in R Square	Change in F
1	.176(a)	.031	1.8191858	.031	1.113
2	.203(b)	.041	1.8359751	.010	.363
3	.203(c)	.041	1.8634602	.000	.004

As can be discerned in Table 30, the results of model 1 are: $R^2=0.031$. This suggests that the predictor variable (ownership concentration) alone accounts for 3.1% of the variance in DY. Model 2 has an R^2 value of 0.041, indicating an increase of 0.01 over model 1. Thus, the predictor variable (board effectiveness) alone accounts for 1.0% of the variance in DY after controlling for ownership concentration. Model 3 has an R^2 value of 0.041, which is equal to the value in model 2. This shows an increment of 0.00 between model 2 and model 3. In a nutshell, the 4.1% of the variance in DY was accounted for by ownership concentration (3.1%), board effectiveness (1.0%) and managerial discretion (0.0%). These statistics suggest that managerial discretion on its own does not account for any variance in DY, after ownership concentration and board effectiveness are excluded.

4.4.11. Incremental Change in DY attributable to each Predictor Variable

As can be discerned from Table 30, ownership concentration, board effectiveness and managerial discretion had insignificant changes in R squared values (0.031, 0.010 and 0.000, respectively), indicating that these variables were not good predictors of DY as an indicator of firm performance.

Table 31: Change Statistics from the Results of Hierarchical Regression Analysis for Predictor Variables associated with DY

Model	r	R-Square	Adjusted R-Square	Std. Error of the Estimate	Change Statistics			
					Change in R Square	Change in F	df1	df2
NO.	Value	Value	Value	Value				
1	.176(a)	.031	.003	1.8191858	.031	1.113	1	35
2	.203(b)	.041	-.015	1.8359751	.010	.363	1	34
3	.203(c)	.041	-.046	1.8634602	.000	.004	1	33

a: Predictors: (Constant), Ownership Concentration (Ownconc)

b: Predictors: (Constant), Ownership Concentration, Board Effectiveness (Ownconc, Boardeffect)

c: Predictors: (Constant), Ownership Concentration, Board Effectiveness, Managerial Discretion (Ownconc, Boardeffect, Mandisc).

4.4.12. Analysis of Variance (ANOVA) for DY criterion variable

As given in Table 31, the incremental values of R^2 for all the models were insignificant (Model 1: $R^2=0.031$; Model 2: $R^2=0.010$; Model 3: $R^2=0.00$). The study therefore, rejects hypothesis H_5 which states that the relationship between ownership structure and firm performance as measured by DY is hierarchical.

Table 32: ANOVA Results for Change in F ratio for DY Criterion Variable

Model		Sum of Squares	df	Mean Square	F
1	Regression	3.684	1	3.684	1.113
	Residual	115.830	35	3.309	
	Total	119.515	36		
2	Regression	4.907	2	2.454	.728
	Residual	114.607	34	3.371	
	Total	119.515	36		
3	Regression	4.923	3	1.641	.473
	Residual	114.592	33	3.472	
	Total	119.515	36		

a: Predictors: (Constant), Ownconc.

b: Predictors: (Constant), Ownconc, Boardeffect.

c: Predictors: (Constant), Ownconc, Boardeffect, Mandisc.

d. Dependent Variable: DY

As can be seen from Table 32, none of the F ratios for the three models was significant. The results of the tests lead us to reject the Hypothesis H_5 which states that the relationship between ownership structure and firm performance as measured by DY is hierarchical.

Results of the data analysis provided an opportunity to draw conclusions based on the study objectives and hypotheses.

CHAPTER 5: SUMMARY, CONCLUSIONS AND IMPLICATIONS OF THE STUDY

5.1. Introduction

The overall objective of the study was to investigate the effect of ownership structure, board effectiveness and managerial discretion on corporate performance. Six specific objectives were drawn from the broad objective. The data for the study were collected using a 5-point Likert-type scale.

5.2. Summary and Conclusions

This section summarizes the findings, interprets the results and draws conclusions. All the objectives are linked to relevant hypotheses. The first objective of this study was aimed at establishing the relationship between ownership concentration (actual percentage of shares owned by the first five shareholders) and firm performance. The objective was addressed by testing hypothesis H₁. The findings of this study indicate that there is a negative and significant relationship between ownership concentration and both Return on Assets and Return on Equity. The relationship between ownership concentration and Dividend Yield is also negative but weak. These findings lead to the rejection of the hypothesis.

The Study used both primary and secondary data. Primary data was collected through a structured questionnaire while secondary data were obtained from the Nairobi Stock Exchange handbooks for 2006. The study questionnaire was developed in tandem with the Brown-Governance Evaluative framework that has been employed in similar past studies (Cadbury, 1992).

Both bivariate and multivariate analyses were done using SPSS version 11.5. The bivariate analysis involved the use of the value of R and R-squared to determine the relationship between independent variables and indicators of firm performance. Multivariate analysis was used to test the combined effect of the explanatory variables using multiple regressions to determine their effect on each of the three indicators of firm

performance: Return on Assets (ROA); Return on Equity (ROE); and Dividend Yield (DY).

Moderation models were used to determine if market influences or internal influences moderated the strength of relationship between managerial discretion and firm performance. On the other hand, hierarchical regression modeling was used to determine if the relationship between ownership structure and firm performance was hierarchical.

In general, prior research has found significant links between ownership structure and firm performance where studies comparing ownership concentration and firm performance have often found a higher rate of return in companies with concentrated ownership. That is, the higher the proportion of shareholding held by the first five shareholders, for example, the higher the returns on firm investments. Further, other studies have also shown that it is not only the amount of equity held by shareholders that matter when studying firm performance but also the identity of the shareholder. Among the different forms of ownership, managerial ownership is seen as the most controversial where its overall effect depends on the relative strengths of the incentive alignment and entrenchment effects (Cho, *et al*, 1998).

There is near convergence that Government ownership of firms leads to bureaucracy and inefficiency that negatively impacts firm performance (Nickel, 1997). Diffusely owned firms have been shown in previous studies to be poor performers in part due to the fact that diverse/diffuse shareholders lack the wherewithal and motivation to monitor, control and ratify management decisions.

The findings appear to contradict the position held by proponents of ownership concentration (Moldoveanu & Martin, 2001; Kuznetsov & Murvyev, 2001; Jensen & Murphy, 1990; Fama & Jensen, 1983; Jensen & Meckling, 1976; Berle & Mean, 1932) who argue that ownership concentration affords the shareholders the motivation and ability to monitor and control management decisions. This, they argue, keeps managers

on their toes and ensures that managers always make decisions that support the wealth creation motivation of the shareholders.

The apologists of strict monitoring and control however, fail to clearly appreciate the fact that ultimately, the shareholders rely on the managers' creativity and innovation to deliver the desired superior corporate performance, and inordinate interference of shareholders in the management processes will certainly undermine corporate outcomes. The latter position is supported by Bergloef and Von Thadden (1999) who posit that concentrated ownership curtails the managers' creativity to a great extent, and therefore force managers to adhere to only those strategies that are favored by shareholders, even if they genuinely doubt the efficacy of those strategies.

The results of this study appear to vindicate the latter position, which essentially means that ownership concentration tends to place inordinate monitoring and ratification powers on shareholders, many of whom may not necessarily understand the business well, thereby undermining firm performance. The findings of this study therefore, conclude that the hypothesis H_1 has not successfully predicted the outcome of the study, and is therefore, rejected. The conclusion that may be drawn from the study findings is that in Kenya, ownership concentration is inimical to manager creativity and innovation, and curtails firm performance.

The second objective sought to establish the relationship between ownership identity (actual identity of shareholders) and firm performance, and it was addressed by testing five hypotheses: H_{2a} ; H_{2b} ; H_{2c} ; H_{2d} ; and H_{2e} . The findings of this study indicate a positive and significant relationship between manager ownership and Return on Assets and Return on Equity. The relationship between manager ownership and Dividend Yield is also positive, but of relatively weak significance. The overall verdict from the study results is that the relationship is positive. It is on the basis of the study findings that the hypothesis H_{2a} was accepted.

The typical agency problems that are very likely to arise in situations where professional managers control the assets of a corporation in which they are not shareholders are adverse selection (miscalculations) and moral hazard (failures of managerial integrity). It has been argued that these problems often arise because managers lack the requisite motivation to ensure prudence since they do not have a stake in the residual income of the firm (Moldoveanu & Martin, 2001; Fama & Jensen, 1983). According to Mork and colleagues (1988) and Stulz (1988), managerial ownership is the most controversial and ambivalent form of firm ownership, and has mixed effects on performance.

Whereas ownership by managers may be seen as a system of aligning the interests of managers with those of the shareholders in a way that enhances corporate performance, this form of ownership can also lead to entrenchment of managers, which is costly when they chose to pursue their self interests. It has been argued that the overall impact of managerial ownership on firm performance depends on how well the entrenchment effects and incentive alignment are balanced (Cubbin and Leech, 1982; Nickel, 1997 Hill and Jones, 1982; Hansmann, 1988, 1996). The findings of this study agree to a significant extent with the argument that managerial ownership enhances corporate performance. In Kenya, manager ownership of firms has been actualized through executive share options. The finding therefore, suggests that when managers also double up as shareholders, they are motivated to work towards realization of the wealth creation objective of the shareholders of whom they are part. On the other hand, managers who are not shareholders are more likely to engage in insider dealings as a way of enhancing their personal wealth and prestige.

Hypothesis H_{2b} was concerned with the relationship between Government ownership and firm performance. The results of the tests of this hypothesis have given a resounding verdict that Government ownership has a negative effect on firm performance. This means that an increase in Government shareholding of a firm results in negative performance. This finding supports what earlier studies have found out regarding this relationship. Many researchers (De Alessi, 1980, 1982; Vickers and Yarrow, 1988; Shapiro and Willig, 1990; Shleifer and Vishny, 1997) have argued that state-owned

enterprises are political firms with citizens as the shareholders, but these citizens have no direct claim to the residual income of those firms. The citizens thus cede their ownership rights to the bureaucracy which does not have clear incentives to improve performance of the corporations. Others (Nickel *et al*, 1997) have attributed the prevalent poor performance of Government owned firms to the tendency of those firms not to strictly adhere to government statutory requirements and regulations. Political manipulation and poor human resource policies are other factors that have been blamed for the general poor performance of state-owned enterprises (Shapiro *et al*, 1990).

Since the early 1990's, the Government has pursued a deliberate policy of divestiture, aimed at reducing state ownership of corporations with a view to attracting private sector participation in management of the fledgling state corporations. It was envisaged that this policy would infuse modern management styles into the public sector that would ultimately improve performance of these companies. The fact that Government ownership of firms still impacts those firms negatively is perhaps an indication that the divestiture programme in Kenya is yet to reach a critical level where its value can begin to reflect on corporate performance.

Hypothesis H_{2c} was aimed at determining the relationship between ownership by corporations (institutions) and firm performance. The findings of this study indicate a moderately significant positive relationship between ownership by corporations and firm performance. Pertinent literature regarding the relationship between ownership by corporations and firm performance emphasizes that investors differ in the degree to which they are prepared to take risks (Shleifer & Vishny, 1997; Welch, 2000; Xu & Wang, 1997). Firm owners make investment choices that are influenced by their interests and preferences.

When a firm obtains shares in another firm, the shareholders extend their investment preferences, interests and risk taking behavior to that new firm. The interesting thing about firm ownership by other firms in Kenya is that the holding firms are typically large corporations with the ability to reorganize their branch/affiliate operations to bail out

non-performing affiliates. Most of these holding firms have also reported good performance during the period of study. The good performance of the firms they own is therefore consistent with the documented practice by firms to extend their investment preferences and risk-taking behavior to the firms they acquire. The study findings have demonstrated that the hypothesis was an effective predictor of the study objective.

Hypothesis H_{2d} sought to determine the correlation between ownership by diverse individuals and performance of listed companies. The study found that there is a positive relationship between diverse/diffuse ownership and firm performance. The findings appear to contradict those of previous researchers (Fama and Jensen, 1983; Jensen and Meckling 1976; Berle and Mean, 1932) who have argued that agency problems are more severe in diffusely held firms due to lack of capacity to collectively monitor the activities of managers, a situation that gives managers unlimited leeway to run the affairs of the corporation in their own self interest. This argument, however fails to appreciate that shareholder-managers will almost invariably demonstrate more commitment to the firm than will their counterparts who are not shareholders since the latter have no stake in the residual income of the firm.

Although some researchers have tended to favor concentrated ownership over diverse ownership, the reality is that the agency costs incurred in monitoring managers (especially if they are not shareholders) are huge, and may undermine firm performance. Thus, it is a lot cheaper for managers to be able to make independent decisions that support shareholder objectives than have shareholders to impose imprudent ideas on them. The import of the study findings is that in Kenya, managers work better in an environment where are afforded an opportunity to own shares of the firm, then allowed free hand to exercise their professional judgment without undue influence from shareholders. This arrangement works best in a diffusely held firm. It can also be argued that the high performing blue chip companies have high likelihood to attract more individual investors to buy their shares, thereby diversifying shareholdings. The hypothesis H_{2d} is therefore, rejected on the basis of the study findings.

The most definitive result was on the relationship between foreign ownership and firm performance. This study has found that there is a significant positive relationship between foreign ownership of firms and corporate performance. The findings have thus vindicated the long-held belief that on average, foreign owned companies perform better than their counterparts with dominant local ownership. All the tests for this hypothesis (Pearson's Product Moment Correlation; Linear Regression; and Logistic Regression) have given a resounding verdict that the relationship is positive and significant. These findings are hardly surprising. Thomsen and Pedersen (1997) posit that preferences regarding company strategies will often involve a trade-off between the pursuit of shareholder values, orientation and other goals. Successful companies with an international presence tend to be large, with well established management systems that are replicated (with minimal customization) in all their branches and affiliates abroad.

International companies also tend to enjoy massive resources that can be used, whenever need arises, to buttress financial strength of their affiliates that are facing difficulty. These companies also tend to use their unique advantage of international presence to defeat local tax authorities by designing complex tax avoidance schemes that re-allocate huge costs to harsh tax regimes in order to minimize tax liability. These factors give foreign companies undue advantages that are not available to the local counterparts, hence their superior performance.

In Kenya, all the listed foreign companies happen to be large and successful. In fact, in the period under review, all the foreign companies made accounting profits while many of the local ones were struggling to remain afloat. This is a clear indication that the foreign companies were enjoying an extra advantage that was not accessible by the local firms. The hypothesis H_{2c} was therefore, supported by the study findings.

The third objective of this study was concerned with effectiveness of the board of directors, and its impact on firm performance, and was addressed by testing hypothesis H_3 . This objective, in a way, is the core of the study on corporate governance since extant literature has paid much attention to the role of the board of directors. In fact, some

scholars have argued that a functional board of directors is a panacea to most of the governance problems in organizations. Many cases of corporate malfeasance have been blamed on non-vigilant boards.

The findings of this study indicate a negative relationship between board effectiveness and firm performance, thus contradicting hypothesis H₃ which suggested to the contrary. The study results appear to suggest that the value of Boards of Directors in corporate performance is negative. The Board of Directors is the ultimate decision making organ of the company, and acts as an intermediary between shareholders and managers in ensuring that capital is directed in the right purpose (McDonald, 2005; Brown Governance Inc., 2004). In playing this role, the board acts as an advisor to the top managers, and enforces high standards of accountability in a manner that discourages insider dealings by the managers.

To effectively discharge both their internal roles (monitoring, controlling and ratifying managerial decisions) and act as the link between managers and shareholders, the selection criteria should ensure that only those who have thorough mastery of the business, and appreciate environmental dynamics find themselves to the Board of Directors (Zahra *et al*, 2005). Besides, care should be taken to balance between internal and external directors to infuse sufficient amount of independence during deliberations (Ezzamel and Watson, 1983; Baysinger and Butler, 1985; Pearce and Zahra, 1992; Rosentein and Wyatt, 1990; Schellenger, Wood and Tashakori, 1989).

This study found out that most of the criteria set for selecting board members are often flouted. For example, appointments to boards of public corporations are made on the basis of regional balance and political expediency rather than merit (Anyang'-Nyong'o, 2000). At the same time, CEOs of listed companies in Kenya have massive powers in suggesting names of outside individuals to join the boards. The board members who can not go along with the CEOs are also fired on the latter's advice.

To make matters even worse, the directors do not have sufficient time in the companies to familiarize themselves with company policies and documents to form an independent opinion on the managerial decisions. The directors are thus left vulnerable, at the mercy of managers whose decisions they are supposed to monitor, control and ratify. In fact, in many companies, the directors are used as rubber stamps, ratifying decisions made by the CEO and top managers, in return for sitting allowance. In these circumstances, it is not surprising that the role of directors in listed companies in Kenya is ambiguous. Those Boards that tried to enforce the rules in terms of monitoring, leadership, stewardship and reporting, were actually seen by managers as a nuisance since they merely curtailed the managers' innovation and creativity without quite appreciating the business of the organization. The findings of this study have therefore led to rejection of hypothesis H₃.

Regarding the moderating influence of market factors on the relationship between managerial discretion and firm performance, the study found mixed results. This objective was dealt with by testing hypothesis H_{4a}. Whereas there was conclusive evidence that the strength of the relationship between managerial discretion and Return on Assets, and between managerial discretion and Return on Equity did not depend on market influences, the strength of the relationship between managerial discretion and Dividend Yield was found to depend on market influences. Market factors that have been identified to influence managerial discretion include managerial labour markets, product markets, industry structure and financial markets (Jensen, 1989; Hambrick and Finkelstein, 1987)

Previous studies (Walsh and Seward, 1990; Kesner, 1987; Baysinger and Hoskisson, 1990; Baysinger, Kosnik and Turk, 1991) have reported that market factors moderate the strength of the relationship between managerial discretion and firm performance. But what they have not said is whether this moderation affects some or all indicators of performance. Return on Assets and Return on Equity are largely under the control of managers, and reflect how well the managers have managed the assets and shareholders' funds to generate income for the company and stockholders. The two indicators of performance are therefore, largely dependent on internal factors. On the other hand,

Dividend Yield is a factor of the dividends per share and share price at a given point in time. Obviously, share prices are affected by many factors, some of which are market based. The findings of this study are therefore, indicative of the real factors at play in determination of firm performance. On this basis, the findings of this study are robust and acceptable.

Similarly, the study has vindicated the long-established position that internal factors have significant moderating influence on the relationship between managerial discretion and Return on Assets, and between managerial discretion and Return on Equity. However, internal factors did not influence the relationship between managerial discretion and Dividend Yield. The typical internal factors that influence managerial discretion include Board of Directors, size, leverage and intangible resources such as formulae, processes, and skills. Hence, the test of hypothesis H_{4b} also reported mixed results in terms of the moderating influence of internal factors on the relationship between managerial discretion and firm performance.

These findings appear to be consistent with results obtained by previous studies and the observed reality. For instance, according to many researchers (Kennon, 2005; Neubauer, 1992; Conforth, 2001; Xu and Wang, 1997), DY is a typical tool for measuring market-related performance even though it is generated from internal financial statements. On the other hand, Return on Assets and Return on Equity are determined by internal factors to a great extent. The implication of the study findings is that managers must weigh internal and external factors carefully as they make decisions since both factors impact firm performance.

The last objective of this study sought to establish whether the relationship between ownership structure and firm performance was direct or hierarchical (i.e. through board effectiveness and managerial discretion). This objective was addressed by testing hypothesis H_5 . To investigate the incremental value of an additional variable, Analysis of Variance (ANOVA) and F-tests were conducted. The tests for hierarchical relationships between ownership structure and firm performance through board effectiveness and

managerial discretion indicated that whereas there was a hierarchical relationship between ownership structure and firm performance as measured by ROA and ROE, the relationship was not hierarchical with respect to DY. This means that while a significant variance in firm performance as measured by ROA and ROE is attributable to board effectiveness and managerial discretion, the variance in firm performance as measured by DY was infinitesimal. With F ratios for all the predictor variables being significant with respect to ROA and ROE, but insignificant with respect to DY, the study concluded that the relationship between ownership structure and firm performance as measured by ROA and ROE was hierarchical through board effectiveness and managerial discretion. However, the relationship between ownership structure and firm performance as measured by DY is not hierarchical.

The study findings mean that virtually no variance in the relationship between ownership structure and firm performance as measured by DY can be significantly explained by either board effectiveness or managerial discretion. In other words, ownership structure (ownership concentration and ownership identity), on its own, has significant effect on firm performance as measured by DY, and the relationship does not need to be strengthened or weakened by board effectiveness and managerial discretion. On the other hand, the effect of ownership structure on firm performance as measured by ROA and ROE is through board effectiveness and managerial discretion.

These findings make a lot of sense since it has also been demonstrated that there are significant relationships (positive or negative) between firm performance and the predictor variables used in this study. The findings however, appear to disagree with many previous studies that found that ownership-performance relationship is direct (Berle and Mean, 1932; Cubbin and Leech, 1983; Shleifer and Vishny, 1997; Demsetz and Lehn, 1985). This should not be surprising at all since all these studies were conducted in the context of developed countries, where information on firm ownership is readily available to citizens, thus enabling them to make more informed decisions.

5.2. Implications of the Research Findings

The general objective of this study was to investigate the effect of ownership structure, board effectiveness and managerial discretion on firm performance. Essentially, this objective sought to address the growing trend of corporate failures across the globe, which appears to be worsening despite the existing corporate governance structures. Researchers and practitioners have questioned the effectiveness of the current corporate governance framework that presumes that once there is an effective board of directors in place, then corporate performance is consequential. By taking the Board as the most critical element in corporate governance, the framework has evidently ignored other equally if not more important organs of governance including ownership structure and managerial discretion.

The specific objectives and the hypotheses drawn from the conceptual framework were therefore, aimed first and foremost at investigating whether the boards are functioning in a manner consistent with what are stipulated as their ideal role. The positions of ownership structure and managerial discretion in driving corporate performance were then put into context under a conceptual framework and analyzed. Some of the research findings have generally vindicated the long-held positions regarding the various relationships that were studied. Other findings however, were inconsistent with pertinent literature and results of previous research, thus preparing ground for paradigm shift in certain aspects of corporate governance, especially with regard to the Kenyan context.

The hypothesis H_1 was based on the widely-held position that there is a positive relationship between ownership concentration and firm performance. According to the principal-agent model, due to the divergence of interests and objectives of managers and shareholders, one would expect the separation of ownership and control to have damaging effects on the performance of the firm. Therefore, one way of overcoming this is through direct shareholder monitoring via concentrated ownership. The traditional difficulty with diffused ownership is that the incentives to monitor management are weak. Shareholders have an incentive to free-ride in the hope that other shareholders will do the monitoring. This is because in a diffuse ownership situation, the benefits from

monitoring are shared with all shareholders, whereas, the full costs of monitoring are borne by those who monitor.

The monitoring and control school of thought argues that the free-rider problems associated with diffuse ownership do not arise with concentrated ownership, since the majority shareholder captures most of the benefits associated with this monitoring. This study has found out that the reverse is actually true in the Kenyan context. The implication is that when more than 30 per cent or more of shares are concentrated on a few hands (i.e. five shareholders or less), there is a tendency for the shareholders to be overzealous in their monitoring, controlling and ratification roles over managers. This stifles managers' creativity and innovation, and ultimately affects firm performance adversely. It is even worse when the shareholders lack specific and general knowledge about the business of the firm. The results of the current study have therefore, shown there is dire need to reasonably diversify shareholding as a way of attracting more skills and competencies among the shareholders that can be tapped to improve firm performance. At the same time, the managers should be protected from unnecessary direct interference by the shareholders.

The findings of the study have shed light on the contentious relationship between manager/insider ownership and firm performance. It has been argued that when managers own shares in the company, they become more committed to the organization since they have a stake in the residual income of the firm, and this commitment translates to superior performance. In fact, the study has reaffirmed the correctness of this position among listed companies in Kenya. What was not established by the study however is the critical level of shareholding, beyond which there would be accelerated firm performance arising from commitment of managers.

Government ownership has been roundly criticized for contributing to generally poor performance of firms, due to excessive bureaucracy, tribalism, nepotism, poor human resource policies, political expediency in appointments and lack of respect for laws and regulations. This study found a very significant negative relationship between

government ownership and firm performance. The implication is that government should infuse private sector-like management systems and progress the divestiture programme to attract more private individuals and institutions to co-own the corporations currently owned by the Government. The performance contracting policy that was recently introduced by the Kenya Government should be developed further and supported as a way of promoting performance-based management in the public sector. This system, if fully implemented, has the potential to move Kenya to the next level where appointments and promotions in the public sector are based on merit.

Previous studies have found ambiguity in the relationship between ownership by corporations and firm performance, due mainly to the differences in investment preferences and shareholders' goals. The results have thus been mixed with some reporting positive relationship while others showing negative relationship. The study has given very categorical results: the relationship is positive for all the listed firms that are owned by other firms, a position attributed to the fact that all the holding companies happened to be large corporations which were themselves performing well. So the good performance is attributable to the investment choices and orientation of the parent companies, and not necessarily the ability of managers. The results are a pointer that companies that are performing poorly need to carefully chose strategic alliance partners to prop up their poor performance.

The global trend toward diffuse ownership has confounded many researchers, since it undermines the popular belief that managers are inherently self-seeking and can easily wreck the organization if left without close monitoring. For a long time, corporate governance has been premised on the need for concentrated ownership to check on managers' insider dealings, and that diffused ownership is bereft of sufficient motivation and wherewithal to monitor managers' actions. The findings have brought a new dimension that emphasizes managerial discretion for creativity and innovation, and less monitoring by shareholders. Thus, diffuse ownership of firms provides a good environment for excellent policies to be developed and implemented by managers. In principle, this is true since the reason why owners hire managers in the first place is

because they needed the managers' specialized human capital to run the firm and to generate returns on their investments. The managers are therefore best informed regarding alternative uses for the investors' funds. As a result, the managers end up with substantial residual control rights and discretion to allocate funds as they choose. The downside of this argument is that it presumes that managers are honest, and always prepared to work in the objective interest of the shareholders, a position that is often not true. The fact that managers have most of the control rights can lead to problems of management entrenchment and rent-seeking behavior by managers. The question of how much discretion (limits) managers should have, and performance accountability by managers is therefore, fundamental.

One of the consequences of the possibility of opportunistic behavior by managers is that it reduces the amount of resources that investors are willing to invest in the firm, leading to socially inefficient levels of investment that, in turn, can have direct implications for economic growth and development. Accordingly therefore, there should be developed corporate governance mechanisms that align interests of managers with those of investors. An effective corporate governance framework can minimize the agency costs associated with separation of ownership and control of firms. This study has shown that managers work best when they have sufficient latitude for innovation and creativity, that is, less monitoring by principals.

Shareholders are unlikely to be comfortable with an arrangement that almost completely removes their monitoring and ratification roles. To remedy this situation, this study suggests three broad mechanisms that can be used to align the interests and objectives of managers with those of shareholders, and overcome the problem of management entrenchment. The first mechanism is to motivate managers to enhance their management practices by directly aligning their interests with those of the shareholders, through executive compensation plans and stock options. The second method is to entrench shareholders' rights in the legal instruments so that they enjoy legal protection from managers' expropriation (moral hazard, insider dealings etc.). Last but not least, is to strengthen the statutory bodies such as Capital Markets Authority and Nairobi Stock

Exchange to provide more effective role in managerial labor markets and markets for corporate control.

The positive and significant relationship between foreign ownership and firm performance appears to have gained universal acceptance across the globe, and therefore, this study went further to investigate the real issues behind the phenomenon. The results are as interesting as they are saddening. First, foreign owned companies have access to management systems whose efficacy has been tested in many contexts. The massive resource base and bail-out plans for fledgling affiliates are other factors that enhance performance of foreign owned firms.

However, the ability of these companies to re-organize their global operations to be able to assign more costs to harsh tax regimes and profits to tax havens in a bid to reduce their overall tax liability, is the most damning feature of foreign ownership. The practice of designing complex tax avoidance schemes is quite devastating to locally-owned firms which have to pay all their taxes, thereby incurring huge costs of operation. Besides the playing field not being level for both foreign and local players, the foreign owned firms actually undermine the host economies through repatriation of profits and stifling growth of local industries. Whereas there is need to attract foreign direct investment, the host countries should develop their capacity to effectively deal with cases of transfer pricing and related practices.

The pertinent literature based on the separation of firm ownership and management has tended to emphasize the need for an effective board to act as a link between managers as agents and shareholders. In this capacity, the board as the supreme organ of the organization is expected to monitor, control and ratify managers' decisions on behalf of the shareholders (principals). To effectively discharge this onerous responsibility, the board should comprise competent individuals with a good balance between executive and non-executive directors to infuse independence in the board processes. While the emphasis is on independence of the board, in reality, there is a very serious problem: like management, the board too can be entrenched and compromised. This is particularly the

case when board members are not commensurately compensated for their role in governance of the firm, yet they are responsible for overseeing executive compensation. And while there is a trade-off between the level of remuneration that attracts and retains high quality individuals as non-executive board members, this also provides incentives for the individual board members to serve on a number of boards in order to maximize their earnings. This in turn can interfere with performance, since service on too many boards reduces the monitoring ability of board members.

Although the Board in theory is the *bona fide* representative of the shareholders, in practice they often become part of management of the corporation. Because of the problems associated with entrenchment of the boards, there is still a widely held perception that the board is a relatively weak monitoring device. In fact, the findings of this study show that the role of boards in Kenya is largely ceremonial. Members of the board, most of whom are retirees without relevant training or experience in the business of the companies on whose boards they sit, are appointed to their positions on the basis of cronyism, and remain there at the pleasure of the Chief Executive Officers whose actions they are supposed to monitor and ratify. In the circumstances, there is hardly any intellectual independence and value to be reaped from these board members.

The result is that most boards in Kenya have no value in terms of corporate performance. Those amongst the board members who attempt to be zealous about their work end up de-motivating managers due to their lack of specific knowledge of the business, hence poor corporate performance. Thus there is urgent need to address the issues of board member selection criteria in order to make them more relevant and effective in corporate governance. In fact, this finding has given a useful glimpse into the weaknesses of the existing corporate governance framework. This study therefore, proposes a reinvigoration of the board as a way of forestalling corporate malfeasance.

Regarding the moderation effect of internal factors (intangible assets, size, and leverage) on the relationship between managerial discretion and firm performance, it is very clear that these factors are crucial particularly in terms of decisions affecting the stewardship

of assets and owners' equity. Organizational processes, formulae and skills should be jealously guarded since they confer certain strategic advantages. To sustain them, there is need for continued Research and Development endeavors. While many of the companies reported the importance of size with regard to economies of scale, they warned that the decision to expand should be considered carefully to avoid overstretching the productive capacity of the available resources. Companies often resort to external financing in order to expand, but it should be borne in mind that wanton indebtedness can choke a company and compromise its solvency, leading to receivership or liquidation.

Market factors (managerial labor markets, financial markets and price policy) were found to be of relevance in decision making, but at varying degrees of importance. First, the managerial labour markets were found to be more or less non-existent in the Kenyan market. Thus, managers in Kenya lack external (market) standards against which their performance is measured. The Centre for Corporate Governance in conjunction with industry players needs to explore the possibility of addressing this crucial area of corporate governance.

The study also found that financiers impose sanctions on companies that have not demonstrated prudence on the use of finances, and may be denied further financing. Likewise, pricing policy is an important consideration for managers since it impacts upon their ability to compete and enhance their market share. Companies must ensure that they produce high quality goods and services, and price them competitively in order to attract and sustain customer loyalty. The perception that customers have of a firm and its products has a bearing on its share price, and thus affects Dividend Yield of that company. This calls for ethical management that also supports environmental issues and corporate social responsibility.

This study found a non-hierarchical relationship between ownership structure and firm performance. What this means essentially is that ownership structure has a direct bearing on firm performance. This finding has been vindicated by the significant relationships between firm performance and ownership concentration and ownership identity. It is

therefore, important for companies to address the issues surrounding ownership concentration and identity, to ensure that a careful balancing act is done to promote managerial discretion while at the same time maintaining sufficient monitoring, control and ratification in the hands of the shareholders.

The challenging task that policy makers must confront is to design a corporate governance framework that secures the benefits of large shareholders whilst preventing them from extracting excessive private benefits. At the same time, the corporate governance framework should protect the minority shareholders from expropriation, as a way of encouraging the development of equity market in Kenya since small investors will be encouraged to buy more of the listed companies' stocks. The Nairobi Stock Exchange and Capital Markets Authority should encourage high standards of disclosure and transparency among companies and stock brokers, to help ensure that the investment environment makes all types of investors (large and small) feel comfortable to participate in the stock market. Disclosure requirements should be mandatory and enforcement should be strict.

Overall, the search for appropriate corporate governance practice in Kenya should be based on an identification of what works for the country, to discern what broad principles can be derived from the local corporate experiences. Where there is need to transfer corporate governance practices from other countries, especially developed countries, the contexts should be well appreciated before they are applied. As has been demonstrated by this study, corporate governance in Kenya is still at its nascent stages, requiring constant nurturing within a dynamic legal framework.

5.3. Limitations of the Study and Directions for Further Research

The first major constraint was the small size of the population. There were fifty four companies listed at the NSE. After six of them were eliminated only forty eight were eligible for the study. Out of the forty eight, six turned down the request to participate in the study for diverse reasons, leaving only forty two companies. The small number of companies made it difficult to include many more variables since data analysis would

have been very difficult. Future research should consider bigger samples. Besides, the study was cross-sectional, and took into consideration data for 2006 only. Perhaps a better picture would have been obtained had more years been taken into consideration.

The second limitation was the inability to fully investigate industry-specific issues due to the general approach of this study. Although there are advantages in studying listed companies, especially the availability of data, this target population does not have good representation of all the industries, with Industrial and Allied sector having the bulk of listed companies, followed by Financial and Investment. The Agricultural sector, which is the mainstay of the Kenyan economy, comes last in terms of representation with less than ten companies. A detailed analysis of performance of specific sectors is difficult using listed companies alone. Generalizations have therefore, been made regarding performance of sectors, but which require further studies. Future research should consider case studies of specific industries for more insightful analysis.

The study results have shown that manager ownership of shares has a positive effect on firm performance, but the study failed to determine the critical level of ownership beyond which performance is affected positively. Future research should conduct sensitivity analysis to determine this level.

The study findings show that the relationship between ownership structure and firm performance is non-hierarchical. This means that the relationship between the two variables was not affected in any significant way by other explanatory variables such as board effectiveness and managerial discretion. Future research should try to look at the relationship between ownership structure and performance alone, to see if the results could be any different from what this study has found out when board effectiveness and managerial discretion were factored in.

There are other types of firm ownership identity, such as family ownership or ownership by different races, which were not considered due to the restrictive nature of the requirements for listing at the Nairobi Stock Exchange. In future, researchers should pick

up this lead and investigate whether there are any significant differences in firm performance based on race of managers or entrepreneurs.

Last but not least, the data collection tool for this study was customized from the Brown Governance Evaluative Framework, which has been applied mainly in the developed countries where statutory requirements on disclosure levels of corporate are very high. The tool is largely qualitative, and in some aspects targets perception of the managers instead of observable attributes. Although extreme care was taken to cross-check the responses at three levels of corporate governance framework (CEO, Top Management other than CEO, and Line Management), there is still need to improve on this tool to keep up with the changing circumstances in Kenya. Future studies should rely more on proxies than perception.

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APPENDIX 1 VARIABLES AND INDICATORS

Variable	Indicator	Source of Data
<p>Education</p> <ul style="list-style-type: none"> 1. Literacy rate 2. Enrollment rate 3. Drop-out rate 4. Completion rate 5. Knowledge level of local resources 6. Competence in using modern technology 7. Cost effectiveness of training 8. Participation of women in training 9. Character 	<p>Education</p> <ul style="list-style-type: none"> 1. Literacy rate 2. Enrollment rate 3. Drop-out rate 4. Completion rate 5. Knowledge level of local resources 6. Competence in using modern technology 7. Cost effectiveness of training 8. Participation of women in training 9. Character 	<p>Education</p> <ul style="list-style-type: none"> 1. Literacy rate 2. Enrollment rate 3. Drop-out rate 4. Completion rate 5. Knowledge level of local resources 6. Competence in using modern technology 7. Cost effectiveness of training 8. Participation of women in training 9. Character
<p>Management</p> <ul style="list-style-type: none"> 1. Management of resources 2. Management of time 3. Management of people 4. Management of information 5. Management of technology 6. Management of quality 7. Management of cost 8. Management of risk 9. Management of change 10. Management of innovation 11. Management of learning 12. Management of leadership 13. Management of communication 14. Management of conflict resolution 15. Management of decision making 16. Management of problem solving 17. Management of team building 18. Management of organizational culture 19. Management of strategic planning 20. Management of performance evaluation 21. Management of human resources 22. Management of financial resources 23. Management of physical resources 24. Management of information resources 25. Management of technological resources 26. Management of intellectual resources 27. Management of social resources 28. Management of cultural resources 29. Management of environmental resources 30. Management of global resources 	<p>Management</p> <ul style="list-style-type: none"> 1. Management of resources 2. Management of time 3. Management of people 4. Management of information 5. Management of technology 6. Management of quality 7. Management of cost 8. Management of risk 9. Management of change 10. Management of innovation 11. Management of learning 12. Management of leadership 13. Management of communication 14. Management of conflict resolution 15. Management of decision making 16. Management of problem solving 17. Management of team building 18. Management of organizational culture 19. Management of strategic planning 20. Management of performance evaluation 21. Management of human resources 22. Management of financial resources 23. Management of physical resources 24. Management of information resources 25. Management of technological resources 26. Management of intellectual resources 27. Management of social resources 28. Management of cultural resources 29. Management of environmental resources 30. Management of global resources 	<p>Management</p> <ul style="list-style-type: none"> 1. Management of resources 2. Management of time 3. Management of people 4. Management of information 5. Management of technology 6. Management of quality 7. Management of cost 8. Management of risk 9. Management of change 10. Management of innovation 11. Management of learning 12. Management of leadership 13. Management of communication 14. Management of conflict resolution 15. Management of decision making 16. Management of problem solving 17. Management of team building 18. Management of organizational culture 19. Management of strategic planning 20. Management of performance evaluation 21. Management of human resources 22. Management of financial resources 23. Management of physical resources 24. Management of information resources 25. Management of technological resources 26. Management of intellectual resources 27. Management of social resources 28. Management of cultural resources 29. Management of environmental resources 30. Management of global resources
<p>Marketing</p> <ul style="list-style-type: none"> 1. Market research 2. Product development 3. Pricing strategy 4. Promotion strategy 5. Distribution strategy 6. Customer relationship management 7. Sales strategy 8. Brand management 9. Advertising strategy 10. Public relations 11. Market segmentation 12. Target marketing 13. Positioning strategy 14. Competitive analysis 15. Market entry strategy 16. Market expansion strategy 17. Market exit strategy 18. Market consolidation strategy 19. Market diversification strategy 20. Market globalization strategy 21. Market localization strategy 22. Market adaptation strategy 23. Market innovation strategy 24. Market sustainability strategy 25. Market resilience strategy 26. Market flexibility strategy 27. Market agility strategy 28. Market speed strategy 29. Market accuracy strategy 30. Market consistency strategy 31. Market coherence strategy 32. Market complementarity strategy 33. Market synergy strategy 34. Market fit strategy 35. Market alignment strategy 36. Market integration strategy 37. Market collaboration strategy 38. Market partnership strategy 39. Market ecosystem strategy 40. Market network strategy 41. Market platform strategy 42. Market ecosystem strategy 43. Market network strategy 44. Market platform strategy 45. Market ecosystem strategy 46. Market network strategy 47. Market platform strategy 48. Market ecosystem strategy 49. Market network strategy 50. Market platform strategy 	<p>Marketing</p> <ul style="list-style-type: none"> 1. Market research 2. Product development 3. Pricing strategy 4. Promotion strategy 5. Distribution strategy 6. Customer relationship management 7. Sales strategy 8. Brand management 9. Advertising strategy 10. Public relations 11. Market segmentation 12. Target marketing 13. Positioning strategy 14. Competitive analysis 15. Market entry strategy 16. Market expansion strategy 17. Market exit strategy 18. Market consolidation strategy 19. Market diversification strategy 20. Market globalization strategy 21. Market localization strategy 22. Market adaptation strategy 23. Market innovation strategy 24. Market sustainability strategy 25. Market resilience strategy 26. Market flexibility strategy 27. Market agility strategy 28. Market speed strategy 29. Market accuracy strategy 30. Market consistency strategy 31. Market coherence strategy 32. Market complementarity strategy 33. Market synergy strategy 34. Market fit strategy 35. Market alignment strategy 36. Market integration strategy 37. Market collaboration strategy 38. Market partnership strategy 39. Market ecosystem strategy 40. Market network strategy 41. Market platform strategy 42. Market ecosystem strategy 43. Market network strategy 44. Market platform strategy 45. Market ecosystem strategy 46. Market network strategy 47. Market platform strategy 48. Market ecosystem strategy 49. Market network strategy 50. Market platform strategy 	<p>Marketing</p> <ul style="list-style-type: none"> 1. Market research 2. Product development 3. Pricing strategy 4. Promotion strategy 5. Distribution strategy 6. Customer relationship management 7. Sales strategy 8. Brand management 9. Advertising strategy 10. Public relations 11. Market segmentation 12. Target marketing 13. Positioning strategy 14. Competitive analysis 15. Market entry strategy 16. Market expansion strategy 17. Market exit strategy 18. Market consolidation strategy 19. Market diversification strategy 20. Market globalization strategy 21. Market localization strategy 22. Market adaptation strategy 23. Market innovation strategy 24. Market sustainability strategy 25. Market resilience strategy 26. Market flexibility strategy 27. Market agility strategy 28. Market speed strategy 29. Market accuracy strategy 30. Market consistency strategy 31. Market coherence strategy 32. Market complementarity strategy 33. Market synergy strategy 34. Market fit strategy 35. Market alignment strategy 36. Market integration strategy 37. Market collaboration strategy 38. Market partnership strategy 39. Market ecosystem strategy 40. Market network strategy 41. Market platform strategy 42. Market ecosystem strategy 43. Market network strategy 44. Market platform strategy 45. Market ecosystem strategy 46. Market network strategy 47. Market platform strategy 48. Market ecosystem strategy 49. Market network strategy 50. Market platform strategy

	<p>information reported to principals</p> <ul style="list-style-type: none"> • Timeliness of reports • Transparency of reports • Customer focus • Employee focus • Environmental, social and public responsibilities • Communication with stakeholders • Organization's reputation 	Primary Data
Managerial Discretion	<p>Locus of Control</p> <ul style="list-style-type: none"> • Internal locus of control • External locus of control <p>Perception of Discretion</p> <ul style="list-style-type: none"> • Manager's perception of his/her power 	<p>Primary Data</p> <p>Existing literature</p>
Performance Measurement	<p>Return on Assets: measured by dividing annual earnings by total assets</p> <p>Return on Equity: measured by dividing annual earnings by issued shares (equity)</p> <p>Dividend Yield: measured as annual dividend per share divided by market price per share</p>	<p>Financial statements of companies</p> <p>The ratios to be computed using financial statements</p>
Market Influences	<p>Managerial Labour Markets</p> <p>Product Markets</p> <p>Financial Markets</p> <p>Industry Structure</p>	Primary Data
Internal Influences	<p>Intangible Resources</p> <p>Leverage: measured by total debt divided by equity</p> <p>Size: measured by the shareholders Funds</p>	<p>Primary data</p> <p>Financial Statements</p> <p>Financial Statements</p>

Appendix 2: Summary of Tests and Measurement Criteria

Hypot hesis	Key Dimension	Independent Variable	Dependent Variable	Measurement Criteria	What was tested or measured	Tests
H ₁	Ownership Concentration	Ownership Concentration	Firm Performance	% of shares owned by the first 5 shareholders	Significance of differences in levels of performance at different levels of concentration	1. Pearson's Product Moment Correlation Coefficient (r) (PPMC) Ranges from -1 to +1 Multiple Regression: determine regression coefficient (b)-strength and direction of the relationship; level of significance of the relationship.
H _{2a}	Manager (insider) ownership	Manager (insider) Ownership	Firm Performance	% of shares owned by managers	Significance of differences in levels of performance attributed to manager ownership of shares	Two levels: 1) Discrete: 1=insider owned; 0=Otherwise 2)Continuous % of insider ownership: use Multiple/multivariate regression. Regression Coefficient, b to determine strength and significance of relationship. B can take any value (-infinity to +)

						infinity)
H _{2b}	Government Ownership	Government ownership	Firm performance	% of shares owned by the government	Significance of differences in performance attributed to government ownership	1): Dummy Variable where: 1=Government Ownership 0=Otherwise Bivariate analysis
H _{2c}	Ownership by Corporations	Ownership by corporations	Firm Performance	% of shares owned by corporations	Correlation between ownership by corporations and firm performance	"
H _{2d}	Diffuse/Diverse Ownership	Ownership by diverse individuals	Firm performance	% of shares owned by diverse individuals	Correlation between diverse/diffuse ownership and firm performance	"
H _{2e}	Ownership by Foreigners	Ownership by Foreigners	Firm Performance	% of shares owned by foreigners	Correlation between foreign ownership and firm performance	"
H ₃	Board Effectiveness	Board Effectiveness	Firm Performance	Roles of the Board e.g. Stewardship, Leadership, Monitoring and Reporting	Correlation between Board Effectiveness and Firm Performance	Multivariate Linear Regression. Total sum of respondent rating run against performance indicator.

H _{4a}	Managerial Discretion (moderated by internal influences)	Managerial Discretion	Firm Performance	Elements of Managerial Discretion-Locus of control, perceived Discretion, Perceived Power	Correlation between Managerial Discretion and Firm Performance when moderated by internal influences	Multiple Regression Analysis: R-Squared (Beta Coefficient), ANAOVA, F tests
H _{4b}	Managerial Discretion (moderated by external influences)	Managerial Discretion	Firm Performance	Elements of Managerial Discretion-locus of control, perceived discretion, perceived power	Correlation between managerial discretion and firm performance when moderated by external influences	Change Statistics, ANOVA, F tests
H ₅	Ownership Structure, Board Effectiveness, Managerial Discretion	Ownership Structure, Board Effectiveness, Managerial Discretion	Firm Performance	Step-wise effect of Ownership Structure on Firm Performance through Board Effectiveness, Managerial Discretion	Step-wise relationship between ownership structure and firm performance through Board effectiveness and managerial discretion.	Step-wise Regression Analysis, ANOVA, F tests

APPENDIX 3

**SURVEY INSTRUMENT
QUESTIONNAIRE**

Appendix 3
Survey Instrument
Questionnaire

This survey instrument was developed to capture data on board effectiveness and managerial discretion of listed companies in Kenya. The data obtained from this exercise will be used for a thesis for fulfillment of the requirements of the degree of Doctor of Philosophy (Ph.D) in Business Administration, School of Business, University of Nairobi. Your company has been identified as an integral player at the Nairobi Stock Exchange. In this regard, you are requested to participate in this survey by providing answers to enable the researcher fulfill the research objective.

SECTION A: BIO-DATA

- A1: Name of the Company.....
- A2: Date of Incorporation.....
- A3: Date of Listing at NSE.....
- A4: Name of Respondent (Optional).....
- A5: Rank of Respondent.....

SECTION B: BOARD EFFECTIVENESS

Using a ranking scale of 1–5 where:

- 1 = not at all
- 2 = some what
- 3 = moderately well
- 4 = quite well
- 5 = very well

Kindly answer the questions below by indicating a tick inside the correct box:

Leadership Assessment

1 2 3 4 5

LA 1: How clear is it to you who own the company?

LA 2: How clear is it to you who manage the company?

LA 3: How clear is it to you who the Board members are?

LA 4: How well has the organization established its mission?

LA 5: How well has the organization established its vision?

LA 6: How well does the strategic plan align with the
Mission and Vision of the organization?

LA 7: How active is the Board in setting strategic plan
of the organization?

LA 8: How knowledgeable are the Board members
in the business/purpose/strategy of the organization?

LA 9: How well does the Board selection process result in the
best mix of Board members?

LA 10: What is the proportion of outside (non-executive) directors
in the Board of Directors? **Below 10%** **10-30%** **30-50%** **Over 50%**

LA 11: How well do the owners of the organization communicate
their needs and expectations to the Board?

LA 12: How well does the CEO selection process result in the most qualified candidate?

LA 13: How well is the organization “living” its mission (purpose)?

Stewardship Assessment

SA 1: How well are the assets, resources and investments stewarded and protected?

SA 2: How clear is the mandate of the Board?

SA 3: How well is the board “living” its mandate?

SA 4: How clear is the mandate of the CEO?

SA 5: How clearly separated are governance (Board) and Management (CEO) responsibilities?

SA 6: How effectively are committees used to enhance governance?

SA 7: How effective is the internal audit regime?

SA 8: How free, open and frank are board meetings?

SA 9: How strategic (forward looking) is the Board in its deliberations and functioning?

SA 10: How well do the Board and management function together?

SA 11: How well does the organization ensure effective development of its human resources?

SA 12: How well does the organization reflect a culture of continuous learning and innovation?

Monitoring Assessment

MA 1: How accurate is the information received by the Board?

MA 2: How timely is the information received by the Board?

MA 3: How complete is the information received by the Board?

MA 4: How well does the board ensure the integrity of information it receives?

MA 5: How effective is the internal audit system?

MA 6: How well are the owners of the organization engaged in receiving and reviewing the Auditors Report?

MA 7: How well does the performance measurement system reflect the mission and vision of the organization?

MA 8: How effectively does the Board evaluate performance of the CEO?

MA 9: How well does the Board evaluate its own performance?

Reporting Assessment

RA 1: How complete and credible is the information reported by the organization to its owners?

RA 2: How timely is the information reported by the organization to its owners?

RA 3: How clear (transparent) is the information that the organization reports to its owners?

RA 4: How effectively does the organization address the needs and complaints of its customers ?

RA 5: How effectively does the organization deal with its employees?

RA 6: How effectively does the organization undertake its corporate social responsibilities?

RA 7: To what extent does this organization adhere to guidelines for good corporate governance in the conduct of its affairs?

RA 8: How effectively does the board communicate with stakeholders in general?

RA 9: How effectively does the owners receive, review and question information received from the organization?

RA 10: How strong is the organization's reputation?

SECTION C: MANAGERIAL DISCRETION

Perception of Discretion Assessment

PD1: How well do managers make decisions without reference to the CEO and board?

PD2: How knowledgeable are managers in the business of the organization?

PD3: How well does the Board support management decisions?

PD4: How well does the Management recruitment process result in independent managers?

Locus of Control Assessment

LC1: How confident are managers in making decisions?

LC2: How clearly are results related to managers' personal initiatives?

LC3: How effectively do managers make decisions without external motivation?

Perceived Power Assessment

PP1: How clear is it to managers the amount of power they have?

PP2: How clear is it to the employees how much power their managers have?

PP3: How well do managers who are perceived to have power make independent decisions?

PP4: How effectively do "powerful" managers get results from their subordinates?

SECTION D: GENERAL QUESTIONS

GA 1: How effective is the governance of this organization?

GA 2: How well does this organization accomplish its Mission and Vision?

GA 3: How well is power/authority divided among the owners, board and management of your company?

GA 4: To what extent is your company affected by the industry characteristics?

- I. Competition
- II. Substitute Products
- III. Strength of Suppliers
- IV. Strength of Buyers
- V. Threat of New Entrants

GA 5: To what extent is your company under the threat of the following?

- I. Receivership
- II. Liquidation

III. Replacement of the entire Management

GA 6: How would you assess your company's relations with its financiers (i.e. banks/financial institutions, creditors etc)?

GA 7: Does this organization have a special programme for employees and managers to acquire/own its shares? **Yes** **No**

GA 8: If the answer to Question G7 is Yes, then kindly indicate the proportion of shares owned by employees and managers as a percentage of total shareholding of the company.

0-1.5%	1.5-3%	3-4.5%	4.5-6%	6-7.5%	Over 7.5%
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

GA 9: What are the greatest strengths of this organization? Comment

GA 10: What are the greatest weaknesses of this organization? Comment

GA 11: Does your company possess any resources or assets that none of its competitors has (i.e. skills, formulae, processes etc)? If yes, please describe them.

GA 12: Is the quality of your company's product or price affecting its market share in any way? Comment

END

THANK YOU VERY MUCH.

APPENDIX 4
SURVEY INTRODUCTORY
LETTER

Director, Center for
Public Policy Studies
1000 University Avenue
Northridge, California 91324
P.O. Box 158000, Los Angeles, CA 90015
Tel: 818/707-1111
Fax: 818/707-1111
WWW.CPPS.CUIC.EDU

Dear Mr. [Name]:

The Center for Public Policy Studies (CPPS) is currently conducting a survey of the public's views on the California High-Speed Rail project. The survey is part of a larger study on the project's impact on the state's economy, environment, and transportation system. Your participation in this survey is important to the success of the study.

The survey is being conducted by a team of researchers at CPPS and is designed to be quick and easy to complete. Your responses will be kept confidential and used only for the purposes of the study.

Thank you for your time and contribution.

Sincerely,
[Name]

Appendix 4: Survey Introductory Letter

Vincent Okoth Ongore,
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NAIROBI

December 11, 2007

TO WHOM IT MAY CONCERN

I am a Ph D candidate at the School of Business, University of Nairobi, and currently conducting a census survey of all companies listed at the Nairobi Stock Exchange for a thesis for fulfillment of the requirements of the degree of Doctor of Philosophy (Ph D). My Thesis is titled: **“Effects of Ownership Structure, Board Effectiveness and Managerial Discretion on Performance of Listed Companies in Kenya.”** Your company has been identified as an integral player at the Nairobi Stock Exchange.

The purpose of this letter is therefore, to kindly ask you to participate in this survey as a respondent, by completing the attached questionnaire as accurately as possible. The data and/or information obtained through this exercise will be used strictly for academic purposes, and all the quotations and references will be appropriately acknowledged.

I look forward to your unequivocal cooperation in this exercise.

Yours truly,

Signed

VINCENT OKOTH ONGORE
STUDENT REG. NO. D80/8987/01

APPENDIX 5

COMPANIES LISTED AT THE NAIROBI STOCK EXCHANGE (2006)

Appendix 5: Companies Listed at the Nairobi Stock Exchange (2006)

1. UNILEVER TEA KENYA LIMITED
2. KAKUZI LIMITED
3. REA VIPINGO PLANTATIONS LIMITED
4. SASINI LIMITED
5. ACCESS KENYA LIMITED
6. CAR & GENERAL KENYA LIMITED
7. CMC HOLDINGS LIMITED
8. HUTCHINGS BIEMER LIMITED
9. KENYA AIRWAYS LIMITED
10. MARSHALLS (EA) LIMITED
11. NATION MEDIA GROUP
12. SCANGROUP LIMITED
13. STANDARD GROUP LIMITED
14. TPS EASTERN AFRICA (SERENA) LIMITED
15. BARCLAYS BANK LIMITED
16. C.F.C. BANK LIMITED
17. DIAMOND TRUST BANK KENYA LIMITED
18. EQUITY BANK LIMITED
19. HOUSING FINANCE COMPANY LIMITED
20. CENTUM INVESTMENT COMPANY LIMITED
21. JUBILEE HOLDINGS LIMITED
22. KENYA COMMERCIAL BANK LIMITED
23. KENYA RE-INSURANCE CORPORATION LIMITED
24. NATIONAL BANK OF KENYA LIMITED
25. NIC BANK LIMITED
26. PAN AFRICA INSURANCE HOLDINGS LIMITED
27. STANDARD CHARTERED BANK LIMITED
28. ATHI RIVER MINING LIMITED
29. B.O.C. KENYA LIMITED
30. BAMBURI CEMENT LIMITED
31. BRITISH AMERICAN TOBACCO (K) LIMITED
32. CARBACID INVESTMENTS LIMITED
33. CROWN BERGER LIMITED
34. E.A. CABLES LIMITED
35. E.A. PORTLAND CEMENT LIMITED
36. EAST AFRICAN BREWERIES LIMITED
37. EVEREADY EAST AFRICA LIMITED
38. KENYA OIL COMPANY LIMITED
39. KENYA POWER & LIGHTING COMPANY LIMITED
40. KENGEN LIMITED
41. MUMIAS SUGAR COMPANY LIMITED
42. OLYMPIA CAPITAL HOLDINGS LIMITED
43. SAMEER AFRICA LIMITED
44. TOTAL KENYA LIMITED
45. UNGA GROUP LIMITED
46. A BAUMANN & COMPANY LIMITED
47. CITY TRUST LIMITED
48. EAAGADS LIMITED
49. EXPRESS LIMITED
50. WILLIAMSON TEA KENYA LIMITED
51. KAPCHORUA TEA COMPANY LIMITED
52. KENYA ORCHARDS LIMITED

- 53. LIMURU TEA COMPANY LIMITED
- 54. UCHUMI SUPERMARKETS LIMITED (IN RECEIVERSHIP)

APPENDIX 6

CRONBACH'S ALPHA RELIABILITY TESTS

Appendix 6: Cronbach's Alpha Reliability Tests

Reliability - Measuring Board Effectiveness: Leadership

RELIABILITY ANALYSIS - SCALE (ALPHA)

- | | |
|-------------|--|
| 1. Q1111 | How clear is it who owns the company |
| 2. Q12111 | How clear is it who manages the company |
| 3. Q13111 | How clear is it who the board members are |
| 4. Q14111 | Well established mission |
| 5. Q15111 | Well established vision |
| 6. Q16111 | Alignment of strategic plan with mission and vision |
| 7. Q17111 | Participation of the Board in setting up strategic plans |
| 8. Q18111 | How knowledgeable the board members are in the business |
| 9. Q19111 | Board selection process |
| 10. Q110111 | Proportion of non-executive board members |
| 11. Q111111 | Communication between owners and the board |
| 12. Q112111 | CEO Selection process |
| 13. Q113111 | How well the mission is lived |

Reliability Coefficients

No. of Cases = 15

No. of Items = 13

Alpha = 0.8193

Verdict: Reliable, Accept.

Reliability - Measuring Board Effectiveness: Stewardship

RELIABILITY ANALYSIS - SCALE (ALPHA)

- | | |
|-------------|---|
| 1. Q21111 | Stewardship of assets, resources and investments |
| 2. Q22111 | Mandate of the board |
| 3. Q23111 | How well the board is living its mandate |
| 4. Q24111 | Mandate of the CEO |
| 5. Q25111 | Separation of responsibilities between CEO and Board |
| 6. Q26111 | Use of Committees in Governance |
| 7. Q27111 | Effectiveness of internal audit |
| 8. Q28111 | Freedom of expression at Board Meetings |
| 9. Q29111 | How strategic is the Board in its deliberations and functions |
| 10. Q210111 | Goal congruence between board and management |
| 11. Q211111 | Policies for Human Resources development |
| 12. Q212111 | Culture of continuous learning and innovation |

Reliability Coefficients

No. of Cases = 15

No. of Items = 12

Alpha = 0.7892

Verdict: Reliable, Accept

Reliability - Measuring Board Effectiveness: Monitoring
RELIABILITY ANALYSIS - SCALE (ALPHA)

- | | |
|-----------|--|
| 1. Q31111 | Accuracy of information received by the board |
| 2. Q32111 | Timeliness of information received by the board |
| 3. A33111 | Completeness of information received by the board |
| 4. Q34111 | Integrity of the information received by the board |
| 5. Q35111 | Effectiveness of internal audit |
| 6. Q36111 | Involvement of owners in reviewing audit reports |
| 7. Q37111 | Effectiveness of the performance measurement system |
| 8. Q38111 | How well the board evaluates the performance of CEO |
| 9. Q39111 | How well does the board evaluate its own performance |

Reliability Coefficients

No. of cases = 15

No. of Items = 12

Alpha = 0.8875

Verdict: Reliable, Accept

Reliability - Measuring Board Effectiveness: Reporting
RELIABILITY ANALYSIS - SCALE (ALPHA)

- | | |
|-------------|---|
| 1. Q41111 | Information reported to owners is complete and credible |
| 2. Q42111 | Owners receive information promptly |
| 3. Q43111 | Clarity of information reported to owners |
| 4. Q44111 | Addressing customer needs and complaints |
| 5. Q45111 | Dealing with employees effectively |
| 6. Q46111 | Corporate Social Responsibility activities |
| 7. Q47111 | Adherence to guidelines on good corporate governance |
| 8. Q48111 | Board's communication with stakeholders |
| 9. Q49111 | Questioning of information by the owners |
| 10. Q410111 | Organization's reputation |

Reliability Coefficients

No. of Cases = 15

No. of Items = 10

Alpha = 0.9134

Verdict: Reliable, Accept

Reliability - Measuring Managerial Discretion: Perception of Discretion
RELIABILITY ANALYSIS - SCALE (ALPHA)

1. Q51111 Managers make decisions without reference to CEO
2. Q52111 Managers are knowledgeable in the business of the coy
3. Q53111 Board's support of Management decisions
4. Q54111 Recruitment of independent managers

Reliability Coefficients

No. of Cases = 15

No. of Items = 04

Alpha = 0.8577

Verdict: Reliable, Accept

Reliability-Measuring Managerial Discretion: Locus of Control
RELIABILITY ANALYSIS - SCALE (ALPHA)

1. Q61111 Managers are confident in making decisions
2. Q62111 Results are related to managers' personal initiatives
3. Q63111 Managers make decisions without external control

Reliability Coefficients

No. of cases = 15

No. of Items =03

Alpha = 0.9342

Verdict: Reliable, Accept

Reliability - Measuring Managerial Discretion: Perceived Power
RELIABILITY ANALYSIS - SCALE (ALPHA)

1. Q71111 It is clear to managers how much power they have
2. Q72111 It is clear to employees how much power managers have
3. Q73111 Powerful managers make independent decisions
4. Q74111 Powerful managers effectively get results

Reliability Coefficients

No. of Cases = 15

No. of Items = 04

Alpha = 0.8936

Verdict: Reliable, Accept

Reliability- Overall Assessment of the Organization
RELIABILITY ANALYSIS – SCALE (ALPHA)

1. Q81111 Effectiveness of governance
2. Q82111 Accomplishment of mission and vision
3. Q83111 Separation of power between owners, board and managers
4. Q84111 Effects of competition
5. Q84211 Existence of substitutes products
6. Q84311 Existence of organized supplier groups
7. Q84411 Existence of strong buyers
8. Q84511 Threat of new entrants
9. Q85111 Quality of the company's products
10. Q86111 Threat of receivership
11. Q86211 Threat of liquidation
12. Q86311 Threat of replacement of entire management
13. Q87111 Relations with financiers
14. Q88111 Executive and employee hare options
15. Q89111 Extent of executive and employee share ownership
16. Q810111 Greatest strengths of the organization
17. Q811111 Greatest weaknesses of the organization
18. Q812111 Possession of intangible/idiosyncratic resources

Reliability Coefficients

No. of Cases = 15

No. of Items = 18

Alpha = 0.8737

Verdict: Reliable, Accept

APPENDIX 7
TESTS OF
HETEROSCEDASTICITY

Appendix 7: Tests of Heteroscedasticity

Testing Heteroscedasticity: The IV Residual Method

Using the SPSS 2SLS model method helps to generate two new data variables FIT_1 (the IV 'fitted value' variable) and ERR_1 (the IV residual).

Generation of New Variables

Equation number: 1

Dependent variable: ROA mean

Multiple R .4449

R Square .4198

Adjusted R Square -.3835

Standard Error 8.1106

Analysis of Variance:

	DF	Sum of Squares	Mean Square
Regression	3	2250.83	1227.6094
Residuals	35	5465.25	54.2930

F = 24.02314 Significance F = .005

Variables in the equation

Variable	B	SE B	Beta	T	Sig T
Boardeffect	3.206414	.912065	.80031	5.159	.0449
Mandisc	2.305727	.725453	.34907	2.152	.0302
Ownconc	3.179896	.828324	.56441	3.178	.0044
(Constant)	12.648593	4.756077	5.008	3.993	

The following new variables were created:

Name	Label
FIT_1	Fit for ROA mean from 2SLS, MOD_2 Equation 1
ERR_1	Error for ROA mean from 2SLS, MOD_2 Equation 1

The R-Square is 0.4198 and F-statistic being significant indicates good overall fit. The three independent variables are both statistically significant. Two variables have been created: FIT_1 is the IV 'fitted value' variable while ERR_1 is the IV residual.

To perform this test the IV residual (ERR_1) was squared to obtain a second order variable ERR_12 (i.e. $ERR_{12} = err_1 * err_1$). Ordinary Least Square regression was used to generate new predictor variables (i.e. pre_1, pre_2 and pre_3). Since only Pre_3 was found to be a good predictor of the three, its square ($Pre_3 * Pre_3$) was used to generate a 2SLS forecast. To obtain the determinant statistics, this residual squared variable (err_12) was then regressed against the 2SLS forecasts (pre_32) and resultant t-ratio on the forecast variable given in Table 4 below was used as the test statistic.

Heteroscedasticity Determination Coefficients

Model	Un-standardized Coefficients		Standardized Coefficients	T-tests	Level of Significance
	B	Std. Error	Beta	t	Sig.
Constant					
Pre_32	21.828	18.997	.071	1.042	.321
	7.650E-02	.015		.795	.589

a: Dependent Variable (ERR_12)

The t-ratio on pre_32 is 0.795 with a p-value of 0.589; this is highly insignificant, indicating the absence of heteroscedasticity.

Appendix 8: Definition of Key Terms

Corporate Governance: The manner in which the power of a corporate entity is exercised in the stewardship of the entity's portfolio of assets and resources with the objective of maintaining and increasing shareholder value while ensuring stakeholder satisfaction within the context of its corporate mission (Ezzamel and Watson, 1983; Baysinger, 1985; Hambrick and Abraham, 1995). This study is actually located within the discipline of corporate governance. All the variables under study were carefully chosen to address the emerging issues of corporate malfeasance and the failure of the existing corporate governance model to address the rampant cases of corporate failure.

Ownership Structure: The composition of shareholding of a corporation. It is operationalized in terms of ownership concentration and ownership identity. Of interest to this study are the monitoring, control and ratification rights that ownership confers to the principals to enable them to support or sanction the decisions made by agents in real time in order to protect the shareholders' wealth.

Ownership Concentration: This refers to the proportion by which a shareholder owns a corporation. Ownership Concentration is measured in terms of percentage of shares owned. This variable is operationalized by using the Herfindahl Index which measures the percentage of shares owned by the first five shareholders. According to this index, if the first five shareholders own thirty percent and more of the issued shares, then ownership is said to be concentrated. On the other hand, ownership of less than thirty percent by the first five shareholders is said to be diverse or diffuse.

Ownership Identity: This refers to the actual identity of the major shareholder (s). The typical owners of the companies listed at the Nairobi Stock Exchange have been identified as Government; Foreigners; Managers/Insiders; Corporations; and Diverse/diffuse persons.

Board Effectiveness: This refers to the ability of the board of directors to effectively protect the wealth-creation objective of the owners of the corporation. In discharging this

onerous responsibility, the board of directors is expected to exercise its business judgment, act as an advisor to top management, and define and enforce standards of accountability, all in a way that ensures that the interests of shareholders are protected.

Board Leadership: This refers to clarity of vision regarding where the organization is heading. Leadership entails ensuring that the board members clearly understand the challenges that the organization is facing, and the ability to craft viable strategies that help to successfully navigate through the turbulent business environment.

Board Stewardship: In discharging their role as stewards, the board is expected to appreciate that they hold assets and other resources, including human resources, in trust for the shareholders. It is therefore, incumbent upon the board of directors to be fully cognizant of the resources and assets at their disposal, and the expectations of the principals regarding their utilization.

Board Monitoring: The board of directors has a responsibility to always remain vigilant in order to support good decisions made by management, and forestall any imprudent ones. The key concern of the shareholders is that due to personal interest or incompetence, some decisions made by management may be motivated by personal gain (moral hazard) or poor judgment on the part of management (adverse selection). The board is expected to monitor the streams of decisions that managers make, and be able to sanction the adverse ones before they see the light of the day.

Board Reporting: This refers to the role of the board of directors regarding the quality and timeliness of information reported to the owners of the organization, and the manner in which the firm discharges its corporate social responsibility. In doing this, the board is expected to scrutinize all the information that the organization releases to its shares to ensure clarity, transparency and timeliness. This helps the shareholders to keep abreast of the goings-on in the organization.

Managerial Discretion: This refers to the executive's ability or latitude to affect organizational outcome through decision making (Hambrick and Finkelstein, 1987). Managerial discretion is a function of the task environment, the internal organization and the managerial characteristics. The goal of this study is to enrich our understanding of why managers and organizations may respond differently when confronted with similar strategic opportunities.

Locus of Control: This is an aspect of managerial personality characteristics that determines whether the managers' actions are controlled by inner drive or some external influence (environment).

Perceived Power: This refers to the amount of power that the managers perceive to wield over their subordinates, and which enables them to enforce action by or against a subordinate.

Perceived Discretion: This refers to a managers' own perception regarding their ability to make decisions without reference to the Chief Executive Officer or other senior managers. This defines the managers' level of innovation and creativity within the organization.

Market Influences: These refer to the forces emanating from outside the organization that come to bear the managers as they make decisions. In this study, the typical external influences that have been identified are: Managerial labour markets (i.e. an organized system that monitors performance of managers, and replacing those with mediocre performance); Product Markets (i.e. industry standards in quality and pricing); Financial Markets (i.e. relationship with providers of capital); and Industry Structure (i.e. competitors, suppliers, buyers, new entrants, substitute products).

Internal Influences: These refer to the internal organizational factors that influence managers' decision making processes. Three of these factors have been identified, namely: Size; Intangible resources; and Leverage.

Corporate Performance: This refers to the corporation's operating results over a period of one accounting/financial year. The results are measured based on predetermined criteria. In this study, corporate performance was measured using three key indicators: Return on Assets (ROA); Return on Equity (ROE); and Dividend Yield as operationalized in Table 1.

Note: In this study, the words "**Firm**", "**Organization**" and "**Company**" mean the same thing.