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ABSTRACT

Purpose: The purpose of the study was to determine the relationship between board characteristics and firm financial diversification (geographic sales) among listed firms on Nairobi securities exchange, Kenya: static panel approach.

Methodology: Fisher and Levin-Lin-Chu tests were used to test the presence of unit root in the series under study. Hadri residual-based Lagrange multiplier test was used to determine the feasible model.

Results: Results revealed existence of positive and significant relationship between interlock directorship and geographic diversification as positive and significant directors' remuneration had a negative and significant effect on firm's geographic sales, while operational risk negatively varied with geographic sales Agency Theory, free cash flow hypothesis Resource Based view theory provided theoretical framework. Directors' remuneration negatively impacted geographic sales but did not explain diversification in relation to national sales. This study affirmed the managerial heuristics as determinant of firm financial diversification providing support to the convectional financial dimensions of firm performance particularly ROE, ROI and EPS.

Unique contribution to theory, practice and policy: The Government of Kenya and Capital Market regulator should enact and implement legislations that guides on interlock directorship, directors remuneration diversity and tolerable operational risks as determinants of diversification.

Keywords: *listed firms, geographic segments sales, Diversification, board characteristics.*

1.0INTRODUCTION

1.1 Background of the Study

Researchers globally have done several studies testing different aspects of diversification on the firm's value. Lung and Stultz 1994; Berger and Ofek 1995 asserts that firms operating in multiple lines of business are valued less than comparable focused firms thus diversification has been observed to have value destruction. Lamont and Polk (2002) offered an alternative approach to causal effects of diversification and argue that firm's diversification status can change even if the firm does not change it on purpose and as such exogenous change in diversification is plausibly independent of a firm's behaviour. Ramanujam and Varadarajan (1987) define diversification as the extent to which firms are simultaneously active in many different businesses. A firm has many ways to alter its degree of diversification. It can either change the number of segments, or it can re-allocate its businesses among divisions. Thus, diversification describes a two-dimensional internal structure: the various types of business and the dispersion of certain characteristics among the businesses. Byers *et al*., (1996) see diversification occurring when the firm wants to take advantage of an extremely attractive opportunity especially when compared to other possible growth strategies. The possible reason for this being that the markets for the current products or services are saturated and or if not the profit potential of diversification appears greater than that of expanding the current business.

International review of finance (2012) sought to investigate the value effects of endogenous and exogenous changes in diversification by combining the methodologies used in Campa and Kondla (2002) and Lamont and Folk (2002). The study isolated exogenous diversification applying a two stage least square and generalized method of moments instrumental variables (GMM-IV) econometrics techniques to identify causality in the endogenous diversification. The research established that an exogenous increase in diversification reduces firm value consistence with Lamont and Folk 2002. In contrast, an endogenous increase in diversification enhances premium for firms consequently causing such firms to alter their organization structure. The paper concluded that the cost of diversification outweighs the benefits.

Studies have also shown that certain factors that negatively affect firm value may also lead firms to diversify. Matsusaka (2001) asserts that firms diversify to search for a better match between their organizational and industrial opportunities. Maksimovic and Philips (2002) established that firms optimally choose organizational structures depending on their comparative advantages. Gomes and Livdan (2004) through their model demonstrate that diversification allows corporations to explore synergies and better production in response to current decline in performance. Their model predicts that a diversification discount could exist even if diversification is intended to enhance value for firms that actually pursue it.

Lewellen (1971) and Shleifer and Vishny (1992) suggest that diversified firms achieve a higher debt capacity hence giving additional interest tax shields. Rajah *et al.*, (2000) observes that diversification strategies allow managers to divert resources to inefficient division and that agency theory predicts that firm value would be destroyed if managers endogenously increase the degree of diversification. Campa and Kendia (2002) show that there are significant differences between firm characteristics that cause firms to adopt various types of organizational structures. Del Brio

et al., (2011) studied the relationship between ownership structure and diversification in an environment of weak shareholder protection and assert that; corporate diversification is associated with lack of alignment between ownership and control, and the failure of control mechanisms.

Yoshikawa and Phan,(2005), observe that firms with greater ownership concentration are less diversified, though, in contrast; provide managers with considerable discretion and greater latitude in determining the corporate strategy, entrench themselves and encouraging very high levels of insider ownership. Del Brıo *et al*., (2010), Miguel *et al.*, (2004), La Porta *et al*., (1998) assert that in French, Spanish, and Turkish firms, ownership concentration is deemed as a good substitute for legal investor protection in weak investor ownership, and entrenchment likeness is very high at higher ownership levels of concentration. Jensen and Zajac (2004) argue that in USA corporations, individual characteristics of corporate elites may imply different preferences for particular corporate strategies such as diversification and acquisitions, these basic preferences, when situated in different agency contexts (CEO, outsider director, non- CEO top management team member), generate very different strategic outcomes. Similarly the study of Sambharya (1996) posits that TMTs with higher mean international experience and greater heterogeneity of foreign experience were associated with the firm's geographic diversification.

The Kenyan Capital Market is part of the global financial market that provides funds for long-term development. Firms trading at NSE are regulated by the Capital Markets Authority (CMA) which is an independent public agency charged with the responsibility of regulating and facilitating the development of orderly, fair and efficient capital markets in Kenya (CMA Act, 2012). Over the years CMA has endeavored to develop critical aspects that include: creation of a nationwide system of stock market and brokerage services for wider participation of the public, maintenance and regulation of an orderly, fair and efficient securities market, protection of investor interests, as enshrined in CMA amendment Act, (2012).

KNBS (2009), posit that the Capital Market performance for the period 2004 – 2008, experienced a downturn in 2008 with NSE share index losing 1,924 points by the end of 2008. It is, however, notable that capitalization in the equities market rose to over one trillion Kenya shillings following the IPO of Safaricom shares in the second quarter of 2008 but declined to Kenya Shillings 854 billion at the end of the fourth quarter. The total bond turnover rose by 12.4% to Kenyan shillings 95.4 billion in 2008 compared to Kshs 84.9 billion in 2007. Over the years some policy measures have been instituted through the budget aimed at deepening the Capital Markets as well as strengthening CMA supervisory capacity, enhancement of corporate governance among the financial market players as well as reducing cost for listed companies. In addition, during the period 2004 – 2008 foreign participation which historically has been of net inflows changed to net out flows. KNBS, statistical abstract (2012) indicate that the NSE share index from the year 1997 – 2011 on month to month basis, has been fluctuating with a high of 5,774.24 January 2007 and a low of 1,027 September 2002. Further, some of the privately and publicly owned firms' have had both operational and financial difficulties caused by Principal-principal conflict and Principal-Manager Conflict (case of CMC Kenya, Access Kenya, Eveready and Uchumi Supermarkets).

KFSSR (2013), indicate that the Kenyan banking sector liquidity has exceeded the statutory requirement of 20% with gross loans to deposits ratio being 73.3% in 2008 to 81.1% in 2013. The banking sector has neither been spared with National Bank of Kenya having remained unprofitable for 12 years and a dry spell of dividends pay-out attributable to uncontrolled investments decisions. Accordingly, industry statistics, show that about 10% of adult Kenyan own shares in the country's

Securities market which translate to about 2 million Kenyans. This figure is lower than that of the USA where up to 48 per cent of the adults have invested in stocks and government papers, in Australia the figure is estimated to be about 40 per cent and in Sweden and Switzerland, 30 per cent of the adults have put their money in securities (See Appendix II Table 1). WEOU, (2014), indicate that Sub Saharan Africa Emerging economies had an average growth rate of 5.8% between 2004 - 2008, slowed to 2.5% in 2009 and closed at 5.0% in 2014 (See Appendix I).

Kenya Institute of Economic Affairs survey (2012) reveal that RGDPG for Kenya grew from 1.5% in 2008 to 2.7% in 2009 with a high of 4.6% in 2012 and that RGDP per capital was low at 36933 in 2008 and a high of 39607 in 2012 and WEOU, (2014) forecasting 5.2% RGDP growth rate for Emerging and Developing economies, 1.5%, for Euro Area, and 3.0% for USA in 2015 (Appendix II Table1). GDP at regional level, Tanzania (6.5%) and Rwanda (7.7%) have continued to post relatively high growth rate comparable to Kenya (4.6%).The various sectors of the economy have equally posted mixed growth rates between the years 2008 and 2012. Manufacturing sector registered highest growth rate of 4.5% in 2010 and a low of 3.1% in 2012, transport and commercial sector, financial sector, and Agricultural sector registering average growth rates of 4.8%, 6.4%, and 1% respectively between 2008 and 2012.

Empirical studies revealed that previous studies have concentrated on the relationship between board diversity and firm performance majorly in USA, Asia and Europe large sized firms (Byers *et al.*, 1996, Pearce *et al.*, 2000, Lukers *et al.*, 2009, Jackling and Shireejit 2009, Lee Li *et al.*, 2013, Letting *et al.*, 2012, Laeven and Levine, 2007, Stephene *et al.*, 2010) among others. This study therefore examined the relationship between board demographics and firm financial diversification on listed firms at NSE, an emerging market focusing on a two-dimensional internal structure: the various types of business and the dispersion of certain characteristics among the businesses. This study is different from previous studies on the basis of sectors chosen (Manufacturing and commercial), study period and method of data analysis.

1.2 Problem Statement

Globally, firms' diversify for a host of reasons. In some cases, it is a survival strategy while in other cases they do so to ensure a regular revenue stream throughout the year. Matsusaka (2001) asserts that firms diversify to search for a better match between their organizational and industrial opportunities. Gomes and Livdan (2004) argue that diversification allows corporations to explore synergies and better production in response to current declines in performance. Kenya Financial Sector Stability Report (2013) reveals that, NSE performance between 2008 and 2013 registered mixed results across key sectors of the economy, with NSE 20 Share Index closing at 3247.40 points in Dec 2009, 4432.6 in Dec 2010 and 4926.97 in Dec 2013. Annual Average Foreign Investors Share (AAFIS) to Total Equity Turnover (TET) fluctuating between 28.52% and 51.38% in the year 2009 and 2013 respectively. Further, equity turnover for (2013) grew by 79.4%, year-on- year to Kshs.155.7 billion on account of increased local and foreign investor participation with foreign investors accounting for 59.2% of the equity purchases and 43.6% of equity sales.

The performances of the various sectors of the economy are driven by a set of variables that are multidisciplinary in nature affecting various investments strategies undertaken by listed firms with varying degrees. Commercial and Manufacturing sectors were considered for the study utilizing data for ten firms from each of the sectors. The sectors consisted of the most promising investments segment appealing for both local and foreign investors. The selected firms had geographic spread

across the country and region offering media, marketing, retail, hospitality, transport and logistics services as well as fast moving consumer goods.

Regionally, the Kenyan firms in the commercial and manufacturing have diversified into Rwanda, Uganda, Tanzania and Southern Sudan while others offer logistical, transport and freight services across Africa Continent and beyond. This expansion tends to expose firms to political risks a notable one being instability in Southern Sudan, Democratic Republic of Congo and partly in Burundi. The firms in commercial and manufacturing sectors have suffered from a raft of factors particularly, regional insecurity, high profile domestic attacks, economic crisis (global financial meltdown, 2008), rising levels of corruption (governance problems in Kenya, BMI Research, 2014) and recently misconceptions about the spread of Ebola in West Africa. These factors have served to keep international tourist arrival low, as well as precipitate threats of closure of subsidiaries disrupting revenues streams, assets utilization and displacement of human resources (KFSSR, 2013).

Retail businesses have incurred high operational costs arising from Principal-principal conflict and Principal- Manager Conflict (Uchumi Supermarket, delisted in 2006 and re-listed in 2011, Muchira, 2013) and currently in cash flow problems having posted a record loss of Kshs. 3.7 billion in 2014/2015 financial year. Irrecoverable investments losses at Kenya Airways (Annual Report, 2011) in addition to poor investments in fuel derivatives at much higher prices than their fair values, record loss of Kshs. 7.9 billion after tax in the financial year 2013-2014 attributable to poor marketing, overpricing of tickets, and unsustainable debt levels with Kenya Senate in its report to parliament questioning the competence of board members (Standard, Dec 3rd 2015). In addition, it has been noted that Express Kenya, Kenya Airways and Uchumi Supermarket are tilting towards insolvency - have negative working Capital (Business Daily, December 11th 2015). Equally, Media, Marketing and other logistical firms within the sector share the global financial crisis that impact on the purchasing power of their respective market segments. In the manufacturing sector, Mumias Sugar Company (heavily indebted requiring Government intervention), Eveready East Africa, and B.O.C (K) have had several cash flow problems and resignations of some board members.

In spite of these challenges, all the firms in the sector continue to spread geographically offering diverse product lines. Geographic diversification has been considered as a strategy that allows a firm to leverage its capabilities across foreign markets enabling it to maximize monopolistic advantages lowering its operational risk (Kim, *et al.*, 1993). The decisions to diversify are majorly undertaken by firms' board of directors as the governance body on behalf of the shareholders in pursuit of wealth maximization. Such decisions are consequential judgement that requires careful review and consideration of a mapping of firm characteristics and environmental scanning for custodial role of the board. In as much as diversification allows a firm to take advantage of economies of scale, arbitrage across factor markets, leverage market power to reduce input, it does present considerable ambiguities, complexities and risks. The associated challenges require a set of rational and objective cognitive abilities, orientation and competencies among board members in decision making regarding financial diversification .This study sought to establish the nature of the relationship between board characteristics and firm diversification for firms listed at the NSE, Kenya, and in particular, Commercial and Manufacturing sectors. The board members were chosen on the basis that managerial responsibilities are rarely exclusive domain of a single person (CEO) (Hambrick & Mason, 1984).

The findings of the study extended and mirrored some prior studies in the literature review and its implication on theory and policy regarding board diversity and firm diversification. However the findings diametrically departed on the previous studies that have concentrated on relationship between board demographics and firm performance with limited studies on relationship between board demographics and firm financial diversification in Kenya. The uniqueness of this study is premised on four perspectives; first the set of control variables that were divided into two: - namely, firm financial based variables and Corporate governance mechanism proxied by operational risk which is often used in financial institutions thus its interaction in non -financial sectors is considered novel, secondly, the study period is recent with the sectors selected not having been covered by prior studies and lastly, method of data analysis - Generalized Least Squares (GLS) Fixed Effect method in both static and dynamic states.

1.3 General Objective of the Study

The major objective of the study was to determine the relationship between board characteristics and firm diversification in firms listed on Nairobi Securities Exchange, Kenya:

1.4 Specific objectives were;

1. To determine the relationship between gender diversity and firm financial diversification.
2. To determine the relationship between board tenure diversity and firm financial diversification.
3. To determine the relationship between board experience diversity and firm financial diversification.
4. To determine the relationship between board interlock directorship diversity and firm financial diversification.
5. To determine the relationship between nationality diversity and firm financial diversification
6. To determine the relationship between directors' remuneration and firm financial diversification

1.5 Research Hypotheses

H_{01} : Board gender diversity has no significant relationship with firm financial diversification.

H_{02} : Board tenure diversity has no significant relationship with firm financial diversification.

H_{03} : Board experience diversity has no significant relationship with firm financial diversification.

H_{04} : Board interlock directorship diversity has no significant relationship with firm financial diversification.

H_{05} : Board Nationality diversity has no significant relationship with firm financial diversification.

H_{06} : Board remuneration has no significant relationship with firm financial diversification.

2.0Theoretical framework

This study relied on four theoretical perspectives of the firm**:** Agency Theory, free cash flow hypothesis, Resource Based view theory and upper echelon theory to provide explanation of relationship between board characteristics' and firm diversification for listed firms' in the selected sectors in Kenya. The directors are associated with negligence and profusion, and, more or less, in the management of the affairs of a company (Jensen and Meckling, 1986). Denis *et al., (*1999), Shleifer and Vishny (1989) argue that, diversification has been an Agency Cost, representing a manifestation of conflicts of interest between managers and stock- holders as well as a form of manager perquisite with the main motivations being entrenchment of managers, making them more valuable to shareholders and costly to replace. RBV emphasizes on the allocation of resources and sharing of competencies across different business lines to enhance performance by either cost reduction or edging competing firms out of the market (Porter, 1980). This exploitation of potential synergies expected from sharing functions lead to generation of sustainable competitive advantages hence profitability accustomed by cost reduction. RBV predicts a positive relationship between diversification and firm's financial performance (Mwau, 2015,, Porter, 1980).

According to upper echelon theory, Top Management Teams background, experiences, and values of corporate executives influence important corporate information. Observable characteristics such as age, tenure, and functional experience might serve as useful proxies for cognitive base that guide top executive decisions. Lawrence (1997) asserts that demographic variables are often used as proxies in subjective concepts and researchers relying on demographics characteristics apply a congruence assumption. Brush, *et al*., (2000) argue that in situations of weak corporate governance, managers use substantial free cash flows to full fill their own needs, rather than those of shareholders. Chatterjee and Wernerfelt (1991) argue that availability of internal funds or unused debt capacity favours higher levels of diversification. Jensen (1986) implies that managers have incentives to use free cash flows to undertake (diversification) mergers and acquisitions in order to improve corporate sales growth

2.1 Geographic Diversification

Geographic diversification has been extensively studied under three dimensions. The first dimension focuses on establishing the relationship between Geographic Diversification and firm performance without much attention to the contingency factors Geringar *et al.,* 1989) Tallman and Li 1996). The second category comprises research that focuses primarily on the contingency conditions affecting Geographic diversification performance relationship (for instance Hitt *et al.,* 2006); Kotabe *et al*., 2002). The third category comprises research that explores the relationship in different empirical settings (see for example Capar and Kotabe 2003; Nachum, 2004).

Literature review of the studies on Geographic diversification that has been done in the last 30 years reveals mixed results. Scholars have found positive relationships (Delios and Beamish 1999; Hitt *et al*., 2006), negative (Denis *et al.,* 2002; Geringer *et al*., 2000) inverted "U" shaped Geringer *et al.,* 1989; Hitt *et al*., 1997) "S" shaped (Contractor et al., 2003). Given the range of time periods, country coverage and the type of firms studied it is quite natural to have different results across studies (Singh *and* Gleason, 2004).

Stephen *et al.,* (2010) sought to establish the relationship between value and diversification choice by considering firms from emerging and developed countries for a period of fifteen years. They

established that firms in less developed countries were more likely to diversify suggesting greater utility of internal capital markets in economies where it is difficult to raise external capital. They further observed that high leverages, larger size, lower levels of growth, R & D, free cash flow, profitability and Tobin's q encourage firms to diversify industrially i.e. across multiple lines of business while reduced growth rates and profitability encourage firms to diversify globally that is across different national markets.

Lee Li *et al.,* (2013) studied the breadth and depth of international diversification and its effects on firm performance. Their research established that the interaction effects is positive and significant when the level of both breadth and depth is moderate, however the positive and significant effect reverses and becomes negative when a higher level of both dimension is reached. They defined breadth of international diversification as the number of foreign markets served by a firm while depth of international diversification as the level of intensity of operation in each country or region that a firm had entered. Kumar and Tsetsekos (1999) defines emerging markets as those characterized by less information efficiency and more volatile corporate governance institutions, taxations on dividends and capital gains, as well as highly concentrated ownership structure.

2.2 Board Characteristics and Firm Performance

Pfeffer (1983) and Finkelstein (1988) have advocated the use of demographic data in view advantages of objectivity and data availability. Studies of Hambrick, Geletkanycz and Fredrickson (1993) Wiersema and Bantel (1992) have argued in support of demographics as psychological factors (beliefs, knowledge, assumptions and values) upholding Upper Echelons Theory. Observable demographic characteristics such as tenure, functional background have been strongly advocated for (Data and Rajagopalan 1998, Shital and Mishra 2012). International experience dimension has been articulated in the study of Sambharya (1996). Hambrick and Masons (1984) posit that observable demographic attributes shape values and beliefs of individual managers and can be seen as valid proxies for underlying cognitive abilities, values and experience which in turn substantially impact decision making and behaviour of the board members. Smith and White (1987)) and Carter, D'Souza, Simkins and Simpson (2003) established relationship between top manager's functional backgrounds and firms' competitive strategies performance. Wiersema and Bangtel (1992) examined relationship between TMTs characteristics and various organisational outcomes (innovation). Further, a study Carmen, Villegas and Perez-Calero (2011) noted that relationship between TMTs characteristics and international diversification are more dominant in better performing than low performing firms.

Much of previous the studies have dwelt on larger firms based in USA, Europe and parts of Asia as it has been argued that such firms possess ownership specific advantages that allow them to compensate for the cost and risks associated with operating in international markets.Miguel *et al.*, (2004), suggests that expropriation by large shareholders is likely to occur for very highly concentrated firms, and that compliance with codes of good practice are deemed key to more effective corporate governance and value maximization, since they may curb managerial discretion and increase minority shareholder protection for Spanish firms. They observed that the codes of good practice involved the following features: low percentage of shares held by the state; correct size, composition, and number of annual meetings of the Boards of Directors; existence of audit and nomination and remuneration committees; low degree of usage of anti-takeover devices; high degree of accounting transparency of information and high degree of transparency of information on the firm's web site.

Lang and Stulz (1994) and Beger and Ofek (1995) through their seminal papers observe that if the segments of a diversified firm could operate separately as a stand -alone firms, the sum of market values of these stand-alone firms would exceed the market value of the original diversified firm. However, these studies do not treat firm value and diversification as endogenously determined. Lamont and Polk (2001) established that exogenous diversification due to industry shocks has negative effects on firm value and that endogenous change in diversification is negatively correlated with firm value. They recommended that the effects of endogenous diversification may not be conclusive.

Porter (1962) asserts that diversification strategies occur where the organization seeks to extend its current range of offerings or spheres of activity. This may be through means of integration or through new product development or new market development. Grant (1991) points out that firms diversify to create competitive advantage hence may trade current profit for investment in market share or technology or may forego profit in the interest of customers' satisfaction or employee benefits consequently increasing her ability to respond more quickly and effectively to external change due to increasing markets turbulence. One of the main motivations behind diversification strategies, for entrenched managers, is making themselves more valuable to shareholders and costly to replace (Denis *et al.*, (1999), Shleifer and Vishny (1989). Stulz (1990), Villalonga (2004a, b) asserts that the pursuit of value- maximizing strategies and growth are not driven by agency problems and self-aggrandizement of management, thus contradicting Jensen and Ruback (1983).

Laeven and Levine (2007),suggest that companies that exhibit more agency problems are more diversified and, more specifically, that firms with greater ownership concentration are less diversified, highlighting the correlation between diversification and ownership structure. Yoshikawa and Phan, (2005), observe that firms with greater ownership concentration are less diversified, though, in contrast; provide managers with considerable discretion and greater latitude in determining the corporate strategy, entrench themselves and encouraging very high levels of insider ownership. Del Brıo *et al*., (2002, 2010), Miguel *et al.*, (2004), La Porta *et al*., (1998) assert that in French, Spain, and Turkish firms, ownership concentration is deemed as a good substitute for legal investor protection in weak investor protection, high level of information asymmetries, entrenchment likeness very high at higher ownership levels concentration. Pindado and De la Torre, (2006) in addition observe that, when rent expropriation by large shareholders takes place, the highly concentrated shareholder ownership structure requires very high levels of insider ownership in order to ensure value maximization. This is in contrast to firms in the USA and other European markets.

Figure 1: Conceptual Framework

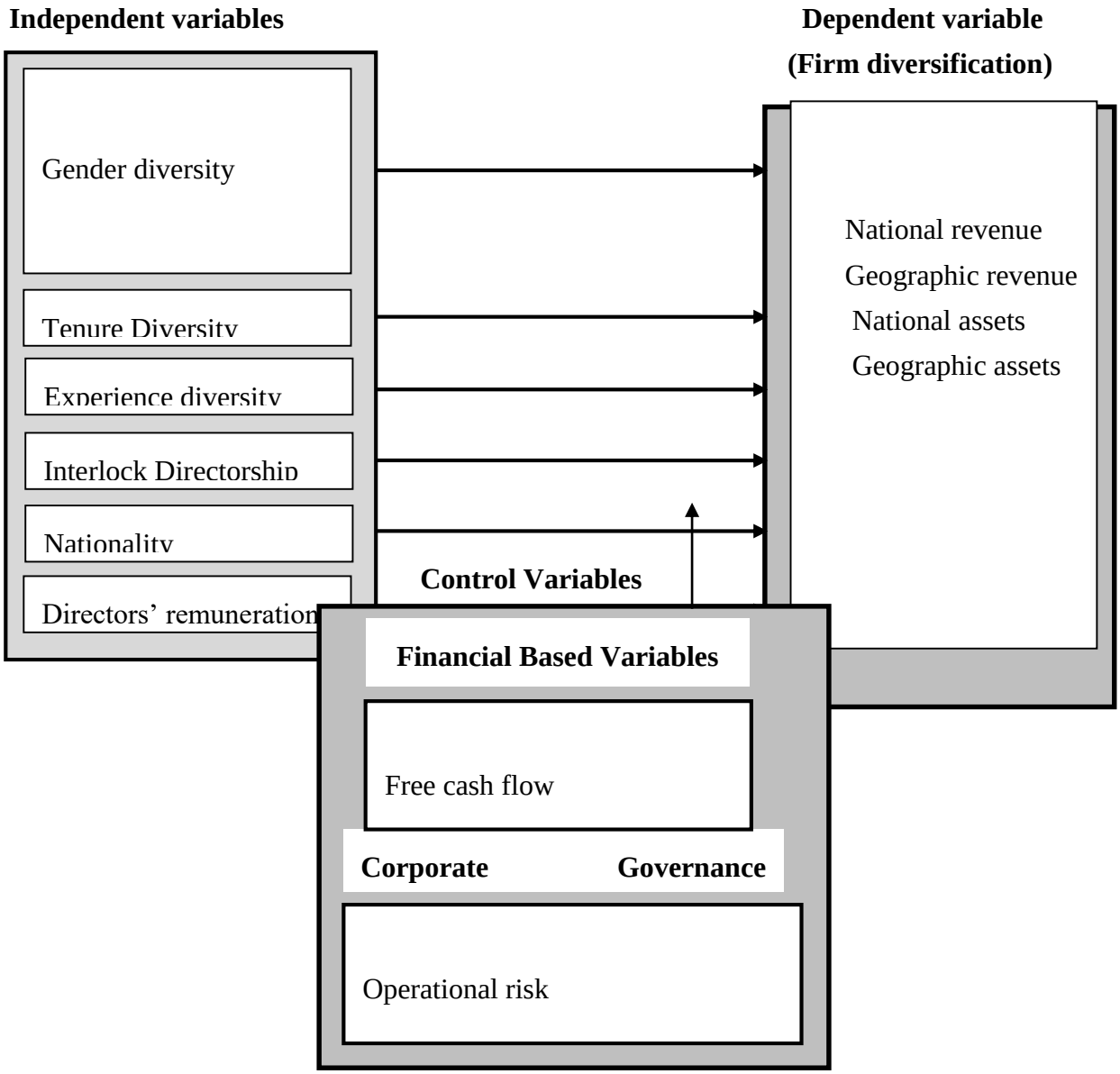

Figure 2.1: Conceptual Framework

Source: Researcher's Own Conceptualization, (2016)

This study conceptualized that board characteristics influences firm diversification among listed firms on NSE, Kenya. The literature reviewed guided on the selection of independent and dependant variables. Researcher hypothesizes on each of the characteristics pointing out expected relationship as summarized in table 2. Firm size, leverage ,free cash flows were used as indirect measures of firms ability to pursue diversification, while operational risk was used to measure board of directors attitude to words risk

2.2 Variables measurement

Geographic diversification was therefore proxied as reported foreign sales out of the total sales (FTS). The foreign sales were those traceable directly to multiple lines of products or segments outside Kenya (Wan 1998; Lin *et al*., 2005).

Gender diversity was measured as the number of female board members (Mishra and Shital 2012, Fanto, *et al.*, 2011). Tenure diversity was measured as the length of stay of the various board members with the firm. The difference between maximum and minimum stay was considered for analysis (Keck, 1997; Mishra and Shital, 2012). Experience characteristic was analysed as proportional board members with international orientation to total number of board members (Lee and Farh, 2004). Nationality diversity was analysed as the number of countries represented on the board (Marimuthu and Kolandaisamy, 2009; Hassan *et al.*, 2006 and Pitts, 2005). Interlock board diversity was measured as the number of board of directors serving on more than one board of the listed firms (Hendry and Kiel, 2004; Fich and Shivdasani, 2006). Firm Operational risk was proxied by the ratio of operating costs to operating income (Bank for International Settlements, 2001).

The control variables for the research were categorized into two. The first category consisted of firm based financial characteristics that included; firm size measured as logarithm of sales, (RamaSwamy, *et al*.,2002), free cash flow was measured as a ratio of current assets to total assets, Leverage measured as a ratio of debt to total assets (indicator of solvency level, Ryan, 2013). The control variables were indirect measures of the firms' ability to undertake diversification.

3.0 Research Design

Longitudinal design was used in the study due to its power in tracking changes over time and relating them to variables that might explain why the changes occur. It is capable describing patterns of change and help establish the direction and magnitude of causal relationships and as well as the prediction of future outcomes based upon earlier. The study targeted a sample of 18 listed firms on NSE under category of Commercial and Services and Manufacturing sectors. Complete information was available on 13 firms for the period 2004 to 2014 bringing a total of 130 observations. The selected sectors consisted of firms that had both local and foreign operations with diverse lines of products or services, largest investments in assets, high sales sufficient information on end-of- financial year common equity, total debt, total sales, assets and liabilities, and information relating to board of directors gender, experience, tenure, Nationality, interlock boards functionality and directors' remuneration.

3.1 Selection of Estimation Method

Having confirmed the presence of unit roots, the previous research and utilizing Hadri (2000) a residual-based Lagrange multiplier (LM), generalised least squares (GLS) fixed effect and random effects was found suitable for the data. GLS has the advantage of powerful assumptions about homoskedasticity and no serial correlation that is common in Pooled Ordinary Least Squares (Wooldridge, 2012, 2002 and Ujunwa *et al.*, 2012). GLS assumes that regression parameters do not change over time and do not differ between various cross sectional units, thereby enhancing the reliability of coefficients estimates (Gaur & Gaur, 2006).

Following Hadri (2000) and SPPS test, the regression model was derived from the following procedure following two equations:

$$Y_{it} = R_{it} + \varepsilon_{it} \quad i = 1,2,\ldots,N;\ t = 1,2\ldots,T \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots \ (1.1)$$

And

$$Y_{it} \ R_{it} + \beta_i t + \varepsilon_{it} \quad i = 1,2,\ldots,N;\ t = 1,2\ldots,T \ \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (1.2)$$

Where $R_{it} = R_{i,t-1} + \mu_{it}$ is a random walk $\varepsilon_{it} \sim IIND(0,\sigma_\varepsilon^2)$ and $\mu_{it} \sim IIND(0,\sigma_\mu^2)$ are mutually independent normal that are *IID* across *i* and over *t*. Back substitution was used to get the following model that was estimated;

$$Y_{it} = R_{i0} + \beta_i t + \sum_{s=1}^{t} \mu_{is} + \varepsilon_{it} = R_{io} + \beta_i t + \upsilon_{it} \ \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots \ (1.3)$$

Where $\upsilon_{it} = \sum_{s=1}^{t} \mu_{is} + \varepsilon_{it}$. The stationarity hypothesis was $H_0 : \sigma_\mu^2 = 0$ in which $\upsilon_{it} = \varepsilon_{it}$ The LM statistic given by

$$LM_1 = \frac{1}{N}\left(\sum_{i=1}^{N} \frac{1}{T^2} \sum_{t=1}^{T} S_{it}^2 \right) / \hat{\sigma}_\varepsilon^2 \ \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots \ (1.4)$$

Where $S_{it} = \sum_{s=1}^{t} \hat{\varepsilon}_{is}$ were the partial sum of OLS residuals $\hat{\varepsilon}_{is}$ from equation (1.4) and $\hat{\varepsilon}_\varepsilon^2$ is a consistent estimate of σ_ε^2 under the null hypothesis H_0 (Greene, 2012). A possible candidate is;

$$\hat{\sigma}_\varepsilon^2 = \frac{1}{NT} \sum_{i=1}^{N} \sum_{t=1}^{T} \hat{\varepsilon}_{it}^2 \ \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots \ (1.5)$$

.

To allow for Heteroscedasticity the procedure that was suggested by Hadri (2000) was used. The alternative Lagrange multiplier (LM) test that allowed for heteroskesdacity across *i*, for instance $\sigma_{\varepsilon i}^2$ was as follows:

$$LM_2 = \frac{1}{N}\left(\sum_{i=1}^{N} \left(\frac{1}{T^2} \sum_{t=1}^{T} S_{it}^2 / \hat{\sigma}_{\varepsilon i}^2 \right) \right) \ \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots \ (1.6)$$

The test statistic was given by $Z = \sqrt{N(LM - \xi_1)/\zeta}$ and is asymptotically distributed as $N(0,1)$ where $\xi = 1/6$ and $\zeta = 1/45$ if the model only includes a constant and $\xi = 1/15$ and $\zeta = 11/6300$ otherwise (Wooldridge, 2012, Newey and West, 1994).

In order to fit the parameters used to explain the dependent variable and with appropriate transformations, equations 1.7 and 1.8 were finally used on static and dynamic panels respectively.

$$Y_{1it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \beta_4 X_{4it} + \beta_5 X_{5it} + \beta_6 X_{6it} + \beta_7 X_{7it} + \beta_8 X_{8it} + \beta_9 X_{9it} + \beta_{10} X_{10it} + \varepsilon_{it} \quad \text{.....(1.7)}$$

$$Y_{2it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \beta_4 X_{4it} + \beta_5 X_{5it} + \beta_6 X_{6it} + \beta_7 X_{7it} + \beta_8 X_{8it} + \beta_9 X_{9it} + \beta_{10} X_{10it} + \varepsilon_{it} \quad \text{.....(1.8)}$$

3.2 Linear Regression Analysis

To test the specific hypotheses, this study used multivariate regression analysis (Feasible Generalized Least Squares fixed effect method) in order to isolate the main effects of the corporate governance mechanisms on firm diversification at the same time independently assess how each of the independent variable influence the dependent variable. This method has been previously used by Kayo and Kimura (2010; Ujunwa, *et al.*, 2012). Feasible Generalized Least Squares fixed effect method was used to test the hypotheses of the study.

$$Y_{1it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \beta_4 X_{4it} + \beta_5 X_{5it} + \beta_6 X_{6it} + \beta_7 X_{7it} + \beta_8 X_{8it} + \beta_9 X_{9it} + \beta_{10} X_{10it} + \varepsilon_{it} \quad \text{.....(3.13}a\text{)}$$

Where Y_{1it} is diversification due to geographical sales proxied as sales generated from different regions and other countries in static state (static state). X_{1it} is the number of female members on the board, X_{2it} is the length of stay of a director on the board measured as maximum duration minus minimum duration, X_{3it} is the number of directors on the board with international orientation in terms of management, X_{4it} is interlock directorship measured as the number of board of directors serving on more than one board either intra or extra industry, X_{5it} is nationality which was treated as the number of countries represented by the board members, X_{6it} is free cash flow measured as the ratio of current assets to total assets, X_{7it} is operational risk proxied by the ratio of operational costs to operational income, X_{8it} was directors' remuneration measured as the total amount paid to directors in form of fees, X_{9it} was the size of the firm as logarithm of sales, X_{10it} was leverage measured as ratio of debt to equity and ε was stochastic error term assumed to be a white noise process, t was time trend(current, Static). i was cross-sectional units.

4.0 Panel Unit Root Tests

The next step of the analysis was testing for unit root. This was done to determine stationarity of the time series variables because regressing non stationary time series gives spurious regression results. The results for panel unit root tests indicated that there was unit root on tenure diversity, experience, free cash flows, and operating risk by both fisher and Levin-Lin-Chu tests. The results also revealed that there was conflicting evidence for unit root between Fisher and Levin-Lin-Chu panel unit root tests for interlock directorship, nationality, directors' remuneration, leverage and

geographic sales. These conflicting results were resolved by use of Hadri Lagrangian Multiplier test utilizing both Swamy-Arora and Nerloves' transformations. The results of LM test gave evidence of unit root for all variables (see Museve *et al*., 2016, Table 4.3).

4.1 Model Selection

Having confirmed the presence of unit root, selection of feasible model for estimation was done. This was accomplished by use of Hadri Lagrangian Multiplier test and results are presented in table 4.4. The results showed that there was homogeneity, heterogeneity and serial dependence across the panels. In such cases, the appropriate model for estimation was Feasible Generalised Least Squares (FGLS). FGLS was preferred due to its powerful assumptions about homoskedasticity and no serial correlation that is common in Pooled Ordinary Least Squares (Wooldridge, 2012 and Ujunwa *et al.,* 2012) and assumes that regression parameters do not change over time and do not differ between various cross sectional units, thereby enhancing the reliability of coefficients estimates (Gaur and Gaur,2006). Therefore, random and fixed effects model were fitted to the data with appropriate transformations. Both Akaike and Bayesian Information criteria were used to identify the goodness of fit of the model with their Loglikelihood with values > 30 indicating the power of the statistics. Homogeneity implied that there was some uniformity among some panels while heterogeneity meant that significant differences existed among some panel. Serial dependence showed close dependencies among the panels. Hence Bartlett kernel test was used to test for homogeneity. See Table 4.4 Results of Hadri Lagrangian Multiplier Panel Data Unit Root Test, Swamy- Arora Transformation (Museve *et al*., 2016)

4.2 Regression Results for Geographic Sales - Static Panels

The results of the regression analysis for geographic sales are presented in table 4.6. The regression results indicated that R^2 was 0.5719 indicating that the independent variables in the regression model explained 57% of the variation in the dependent variable. The F-Statistic was also significant (p – value 0.0000 < 0.05) indicating that all the variables included jointly explained the variation in the dependent variable. The study established the relationship between interlock directorship and geographic diversification as positive and significant (p – value 0.0327 < 0.05). This inferred that the BOD provides critical resources to the firm in terms of advice, legitimacy and counsel regarding opportunities available in regional and foreign markets in addition to community influential, government interconnections and access to distribution network. The findings upheld the use of the RBV Theory of the firm as used previously by Hillman and Dalziel (2003) and Fama and Jensen (1983).

Directors' remuneration was found to have a negative and significant effect on firm's geographic sales with (p – value 0.0464 < 0.05). These results implied that managers undertake geographic diversification not in the interest of the shareholders but rather than in their own interest especially diversifying their employment risks, generation of personal gains and self-aggrandizement. These results mirror the findings of Stulz (1990), Levin (2007), and Villalonga (2004). This finding confirmed Agency Theory for the selected firms' listed on Nairobi Securities Exchange. Interestingly, it was noted that operational risk negatively varied with geographic sales with (p – value 0.0003 < 0.05).

Table 4.6: Regression results for Geographical Sales-Static Panel

Model 8: Fixed-effects, using 130 observations: Included 13 cross-sectional units: Time-series length = 10; Dependent variable: Geographical Sales-Static Panel

Variable	*Coefficient*	*Std. Error*	*t-ratio*	*p-value*	
Constant	−9.89662e+06	2.54402e+07	−0.3890	0.6980	
Gender	−437787	960068	−0.4560	0.6493	
Tenure diversity	−102214	163811	−0.6240	0.5340	
Experience	394271	465295	0.8474	0.3987	
Interlock director	1.25709e+06	580994	2.1637	0.0327	**
Nationality	−9429.7	1.6282e+06	−0.0058	0.9954	
Free cash flow	−1.29913e+06	1.70394e+06	−0.7624	0.4475	
Operation risk	−524509	138545	−3.7858	0.0003	***
Remuneration	−17.2243	8.54589	−2.0155	0.0464	**
Size	516362	1.69272e+06	0.3050	0.7609	
Leverage	1163.8	17703.2	0.0657	0.9477	

Mean dependent variance	3535584	S.D. dependent variance	9565137
Sum squared residual	5.05e+15	S.E. of regression	6871467
LSDV R-squared	0.571934	Within R-squared	0.201670
LSDV F(22, 107)	6.498251	P-value(F)	1.16e-11
Log-likelihood	−2218.382	Akaike criterion	4482.763
Schwarz criterion	4548.717	Hannan-Quinn	4509.562
Rho	0.080091	Durbin-Watson	1.756131

Joint test on named regressors - Test statistic: F (10, 107) = 2.70297; with p-value = P (F (10, 107) > 2.70297) = 0.00539154; Test for differing group intercepts - Null hypothesis: The groups have a common intercept Test statistic: F (12, 107) = 5.1392; with p-value = P(F(12, 107) > 5.1392) = 9.84653e-007 (***) Significant at 1% (**) Significant at 5%

Source: Author's Computation, 2016

Results disclosed that Board interlock directorship diversity had positive and significant effect on the firms' geographic sales (p – value 0.0327 < 0.05). The results showed that a unit increase in board interlock participation, increased geographic sales by 2.1637 units. This was an indication that directors who participate in more than one board bring in vast experience particularly on financial management, product market resource network, consumer tastes and improved decision making. Further, this analysis imply that board interlock diversity provide a critical proxy for

cognitive base that provides guidance to board members when implementing diversification in selected firms' hence justifying RBV Theory of the firm.

5.1 Summary of Findings

The major objective of the study was to determine the relationship between board characteristics and firm financial diversification in commercial and manufacturing firms listed on the Nairobi Securities Exchange, Kenya. This research revealed that board characteristics continue to have different outcomes on firms' financial diversification. This finding supports prior studies of Pearce *et al.,* (2000), Laeven and Levine, (2007), Lukers *et al.,* (2009), Jackling and Johl (2009), and Stephen *et al.,* (2010), Pierre (2010), Bear *et al.,* (2012), Shital and Mishra (2012) but depart from them on the basis of variables involved in the modelling, and nature of methodology adopted for analysis (static and dynamic panel regressions). Firm size, leverage, free cash flow and operational risk cannot be ignored as the firms pursue diversification since they act as indirect measure of firms' capacity to undertake diversification.

Diversity among the board members hence affirmed the use of RBV of the firm and the Upper Echelon Theory. The boards of the sampled firms were noted to have lower agency problems since excess cash was prudently invested in assets and generated sufficient sales outside the country. Skilled and experienced boards ensured that firms diversification processes were cost friendly as proxied by the operational risk. Operating risk influence was noted to be a factor considered critically by the boards as it influenced geographic sales. These results implied that managers undertake geographic diversification not in the interest of the shareholders but rather than in their own interest especially diversifying their employment risks, generation of personal gains and self-aggrandizement. This finding confirmed Agency Theory for the selected firms' listed on Nairobi Securities Exchange.

The research noted that cross board's membership appeared to be linking the sampled firms to geographic business environments as evidenced by the results of static panel regressions on sales. This finding implies that such board members have access to distribution channel, have a better understanding of sectors regulations and can effectively mitigate the risk posed by Multinational Corporations.

5.2 Recommendations

The study findings add to the inconclusive findings of previous studies on the relationship between board demographics and various outcomes of firm performance. However, the findings have implications both to theory and practice of management in the following way:

5.2.1 Implication to Theory

The results provide support for the RBV, Upper echelon theory, Agency theory, and free cash flow hypothesis on firm geographic diversification. The board of directors provide a set of skills, expertise and knowledge that together with firm resources creates synergy and competitive advantage for the investment within and outside the country. Further, the results revealed that geographic diversification is associated with agency conflict and provide a platform through which managers diversify employment and increase chances of rent extraction. The attitude of the board of directors towards risk as they increase the scope of the firm geographically based on their observable characteristics' and cognitive skills validated the use of Upper Echelon Theory.

Operational risk predominantly used in financial institutions was used to proxy risk in commercial and manufacturing sectors evident by the interaction effect with study variables. This study affirmed that besides the convectional measures of firm financial performance, board demographics cannot be underscored.

5.2.2 Implication to Practice and policy

There is need for legislation of laws or regulation imposing interlock directors on boards in both public and private sector firms. The presence of interlock directors is positively related with firm reputation, has lower agency costs and links the firm to foreign markets. This should be done both in short and long run as part of the system-wide adjustments to develop strengthens the efficacy of boards of listed firms.

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APPENDEX I: Economic Outlook

Table 1: World Economic Outlook Update

OUTPUT INDICATORS					Difference from April 2014 WEO projections	
Real GDP Growth (%)	**2012**	**2013**	**2014e**	**2015f**	**2014**	**2015**
World Output	3.5	3.2	3.4	4.0	-0.3	0.0
Advanced Economies	1.4	1.3	1.8	2.4	-0.4	0.1
Euro Area	-0.7	-0.4	1.1	1.5	0.0	0.1
Japan	1.4	1.5	1.6	1.1	0.3	0.1
United States	2.8	1.9	1.7	3.0	-1.1	0.1
Emerging & Developing Countries	5.1	4.7	4.6	5.2	-0.2	-0.1
China	7.7	7.7	7.4	7.1	-0.2	-0.2
Russia	3.4	1.3	0.2	1.0	-1.1	-1.3
Brazil	1.0	2.5	1.3	2.0	-0.6	-0.6
MENA, Afghanistan, Pakistan	4.9	2.5	3.1	4.8	-0.2	0.2