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The Effects of Ownership Structure and Board Effectiveness on Firm Performance: New Evidence from Kenya

Vincent O. Ongore
(Kenya Revenue Authority, 00100 GPO, Nairobi, Kenya)

Abstract: Research on corporate governance is very thin on the role of owners on corporate performance, especially how risk-taking orientation of owners comes to bear on decision making processes of the firm. The Board has been given inordinate attention in corporate governance literature, and yet a lot of corporate failures and malfeasance have occurred in spite of effective boards. This raises the question of whether the board alone is sufficient in corporate governance. The study therefore, investigated the combined effects of ownership structure and board effectiveness on performance of listed companies in Kenya using agency theory as an analytical framework. Ownership structure was operationalized in terms of ownership concentration and ownership identity, while elements of board effectiveness were leadership, stewardship, monitoring and reporting. Measures of performance were return on assets, return on equity and dividend yield. Using Pearson's Product Moment Correlation, logistic regression and step-wise regression, the study found that ownership concentration and government ownership have significant negative relationships with firm performance. On the other hand, foreign ownership, diffuse ownership, corporation ownership, and manager ownership were found to have significant positive relationships with firm performance. The Board has no effect on firm performance.

Key words: ownership structure; ownership concentration; ownership identity; firm performance; board effectiveness

JEL Code: G34

1. Introduction and Research Objective

This paper reports the findings of a study conducted to establish the combined effects of ownership structure and board effectiveness on performance of listed firms in Kenya. The country has experienced turbulent times with regard to its corporate governance practices in the last two decades, resulting in generally low corporate profits across the economy (Anyang'-Nyong'o, 2005). Coincidentally, this picture is fairly well replicated globally in the same period. From the global perspective, 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. Subsequent research (Shleifer and Vishny, 1997; Shleifer, 2001; Jensen, 2000) has thus

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Vincent O. Ongore, Ph.D., assistant commissioner, Kenya Revenue Authority; research areas: corporate governance and strategic management. E-mail: Vincent.ongore@kra.go.ke.

called for an intensified focus on the existing corporate governance structures, and how they ensure 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 existing corporate governance structures.

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.

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 paper, therefore, proposes a more vibrant conceptual framework (Figure 1) combining both ownership structure and the board. This framework can help us better understand the corporate governance phenomenon.

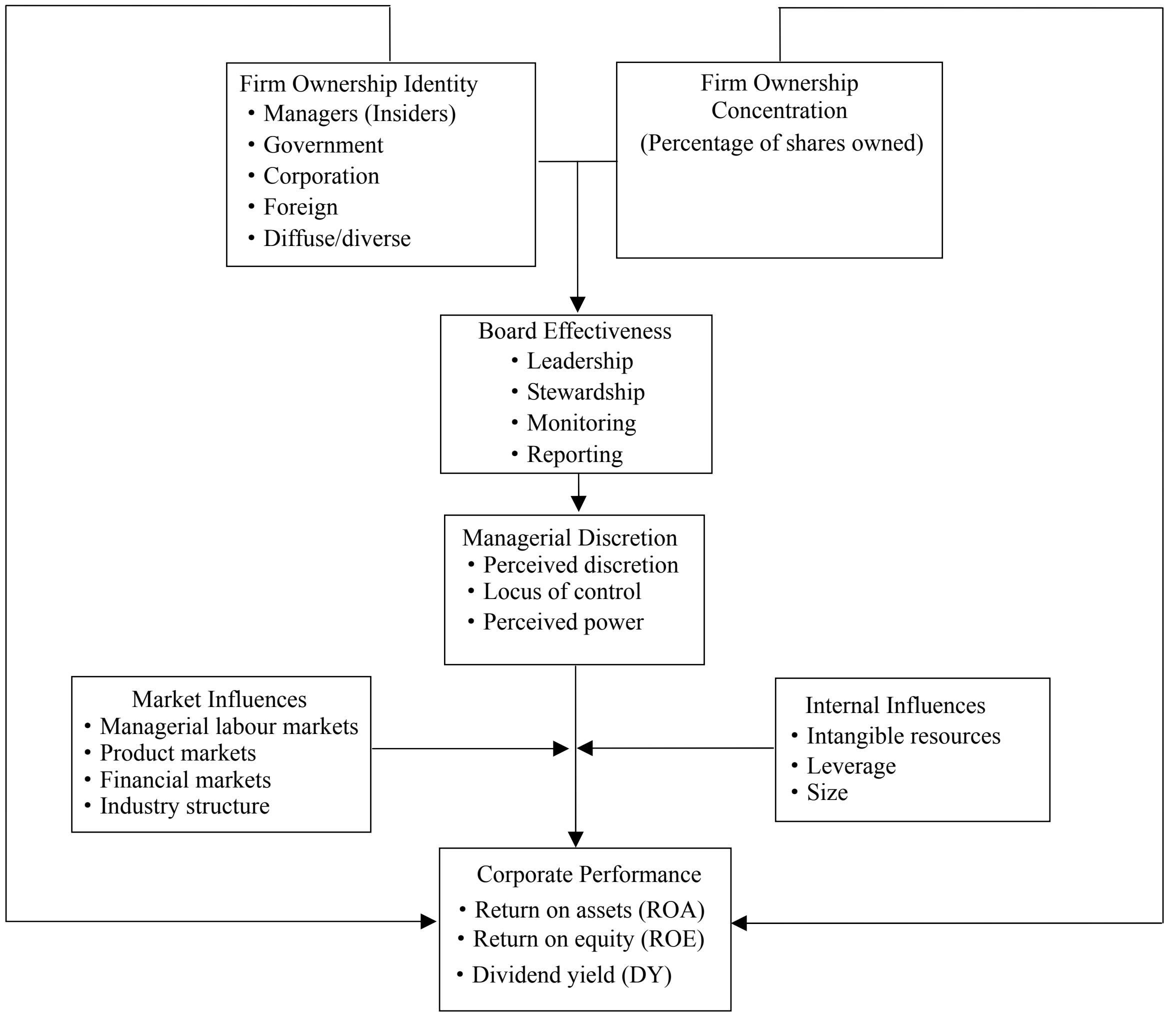

Figure 1 Corporate Governance Model

Ownership structure has a direct bearing on the risk-taking orientation of the firm. Agency problems arise whenever investment ideas and preferences of principals (owners) 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, and is charged with four main responsibilities: leadership; stewardship; monitoring; and reporting back to the principals. The effectiveness of the board helps in, among other ways, monitoring and controlling managerial discretion.

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.

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).

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.

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2. Theoretical Background and Informing Literature

This paper argues that the Board alone is not a panacea to all the governance problems afflicting the modern corporation. To better appreciate the corporate governance issues, firms need to also take into consideration the risk-taking orientations of their shareholders as these have a direct bearing on the type of investment decisions that managers will prefer. Firm ownership structure is thus discussed in terms of the actual identities of the owners as well as percentages of shareholding by these shareholders (ownership concentration).

2.1 Ownership Identity and Firm 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.

2.2 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 Cho (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.

2.3 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). In this study, board effectiveness was looked at in terms of leadership, stewardship, monitoring and reporting roles. 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. To effectively discharge this onerous responsibility, the board composition and selection criteria should be meticulously balanced.

2.4 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, 1983).

According to the agency theory, 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).

2.5 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 H_3: Board effectiveness has a positive effect on firm performance.

3. Methodology

The relationship between ownership structure and firm performance was conceptualized based on pertinent literature on corporate governance. Ownership Structure was conceptualized as comprising ownership concentration and ownership identity. Ownership concentration (shareholding above 30%) was determined using Herfindahl Index, or the equity stake of several largest investors, typically the top five shareholders (Demsetz and Lehn, 1985). Four ownership categories were identified, namely: foreign; institutional; government; and diverse. Each of these ownership identities has different risk-taking orientations, which in effect impact investment decisions and firm performance differently. On the other hand, board effectiveness was analyzed based on how well they discharged leadership, stewardship, monitoring and reporting functions. To test the value of the board of directors, step-wise regression was used, and the marginal changes in value of R monitored to confirm whether the additional variables were of significant or not.

3.1 Measuring Corporate Performance

This study used Return on Assets (ROA), Return on Equity (ROE), and Dividend Yield (DY) to measure firm performance. These measures of firm performance have been used extensively in research in corporate governance (Laffont, 1988; Scholes, 1994; Xu and Wang, 1997; Milgrom and Roberts, 2000; Heracleous, 2001; Kennon, 2005). ROA measures how much profits a firm can achieve using one unit of assets. It helps to evaluate the result of managerial decisions on the use of assets which have been entrusted to them. ROE measures the earnings generated by shareholders' equity of a period of time, usually one year. It encompasses three main levers which management can utilize to ensure health of the firm: profitability; asset management; and financial leverage. DY refers to the annual dividend per share divided by current stock price. DY is an easy way to compare relative attractiveness of various dividend-paying stocks.

3.2 Sampling Approach

A census approach was used, and thus the sampling frame consisted of all listed firms in Kenya. Using the Nairobi Stock Exchange Handbooks (2006, 2008), 54 firms were on the roll, out of which six had not compiled their financial reports for the relevant period of study. Another six failed to take part in the study. The final sample therefore, consisted of forty-two firms, representing about 78 percent response rate. The sample comprised four firms from the Agricultural sector (9.5%), seven from Commercial Services (16.7%), ten from Finance and Investment (23.8%), fourteen from Industrial and Allied (33.3%), and seven from Alternative Investment Market (16.7%).

3.3 Reliability Analysis

Reliability analysis was used to assess internal consistency (degree of homogeneity among the items). Cronbach's Alpha coefficients were computed for 18 items under board effectiveness and managerial discretion, and the overall assessment was 0.87. According to Nunnally (1978), a data collection instrument with a good internal consistency should have Cronbach's Alpha coefficients that are higher than 0.7. The items were therefore, found to be highly homogeneous.

4. Data Analysis and Results

The data in this study were analyzed using Pearson's Product Moment Correlation and Logistic Regression.

The results were presented in two categories: (1) ownership concentration and firm performance, and (2) ownership identity and firm performance.

The general form of the models used was:

$$Firm\ Performance = b_0 + b_1 OWNCONC + b_2 FORENOWN + b_3 INSTOWN + b_4 GOVOWN + b_5 DIVOWN + b_6 MANOWN + b_7 BOARDEFFECT.$$

where *OWNCONC* –Ownership Concentration; *FORENOWN*–Foreign Ownership; *CORPOWN*–Ownership by Corporations; *MANOWN*–Ownership by Managers; *GOVOWN*–Ownership by Government; *DIVOWN*–Diverse Ownership; *BOARDEFFECT*-Board Effectiveness

Table 1 Linear Regression Results for the Effects of Predictor Variables on Firm Performance

Indicator variable	ROA	ROE	DY
Predictor variable	Parameter estimates (β)	Parameter estimates (β)	Parameter estimates (β)
Ownership concentration			
Ownership concentration	-0.761	-0.645	-0.888
Ownership identity			
Foreign ownership	1.598*	1.218*	1.592*
Institution ownership	1.012*	0.775	0.826
Government ownership	-0.798	-0.616	-0.483
Diverse ownership	0.946*	0.789*	0.723
Board effectiveness			
Board effectiveness	-0.557*	-0.237*	-0.111
Manager ownership			
Manager/Insider ownership	1.003	0.792	0.241

Note: *p<0.05

The results of the Linear Regression presented in table 1 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 ($\beta = -0.761$, $p<0.05$), Return on Equity ($\beta = 0-.645$, $p<0.05$) and Dividend Yield ($\beta = -0.888$, $p<0.05$) all recorded significant negative correlations with ownership concentration.

Table 2 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	-0.360*	-0.085	-0.102*
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	-0.033	-0.042	-0.035
Manager/Insider ownership	5.013	4.049	5.162

Note: *p<0.05

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

The results of the Logistic Regression tests in Table 2 indicate that there is a negative and significant correlation between ownership concentration and Return on Assets (β=-0.360, $p<0.05$) and Return on Equity (β = -0.085, $p<0.05$). The results for Dividend Yield (β = -0.102, $p<0.05$) were also negative but not significant. These results lead to a rejection of the hypothesis $H_{1.}$

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

The Linear Regression results: ROA (r=0.026, $p<0.05$), ROE (r=0.038, $p<0.05$) and DY (r=0.041, $p<0.05$). Logistic Regression results: ROA (β=5.013, $p<0.05$), ROE (β= 4.409, $p<0.05$) and DY (β = 5.162, $p<0.05$). The relationship was positive and significant, and hypothesis H_{2a} was accepted.

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

The Linear Regression results: ROA (r=-0.017, $p<0.05$), ROE (r=-0.058, $p<0.05$); DY (r=-0.077, $p<0.05$). Logistic Regression results: ROA (β=-15.794, $p<0.05$), ROE (β=-17.778, $p<0.05$) and DY (β=-17.021, $p<0.05$). The relationship was negative and significant, leading to acceptance of the hypothesis H_{2b}.

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

The Linear Regression results: ROA (r=-0.016, $p<0.05$), ROE (r=-0.014, $p<0.05$); DY (r=-0.029, $p<0.05$). Logistic Regression results: ROA (β=4.888, $p<0.05$), ROE (β=2.595, $p<0.05$) and DY (β=3.120, $p<0.05$).The results were positive and significant, leading to acceptance of the hypothesis $H_{2c.}$

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

The Linear Regression results: ROA (r= 0.012, $p<0.05$); ROE (r=0.023, $p<0.05$); DY (r=0.061, $p<0.05$). Regression results: ROA (β=6.041, $p<0.05$), and ROE (β=5.038, $p<0.05$); DY (β=3.718, $p<0.05$). The results led to a rejection of the hypothesis $H_{2d.}$

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

The Linear Regression results: ROA (r=0.044, $p<0.05$), ROE (r=0.037, $p<0.05$); DY (r=0.041, $p<0.05$). Logistic Regression results: ROA (β=6.436, $p<0.05$), ROE (β=3.810, $p<0.05$; DY (β=6.579, $p<0.05$), leading to acceptance of the hypothesis $H_{2e.}$

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

Linear Regression results: ROA (r= -0.557, $p<0.05$), ROE (r= -0.237, $p<0.05$); DY (r= -0.111, $p<0.05$). Logistic Regression results: ROA (β= -0.033, $p<0.05$), ROE (β= -0. 042, $p<0.05$; DY (β= - 0.035, $p<0.05$), leading to rejection of the hypothesis $H_{3.}$

5. Summary and Conclusions

Prior research has found significant links between ownership structure and firm performance. Studies comparing ownership concentration and firm performance have often found a higher rate of return in companies with concentrated ownership. 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. The findings of this study therefore, appeared 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 posit, ensures that managers make decisions that support the wealth creation motivation of the shareholders.

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).

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 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 appeared 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 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 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 agreed 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 findings therefore, suggest 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.

There is near convergence that Government ownership of firms leads to bureaucracy and inefficiency that negatively impacts firm performance (Nickel, 1997). 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 1990s, the Kenyan 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 was found to still impact firm performance negatively is perhaps an indication that the divestiture program in Kenya is yet to reach a critical level where its value can begin to reflect on corporate 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 acquires shares in another firm, the shareholders of the first firm 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.

Regarding the impact of diverse ownership on firm performance, the findings of this study 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 they are afforded an opportunity to own shares of the firm, then allowed freehand 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 results were on the relationship between foreign ownership and firm performance. The significant positive relationships have vindicated the long-held belief that on average, foreign owned companies perform better than their counterparts with dominant local ownership. 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.

6. Implications of the Findings

There is a significant negative relationship between ownership concentration and firm performance. 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 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 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.

There is a positive relationship between insider ownership and firm performance. It has been argued that when managers own shares in their company, they become more committed to the organization since they have a stake in the residual income of the firm, and are likely to bear the cost of mismanagement. This commitment translates to superior performance. In fact, the study reaffirmed 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.

There is a significant negative relationship between government ownership and firm performance. 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 of the country. The current study has confirmed this long-held position. The implication is that government should infuse private sector-like management systems and progress the divestiture program to attract more private individuals and institutions to co-own the state corporations.

There is a positive relationship between ownership by corporations and firm performance. 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. 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 partners to prop up their poor performance.

There is a positive relationship between diverse ownership and firm 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. 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. 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. This study has shown that managers work best when they have sufficient latitude for innovation and creativity, that is, less monitoring by principals.

The positive and significant relationship between foreign ownership and firm performance appears to have gained universal acceptance across the globe due to a number of factors. 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 significant negative relationship between board effectiveness and firm performance suggests that the boards in Kenya do not add much value to the decision making processes and firm performance. This result appears to contradict the long-held notion that boards are responsible for corporate performance. Perhaps, it is a wake-up call to the appointing authorities to pay more attention to board composition and selection criteria if the boards in Kenya were to reclaim their rightful role in corporate governance.

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