

Board Demographics and Financial Performance of Firms Listed in NSE, Kenya

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Abstract

Recent global events concerning high-profile corporate failures such as Enron in the US have put back on the policy agenda and intensified debate on the efficacy of corporate governance mechanisms as a means of creating confidence in capital markets. Following the unprecedented growth of the Kenyan financial markets in the recent past, new challenges have emerged which require concerted efforts of all players in order to safeguard the integrity of the stock exchange (Mbaru, 2008). Locally, CMC holdings have been embroiled in leadership wrangles after the former chairman was ousted due to claims of overbilling of freight services. The poor corporate governance led CMC to be kicked out of the NSE by the capital markets authority. East African Portland Cement Company (EAPCC) has also been involved in irregularities and was also kicked out of NSE. In both instances, the board of directors was cited as the source of the malpractices yet they are supposed to oversee the institutions on behalf of the public. This trend of public companies engaging in malpractices is bound to lead to poor investor confidence and therefore inhibit achievement of MDG number 8 on development of global partnership for development. This paper sought to find out the role of board independence and board size on financial performance of listed companies in the NSE. The study used a descriptive survey research design and targeted all companies listed in the NSE. Questionnaires were the main data collection instruments. Data was analyzed descriptively and inferentially using SPSS version 19. The study is significant since it will provide insight into the current corporate governance problems and assist the relevant ministry to formulate policies to create confidence in our capital market. The results support the conventional wisdom that greater board independence improves firm performance. The regulatory authorities in Kenya need to strengthen the independence of board of directors by for example making it mandatory upon firms to ensure that boards of directors have sizeable representation of outside directors.

Keyword: Board independence, Board Size, Firm performance, listed firms, capital market

Introduction

Effective corporate governance has been identified to be critical to all economic transactions especially in emerging and transition economies (Klein, 1998; Bhagat and Black, 2000). However, at varying levels of agency interactions, market institutional conditions that reduce informational imperfections and facilitate effective monitoring of agents impinge on the efficiency of investment. Likewise, corporate governance has assumed the centre stage for enhanced corporate performance. What then is corporate governance? Corporate governance could be defined as “ways of bringing the interests of investors and managers into line and ensuring that firms are run for the benefit of investors (Hutchinson, 2002; Young, 2003; Weisbach, 2008). Corporate governance is concerned with the relationship between the internal governance mechanisms of corporations and society’s conception of the scope of corporate accountability (Ayogo, 2005). It has also been defined by Park and Shin (2003) to include ‘the structures, processes, cultures and systems that engender the successful operation of organizations’.

Many commentators, such as Musila (2007), argued that the erosion of investor confidence Kenya was brought about by the country's poor corporate governance standards and a lack of transparency in the financial system.

This is evidenced by the collapse of firms listed in the NSE such as Uchumi and many stock brokerage firms in a period of just under ten years. Therefore, the restoration of confidence in the economy by investors will rely on improvements in corporate governance standards, including the adoption of transparency as an important strategy in corporate management. With the economic recovery of most East African countries, attention has understandably been drawn to addressing and researching the underlying issues and factors that can lead to a crisis like that witnessed in the US (Jensen, 2001).

In 1984, a study on the Development of Money and Capital Markets in Kenya was jointly undertaken by the Central Bank of Kenya (CBK) and the International Finance Corporation (IFC) with the objectives of making recommendations on measures that would ensure active development and strengthening of the financial sector.

This became a blueprint for structural reforms in the financial markets. The Government further re-affirmed its commitment to the creation of a regulatory body for the capital markets in the 1986 Sessional Paper on "Economic Management of Renewed Growth" (Mbaru, 2008). In November 1988, the Government set up Capital Markets Development Advisory Council and charged it with the role of working out the necessary modalities including the drafting of a bill to establish the Capital Markets Authority (the Authority). In November 1989, the bill was passed in parliament and subsequently received Presidential assent (The Capital Markets Authority was set up in 1989 through an Act of Parliament (Cap 485A, Laws of Kenya)). The Authority was eventually constituted in January 1990 and inaugurated on 7th March 1990.

The Authority is a body corporate with perpetual succession and a common seal. When the CMA was established in 1988, it was in all likeness just another state body that was meant to protect public interest while drawing its funding from Treasury. The authority remained a nondescript entity throughout the 1990s which some analysts have termed as Kenya's lost decade as the economy came down on its knees owing to mismanagement and investor fear wrought by political uncertainty. But come the year 2003, the change in government revived economic activity and had the visible effect of boosting investors' confidence and money flowed freely to the stock exchange as the newly rich sought avenues for investing their disposable incomes. What followed was a strong market bull run that set new NSE 20 share index (6,000 points) and market capitalization (Sh1.2 trillion) records in early 2007 and late 2008 respectively (Mbaru, 2008).

Statement of the Problem

Recent global events concerning high-profile corporate failures such as Enron in the US have put back on the policy agenda and intensified debate on the efficacy of corporate governance mechanisms as a means of increasing firm financial performance. Kenya also has had a share of its failures. Rupert Murdoch new corporation has also been in the news due to poor corporate governance structures after it was being accused of hacking into people's phones and mails in order to create stories. Following the unprecedented growth of the Kenyan financial markets in the recent past, new challenges have emerged which require concerted efforts of all players in order to safeguard the integrity of the stock exchange (Mbaru, 2008). A number of stock brokers have not been operating their businesses within the kind of corporate governance framework that would be expected of them.

Failure to manage their businesses in a professional manner and serious governance malpractices has seen some stock brokers so far experience significant financial difficulties forcing the Capital Markets Authority to place them under receivership/statutory management (CMA Report, 2009). The firms listed in the NSE are supposed to serve as investing vehicles for the public and they are supposed to be managed professionally in order to attract investor confidence and safeguard the public's interest. The placement of Uchumi under receivership in 2006 and eventual delisting from the NSE is just but an example. The responsibility for collapse of Uchumi then was placed right under the board of directors who were accused of ignoring governance structures and engaging in malpractices. This study aimed at the effects of corporate governance on financial performance of firms listed in NSE, Kenya.

Literature Review

The study is based on stakeholder theory. Jensen (2001) provides a comprehensive review of corporate governance, with a particular focus on the stakeholder theory. The authors note the presence of many parties interested in the well-being of the firm and that these parties often have competing interests.

While equity holders might welcome investments in high yielding but risky projects, for example, such investments might jeopardize the interests of debt holders especially when the firm is teetering on the edge of bankruptcy.

John and Senbet (1998) argue that a board is more independent if it has more non-executive directors (NEDs). As to how this relates to firm performance, empirical results have been inconclusive. In one breath, it is asserted that executive (inside) directors are more familiar with a firm's activities and, therefore, are in a better position to monitor top management. On the other hand, it is contended that NEDs may act as "professional referees" to ensure that competition among insiders stimulates actions consistent with shareholder value maximization (Fama, 2000). Cotter *et al.* (1997) support this view underscoring the important role of outside directors in protecting shareholders' interest through effective decision control.

Some authors have also found that there is no significant relationship between proportion of NEDs and firm performance (Bhagat and Black, 2002). It has been shown that the effectiveness of a board depends on the optimal mix of inside and outside directors (Baums, 1994).

Large boards could provide the diversity that would help companies to secure critical resources and reduce environmental uncertainties (Goodstein *et al.*, 1995). But, as Yermack (1996) said, coordination, communication and decision-making problems increasingly impede company performance when the number of directors increases. However, board size recommendations tend to be industry-specific, since Adams and Mehran (2003) indicate that bank holding companies have board size significantly larger than those of manufacturing firms.

A review of the empirical evidence on the impact of board size on performance shows mixed results. Dehaene *et al.* (2001) find that board size is positively related to company performance. However, the results of Haniffa *et al.* (2006) are inconclusive. Using a market return measure of performance, their results suggest that a large board is seen as less effective in monitoring performance, but when accounting returns are used, large boards seem to provide the firms with the diversity in contacts, experience and expertise needed to enhance performance. Yermack (1996) finds an inverse relationship between board size and firm value; in addition, financial ratios related to profitability and operating efficiency also appear to decline as board size grows. Finally, Connelly and Limpaphayom (2004) find that board size does not have any relation with firm performance.

Research Methodology

The study employed a descriptive survey study consisting of a sample population of the four (4) managers from Nairobi Stock Exchange, the head of Market Surveillance and Enforcement department from Capital Market Authority (CMA), managers from the fifty seven (57) listed firms in the NSE,. The targets were 4 top managers from the 57 listed firms in the NSE. For listed firms they have been divided into ten and the researcher sampled randomly selecting 4 managers from each of the 17 selected firms. This gave a total of 68 managers.

The study adopted stratified sampling technique to select suitable sample sizes on basis of category of the firm.

The strata's were ten: Agricultural, Commercial and Services, Telecommunication and technology, Automobiles and accessories, Banking, Insurance, Investment, Manufacturing and Allied, Construction and Allied and Energy and Petroleum.

The main research instrument used in this study was questionnaires and interview schedules.

Data capturing were done using Excel software. The data from the completed questionnaires were cleaned, re-coded and entered into the computer using the statistical package for social sciences (SPSS) for Windows for analysis using both descriptive (Quantitative) and inferential statistics (Qualitative).

Discussion of Findings

In order to fulfill this purpose of the study, the researcher found it paramount to establish the board independence on firm performance and board size and firm performance. The study findings are as shown in the table below.

Board Independence on Firm Performance

The table below indicates the respondents' response on board independence on firm performance to the opinion for each statement. A five point likert scale was used to interpret the respondent's extent of agreement.

According to the researcher, those factors with a mean close to 4.5 were rated as to a strongly agree while those with a mean close to 1.0 were rated to a strongly disagree or even not considered at all. The higher the standard deviation the higher the level of disagreement or dispersion among the respondents

Table 4.1: Board Independence on Firms' Performance

Statement	Strongly agree	Agree	Neutral	Disagree	Strongly disagree	Mean	Std deviation
Are executive directors more familiar with the firm's activities and therefore in a better position to monitor top management?	30 42.9%	24 34.3%	12 17.1%	4 5.7%	0 0%	4.11	0.64
Do the non executive directors act as professional referees to ensure that competition among the insiders stimulates actions consistent with shareholder value maximization?	12 17.1%	36 51.4%	12 17.1%	6 8.6%	4 5.7%	4.09	0.67
Is it an important role of outside directors to protect shareholders' interest through effective decision control?	14 20%	33 47.1%	3 4.3%	12 17.1%	8 11.4%	4.02	0.64
Does the effectiveness of the board depend on the optimal mix of inside and outside directors?	36 51.4%	14 20%	10 14.3%	4 5.7%	6 8.6%	4.41	0.61
Is there any significant relationship between proportion of non-executive directors and firm performance?	5 7.1%	13 18.6%	20 28.6%	27 38.6%	5 7.1%	4.31	0.68
When the number of directors increases, does the company performance impede increasingly in problems like decision-making, communication and coordination	5 7.1%	40 57.1%	15 21.4%	6 8.6%	4 5.7%	4.03	0.63
Do large boards seem to provide the firms with the diversity in contacts, experience and expertise needed to enhance performance?	12 17.1%	38 54.3%	4 5.7%	10 14.3%	6 8.6%	4.26	0.59
Do you find that board size does not have any relation with firm performance?	5 7.1%	10 14.3%	20 28.6%	30 42.9%	5 7.1%	1.65	1.43

From the findings, majority strongly agree that executive directors are more familiar with the firm's activities and therefore in a better position to monitor top management and that the non executive directors act as professional referees to ensure that competition among the insiders stimulates actions consistent with shareholder value maximization supported with mean of 4.11 and 4.41 with relative standard deviations of 0.64 and 0.61 respectively. However majority also disagree with the statement that board size does not have any relation with firm performance.

Board Size and Firm Performance

The researcher also sought to find out the views of the respondents on the role of board size on firm performance. The findings were as indicated in the table below.

Table 4.2 Board Size and Firm Performance

Statement	Strongly agree	Agree	Neutral	Disagree	Strongly disagree	Mean	Std deviation
Is the board size considered a characteristic of the board structure	30 42.9%	26 37.1%	4 5.7%	7 10%	3 4.3%	4.42	0.59
Does the board size affect the company's performance?	12 17.1%	28 40%	10 14.3%	15 21.4%	5 7.1%	3.88	0.73
Do large boards provide the diversity that would help companies to secure critical resources and reduce environmental uncertainties?	28 40%	22 31.4%	4 5.7%	10 14.3%	6 8.6%	4.43	0.61
Do bank holding companies have board size significantly larger than those of manufacturing firms do?	12 17.1%	36 51.4%	2 2.9%	7 10%	3 4.3%	3.98	0.67
Is a large board viewed as less effective in monitoring performance?	30 42.8%	24 34.3%	6 8.6%	8 11.4%	2 2.9%	4.40	0.58
When the number of directors increases, does the company performance impede increasingly in problems like decision-making, communication and coordination	16 22.9%	24 34.3%	12 17.1%	10 14.3%	8 11.4%	3.90	0.76
Do large boards seem to provide the firms with the diversity in contacts, experience and expertise needed to enhance performance?	20 28.6%	34 48.6%	6 8.6%	9 12.8%	1 1.4%	3.88	0.73
Do you find that board size does not have any relation with firm performance?	5 7.1%	10 14.3%	15 21.4%	30 42.9%	10 14.3%	1.66	1.32

From the findings, majority of the respondents strongly agree with the statements that, the board size is considered a characteristic of the board structure and that a large board is viewed as less effective in monitoring performance supported by the means of 4.42 and 4.40 with their standard deviations of 0.59, and 0.58 respectively. However majority also disagree with the statement that board size does not have any relation with firm performance supported by mean of 1.66 and its relative standard deviation of 1.32.

Multiple Regression Equation

Firms performance = $\beta_0 + \beta_1 + \beta_2 * \text{board independence} + \text{board size} + e$

Where β_0 .the constant term

β_1 . coefficients

e- random error

Table 4.3: Regression Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	.483	.354		4.13	.012
Board independence	0.837	.541	.072	2.438	.465
Board size	1.593	.368	.241	2.439	.033

Dependent variable: Firms performance

The R square of 0.63 indicates that both board independence and board size jointly influence 63% of changes in financial performance. Board independence is positively related to the firms' performance. This is shown by the positive sign of the coefficient. The coefficient is statistically significant as indicated by a t-ratio of 2.438. Board size is positively related to firms' performance and has the most statistically significant coefficient as indicated by a t-ratio of 2.439. This implies that a one unit change in board size will change the firms' performance by 1.593 units.

Conclusion

From the findings in can be concluded that, executive directors are more familiar with the firm's activities and therefore in a better position to monitor top management. It can also be concluded that the non executive directors' act as professional referees to ensure that competition among the insiders stimulates actions consistent with shareholder value maximization. Further it can also be concluded that it is an important role of outside directors to protect shareholders' interest through effective decision control and also the conclusion can be made that the effectiveness of the board depend on the optimal mix of inside and outside directors. This is as supported by means of 4.11, 4.41, 4.31 and 4.26 respectively. However majority also disagree with the statement that board size does not have any relation with firm performance. This can be concluded that firms' performance is highly influenced by the board size. This is indicated by a mean of 1.66 and a standard deviation of 1.32.

This study recommends that the country therefore needs to strengthen policies to improve firm-level corporate governance in order to attract such investors and bolster overall growth. The regulatory authorities in Kenya need to strengthen the independence of board of directors by for example making it mandatory upon firms to ensure that boards of directors have sizeable representation of outside directors, as is the practice in other countries, and since the evidence from this study suggest the need for this. We also like to call on the authorities in Kenya to formulate policy that will exclude CEOs from participation in audit committees.

We should caution though that our study leaves a lot of unanswered questions. A crucial question for which we have no answer is whether listed firms in the NSE are afflicted with expropriation of minority shareholders. A related unknown issue is whether there is a bidirectional causality in which board independence is both the cause and consequence of firm performance. We leave these as potential areas for further empirical scrutiny.

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