

**A STUDY OF THE RELATIONSHIP BETWEEN BOARD INDEPENDENCE  
AND BANK PERFORMANCE: EVIDENCE FROM COMMERCIAL BANKS IN  
KENYA**

**BY  
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## **DECLARATION**

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

Signed.....

Date.....

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**D61/P/8479/05**

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

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# **DEDICATION**

To my family and friends

## **ABSTRACT**

The main objective of this paper was to examine the relationship between measures of board independence and the financial performance of commercial banks in Kenya. The specific objectives were to ascertain the extent to which firm performance is influenced by the tenure of CEO; to investigate whether or not there is a significant relationship between the proportion of outside directors on the board and firm performance; and to assess the influence of audit committee structure on firm performance.

This was a cross-sectional survey. A cross sectional survey was selected because it enabled data to be collected across several respondents at the same time. The target population was all the 45 commercial banks in Kenya operating within Nairobi. From the population, all the commercial banks were to be used in the study but data for only 36 firms was available during analysis hence were used during analysis. Data for the period 2004 through 2008 were obtained from the annual financial reports of commercial banks in Kenya. There were basically two categories of variables for this study. On the one hand were measures of firm performance: ROA. On the other hand were measures of board independence along with some control variables. The measures of board independence were: CEO tenure; proportion of outside directors on the board and audit committee. Two methods of data analysis were employed and the results were therefore divided into two to reflect this categorisation. The first type of analysis was descriptive analysis, which provided some averages of relevant variables. The second method of analysis was regression analysis.

The study found that CEO tenure has a positive significant influence on performance of smaller firm. It was also noted that board composition affects performance of smaller firms. The study also found that firm performance is not significantly influenced by audit committee structure. The study therefore concludes that CEO tenure has a significant positive influence on firm performance, especially for smaller firms. It is also concluded that board composition has a significant negative correlation with performance of smaller firms and not for larger firms. The study further concludes that audit committee structure does not have a significant influence on bank performance.

The study recommends that there is need for small firms to take cognizance of the fact that CEO tenure may have a major influence on their performance. The shareholders should always strive to ensure that good CEOs are retained in the firms for as long as they are deemed fit for the job if the firms are to ensure constant better financial results. It is also recommended that smaller firms should keep the number of board members at a regulatory minimum since additional outsiders may hamper firm financial results. There is need to carry out more research on board independence especially for large firms to establish what board characteristics determine their performance.

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# CHAPTER ONE

## INTRODUCTION

### 1.1 Background of the Study

The board of directors has long been recognised as an important corporate governance mechanism for aligning the interests of managers and all stakeholders to a firm. The need to adopt the right corporate governance mechanisms for the purpose of such alignment is driven by the agency problem and the associated free-rider problem that makes it difficult for any single investor or stakeholder to bear the cost of monitoring managers. The central role of board of directors in this process has therefore been recognized and in recent years has gained significant attraction for at least a couple of reasons. One, both transition countries and other developing countries are struggling to attract resources for investment in an increasingly competitive global environment. Two, events at Enron and several other large corporations suggest the need for policies to promote board independence and other aspects of corporate governance.

Both Oman et al. (2003) and Morck and Yeung (2004) argue that different forms of ownership structures are associated with different sets of agency problems. In countries such as US and the UK where share ownership is widely diffused, agency problem is more common between managers and shareholders. In contrast, in developing countries characterized with concentrated equity ownership, agency problem is most predominant between controlling shareholders and minority shareholders. Controlling shareholders acquire and maintain effective control over firms beyond what can be justified by their equity interest, and they often take advantage of that control to expropriate resources from minority shareholders. Developing countries could ill afford to maintain structures

that perpetuate expropriation of minority shareholders since such countries are in need of additional, especially outside, resources to support investment and growth. Foreign investors may be scared of such expropriation and they might well argue for an effective control of the firms themselves, but the political backlash that this will unleash could cause political resistance to such levels of foreign control. Thus, strengthening board independence and other forms of firm-level governance is important, and particularly so in developing countries with weak institutions but are yearning to attract foreign resources.

Beyond helping to resolve agency problems between managers and other stakeholders, corporate governance is important to the economy (Levine, 2004; and Oman et al., 2003). In developing countries with weak legal institutions it is sometimes difficult for foreign investors to seek legal redress when the developing country partner violates a contractual agreement (Collier, 2006). Since there are no global law enforcement agencies to deal with the concomitant problems (Collier, 2006), it could be argued that strengthening board independence and other firm-level mechanisms of corporate governance could serve as a means of ameliorating the weakness of legal institutions and hence aid the attraction of foreign investment, with significant ramifications to the economy.

Levine (2004) also sees a link between corporate governance and the economy, arguing that it has the capacity to foster economic growth. According to him sound corporate governance makes it more likely for owners of capital to monitor the activities of managers either directly through voting on crucial matters or indirectly through the board

of directors. This helps to protect shareholder interest, promote savings, investment and economic growth. Oman et al. (2003) argue along similar lines, but see the importance of corporate governance on growth through a different channel. For them, well-governed firms are better able to raise productivity and aid economic growth.

Commercial banks in Kenya are governed by the Companies Act, the Banking Act, the Central Bank of Kenya Act and the various prudential guidelines issued by the Central Bank of Kenya (CBK). The banking sector was liberalised in 1995 and exchange controls lifted. The CBK, which falls under the Minister for Finance's docket, is responsible for formulating and implementing monetary policy and fostering the liquidity, solvency and proper functioning of the financial system. The Central Bank of Kenya publishes information on Kenya's commercial banks and non-banking financial institutions, interest rates and other publications and guidelines. The banks have come together under the Kenya Bankers Association (KBA), which serves as a lobby for the banks' interests and also addresses issues affecting its members.

The commercial banks offer corporate and retail banking services but a small number, mainly comprising the larger banks, offer other services including investment banking. They are faced with a lot of challenges that requires only those with the best mix of personnel and objectives to survive. Such challenge is competition. The increasing competition amongst commercial banks in Kenya has forced the management to look for ways through which they can improve their performance. The focus has now shifted from employee to customer management (Trethowan and Scullion, 1997).

## **1.2 Statement of the Problem**

Most companies have boards with a majority of independent directors; almost all have a majority of outside directors. This pattern reflects the common view that the board's principal task is to monitor management, and only independent directors can be vigorous monitors. In contrast, an insider-dominated board is seen as a device for management entrenchment (Eisenberg, 1976; Millstein, 1993). The proposition that large-company boards should consist mostly of independent directors has become conventional wisdom. This conventional wisdom has only an occasional dissenting voice (Longstreth, 1994; Tobin, 1994). Does greater board independence produce better corporate performance, as conventional wisdom predicts? Conversely, does board composition respond to firm performance? The quantitative research on these questions has been inconclusive.

This study seeks to examine the relationship between measures of board independence and the financial performance of commercial banks in Kenya. Addressing this aforementioned objective is motivated by certain methodological issues commonly adopted in earlier research in other countries on the link between board independence and corporate performance. Lasfer (2002), Coles et al. (2004) and Pass (2004) argue that the size of the firm tends to affect the extent to which board independence may influence corporate performance. According to them in small firms it is more likely for board independence to have significant effect on performance. Large firms tend to be more complex and for them, the influence of board independence on performance may be blurred.

## **1.3 Objectives of the Study**

### ***1.3.1 Broad Objective***

The main objective of this paper was to examine the relationship between measures of board independence and the financial performance of commercial banks in Kenya.

### ***1.3.2 Specific Objectives***

This broad objective can be divided into three specific objectives, one each for the three measures of board independence:

1. To ascertain the extent to which firm performance is influenced by the tenure of CEO;
2. To investigate whether or not there is a significant relationship between the proportion of outside directors on the board and firm performance;
3. To assess the influence of audit committee structure on firm performance.

## **1.4 Research Hypotheses**

In line with the above objectives, three hypotheses were tested. Thus, the hypotheses proposed that there was no significant relationship between firm performance and

1. CEO tenure
2. Proportion of outside directors on the board
3. Audit committee structure

## **1.5 Importance of the Study**

This study is important to the management of commercial banks in Kenya especially the marketing divisions as they would better understand the importance of customer relationship marketing to company bottom-line.

Marketers and other practitioners in the service industry will also find the results of this study intriguing. The findings will help them in appreciating the need for them to implement more loyalty programs in their firms in order to reap from the benefits of good customer relationships.

Researcher, scholars and students of marketing and strategy will gain from this research. Suggestions will be made on where more studies need to be done in the area thus will greatly be helpful to future researchers. Scholars and students of marketing and strategy will use this study as a guide to discussing issues of relationship marketing in developing economies like Kenya.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Theoretical Framework**

Agency theory provides the theoretical framework for this study. The theory states that in the presence of information asymmetry the agent is likely to pursue interests that may hurt the principal, or shareholder (Ross, 1973; Fama, 1980). Within the context of the stakeholder theory, the problem of agency has been widened to allow for multiple principals. Thus, instead of treating shareholders as the sole group whose interest the agent should protect, the stakeholder theory sees other groups such as employees of the firm, creditors, government etc. also as having equally vital stakes in the performance of the firm, a fact amply demonstrated by the thousands of job losses, reduced tax revenues, high costs of litigation etc that came in the wake of such high-profile corporate frauds that occurred at Enron, Global Crossing, Parmalat, Worldcom to name but a few. Since there are many stakeholders, the agent is sometimes confronted with the difficult choice of meeting competing stakeholder interests.

Extending the stakeholder theory, Jensen (2001) proposes the enlightened stakeholder theory and goes further to suggest that by pursuing the goal of maximizing long-term value of the firm, managers could serve the interests of all stakeholders. SMG (2005) note that this criterion has not been subjected to empirical verification. In a review of the stakeholder theory, John and Senbet (1998) note that the multiplicity of principals tends to give rise to conflicting interests. The authors note the vitality of board independence and committee structure as means of overcoming the agency problem. They also

emphasize the importance of board size, noting that after a point the size of the board could be detrimental to firm performance.

## **2.2 Board Independence and Firm Performance**

The literature on the relation between board independence (as a corporate governance device) and firm performance has registered significant growth, buoyed mainly by studies from developed, and to a lesser extent some developing, countries. The rapid growth in the literature is perhaps motivated by the realization that left to itself, the market system does not have the capacity to address the problems of agency. However, it is in order to present an overview of what the literature says about the main ways in which the market mechanism might help alleviate the agency problem. As Fama (1980) argues, the managerial labour market does recognize the current and previous performance of every manager and therefore has the capacity to encourage good-performing managers and punish poor-performing ones.

This market mechanism provides an incentive for managers to promote shareholder wealth and to deter the pursuit of interests that may be injurious to the health of the firm. Another market mechanism for dealing with agency problem is through the market for corporate takeover. Managers of poor performing firms run the risk of losing their jobs once the firm is acquired by other firms. Fearing this prospect, managers act as a team, each one realizing that their job security is dependent on performance of every manager in the team. This gives each manager an incentive to monitor the behaviour of other managers in the team.

Despite the presumed ability of the market to help align the interests of all parties interested in the wellbeing of the firm, sporadic cases of corporate malfeasance have continued unabated, promoted either by the managers hired to protect the firm, or orchestrated by the controlling shareholders. A number of reasons have been given for the inability of the market to serve as an effective disciplining device. One, insiders know about the enterprise better than outsiders do. Therefore managers will not allow a takeover bid to succeed unless the buyer is ready to pay more than the value of the firm. Should a potential bidder research the ailing firm and discover the need for and takes action to raise the bidding, other suitors will observe this behaviour and raise their own bidding for it. Thus, the market for corporate takeover, designed to solve the agency problem, is itself afflicted with the very problem it is intended to solve. Second, the market for corporate takeover may fail to work because managers could take actions such as poison pills to deter takeover. Third, managers could develop incestuous relationship with the board of directors, a relationship that could cause the market system to fail to discipline them.

Given the weakness of the market system to handle the problem of agency, a broad spectrum of corporate governance measures have been suggested as effective mechanisms for promoting corporate performance. The literature surveyed below is divided into two categories, the first concerning board characteristics, and the second on other control variables affecting firm performance.

### ***2.2.1 Board Characteristics***

The first element of board characteristics is concerning its composition. A board comprising a reasonable proportion of inside and outside directors is more likely to be independent of management than one dominated by inside directors, and therefore more likely to protect the interests of other stakeholders. The importance of outside directors has been recognized even at the level of policy, with codes of corporate governance giving a special attention to the need to have a reasonable proportion of them on the board of listed firms. Empirical evidence has shown that properly constituted boards with the right mix of non-executive directors tend to contribute more to performance than boards with a predominance of inside directors (Bhagat and Black 2001; John and Senbet, 1998).

A closely related issue is the participation of non-executive directors on the main committees of the board. John and Senbet (1998) argue in favour of a committee structure that gives the non-executive directors a key role especially in the audit, remuneration and appointment committees. This recommendation seems to go down well with the policy makers. In Nigeria for example, the new code of corporate governance provides that the non-executive directors should be in the majority, and that a non-executive director should chair the remuneration committee, the membership of which should comprise wholly or mainly of outside directors. In a recent empirical work, Hayes et al. (2004) reported no relationship between the fraction of outside directors serving on a committee and the performance of the firm, a finding that runs counter to that of Klein

(1998) that John and Senbet (1998) noted to have been in support of greater participation of outside directors on the major committees of the board.

The second aspect of board characteristics is the size of the board of directors. A reasonably sized board is expected to be more effective in its statutory function of monitoring the management. Thus, within a certain range the larger the size of the board the better the performance of the firm. While there may be no one-size-fits-all recommendation for the optimal size of board, empirical works from the United States and the United Kingdom (Monks and Minow, 1995; Lipton and Lorsch, 1992) have suggested a board size of ten. Recent evidence by SMG (2005) is consistent with this recommendation.

The third element of board characteristics commonly discussed in the literature is concerned with the prevalence of family relations on the board itself. Boards with several members of the same family are less likely to be effective at replacing a CEO in the event of poor performance especially when such CEO is a family relation [Shleifer and Vishny (1997, 1998)]. However, some scholars (such as Tsai et al., 2006) take exception to the argument that family-controlled boards could engender CEO entrenchment and therefore serve as a setback to other classes of shareholders. Tsai et al. (2006) see the impact of family-controlled boards through a more positive light. Their argument is that in a family-controlled board, a member of the family is often motivated by the bond of family ties to promote organizational, rather than individual, goals, since the success and continuity of the family business is of paramount importance. Thus, they reason, family

controlled boards could in fact be more effective than other boards in mitigating the agency problem and thus aligning the interests of the managers and shareholders.

However, like other scholars on the subject, Tsai et al. (2006) are not oblivious of the possibility of family-controlled boards to protect interests of the family even when such interests may run counter to those of other shareholders, such as the tendency for such boards to use family connection, rather than performance, as a basis for elongation of the tenure of a chief executive. The novelty of Tsai et al.'s argument is that it presents a more balanced view of the impact of family-dominated boards. Indeed, the authors test the two hypotheses using data drawn from listed firms in Taiwan. They report evidence in favour of their thesis that compared to other boards; family-dominated boards tend to be more effective in relating CEO turnover with performance.

Despite Tsai et al.'s (2006) finding of a positive contribution of family domination of boards of directors, some researchers cast a less positive view of it. Morck and Yeung (2003) have advanced a reason why one should expect family controlled boards to pursue interests that may hurt minority shareholders. Their argument runs as follows. In boards without the influence of family connections, share ownership tends to be more diffused, limiting each shareholder's risk to the relatively small investment they have made in the shares of the firm. Thus, boards of firms with diffused ownership are better able to pursue risky, high return projects, since each shareholder's risk exposure is comparatively small. In contrast, familydominated boards are not characterized by such diffused ownership – the interest of the family is often significant. Thus, in order not to expose the family to

significant levels of risk, such boards will pursue low-return, less risky projects, an objective that may hurt small shareholders. Thus, the conflict of interests between families with significant investment and the small shareholders will continue to prevail, the authors argue. Indeed, Morck and Yeung (2003) buttress this argument by referring to the work of Johnson et al. (1985) who report that stock prices tend to rise on the news of death of a long-tenured CEO (presumably of a family-controlled board).

Although they recognize the importance of devising ways to address the problem of agency between managers and other stakeholders, Oman et al. (2003) however argue that agency problem tends to manifest itself in different ways, depending on the pattern of ownership structure. In countries such as the UK and the US where shares are widely diffused, the traditional manager-owner agency problem tends to be most visible. In contrast, in many manifestation of agency problem is the tendency for controlling shareholders to expropriate minority shareholders, using a number of strategies such as multiple classes of shares and pyramidal ownership structures. Such mechanisms enable the controlling shareholders to have effective control over the firms in which they have vested interest. What is more, such schemes enable them to have more control over the firms than can be justified by their ownership control.

The results so far have been mixed. As a measure of board independence, the ratio of outside directors sitting on the board has been found to be closely related to firm performance (Rosenstein and Wyatt, 1990; Zahra and Stanton, 1988; and Wade et al., 1990). In stark contrast to the above, evidence of a negative relation has also been

reported [Agrawal and Knoeber (1996), Weir and Laing (2001) and Daily and Johnson (1997)], while some studies have reported no significant relation [Hermalin and Weisbach (1991) and Bhagat and Black (2000)].

A number of reasons have been advanced explaining the disparate findings. A key explanation, perhaps, is the difficulty often encountered in the measurement of board independence and the concomitant differences in the measures of such independence. While some studies have relied upon CEO turnover following poor performance as a measure of board independence [Shivdasani and Yermack (1999), Liang and Li (1999) and Udueni (1998)], some have attempted to gauge it using multiple, or interlocking directorships [Kaplan and Reishus (1990), Gilson (1990), and Shivdasani (1993)], and yet another group has used the number of outside directors appointed during the tenure of the CEO as a proxy for board independence [Core et al., 1999, Ghosh and Sirmans, 2003]. Other researchers such as Klein (1998) and Hayes et. al. (2004) have undertaken studies using as their measure of board independence the fraction of outside directors serving on each committee.

Each of these measures of board independence is fraught with a number of pitfalls. Take the case of multiple directorships, for example. While persons with track record of performance as independent directors might get appointed in several other boards, such multiple appointments could thin out the director's available time for monitoring, reducing the effectiveness of the board in its monitoring role. Thus the link between multiple directorship and corporate performance could be a tenuous one.

A second methodological issue believed to have contributed to the lack of a coherent picture is the sampling technique. According to Pass (2004) and Lasfer (2002) most studies on board independence have been conducted on the basis of data from large publicly held firms. According to them, for this category of firms, the link between independence and firm performance is not very clear, in contrast to small firms, for which the link is more straightforward. Independent outside board members tend to be ineffective in monitoring complex firms with high growth potential (Coles et al., 2004).

Despite the absence of a coherent picture, a number of stylized facts seem to emerge from the literature. One possible conclusion is that a CEO who performs poorly is more likely to be replaced than one who performs well. A second empirical tendency is for CEO turnover to be more sensitive to performance when the board is independent. Finally, the probability of independent directors being added to the board to tend to rise following poor firm performance, just as board independence has the tendency to decline over the course of a CEO's tenure.

### ***2.2.2 Other Control Variables***

Investigating the effects of the above characteristics of the board of directors requires controlling for certain other variables such as firm size. First, the size of the firm is an important variable that needs to be controlled for in any reduced form regression involving board characteristics and corporate performance. In fact this variable has been controlled for even under different model specifications. The use of the number of employees as a

control for firm size and a number of other studies has been reported in the literature (Bigsten et al. (1997), Mayers et al., 1997; SMG, Sivdasani and Yermack (1999)).

The second control variable is concerned with director equity ownership of the firm. There is the argument both in the literature and in policy that one of the ways in which the board of directors could be motivated to take performance-improving measures and to protect the interests of the shareholders, is for the directors themselves to take part in the ownership of the firm. The argument is that this will enable the managers have more interest in the value of shares of the firm and that they will take measures to improve firm performance (Loderer and Martin, 1997; Nor et al., 1999). Within a certain range, a positive relation is predicted between director equity interest and firm performance. However, when they own a large proportion of shares of the firm, directors could pose other agency problems, especially those associated with conflicts between large and small shareholders.

A third element of board characteristics often cited in the literature is the extent to which the largest shareholders are in control of equity ownership of the firm. Ownership concentration is believed to enable the controlling shareholders to bear the personal costs of monitoring, and hence to contribute towards solving the agency problem. However, two problems are associated with this. It is often the case that members of the same family might take control of a significant proportion of equity, and even make this control very visible through their participation as board members. Levine (2004) points out that this could have adverse consequences not only for the firm but for the entire

economy as well. Where the family members constitute an important influence on the board, they can translate their equity control into actual power. Where such control is spread through their participation in an array of firms, their influence could be so overwhelming as to cause the government to adopt policies that negate the spirit and letter of private entrepreneurship. The adoption of policies to protect local industry, the introduction or maintenance of subsidies are some of the ways in which such equity control could produce power and cause the adoption of inappropriate policies.

### **2.3 Board Composition and Firm Performance**

Bhagat & Black (1999) recently surveyed the literature on how board composition affects firm performance or vice versa, so the survey here is brief. Prior studies of the effect of board composition on firm performance generally adopt one of two approaches. The first approach involves studying how board composition affects the board's behavior on discrete tasks, such as replacing the CEO, awarding golden parachutes, or making or defending against a takeover bid. This approach can involve tractable data, which makes it easier for researchers to find statistically significant results. But it doesn't tell us how board composition affects overall firm performance. For example, there is evidence that firms with majority-independent boards perform better on particular tasks, such as replacing the CEO (Weisbach, 1988) and making takeover bids (Byrd & Hickman, 1992). But these firms could perform worse on other tasks that cannot readily be studied using this approach (such as appointing a new CEO or choosing a new strategic direction for the firm), leading to no net advantage in overall performance.

Prior research does not establish a clear correlation between board independence and firm performance. Early work by Vance (1964) reports a positive correlation between proportion of inside directors and a number of performance measures. Baysinger and Butler (1985), Hermalin and Weisbach (1991), and MacAvoy, Cantor, Dana and Peck (1983) all report no significant same-year correlation between board composition and various measures of corporate performance. Baysinger and Butler report that the proportion of independent directors in 1970 correlates with 1980 industry-adjusted return on equity. However, their 10-year lag period is very long for any effects of board composition on performance to persist.

Three recent studies offer hints that firms with a high percentage of independent directors may perform worse. Yermack (1996) reports a significant negative correlation between proportion of independent directors and contemporaneous Tobin's q, but no significant correlation for several other performance variables (sales/assets; operating income/assets; operating income/sales); Agrawal and Knoeber (1996) report a negative correlation between proportion of outside directors and Tobin's q. Klein (1998) reports a significant negative correlation between a measure of change in market value of equity and proportion of independent directors, but insignificant results for return on assets and raw stock market returns.

Rosenstein and Wyatt (1990) find that stock prices increase by about 0.2%, on average, when companies appoint additional outside directors. This increase, while statistically significant, is economically small and could reflect signalling effects. Appointing an

additional independent director could signal that a company plans to address its business problems, even if board composition doesn't affect the company's ability to address these problems. Rosenstein and Wyatt (1997) find that stock prices neither increase nor decrease on average when an insider is added to the board.

Klein (1998) finds that inside director representation on a board's investment committee correlates with improved firm performance. She finds little evidence that "monitoring" committees that are usually dominated by independent directors -- the audit, compensation, and nominating committees -- affect performance, regardless of how they are staffed

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Research Design**

This was a cross-sectional survey. A cross sectional survey was selected because it enabled data to be collected across several respondents at the same time. The study collected data from several commercial banks in Kenya on the relationship between board independence and firm performance.

#### **3.2 Target Population and Sample Size**

The target population was all the 45 commercial banks in Kenya operating within Nairobi. From the population, all the commercial banks were to be used in the study but data for only 36 firms was available during analysis hence were used during analysis.

#### **3.3 Data Collection**

##### ***3.3.1 Data Sources***

Data for the period 2004 through 2008 were obtained from the annual financial reports of commercial banks in Kenya. This data was collected from the banks, the Capital Markets Authority and the Central Bank of Kenya. The annual reports were the source of information on some important variables of interest such as board composition, audit committee structure and CEO tenure.

### 3.3.2 Variable Measurements

There were basically two categories of variables for this study. On the one hand were measures of firm performance: ROA. On the other hand were measures of board independence along with some control variables. The measures of board independence were: CEO tenure; proportion of outside directors on the board and audit committee.

CEO tenure was measured as the number of years the CEO had served on the board. It was expected to include dummy variable to capture the effect of CEO tenure and the method of creation of this dummy is given in Table 1 below. Another measure of board independence was the proportion of outside directors on the board. Also important in the measurement of board independence was the audit committee structure. To get a proxy for this variable, a dummy variable was created, and the method of its generation is given in Table 1. A number of control variables such as board size, size of the firm, foreign CEO status, and ownership concentration were also included in the analysis and the method of their computation is given in Table 1. In summary, the variables and method of their measurement are given in Table 1 below:

**Table 1: Variables and their measurements**

<b>Variable</b>	<b>Measurement</b>
ROA	Obtained by expressing net profit as a proportion of total assets.
Board size	The number of directors sitting on the board of a firm in a particular financial year.
Firm size	The study shall use total assets to define small firms as those with total assets below the average for the market, and large firms as those with assets above the average. A dummy variable will therefore be created, taking a value of 0 for large firms and 1 for small ones.
Tenure dummy of CEO	From the annual reports, summaries of the number of times a CEO appears in the annual reports will be made. By computing the average number of such appearances, the study shall create a dummy variable,

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	taking a value of 0 for CEOs with a tenure of less than the average, and 1 otherwise.
CEO foreign dummy	A dummy variable taking a value of 1 if the CEO is foreign and 0 otherwise.
CEO Audit membership dummy	A dummy variable taking a value of 1 if the CEO is a member of audit committee and 0 otherwise.
Board composition	Defined as the number of outside directors as a proportion of board size.

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### 3.4 Data Analysis

Two methods of data analysis were employed and the results were therefore divided into two to reflect this categorisation. The first type of analysis was descriptive analysis, which provides some averages of relevant variables. Chapter 4 of this paper presents results based on this method of analysis. The second method of analysis was regression analysis. This in turn was divided into three. The first was based on whole firm effects, the second on large firms and the third on small firms.

#### 3.4.1 Model Specification

The basic model, given in Equation (1) was estimated using the fixed effects approach.

$$Y_i = \alpha_0 + \beta_1 X_i + e_i \text{ _____ (1)}$$

Where:

$Y_i$  = a measure of performance (ROA, ROE, P/E RATIO, RETURN) for firm  $i$ .

$\alpha$  = The intercept term

$\beta$  = The vector of parameters for estimation.

$X$  = The vector of explanatory variables comprising measures of board independence as well as relevant control variables as given in Table 1.

$e$  = Error term

## CHAPTER FOUR

### DATA ANALYSIS AND FINDINGS

#### 4.1 Introduction

This chapter presents the results of the study. The descriptive results are first shown. This is followed by the regression results for the entire sample, the large firms and then the small firms.

#### 4.2 Descriptive Analysis

The descriptive statistics shown in Table 2 indicate the mean scores and standard deviations for the variables used in the study.

**Table 2: Descriptive Statistics**

	<b>Mean</b>	<b>Std. Deviation</b>	<b>N</b>
ROA	.0834	.08029	35
B_SIZE	9.2571	1.19663	35
F_SIZE	.5143	.50709	35
TENURE	.8286	.38239	35
CEO_FOREIGN	.3429	.48159	35
CEO_AUDIT	.3143	.47101	35
B_COMP	.2205	.06361	35

The mean ROA was 0.834 which is a high performance rate for commercial banks. The standard deviation shows that the variance from the mean performance was low. The average number of board members was 9.2571 and the variance from this was low as shown by the standard deviation of 1.19663. The mean firm size was 0.5143 showing that most of the firms were small firms while mean for tenure of CEO was 0.8286. This mean indicates that most of the CEO stayed longer than the average for the industry. CEO\_FOREIGN variable had a mean of 0.3429 indicating that majority of the firms had

local CEOs. The mean for CEO\_AUDIT was 0.3143 showing that most of the firms CEO's did not sit on the audit committees. The mean for B\_COMP which measured the board composition was 0.2205. This shows that most of the boards had less of outsiders sitting on the board. As noted, 22.05% was the average composition of outside board members in the boards surveyed.

### 4.3 Regression Results: Whole Sample

The regression analysis was done in three stages. First, the regression was done based on all the commercial banks that were used in the study. Secondly, size of commercial banks was used to separate the banks as large and small and the regression done based on these sizes. Thus, Table 3 shows the results of the regression when all the firms are involved.

**Table 3: Whole market regression results**

Independent variables	Return on Assets (ROA)
Board size	-.100
p-value	<b>(.284)</b>
Firm size	-.177
p-value	<b>(.154)</b>
Tenure Dummy of CEO	.305
p-value	<b>(.037)*</b>
CEO Foreign Dummy	.037
p-value	<b>(.415)</b>
CEO Audit membership dummy	-.102
p-value	<b>(.280)</b>
Board composition	-.279
p-value	<b>(.052)**</b>
<b>R<sup>2</sup></b>	.272
<b>F</b>	1.741
<b>N</b>	35

\*Significant at 95% confidence level

\*\*Significant at 90% confidence level

As shown in Table 3, the study reveals that board size and firm size (control variables), were negatively correlated with performance as measured by ROA. CEO\_TENURE and CEO\_FOREIGN (control variables) had positive correlations with ROA. CEO\_AUDIT (independent variable) had a negative correlation with ROA (-.102). This relationship was not statistically significant (p-value = .280). Board composition (independent variable) also had a negative correlation with ROA (-.279). This relationship was found to be statistically significant at 90% confidence level (p-value = .052). From the  $R^2$ , it is noted that board independence influences 27.2% of the variance in performance as measured by ROA.

#### 4.4 Regression Results: Large Firms

The analysis was also performed for the large firms in the sample. These were firms that fell above the median for the market. These results are shown in Table 4.

**Table 4: Large firms regression results**

Independent variables	Return on Assets (ROA)
Board size	.006
p-value	<b>(.491)</b>
Tenure Dummy of CEO	.091
p-value	<b>(.364)</b>
CEO Foreign Dummy	-.262
p-value	<b>(.155)</b>
CEO Audit membership dummy	-.237
p-value	<b>(.180)</b>
Board composition	.020
p-value	<b>(.470)</b>
<b>R<sup>2</sup></b>	.155
<b>F</b>	.404
<b>N</b>	17

The results reveal that board size had a positive correlation with performance (.006). The same was the case for CEO tenure, and board composition (.091 and .020 respectively). But none of these variables were statistically significant at either 95% or 90% confidence levels. The study also found that CEO\_FOREIGN and CEO\_AUDIT had negative correlations with performance (-.262 and -.237 respectively). These results were also not statistically significant as their p-values were high (.262 and .180 respectively). The R<sup>2</sup> of .155 shows that for large firms, board independence accounts for up to 15.5% of the variance in performance.

#### 4.5 Regression Results: Small Firms

The analysis for small firms was also done. These were firms that fell below the median for firm size. The results are shown in Table 5.

**Table 5: Small firms regression results**

Independent variables	Return on Assets (ROA)
Board size	-.245
p-value	<b>(.164)</b>
Tenure Dummy of CEO	.460
p-value	<b>(.028)*</b>
CEO Foreign Dummy	.270
p-value	<b>(.139)</b>
CEO Audit membership dummy	-.092
p-value	<b>(.359)</b>
Board composition	-.414
p-value	<b>(.044)*</b>
<b>R<sup>2</sup></b>	.505
<b>F</b>	2.448
<b>N</b>	18

\*Significant at 95% confidence level

The results show that board size was negatively correlated with performance (-.245) but this was not statistically significant (p-value = .164). The study also revealed that CEO tenure was positively correlated with performance (.460). This relationship was statistically significant as shown by the p-value of .028. It was also noted that CEO\_FOREIGN had a positive relationship with performance (.270) but the relationship was not statistically significant (p-value = .139). Further, the study revealed that CEO\_AUDIT had a negative correlation with performance (-.092) with a p-value of .359 which shows that the relationship was statistically insignificant. The study also reveals that board composition was negatively correlated with performance (-.414) and the p-value of .044 shows that the relationship was statistically significant. The R<sup>2</sup> was .505 showing that for small firms, board independence accounts for up to 50.5% of the variance in performance.

## CHAPTER FIVE

### SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

#### 5.1 Introduction

This chapter presents the summary of research findings, conclusions of the study, recommendations for policy and practice and suggestions for further research.

#### 5.2 Summary and Discussion

The descriptive statistics showed that the mean ROA was 0.834 indicating that most commercial banks had high ROAs. The average number of board members was 9.2571. The mean firm size was 0.5143 showing that most of the firms were small firms while mean for tenure of CEO was 0.8286. This mean indicates that most of the CEO stayed longer than the average for the industry. CEO\_FOREIGN variable had a mean of 0.3429 indicating that majority of the firms had local CEOs. The mean for CEO\_AUDIT was 0.3143 showing that most of the firms CEO's did not sit on the audit committees. The mean for B\_COMP which measured the board composition was 0.2205. This shows that 22.05% was the average composition of outside board members in the boards surveyed.

The analysis for the entire sample indicated that board size and firm size were negatively correlated with performance as measured by ROA. CEO\_TENURE and CEO\_FOREIGN had positive correlations with ROA. CEO\_AUDIT had a negative correlation with ROA (-.102). This relationship was not statistically significant (p-value = .280). Board composition also had a negative correlation with ROA (-.279). This relationship was found to be statistically significant at 90% confidence level (p-value = .052). From the  $R^2$ , it is noted that board independence influences 27.2% of the variance in performance

as measured by ROA. Thus, the study found that for the entire sample, the only significant factor that influences performance was board composition and that board independence accounts for up to 27.2% of changes in bank performance.

The findings for large firms revealed that board size had a positive correlation with performance (.006). The same was the case for CEO tenure, and board composition (.091 and .020 respectively). But none of these variables were statistically significant at either 95% or 90% confidence levels. The study also found that CEO\_FOREIGN and CEO\_AUDIT had negative correlations with performance (-.262 and -.237 respectively). These results were also not statistically significant as their p-values were high (.262 and .180 respectively). The  $R^2$  of .155 shows that for large firms, board independence accounts for up to 15.5% of the variance in performance. Thus, for large firms, the study found that board independence did not have a significant influence on performance.

The results for the analysis of small showed that board size was negatively correlated with performance (-.245) but this was not statistically significant (p-value = .164). The study also revealed that CEO tenure was positively correlated with performance (.460). This relationship was statistically significant as shown by the p-value of .028. It was also noted that CEO\_FOREIGN had a positive relationship with performance (.270) but the relationship was not statistically significant (p-value = .139). Further, the study revealed that CEO\_AUDIT had a negative correlation with performance (-.092) with a p-value of .359 which shows that the relationship was statistically insignificant. The study also reveals that board composition was negatively correlated with performance (-.414) and the p-value of .044 shows that the relationship was statistically significant. The  $R^2$  was

.505 showing that for small firms, board independence accounts for up to 50.5% of the variance in performance. These results imply that for small firms, board composition has a significant influence on firm performance.

### **5.3 Conclusions**

The main objective of this paper was to examine the relationship between measures of board independence and the financial performance of commercial banks in Kenya. On the effect of CEO tenure on firm performance, the study revealed that there was a significant positive correlation when the whole sample was analyzed. For the large firms, the relationship was positive and insignificant while it was positive and significant for small firms. These results coincide with the view of most empirical results that CEO tenure has a positive significant influence on performance of smaller firms. The study therefore concludes that CEO tenure has a significant positive influence on firm performance, especially for smaller firms.

As regards whether or not there is a significant relationship between the proportion of outside directors on the board and firm performance, the study revealed that for the entire market, board composition had a significant negative correlation with performance. The same was the case for smaller firms but not for larger firms. The relationship for larger firms was positive and insignificant. The results confirm the findings of most empirical results on board composition and firm performance. It is therefore concludes that board composition has a significant negative correlation with performance of smaller firms and not for larger firms.

On the influence of audit committee structure on firm performance, it was noted that audit committee structure had a negative but insignificant correlation with performance when the entire sample was analyzed. The same was the case for larger firms as well as for smaller firms. This indicates that firm performance is not significantly influenced by audit committee structure. The study concludes that audit committee structure does not have a significant influence on bank performance.

#### **5.4 Recommendations**

The study recommends that there is need for small firms to take cognizance of the fact that CEO tenure may have a major influence on their performance. The more a CEO stays the better for the firm. Thus, the shareholders should always strive to ensure that good CEOs are retained in the firms for as long as they are deemed fit for the job if the firms are to ensure constant better financial results. High CEO turnover for smaller firms may be detrimental to their overall financial performance.

It is also recommended that smaller firms need to check on the composition of board members they have. As it was revealed that board composition has a negative influence on firm performance, the number of outsiders in the board for small firms needs to be kept at a regulatory minimum since additional outsiders may hamper firm financial results.

## **5.5 Suggestions for further research**

There is need to carry out more research on board independence especially for large firms to establish what board characteristics determine their performance. The present study found mixed results for large commercial banks but the results were insignificant.

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## Appendix 1: Regression Data

Name of bank	ROA	B_SIZE	F_SIZE	TENURE	CEO_FOR	CEO_AUDIT	OUTSIDE	B_COMP
ABC BANK	0.103775	9	0	0	1	0	2	0.222
BANK OF AFRICA	0.034581	8	0	0	1	0	1	0.125
BANK OF BARODA	0.140528	8	1	1	1	0	2	0.250
BANK OF INDIA	0.127486	9	1	1	1	0	2	0.222
BARCLAYS BANK OF KENYA	0.17773	11	0	1	0	1	2	0.182
CFC STANBIC BANK	0.148168	10	0	1	0	0	2	0.200
CHASE BANK	0.09393	8	1	1	0	0	1	0.125
CITIBANK	0.206966	9	0	1	0	0	2	0.222
CITY FINANCE BANK	-0.24761	10	1	0	0	0	3	0.300
COMMERCIAL BANK OF AFRICA	0.126903	11	0	1	0	1	3	0.273
CONSOLIDATED BANK	-0.00097	12	0	1	0	1	2	0.167
COOPERATIVE BANK OF KENYA	0.067891	10	0	1	0	1	2	0.200
CREDIT BANK	0.119841	10	1	1	0	0	3	0.300
DEVELOPMENT BANK OF KENYA	0.213782	9	1	1	0	0	1	0.111
DIAMOND TRUST BANK	0.121022	8	0	0	0	0	2	0.250
DUBAI BANK	0.057332	8	0	1	1	1	2	0.250
ECOBANK	0.015142	9	1	1	1	1	2	0.222
EQUITORIAL COMMERCIAL BANK	0.118275	7	1	1	1	1	1	0.143
EQUITY BANK	0.144275	9	0	1	0	0	1	0.111
FAMILY BANK	0.043303	8	1	1	0	1	2	0.250
FIDELITY COMMERCIAL BANK	0.034661	9	1	1	0	0	2	0.222

FINA BANK	0.052956	8	1	0	0	0	2	0.250
GIRO COMMERCIAL BANK	0.023936	10	1	1	1	0	3	0.300
GUARDIAN BANK	0.045317	11	1	1	1	0	3	0.273
HABIB AG ZURICH	0.157404	10	1	1	1	0	3	0.300
HABIB BANK LTD	0.038398	10	1	1	0	1	2	0.200
HFCK	0.045053	9	0	1	0	0	1	0.111
I&M BANK	0.145783	8	0	1	0	1	2	0.250
IMPERIAL BANK	0.109009	9	1	1	1	0	2	0.222
KENYA COMMERCIAL BANK	0.104347	12	0	1	0	0	3	0.250
K-REP BANK	0.052049	9	1	1	0	0	3	0.333
MIDDLE EAST BANK	0.117022	10	1	0	1	0	2	0.200
NATIONAL BANK OF KENYA	0.084175	8	0	1	0	0	1	0.125
NIC BANK	0.099793	9	0	1	0	0	2	0.222
STANDARD CHARTERED BANK	-0.00396	9	0	1	0	1	3	0.333