AN INVESTIGATION INTO WHETHER THE DEMERGER OF COFFEE MARKETING SOCIETIES HAVE CREATED OR ERODED OWNERS WEALTH IN PARTS OF CENTRAL PROVINCE OF KENYA

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DECLARATION

This Project is my original work and has not been submitted for a degree in any other university

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Lastly, to all my friends and all those people who in one way or another contributed to the success of this project.

DEDICATION

To my parents, Peter & Hanna Njenga, my wife Margaret Kigo and our children

ABSTRACT

This study aimed at establishing whether there existed any benefit or erosion of wealth in demerging co-operative societies in Thika, Maragwa and Murang'a Districts of Central Kenya. The practise had spread like a bush fire despite the advise the societies were given by Government and professionals. In the contrary worldwide merger of institutions and nations into economic blocks had proved optimal.

To achieve the objective, the researcher set out to establish reasons given for their action by perusing through minutes and reports produced by the members at their Annual General Meetings, liquidation reports and audited financial statements 2 years before and after the split.

A population of 12 societies in each category of merged and demerged society was established out of which 6 of each group was sampled. To avoid biasness the smallest and the largest in each district was picked.

The information was then presented in tables, bar charts and line graph before being statistically analysed.

The study concluded that in almost every aspect, from cost savings, higher sales and even payment to members, there was no advantage in splitting the societies.

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CHAPTER ONE

INTRODUCTION

1.0. Background Information

Kenya, is located along the Equator on the East Coast of Africa. Only about 20% of her land is suitable for cultivation, with majority of Kenyans being farmers who produce crop mainly for their own needs. Agriculture contributes immensely to the general economy of Kenya. According to the Kenya Quarterly Economic Survey (January – March 2002), agriculture contributed 25% of the Gross Domestic Product and employed 80% of Kenya's labour force.

Coffee, a major cash crop in Central Kenya, is grown in large plantations previously owned by white settlers in the colonial era but africanised upon attainment of independence in 1963. Some of the plantations were purchased by land buying companies owned by local groups of investors, while some were purchased by African individuals or family businesses.

Coffee is a foreign crop, which was introduced by the colonial government. It was illegal for the indigenous African farmer to grow coffee during the colonial era. The major type of coffee grown in Kenya is Arabica. It does well in the highlands East of the Rift Valley, especially in the Central Region of Kenya. It also thrives in lowland areas neighbouring the said highlands, where rainfall is sufficient.

As part of the poverty eradication programmes, especially after independence, the crop was introduced in small scale production by individual farmers. Factories were built to semi process the coffee berries. The pulped coffee beans, once dried are ready for further processing by the Kenya Planters Co-operative Union Limited (K. P. C. U. Ltd.) . In the early 1990s the milling sector was liberalized leading to the establishment of individual milling plants such as the Thika Coffee Mills and the Socfina Limited. To market the milled coffee, the government created social organizations called Coffee Marketing Co-operative Societies and a law to govern them was enacted by the independent Kenya Government in 1966, referred to as the Co-operative Societies Act (Chapter 490 of the Laws of Kenya) to replace the Colonial Ordinance.

Several factories in a given region, for example a division, formed a single society. The societies' major role is to collect the raw coffee beans, pulp and dry them and grade them into clean coffee of various grades (referred to as Grade 1, Grade 11 and 111). They are then packed in separate bags for delivery to the millers. The societies pay all the costs to run the factories, transport the beans and even semi process the product. Charges payable to the millers are recovered by the monopolistic marketing agent, the Coffee Board of Kenya. The balance of the produce would be remitted to the societies which recover their working capital costs and then distribute the remaining amount to the cooperators on the basis of their cherry deliveries (usually on a prorata basis based on the amount per kilogram of the delivered product).

Over the years, the societies built many other factories in strategic positions under the same management and the institutions grew in size and capacity. The societies, working under the support of the government through the Coffee Research Foundation, have continuously promoted the development of the crop. Coffee therefore thrived as the main cash crop in Central Region of Kenya and marketing societies have grown to market the product thereby becoming contributors to the improved standards of living of the people of this region.

Recently in the 1990s, acting within the provisions of the laws of Kenya, most of the societies embarked on splitting their institutions into small units (demerger). The first society to be demerged was Kagima F. C. S. Limited in Muranga District, which split into five new societies. Thereafter Gatukuyu Coffee Growers Co-operative Society

Limited was split into 4 new ones. The new practice spread like a bush fire and several other societies followed suit.

In contrast to this move by coffee societies, the popular trend is that of organisations worldwide merging, which practice is also being adopted by some Kenyan firms. Recent organizations that have merged or entered into joint ventures include:-

(i) the Central Bank of Kenya facilitating the merging of various non-performing banks in the early 1990s to form the Consolidated Bank of Kenya,

(ii) the merger of Ambank Limited with National Industrial Credit Bank Limited,

(iii) Pricewaterhouse merging with Coopers & Lybrand to form Pricewaterhouse Coopers,

(iv) Merger of Coca cola with Dr. Pepper in the U.S.A,

(v) the merger of B.P. Shell and Agip Kenya Limited,

(vi) the merger of Kenol – Kobil and Mid-Oil Africa,

(vii) the joint venture of Kenya Airways and KLM, Kenya Airways and Uganda, Airlines, Kenya Airways and Air Malawi, and

(viii) the 25 billion USD merger between Hewlett Packard and Compaq Computer companies in the U.S.A,

Organisations, worldwide, are coming together to form a united front to tackle an obstruction, to achieve a common goal, or even to undertake particular assignments. This is not the case with coffee marketing societies in Kenya. A turn of events has commenced the split of coffee marketing societies into smaller units. It is the factors that have lead to this turn of events, and the extent to which this reversal has achieved the basic aim of these institutions by ignoring mergers and going for demergers that this research will address.

1.I. The statement of the research problem

Kenya's economy largely depends on agriculture, which for many years has been a major employer, especially in the rural areas. Various food crops such as maize, beans, bananas, potatoes, cabbages and oranges are grown alongside cash crops such as coffee, tea, pyrethrum, cotton and sisal. Food crops are in most cases grown for subsistence as well as for commercial purposes. Cash crops on the other hand are grown for export, usually after being semi processed. One such crop is coffee, which for many years has been rated among the top major export earners in this country.

Coffee in most parts of Central Kenya is grown on small scale. Modern agricultural techniques such as irrigation have not been applied due to cost constraints. Mostly, labour intensive techniques are used to husbandry the crop as well as harvest it. Productivity depends on weather patterns and labour availability at time of husbandry and harvest.

Farm inputs such as fertilizers, pesticides and herbicides are imported. Individual farmers are not able to solicit such inputs due to their meagre requirement of such inputs and the high costs associated with importing these products individually. The marketing of the product by individual farmer would be costly. Farmers would be required to construct their own factories, semi-process the coffee, ship the semi-processed product to foreign markets, auction their product and collect their sales proceeds individually.

To overcome these many hindering factors, the Government through Sessional Paper No. 10 of 1965, embarked on the creation of institutions to facilitate availability of inputs and marketing of products. Coffee factories were built and coffee marketing societies created by merging a convenient number of such factories in various administrative regions.

Merging of institutions, enterprises and even nations appears to be the order of the day. The opening up of the Berlin Wall that facilitated East and West Germany to form one nation, the formation of the European Union to bring European powers together, the formation of Comesa region, the G8 Agenda, the North Atlantic Trade Organisation (NATO), the revival of the East African Community, the mergers of Coca Cola and Dr. Pepper, B.P. Shell and Agip Kenya Limited, Kenol – Kobi and Mid-Oil Africa, Pricewaterhouse and Coopers and Lybrand, Hewlett Packard and Compaq Computer companies, SmithKline Beecham and Glaxco Wellcome are but a few examples.

In contrast to such global strategies the 1990s saw coffee marketing societies splitting into smaller units. Many societies have embarked on demerger programmes, in spite of the advantages associated with mergers.

1.2 Objectives of the study

(i) To identify the factors that have influenced coffee marketing societies to demerge.

(ii) To determine whether such demergers have eroded or increased owner's wealth.

1.3 Importance of the study

(i) To the farmer

An investigation into the demerger phenomenon that faced coffee farmers in such a wide region may assist in formulating appropriate policies for the better performance of the sector. Farmers who are the chief authority must resolve at the annual general meeting on such matters as merger or demerger. They can be guided by the study in their decision making process. The study therefore adds to the body of knowledge to form the basis of demerger decisions.

(ii) To legal experts

The laws of Kenya are subject to review by parliamentary amendments depending on changing circumstances. The 1966 Co-operative Societies Act was amended in 1997. Usually, legal experts and the office of the Attorney General consult in cases of such changes. The results of provisions for voluntary liquidation resulting to de-merger could be quantified in a real world situation. This study may therefore be a reference especially at this time when the Constitution of Kenya and its constituent Acts are being reviewed.

(iii) To political leaders and policy makers

Political leaders from coffee growing areas have been meeting in various forums to map out the way out strategies for the declining coffee sector. The study may provide insight into the possible way forward for such societies.

(iv) To scholars and researchers

David Hirshleifer in a study of mergers and acquisition, among other scholars, reviewed the strategic and information issues on mergers. A study of demerger should be triggered to add to the existing body of knowledge. Therefore, these actions which have financial implications should not be left out in academic records as a source of knowledge, and for future references by researchers.

Most of the researches done have concentrated on mergers, acquisition and takeovers in public companies, with not much being done on demergers of unquoted companies (such as the case of coffee marketing societies). An insight to such situations may be achieved by the study.

CHAPTER TWO

LITERATURE REVIEW

2.1. INTRODUCTION

A merger is a transaction that combines two firms leaving one surviving entity. An acquisition is the purchase of one firm by another. Both actions are seen as takeovers or mergers.

According to a study by David Hershleifer, takeovers or mergers play constructive economic roles, such as removing inefficient management or achieving economies of scale or complementarities. Mergers can also have the less desirable effect of re-distributing wealth by exploiting tax benefits or expropriating stakeholders. They may also counter efficiency if mergers reflect agency problems in cases of bidding managers or simply by misjudgment in the case of several conflicting interests by the various parties thereon.

EMPIRICAL RESEARCHES

In his empirical synopsis, Hershleifer observed that, on average, target shareholders earn large positive abnormal returns while returns of bidding shareholders are close to zero. For example, in Western, Chung & Hoag (1990) there were high target returns while in Nathan & O'Keefe (1989) successful premia for cash tender takeovers rose form 41% to 75% in the 1963 – 1973 and 1994 – 1985 periods.

He made some of the following propositions:-

(i) Under complete information, the bidders' profit in conditional unrestricted offers is $DV + (1-\alpha)\ v - c$

Where

(i) dv = improvement in value of bidders initial shareholdings

(ii) $(1 - \alpha)$ $(v - c)$= profit on the share purchase in the tender offer

In the case of coffee marketing societies, the value gained can only be measured by what the owners take home since the shares are unquoted and are only a vehicle by the members to be enjoined together to market their produce. The value before demergers can be compared with value at the time when the society remains merged.

The information is asymmetric to all at all times due to lack of perfect markets. It is the reverse value of these two conditions that is being compared under these circumstances, that is:-

(a) Under complete information, if a bidder's initial shareholding in the target and dilution opportunities is sufficiently small, then a conditional unrestricted tender is unprofitable.

In this case of coffee marketing societies, if the members' wealth as measured by the percentage of his product sale is diluted by being in the new firm, then such an action is unprofitable. Since the major aim of venturing into any business is to maximize wealth, it would be advisable to drop demerging decision.

(b) Under asymmetric information, an equilibrium in which a bidder pays a price equal to expected post merger value, the gain is positive and negative if vice versa.

If the payment to member as a percentage of product sale is higher before than, after demerger, then loss in wealth occurs and if vice versa gain is realised. It is this measure of demerger and its impact on shareholders' wealth that the research undertakes.

(c) The revelation of information of bids

This is not relevant to the study since no actual bids occur but demerger is by voting in an Annual General Meeting. Management defensive strategy to block demergers would be illegal and not possible once a resolution by the two-thirds majority has been passed, unlike in case of takeover bids.

Further, there is no value reduction strategy by increasing or decreasing importance of publicly known information relative to that privately known by bidders. This can only be obtained when scholars postmortemize demerger decision thus making the study a reference for future mergers or demergers. This study triggers further research in this field.

(d) In the proposition, there is absence of complete information and management defensive strategy thus, the minimum value required to shift control supercedes the value obtained. There exists strong Nash equilibrium in which the offer value is just above zero and receives just enough to transfer control.

The basic aim of marketing societies is to control the operations and assets of the organisation. Value *perse* may not be considered initially but in future. Some coffee marketing societies cover a wide geographical region making many members feel they have lost control. Agency problem may thus arise. The decision to demerge may thus ignore value. The research will capture possible existence of such situations.

In his conclusion, Hershleifer found out that:-

(i) There exists free rider problem in tender offers when an individual shareholder does not take into account that, by tendering his share to the bidder (thus merger occurs), there is an increase in the expected wealth of the other shareholder and vice-versa.

In coffee marketing societies there are various stakeholders such as members, the management, millers, marketers, the Government, etc who are all involved in the decision to demerge or merge. The information available before such a decision is made is assymetric due to non-quotation of the firm and the futuristic nature of the decision.

(ii) Existence of noise on likelihood of shareholders being pivotal. It was conjured that this degree of coordination may not be possible when plausible noise is added in form of a fraction of shareholders who are influenced by cost benefit not observed by others. In these societies, this is the difference in opinion that necessitates voting and a two-thirds majority is required in order to decide to remain merged or demerged. Thus, there remains reason to expect that the free rider problem will be effective.

(iii) There exists means by which value improving bidders can profit in a tender offer despite the free rider problem.

(iv) Adverse selection amongst targets due to information possessed by targets who accept offers that are too generous and reject stingy ones.

(v) There exists offer success and information superiority of the bidder

(vi) There exists communication and structuring offers

(vii) There is an ambiguous nature and effect of managerial defensive strategies

(viii) Management voting right is a takeover defense.

(ix) Effect of target capital structure and managerial voting powers are influenced by target capital structure and voting powers.

(x) There are other uses of capital structure as a device for strategic positioning

This research is directed towards establishing the relevance of this study to the finding of Hirsleifer.

2.2. Benefits of mergers as viewed by other scholars

J. F. Weston in his article " Brief History of Finance Ideas" explains the following as some of the benefits of mergers

(i) Efficiency explanation

This involves the performance of incumbent management or achieving some forms of synergy. Weston views efficiency explanation as a potential for social benefit where superior management of the acquired company improves efficiency in operations. When factories are merged into a large marketing society, efficient management in one factory can be used to improve on the performance of the others. When demerged, such managers would have to be hired, duplicating expensive resources.

(ii) Operating Synergy

This refers to better utilization of capacity after the merger by complementing organizational capability, resulting in gains not readily available internally in the short run. In vertical mergers, communication is efficient. Financial synergy occurs when cost of capital is lowered if the cash flow streams are not perfectly correlated and corporate failure probabilities are lower resulting in avoided cost of such failure.

Since marketing societies are spread over a wide region it is possible that one area may have bumper harvest while the other suffers a slump. The society as a whole would remain stable since surplus from the boom factories offsets deficit from the badly affected ones. When many organizations are merged, stable assets and revenues would make credit rating favourable thus access of funds for growth and development is easily and cheaply obtained.

(iii) Strategic realignment to changing environment

This is the issue of strategic planning to position firms to utilize unused capacities in the existing managerial capabilities. It also involves the issue of new markets penetration and development aimed at maximising shareholders' wealth. In the case of marketing societies there are savings in fixed costs. In demergers, each factory employs its committee, managers and professionals thus duplicating resources and eroding shareholders' wealth. A merger can therefore be a strategy to reduce cost.

(iv) Information and signaling hypothesis

This refers to high valuation of firms due to the new information released in merger negotiations, if positively interpreted by investors. In demergers, those not in favour will lose confidence in the organization and may even withdraw their investments in the organization.

Other benefits include:-

(i) Dealing with agency problem

According to a study done by Michael C. Jensen and William H. Meckling entitled *"Theory of the firm, management behaviour, agency cost and ownership structure,"* agency problem is described as that arising due to separation of ownership shares. Agents work less hard, they demand more perquisites, pursue short-term profits and power goals. According to the authors, one of the solutions to this problem is merger activity.

Managerialism theory argues that agency problem is not solved by market for managers but that merger activity is a manifestation of the agency problem of inefficient external investment by managers. In co-operative societies there is total separation of ownership and control and therefore agency problem is a major issue that needs to be dealt with if these organisations are to meet their objectives.

They defined agency cost as the sum of:-

(i) Monitoring expenditure by the principal who in this case are the equity holders;

(ii) The bonding expenditure by the agents such as liquidators;

(iii) The residual loss which is the reduction in welfare experienced by the principal due to divergence of interest among the other stakeholders.

Some of the basic assumptions relevant to our study are:-

(i) No taxes;

(ii) No credits;

(iii) Size of the firm is fixed;

(iv) Existing manager (for example the liquidator) has ownership interest in the firm (obviously his fee);

(v) No debt financing – Firms under liquidation do not qualify to borrow;

(vi) No complex financial claim for example convertible bonds or preferred stock is issued (since the societies are legally liquidated);

(vii) No outside owners gain utility from ownership in any way other than through its effect on their wealth or cashflow;

(viii) Only one production – financing decision can be made by entrepreneurs; and

(ix) Manager (for example liquidator's) wages are held constant throughout the analysis.

They basically observed the following:-

(i) The value of the firm and the level of non-pecuniary benefits consumed represent the owners' indifference curve between wealth and non-pecuniary benefits. In the case of demergers, this refers to the erosion of wealth and value and denotes owners appreciation of the decision. Firms that remain merged avoid this cost but at what gain? This is what the research is all about. Non-pecuniary cost will include fees for liquidator, lawyers, valuers, engineers e.t.c.

(ii) There exists an optimal level where wealth is created by incurrence of bonding and monitoring costs where certain levels of these activities will satisfy conditions of efficiency (Pareto optimality). By comparing value created or eroded by demerger decision and extending significant tests, the case of optimality can be established in coffee marketing societies.

Jensen and Meckling concluded that huge personal wealth is entrusted to agents by contracts and that owners and creditors have not been disappointed by their results despite agency costs inherited in the corporate form. Agency costs are as real as any other cost. In the case study the impact of wealth by this cost is reflected by quantifying owners wealth variation in situation of merge and demerger.

(iii) Market power

Large firms possess market power. The research shall investigate the effect of merged societies and demerged ones in their marketing cost savings under the two states since this translates into owners' wealth creation or erosion.

(iv) Tax consideration

There is better utilization of tax credits where tax losses of one partner offsets tax profits of the other. The impact of accumulated tax losses is investigated in this study.

(v) Incentive alignment

This refers to creation of executive compensation packages to better align managerial incentives with those of shareholders.

In a study by Richard A. Lambert and David F. Larcher entitled "*Executive compensation, Corporate decision making, and shareholders wealth: A review of the evidence*," three kinds of conflict as a result of agency problem were identified as follows:-

(a) Shareholders and managements each striving to maximize their returns;
(b) Their difference in attitude towards risk of potential investment (by extension divestment strategies); and
(c) Time horizon in executive and shareholders evaluation and implementation of decisions.

They suggested compensation "score cards" and contract designs that motivate managers to make expenditure decisions thus capturing risk attitude and time horizons.

In conclusion, Lambert and Larcher found that executives respond predictably to the incentive built into compensation contracts. Available evidence shows a correlation between executive pay and corporate performance.

In the case of coffee marketing societies a merger or demerger decision may have a double edged owner and manager interest. The research will capture agency problem if it exists and the cost of operation as well relative to value created. The effect of executive compensation is however hard to quantify.

(vi) Expansion

A merger has been likened to a marriage between two willing parties after a period of courtship to pool resources or to undertake expensive or risky ventures with the ultimate aim of expanding the business.

With such benefits of merger, why then should firms demerge? Are these benefits relevant to coffee marketing societies?

2.3. Demergers

Demerger is viewed as a form of divesting that emerged in the 1980s in the United Kingdom. In demerger, the divesting company issues shares in the demerged company to its current shareholders usually in proportion to their existing shareholding. Shareholders participating in a demerger will hold shares in two or more separate parts of a unified business. The process involves a return to the principle of investor diversification rather than corporate diversification.

This is the situation in coffee marketing societies where one large unified business is split to two or more new organizations, made of shareholders of the previously unified society. The new societies share the assets and some of the liabilities of the former society in a ratio based on the amount of shares previously held by the members who form the new society. This is obviously a case of shareholder diversification as opposed to corporate diversification.

Demerger may occur in order to free sluggish parts of a business or to hive off sluggish risk component from other activities. It is also to allow the management of demerged firms greater opportunity to control the policy of their own business.

In the case of coffee marketing co-operative societies, the demerged organizations form a new board of management committees that pursue the business of their newly formed society. By so doing, members participate in the management of their organization from a closer range.

Since they pursue the same trade of marketing their produce, the issue of freeing profitable parts of the business from sluggish ones do not occur. They inherit the assets of the original firm hence do not hive off risky components of their business by demerging.

An early example of demerger in the United Kingdom involved the Reliant Motor Company by J. F. Nash in 1981. The reasons given for the demerger were:-

(a) Reliant Motor Company was engaged in business substantially different form Nash activities.

(b) The size of Reliant and its trading results distorted the consolidated profits of the group.

(c) The directors were of the opinion that Nash could no longer make a significant contribution to the development of Reliant Motor Company.

The reasons as to why the societies decided to demerge shall be established as well as the quantifiable economic impact of the decisions.

In any demerger, the value of exchange and the method of settlement are agreed upon as an initial step in the process. In the case of Nash and Reliant, every existing shareholder of Nash got 130 ordinary shares of 5p each in Reliant, for every 100 shares in Nash, to retain.

Demerging is the reverse of merging. The advantages derived by mergers can therefore be construed to be the disadvantages of demerger, that is:-

(i) Inefficiency explanation

By demerging, skills are disintegrated to the many newly formed organization.

(ii) Non operating synergy

This refers to disintegrated communication and duplication of skills and under-utilising of capacities. By demerging there is duplication of manpower because each of the new societies shall employ its own managers, management committees, auditors, lawyers and workers. These officers of the societies may not be fully utilised by the new, smaller societies. The smaller units may as well not be able to engage highly qualified personnel due to cost constraints. As a result, communication between the organisation and the various stakeholders may be distorted.

(iii) Poor financial synergy

Cash flows if correlated are reduced in exposure and amount resulting in high financial cost. If not correlated the benefit of reduced risk is lost and this may result in corporate failure.

(iv) Strategic realignment

Strategic realignment may not be achieved resulting in unused capacity, managerial skill, market skill, and market power.

(v) Information hypothesis

When companies worldwide are merging, a demerger would imply poor decision if interpreted so by the investors.

(vi) Agency problem

Creating new organizations may imply creating new agency problems.

(vii) Loss of market power

Loss of market power may occur, as the formed companies are small separate entities.

(viii) Lost tax benefits

No tax benefit shall occur as no new line of business is created. The same firm is being demerged.

(ix) Disincentive

Small firms will face same fixed cost, hence eroded profits and weak cashflow position and may not be able to pay executives as well as a large entity can.

The study shall explore such issues to see their relevance in the case of coffee marketing co-operative societies demerger.

2.4. Methods of settlement

In his study David Hirshleiner points out that when organisations are demerged, the stakeholders of the firm that is being wound up must be paid off by the company itself, or the acquirer before such actions. In most cases the following parties need to have their dues settled:-

(i) Creditors

The creditors will require to be paid their dues.

(ii) The shareholders

The shareholders will need to be paid the surplus of their assets over liabilities

(iii) The workers

The workers need to be paid their terminal benefits.

(iv) The government

The government will demand payment of the past and final tax liabilities.

Traditionally, the methods of settlement amongst parties in mergers and acquisition have been either by:-

A. Cash generated internally or externally

To be able to pay the various claimants, cash generated from within the organisation by accumulated past earnings can be used. Cash can also be obtained by sale of assets to outsiders. It can also be obtained from the equity holders by requesting them to contribute in cases of deficit. Where a society has been split, the newly formed co-operative societies can:-

(i) Utilise assets allocated to them as collateral to borrow from banks and financial institutions.

(ii) Utilise the funds so obtained to buy assets from the parent company. The parent company in return shall use cash obtained to pay off its liabilities.

B. Fixed interest securities or loan stocks

Where companies have invested in fixed interest securities or loan stocks, such investments can be redeemed within maturity and cash so obtained utilised to pay off the claimants upon demerger. In mergers, the acquiring company can sell its securities or loan stocks to pay off share interest of the company being acquired.

C. New equity capital issued

The newly formed organisations can require its shareholders to buy new shares and the funds obtained from the issue be utilised to pay off their share of liabilities from the parent company in case of demerger. In mergers, shareholders of the acquiring company can buy new shares to settle amounts due to those of the target company. However, a combination of any or all of the above alternatives is possible.

When cash is available, say from past accumulated profit or can be raised from outside, it would not be difficult to use it to acquire the target company. For instance, Nestle had huge cash resources to meet the purchase price of Rowntree in 1988, and Hanson had no difficulty in funding from its resources a significant proportion of Consolidated Goldfield in 1985, both in the United Kingdom. The research shall establish the options coffee marketing co-operative societies have taken to settle stakeholders dues upon demerger.

2.5. Regulation of mergers and takeovers: The legal perspective

In the United Kingdom, the Monopoly and Mergers Commission (MMC) was set up in 1948 with powers to investigate and report monopoly situation. Monopoly was seen to exist when a merged company produced one-third of the supply of particular goods. From 1965, the Board of Trade was to refer prospective or actual mergers to the Mergers Commission if the resulting company was monopolistic.

The City Code of Takeovers and Mergers of 1968 provided a code of behaviour relating to the conduct of takeovers and mergers. It provides the following:-

(i) Right of investors to receive all relevant information to help them form an opinion

(ii) Requirement that communication to shareholders should be done carefully and diligently.

(iii) Require directors and their families to give advice with no personal interest influencing it.

The Kenyan Companies Act (1948) borrows heavily from the U.K. Act. The Co-operative Societies Act again borrows heavily from the Companies Act. It allows two or more co-operative societies to amalgamate as a single society by special resolutions.

A copy of the resolution is required to be sent to creditors and members whose interests in any of the amalgamating society will be affected. Any society not willing to merge has the option to avoid it. On the other hand, any creditor who is affected by the amalgamation is given a chance to demand payment before such action.

If the Registrar of Co-operative Societies consider it reasonable and is satisfied that the secondary resolution to amalgamate the society complies with the statute, he will register the amalgamated society and its by-laws. The amalgamating societies shall be dissolved and their registrations cancelled.

The Co-operative Societies Act also allows societies to demerge or split themselves. A special resolution referred to as preliminary resolution must be passed authorising a co-operative society to be split into two or more units.

The preliminary resolutions should contain proposals for division of assets and liabilities and may prescribe area of operation and specify the members who will constitute each of the new societies. Upon confirming preliminary resolution by a secondary resolution, the Registrar for Co-operative Societies registers the new organisations and the old society is dissolved. The registration of the new entities is sufficient to vest the assets and liabilities of existing society into the new firms as specified in the preliminary resolutions. Thereafter a liquidator is appointed.

Several coffee marketing societies in some parts of Central Kenya have used the legal provisions to split their organizations. The effect of such legal compliance once captured can be used for reference in case of probable future review of such laws.

2.6. A brief history of the co-operative movement in Kenya

The co-operative movement can be traced back to 1908 when the first society was formed to market agricultural products and channel inputs.

The colonial government enacted the Co-operative Societies Ordinance in 1931, though Africans were excluded from the movement until 1946 when they were allowed to form their societies. The Africans, however, did not embrace the idea as they viewed it as a way of further colonizing them. Communication between the Registrar and the indigenous Kenyan African became difficult.

In 1947, several societies were registered in Nyanza and subsequently in other parts of Kenya, including the central region. A registrar, Mr. Leshlie pointed out in his Annual Report of 1947 that the Africans most willing to form co-operatives were unable to find a committee of men to manage their affairs and keep the books.

Obviously, technical knowhow among Africans was scarce or absent. The Registrar undertook to train and post staff to the various districts in Kenya. By his good intention the number of skilled staff increased from 6 in 1946 to 25 in 1952. Later, the East African School of Co-operatives was established in Nairobi in 1952 to train personnel to serve in Kenya, Tanganyika (now Tanzania) and Uganda. The college was housed at Jeans School. In 1954 the number of students was 324 with only 28 being Kenyans.

Between 1952 and 1960, a State of Emergency was declared in Kenya. The issue of land consolidation and registration was started during the period as a remedy for clamour for land in Central Province. Another objective was to create a middle class of African farmers who were expected to support the government of the day. The other aim was to start planting coffee and other cash crops on small scale holdings and leading to the formation of coffee marketing societies. However, all these objectives were threatened or shaken by the Mau Mau rebellion, which was most prevalent in Central Kenya where coffee was thriving well as a cash crop.

The spirit of the co-operative movement continued to exist despite the revolution and clamour for an independent state. As the Mau Mau war subsided, the co-operative spirit thrived to grow in size and capacity. Between 1959 and 1961 there was a tremendous increase in the number of registered societies with Central Province alone having over 123 societies with membership in excess of 17,000 and a turnover exceeding K£280,000.

Upon attainment of independence, the movement was pointed out as a good tool to introduce the Kenyan African to the monetary economy by promoting produce, marketing and training personnel to lead them. The overall objective was the opening of African Kenyans to a market economy. This is stipulated in Sessional Paper No. 10 of 1965. With this vision as a priority, the co-operative movement grew and by 1964, a total of 386 co-operative societies were already registered.

By 1969, Kenya had not only succeeded in promoting co-operative societies but established the Co-operative College through the assistance of Nordic Technical Aid Project. The total number of societies registered by then was 1449.

With all these efforts by the colonial and independent Kenyan Governments, societies grew from strength to strength. More factories were built and merged to large coffee marketing societies and only much later in the 1980s and 1990 did the split of these institutions commence.

The benefit of wealth creation is undoubtedly a core objective of the organisations. The issue at hand is to establish whether by demerger, wealth is further created or eroded. A comparison therefore between the affected societies and those that remained as single entities will help establish the impact of such decision.

2.7. How co-operative societies are governed

Farmers buy shares in the societies by paying a meager Kshs. 20/= per share and some entrance fee per individual which is usually Kshs. 5/=. Upon doing so, one becomes a member of the society with all the rights and privileges as stipulated in the Societies Act of 1997. Any person who joins the membership has, in particular, the right to vote in an annual general meeting.

A central management committee is then entrusted with implementation of all resolutions of the society. Members of the central management committee are supposed to range from 5 to 13 members. They are elected from the grass roots or zones. Amongst themselves they elect a chairman, a vice chairman, a honorary secretary and a treasurer. The management has the power to hire and fire. The Central Management Committee is supposed to employ a manager who acts as the executive of the society. Other persons are also employed, among them factory managers and workers.

The annual general meeting also appoints the auditors, bankers, lawyers and millers. The Co-operative Societies Act requires an annual general meeting to be held within 3 months after the year end, where financial reports, auditor's report and management committee report are tabled. In case of zonal elections, the annual general meeting confirms those elected to be office bearers.

The corporate governance structure of coffee marketing societies can be summarized as shown below:-

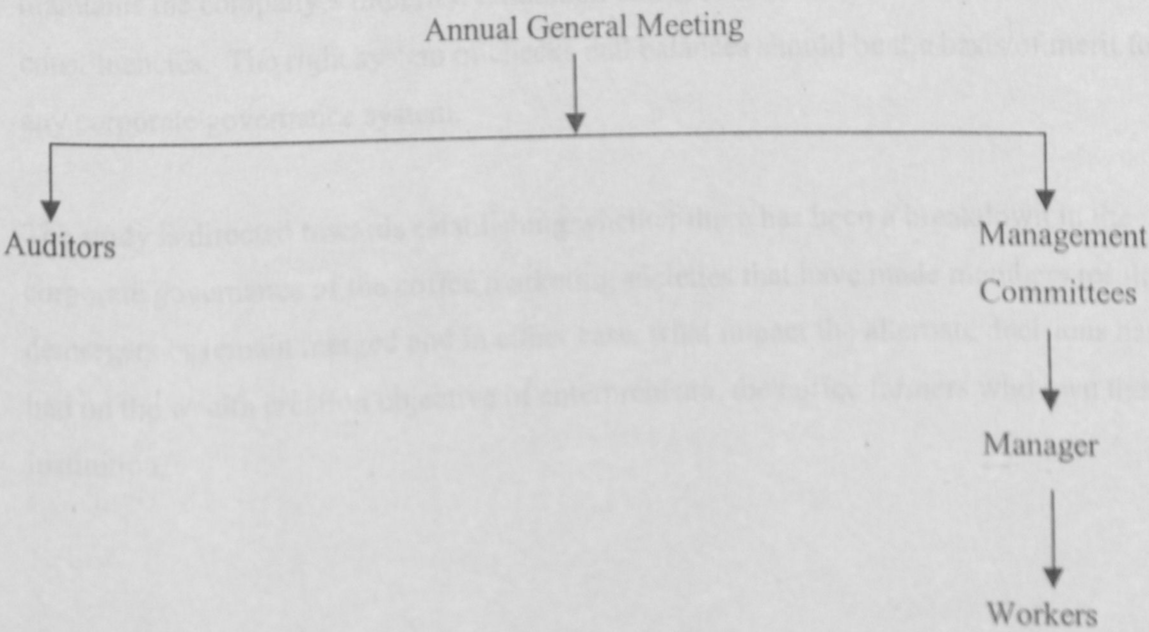


Figure 1: Corporate governance structure of coffee marketing societies

Representatives of the Ministry of Agriculture and Rural Development under whose docket the Department of Co-operative Development falls act as advisers to the societies. Good corporate governance seeks to have the following in place:-

(i) Find the appropriate mechanisms for governing the relationships of constituent groups with the organisation so as to generate long-term value;

(ii) Reduce conflicts of interest among various stakeholders;

(iii) Make sure that the right people make the decisions;

(iv) Create and implement internal organisation of the society and define more closely the interest to which management should respond and the goals toward which they should strive;

(v) Ensure that corporate power is exercised in the best interest of society.

The focus of corporate governance is on the system by which organisations are directed and controlled. Effective corporate governance ensures that long-term strategic objectives and plans are established, and that the proper management and management structure is in place to achieve those objectives and making sure that the structure maintains the company's integrity, reputation and accountability to its relevant constituencies. The right system of checks and balances should be the basis of merit for any corporate governance system.

The study is directed towards establishing whether there has been a breakdown in the corporate governance of the coffee marketing societies that have made members result to demergers or remain merged and in either case, what impact the alternate decisions have had on the wealth creation objective of enterpreneurs, the coffee farmers who own these institution.

2.8. Recent development in coffee marketing societies in parts of central Kenya

Both the colonial and the independent Kenya Governments made efforts to develop and grow co-operative movements. Many problems however, have emerged. Some of the problems as stated by N. M. Kusero in her unpublished MBA thesis, 1983 include:-

(i) Lack of integrity from management committee members and employees;

(ii) Misappropriation and misapplication of funds and;

(iii) Excessive cost in handling members produce and general inefficiency in the operation of societies, among others.

This could have led to acute agency problem within the various stakeholders. Agency relationship according to Michael C. Jensen and William H. Meckling is defined as, "a contract under which one or more persons (the principal) engages another person to perform some services on their behalf which involve delegating some decision making authority to the agents".

The agents can act in their interest and make decisions that do not maximize the welfare of the principal since there is separation of ownership and control. This attracts monitoring and bonding costs to curb any deviant action of the agents and thus erode owner's wealth. At the very extreme it can lead to bankruptcy and reorganizational costs.

In co-operative societies, the supreme authority is the annual general meeting. The authority to implement is passed on to the management committees while the managers execute the decisions. The management committee may act in their best interest ignoring the owners. On the other hand, the manager, too, can act to his benefit ignoring both the general membership and the management committee. Therefore, room for agency problem appears to exist in the movement. Today, fracas leading to deaths and destruction of what has been developed for almost a century is the order of the day.

Much as corporations are striving to maximize their wealth, it is also true that individuals also strive to maximize their welfare. The research will investigate whether members of the societies have interpreted the action of their agents as contradicting that of their organizations and hence resulting to demerger decisions or otherwise.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Population of the study

The population of interest comprised of:-

(i) All 12 coffee marketing societies that have been split in Thika, Maragua and Murang'a districts in the 1990s and where the process was complete two years before 30^{th} September, 2000

(ii) All 12 coffee marketing societies that remained merged in the same regions in the same period.

3.2. Sampling plan

The stratified sampling method on the basis of administrative regions was used. The population was selected into administrative regions as follows:-

(i) Administrative divisions was established in all administration districts;

(ii) Each category of societies was allocated to the region (divisions);

(iii) The number of members in each society was determined so as to create stratas from which sample were selected;

(iv) Two societies from each of the category (merged and demerged) was chosen for study. The largest and smallest in membership from the two independent samples was taken so as to reduce bias and facilitate comparability of results.

3.3 Data Collection

The data was collected using desk research. The Ministry of Agriculture and Rural Development was requested to provide minutes of all relevant management and annual general meetings. Where this was not possible, the District offices through the Commissioner for Co-operative Development, was requested to provide the information.

3.4 Data Analysis

To achieve the objective of identifying factors that had influenced demerger, the collected data was analysed by use of descriptive statistics measures such as means and standard deviations:-

FOR DEMERGED SOCIETIES

(i) The reason as to why demerger occurred according to official documents such as minutes and reports were categorised into factors such as agency problem, regional diversity, poor corporate governance, government influence and so on.

(ii) Total cost before and after demerger was established;

(iii) Payment to members as a percentage of sales for each factory two years before and after the demerger was established.

FOR SOCIETIES NOT DEMERGED

(i) Payment to members as percentage of sales for each society for similar period as that of those demerged, in the same locality (district or division) was established.

LINE GRAPHS AS A PRESENTATION METHOD

Factories report individually. The Nordic System of accounting advocate separate reporting. The joint costs are shown in Societies General Activity. It was therefore possible to detect affairs of each factory before and after demerger. Linegraphs were used where appropriate to show:-

(i) Gross sales and payment to members

(ii) Payment to members as a percentage of sales, both before and after demerger, as well as of those that remained merged.

3.5 Significant tests

To achieve the objective of identifying whether demerger eroded or created wealth, the following hypotheses was tested:-

(i) Null hypothesis (H_O) - There was no difference on percentage of sales paid to members due to demerger.

(ii) Alternative hypothesis (H_a) – There was difference in percentage of sales paid to members due to demerger.

Since the data were independent, whereby the selection of any one case did not affect the chance of any other case being included in the sample, and the fact that there were two separate samples; that is, those of the demerged and merged societies, significant tests (The t test) was used:-

Where:-

$$t = \frac{(x_1 - x_2) \; - \; u_1 - u_2)}{S^2_p\,(1/_{n1} + 1/_{n2})}$$

Where X_1 = Mean payment to members as a percentage of sales for merged societies

X_2 = Mean of payment to members as a percentage of sales for demerged societies

$U_1 - U_2$ = The difference between the two population means

S^2_p = The pooled variance estimated i.e.

$$\frac{(n_1 - 1)\,S^2_1 + (n_2 - 1)\,S^2_2}{(n_1 + n_2 - 2)}$$

s_1 = Mean standard deviation of merged societies

s_2 = Mean standard deviation of demerged societies

n_1 and n_2 = Sample size of the merged and demerged societies respectively

Statement of hypothesis:-

(i) Null hypothesis (H_o) : There was no difference on percentage of sales paid to members due to demerger.

Alternative Hypotheses (H_a) : There was a difference in percentage of sales paid to members due to demerger.

(ii) Significant Level (α) = 0.05 or 5%. (It is a two tailed test)

(iii) Critical value test - Determine degree of freedom (d.f.) and use the table of t distribution to obtain critical value.

$$Df = n - 2$$

Standard error of the mean $= \frac{s}{\sqrt{n}}$

Where n = Sample size

s = Standard deviation

(iv) Decide if calculated value is greater than the critical value thus reject H_o and accept H_a and vice versa.

CHAPTER FOUR

DATA ANALYSIS AND FINDINGS

4.1. Introduction to pooled variance t-tests for differences in two means

This survey compared important cost and revenue measures for merged and demerged co-operative societies as defined in Chapter three (Research Methodology). The objective was to investigate if there was any difference in the performance of these two categories of societies to justify (if at all possible) the demerger processes that many societies took.

4.2. A word on comparing two independent samples

Over the years, many statistical test procedures had developed that made it possible to compare and examine differences between two groups based on independent samples using numerical data. The following factors were considered before the pooled variance t-test was adopted in this survey:-

(i) The underlying assumptions for hypothesis testing for two independent samples;
(ii) The simplicity and applicability of the procedure;
(iii) Generalisability of the conclusions to be drawn;
(iv) Accessibility of the tables of critical values for the test statistic;
(v) The availability of a suitable computer software package (The Microsoft Excel Data Analysis Software was used in this analysis) and
(vi) The statistical power of this procedure

Following the general application of the above considerations to this study, the pooled-variance t-test for two independent samples was selected as the most appropriate.

4.3. Key assumptions

Two key assumptions for this study are:-

(i) Sampling of participating co-operative societies was from a normally distributed population and;

(ii) The population from which sample units were selected had equal or constant variances, that is homoskedasticity

In addition, the following basic assumptions were adopted:-

(i) The null hypothesis was the hypothesis that was being tested;

(ii) The alternative hypothesis was set up as the opposite of the null hypothesis and represented the conclusion supported if the null hypothesis was rejected.

4.4. The *p*-value approach to hypothesis testing: two tailed tests

Because of the availability of powerful statistical software, it was possible to use the modern approach to hypothesis testing that relied on *p*-value approach.

The *p*-value approach made use of probability principles in the accept/reject decisions in hypothesis testing. *P*-value was defined as the probability of obtaining a test statistic equal to or more extreme than the result obtained from the sample data given that the null hypothesis was really true. It was also referred to as the observed level of significance being the smallest level at which the null hypothesis could be rejected for a given set of data.

The following criteria were used for decision making:-

(i) If the p-value was greater than or equal to the significance level, the null hypothesis was not rejected;

(ii) If the p-value was smaller than the significance level, the null hypothesis was rejected.

The following results were obtained from empirical investigations

4.5. Performance of demerged societies

Cost Structures

As stated elsewhere in this report, many societies opted to split from parent organisations and became independent. This had been prompted by a feeling among members that they were better off as a result of the split compared to their earlier position in a large amalgamated society. As noted also, agency problems had played a part in the split of giant societies into smaller ones.

The study looked at the cost structure of societies before and after demerger and obtained the following results in table 1

A. DEMERGED SOCIETIES

Table 1: Total cost as proportion of sales for two year periods: before and after demerger

Period of comparisons	Before demerger	After demerger
Year 1	3.44	6.814
Year 2	3.86	4.049

An analysis of the above data (Using the t-test for two samples) on the following hypotheses:-

H_O : There was no difference between cost structures of societies before and after demerger

H_a : There was a difference in cost structures

($\alpha = 0.05$) (A two-tail test)

Summary statistics were shown in output 1 below:-

Output results for comparison of total costs for demerged societies: before and after demerger

T – test: Two-sample assuming equal variances

Output 1: Output results for comparison of total costs : demerged societies, before and after demerger

	Before demerger	After demerger
Mean	3.65	5.43
Variance	0.09	3.82
Observations	2.00	2.00
Pooled Variance	1.96	
Hypothesized Mean	-	
Difference	-	
Df	2.00	
t Stat	(1.27)	
P (T <=t) one-tail	0.17	
t Critical one-tail	2.92	
P (T <= t) two-tail	0.33	
t Critical two-tail	4.30	

Empirical results did not provide sufficient evident to reject the null hypothesis (The p-value of 0.331 is greater than the $\alpha = 0.05$)

It was concluded that societies, which opted to split, did not show any significant difference in their cost structure relative to their former unsplit state.

Thus, demerger of societies did not seem to add any economic/cost synergy and societies which opted to demerge, did not experience any cost savings that could positively impact on the profitability of those entities. There was therefore no economic justification (as far as costs were concerned) for demerger decisions.

Payments to members

Many co-operative societies in the geographical area of this study split following accusations of members against management that the latter did not pay farmers reasonable compensation for their crop produce. Accordingly, the new split societies were expected to deliver on the promise to pay their members better returns than that of the parent.

The following data, which covers a four year window (two years before and two years after demerger) was analysed to test the hypothesis:-

Ho : There was no difference in payments of societies to members before and after demerger

Ha : There was a difference in payments made to members of societies before and after demerger

(A two-tail test)

B. DEMERGED SOCIETIES

Table 2: Payment to members as proportion of sales

	Before demerger	After demerger
Year 1	0.709	0.852
Year 2	0.741	0.752

The analysis of above data is captured in output 2 below: -

Significance Tests For Demerged Societies

t-Test: Two-sample assuming equal variances

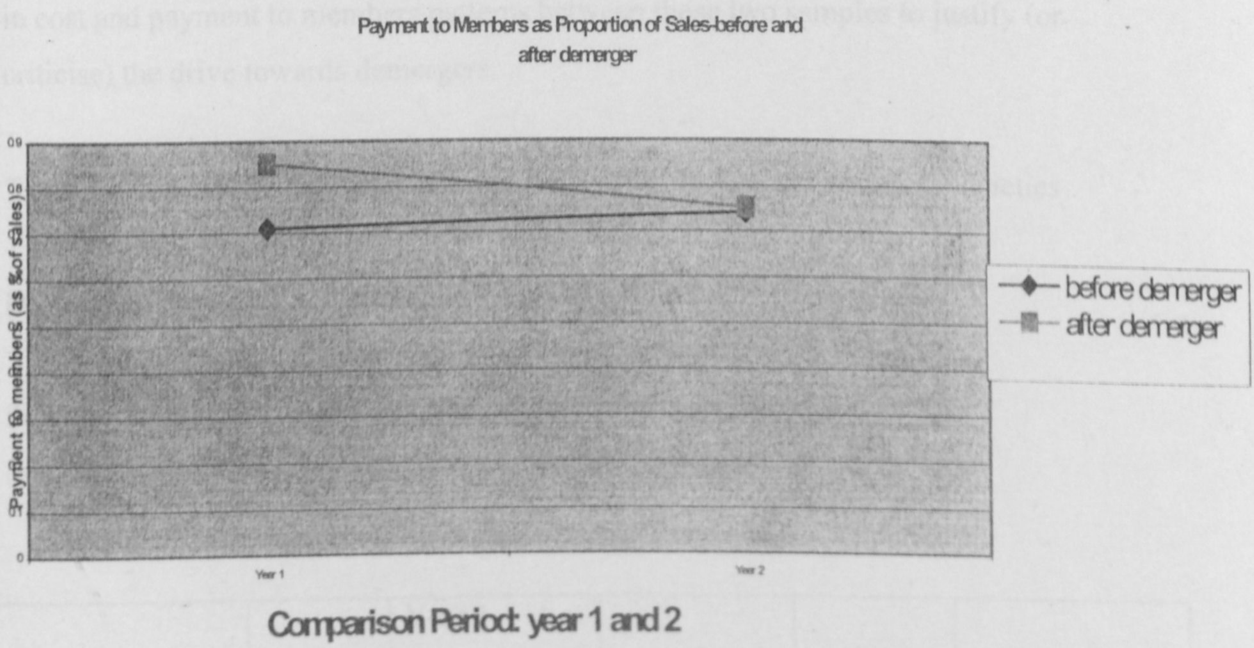
Output for comparing payment to members as percentage of sales for demerged societies

	Before demerger	After demerger
Mean	0.725	0.802
Variance	0.000512	0.005
Observations	2	2
Pooled variance	0.002756	
Hypothesized mean	0	
Difference		
Df	2	
t stat	-1.466733187	
P (T = t) one-tail	0.14006114	
t Critical one-tail	2.91998731	
P (T = t) two-tail	0.28012228	
T critical two-tail	4.302655725	

Output 2 : *Comparison of payment to members as percentage of sale*

The *p*-value (for a two-tail test) of 0.280 revealed that there was no sufficient evidence from empirical data to show a significant difference in payments to members made by societies before and after they demerge.

These results are further highlighted in the graph below:



Thus, it could be concluded that co-operative societies, which demerge from parent organisation, did not seem to fare any better in this promise to add value to their members' payments.

As for the cost structures, demerged societies could not be said to add value to their members in terms of payments for crop delivered superior to when such societies were not split.

Therefore, the true consequences of demergers appeared to be other than economic value adding.

Performance of demerged societies vis-a-vis non-split societies

The study attempted to compare the performance of demerged societies (sample size, n = 6) with the performance of societies which remained non-split (or merged) over the same period of time). The rationale was to understand if there were any significant differences in cost and payment to members patterns between those two samples to justify (or criticise) the drive towards demergers.

Table 3 below shows the comparison of costs of demerged and non-split societies

D: TOTAL COSTS AS PERCENTAGE OF SALES

Table 3: Cost comparisons for demerged and non-split societies

(Year 1)

Nature of society		Year 1 Comparisons		
Demerged	6.814	6.2	6.273	7.429	7.669
Non split	0.373	0.272	0.224	0.183	0.189

The data revealed a case for rejecting the null hypothesis (that there was no difference in cost patterns between demerged and non-split societies) and concluding that available data showed a significant difference in the cost patterns of the two types of societies (See output 3 in the next page)

Comparison results for demerged and non-split societies

t-test: Two-sample assuming equal variances

Output 3

Output for comparison of total costs as percentage of sales for demerged and non-split societies

	Demerged	Non-split
Mean	6.8155	0.245167
Variance	0.3745099	0.004952
Observations	6	6
Pooled variance	0.189730833	
Hypothesized mean	0	
Difference		
Df	10	
T stat	26.12637003	
P (T < = t) one-tail	7.76833	
T Critical one-tail	1.812461505	
P (T < = t) two-tail	1.5536	
T Critical two-tail	2.228139238	

In fact, a closer examination of the above statistics revealed that demerged societies had a phenomenally high cost structure (681.5% of sales) compared to only 24.5% for merged societies.

This meant that when societies splinted into smaller entities they suffered a deterioration of their cost base, which no doubt eroded their profitability. Co-operative societies which have never splinted, in contrast, enjoyed a very healthy cost structure relative to their sales revenue.

This is represented in the graph below:-

Table 4: Cost comparisons for demerged and non-split societies (year 2)

Nature of Society						
Demerged	4.049	3.907	4.168	4.018	4.385	3.765
Nonsplit	0.204	0.212	0.144	0.07	0.133	0.152

There was a difference in cost patterns between demerged and non-split societies (See output 4 below)

Significance Tests – Demerged And Non-Split Societies

t-Test : Two-sample assuming equal variances

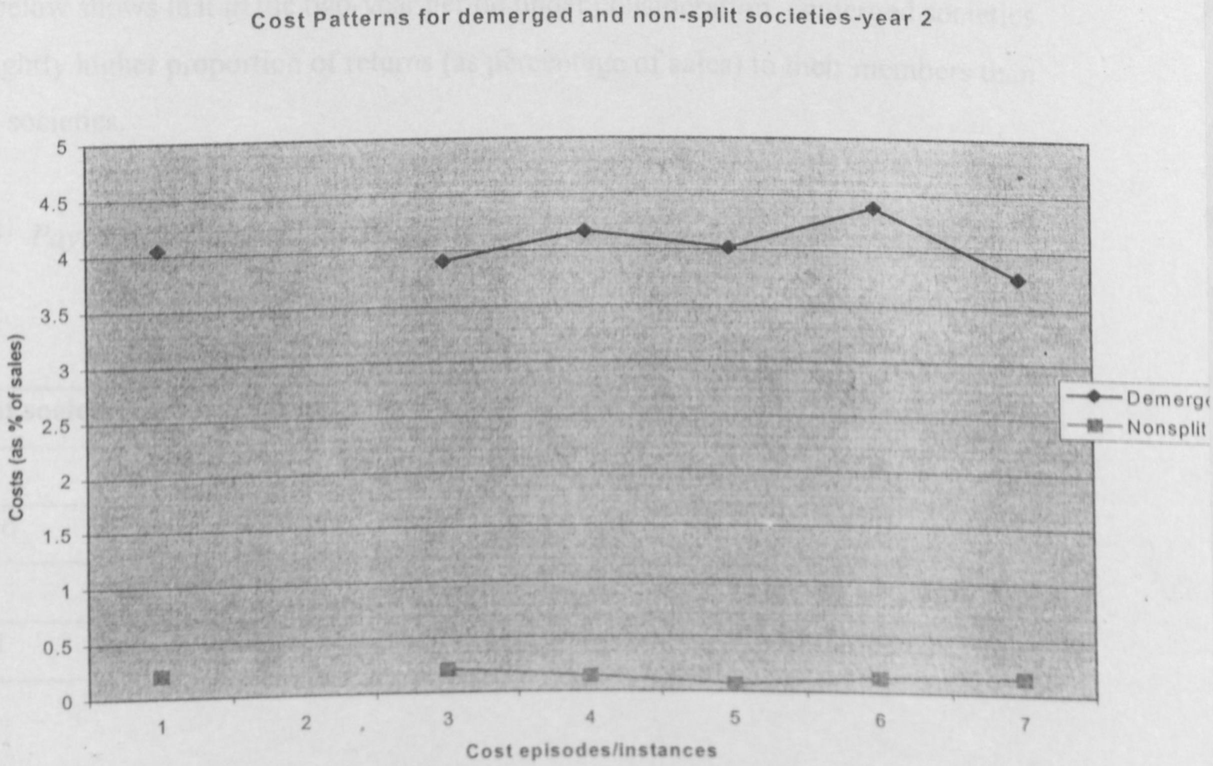
Output results for comparing cost patterns for demerged and non-split societies

	Demerged	Non-split
Mean	4.048666667	0.1525
Variance	0.045767467	0.00269
Observations	6	6
Pooled variance	0.024228883	
Hypothesized mean	0	
Difference		
Df	10	
t stat	43.35422772	
t critical one-tail	1.812461505	
P (T <= t) two-tail	1.02382	
t critical two-tail	2.228139238	

Output 4: Output for comparing costs (year 2) – demerged and non-split societies

As in the result for year 1, demerged societies suffered an erosion in their cost structure with their cost to sales percentage exceeding 404.8% compared to only 15.25% for non-split societies.

The graph below shows how this is the case for Year 2:



Clearly, there was no cost advantage in demerger of societies. If anything, such demerged co-operative societies bear heavy burden of serving costs which seriously eroded their profitability. In contrast, societies which had never split enjoyed cost containment and healthier bottom-line.

Payments to members : comparing demerged and non-split societies

Although non-split societies had a strong cost structure relative to sales as was shown in the previous section, (compared to demerged societies) they did not seem to have a more generous payment policy to their members relative to demerged societies.

Table 5 below shows that in the two-year period under consideration, demerged societies paid a slightly higher proportion of returns (as percentage of sales) to their members than non-split societies.

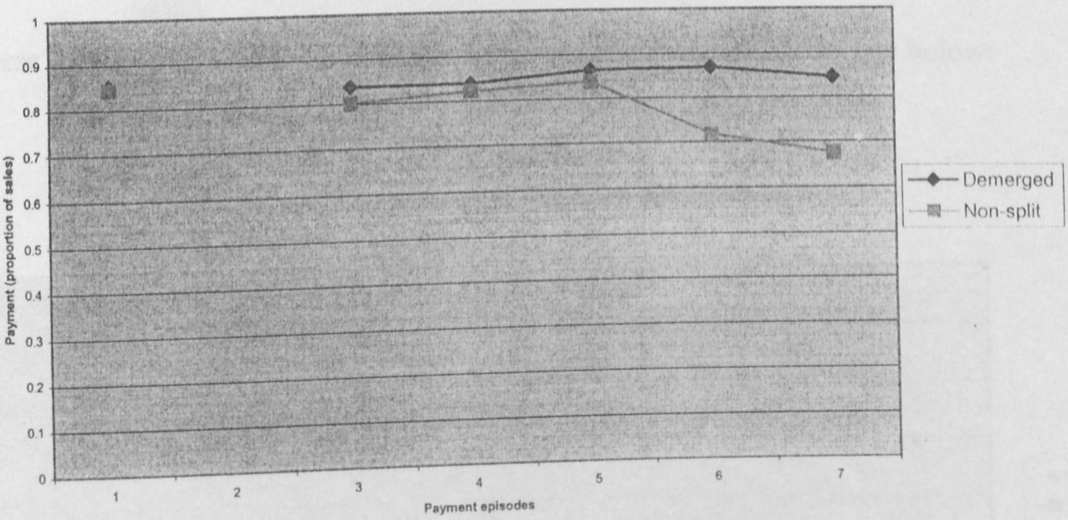
TABLE 5: Payment to members (as % of sales) – demerged and non-split societies

Nature of society	Year 1	Year 2
Demerged	85.17	75.20
Non-split	78.32	68.63

The expected net effect for demerged societies of a high cost base and a generous payment policy seemed to be an erosion of revenue reserves in the short and medium term making future growth very difficult, if not impossible. It was also possible that demerged societies were forced to make generous pay-outs (relative to non-split societies) to appease members who demanded to demerge in the first place (perhaps to protest against what they perceived to be a stingy payment policy in the original society).

Non split societies on the other hand, showed what could have been considered a more prudent payout policy. Considered against the background of a sustainable cost base, it was not difficult to see that these societies were poised to thrive in the medium and long-term. These results are depicted in the graph below:-

Payment to Members as a Proportion of Sales-year 1



(iii) Meeting contingencies. Unforeseen circumstances could befall the company. Retained reserves could serve to cushion the effects of abrupt price increases in the company's overheads, or other hazards (such as fires).

(iv) Promotion and growth activities. Revenue reserves generated investments and from these investment the company was able to grow.

It is likely, therefore that those societies which had never split, were better managed and were likely to be better investments for members than the demerged societies.

As stated above output results did not show significant differences in payment to members between demerged and non-split societies (See output 5 below)

Output 5 :Output results for comparison of demerged and non-split societies.

Output results for comparison of demerged and merged societies:

Payment to members

	Demerged	Non-split
Mean	0.752	0.68635
Variance	0.0001628	0.019987
Observations	6	6
Pooled variance	0.010075116	
Hypothesized mean	0	
Difference		
Df	10	
T stat	1.132844606	
P (T < = t) one-tail	0.141855044	
t Critical one-tail	1.812461505	
P (T < = t) two-tail	0.283710089	
t Critical two-tail	2.228139238	

CHAPTER FIVE

CONCLUSIONS

5.0. INTRODUCTION

Co-operative societies have been in this country for a long time. Because of the ease of forming a co-operative society and the comparatively flexible operating framework, many such organisations have been created to address member's business needs.

In common with other businesses, the co-operatives sampled in this study have the following business goals:

(i) Surplus maximisation : Co-operative societies need to make profits to:

a) Give a return to their members (shareholders);
b) Give reasonable reward, in form of salaries and wages to employees.

(ii) Wealth maximisation : This is achieved through payment as members earnings and subsequent reinvestment of any retained earning in the society or other investments (such as corporate securities and bank term deposits). This has the effect of boosting the value of the organisations leading to better returns for members.

(iii) Maximisation of the welfare of its employees: Well-remunerated employees will boost the company's productivity and in the process improve its networth.

(iv) Easy marketing of members produce and subsequent payment for the deliveries.

While co-operative societies have sought to fulfil those objectives, the recent past has seen a trend of splitting viable co-operatives into smaller societies. This, as discussed in the literature review, is counter to the direction many business organisations are taking – namely, that of consolidations, mergers and alliances.

This study of co-operative societies that have split (or demerged) compared to those that have not split has revealed that there is a big disadvantage in demerging. The cost structure of demerged societies vis-à-vis non-split societies bears testimony that it is better not to split. It was found that demerged societies suffer an inordinately high cost burden of between 400% and 600% (of sales) compared to less than 25.0% for non-split societies.

In addition, an examination of the performance of societies before and after demerger reveals no significant difference in an economic performance. In fact, it can be opined that co-operative societies might have performed better (because of the synergy of all its resources) had they not been split – the evidence is in the stable cost-structure and prudent payout policies of societies, which have never split.

There being no significant advantage in splitting, why have co-operative societies rushed to demerge? The answer was uncovered through newspaper reports, liquidation reports (from which data for statistical analysis was obtained) and other statutory records. It all lies in the agency problem.

5.1. The agency problem

From ancient times, it has been understood that one person, known as the principal (who is the owner of the property) would employ another – the agent to manage the former's (principal's) assets. This has given rise to what is known as stewardship accounting.

In return for his management of the owner's assets the agent (management committee and manager) are entitled to a reasonable reward – called a salary (or wages and committee allowances). While the principal undertakes to pay a reasonable reward for his agent's service, the manager is duty-bound to safeguard the assets of his master and not to waste them.

Unfortunately, the existence of this principal-agent, owner- manager relationship has not always worked out as intended. Because of the almost always absent nature of owner oversight, the manager is left in near total control of assets under him. This separation of ownership from control leads to what is known as the agency problem. In this regard, it is evident to shareholders that where control rests in the hands of the said agents, instances are bound to arise where the latter would choose to conduct corporate activities in a matter that best suits their interests rather than the welfare of the owners (that is shareholders).

This situation is well known to owners who in turn are forced to institute extra measures to protect their assets from managers whose goals may not be in tandem with the expectations of the company. These mechanisms may take the form of requirements that managers provide shareholders with periodic performance of the company. The reports are to be audited by external auditors who are appointed by the owners (that is shareholders) Over the years, new remuneration measures have been designed by owners in an effort to align managers interest to those of the shareholders. The costs of such safeguards along with the effects of the residual abuses by agents that may be impossible to prevent are known as agency costs and in turn give rise to the agency problem.

The specific instances of the agency problem in this study were found to apply as follows:-

1. Kagima

The society had an upper zone with higher yield than lower zone. Tea was also grown alongside and had 2 seasons. The lower zone had a single season and was rather unfavourable climatically compared to the other zone. Ideological difference arose where upper zone felt they should provide leadership. It became more emphasised when society headquarter was transferred to upper zone in Kiria-ini market. Management committee equally became divided on zonal basis. Mistrust therefore arose.

2. Kiriti

Like the mother society in 1997 the lower zone Kangunu factory which only had coffee as the cash crop and had bigger volume than the other 3 factories of the society, felt it should operate separately. As a result there was misunderstanding and mistrust between management and shareholders

3. Kiangoma

In 1997 members felt that their society would be well run if divided into small unit. Also issue of misunderstanding between management and members.

4. Njora

The management committee was not trusted in running affairs of the society and there was total misunderstanding between them and members.

5. Gatukuyu

There was total misunderstanding between management and members and former President Moi intervened by forming task force that recommended the split of the society if management was to be popular. There was also the case of failure to alternate some management committee for over 10 years.

6. Gatundu

The society had 3 zones, the upper that had tea and coffee, the middle with coffee only. The lower zone had adverse weather conditions. Members felt that there should have been division as early as 1980s. They perceived a need for a very well supervised election according to presidential task force so that free and democratic leaders were elected.

5.1.1. Agency problem in management of co-operative societies in central province of Kenya

As already stated in the foregoing, two main theories exists by which the agency problem may be lessened namely:-

(i) Remunerating managers handsomely so that their interest coincide with those of the shareholders and; secondly;

(ii) Monitoring the actions of managers and penalising them for non-compliance. The use of the second approach takes the form of the appointment of independent auditors to verify the authenticity of co-operative societies financial statements and the threat of (and often, actual) sacking.

It is with regard to this second solution to the agency problem that co-operative societies in this study have had to contend with. Societies which have experienced agency problems have in addition to firing managers, gone a step ahead and actually split into smaller (sometimes barely viable) entities. The recourse to splitting becomes even more desirable when it is understood that the procedure for demerging is not complicated at all – all that is needed is a resolution by a two-thirds majority of registered members to effect the same.

The study unveiled many instances of agency problems, which directly led to the decision to demerge. As empirical results have shown, the act of demerging has not been attended with economic opportunities, leading instead to higher costs and erosion of the members net worth. In spite of this, the trend towards demergers seems set to continue.

5.2. Recommendations and the way forward

In view of the absence of economic opportunities as a consequence of demerging, and in the light of the major underlying driver to demerging, this study recommends that policy-makers seek alternative measures to deal with the agency problem. Such measures could include:-

(i) Regular monitoring by a government watchdog of activities of managers in co-operative societies;

(ii) Establishing a self-regulating mechanism for all co-operative societies;

(iii) More efforts by members of societies to align their managers interests with those of the company by, for example, better salaries and other emoluments;

(iv) Thorough and directed training or continuos education to managers, management committees and members on legal and financial matters especially on governance and appropriate solution to agency and other problems

This study recommends a radical change in the way societies are managed and in particular a re-appraisal of the ease with which societies can split from parent organisations to begin existing on their own.

5.3. Limitation

The population of the study is so large but due to limitation of monitoring resources we could not extend the study to other areas where demerger occurences are known to have occurred such as, in Nyeri district, Eastern province in areas such as Meru, Embu, Machakos and even in the case of savings and credit societies that have split their activities and formed new entities to take them.

GLOSSARY OF TERMS

Arabica - A type of coffee that does well in Kenya. Also regarded to be of higher quality than other types.

Bonding cost - Cost incurred on provisions which impose constraint on management by putting restrictive covenant in bond agreement e.g. writing of such covenants and enforcing them.

Colonial Era – Pre-independence time i.e. the period from the late 1800 to the early 1960s when Kenya was under the colony of the British Government.

Colonial Government – Government of the colonial era.

Coffee Marketing Societies – Limited liability companies whose main role is to facilitate farm inputs, collect ripe coffee berries from its members, pulp and dry the beans, organise for it to be milled into powder which is auctioned by a parastatal called Coffee Board of Kenya.

C. G. C. S. Ltd. - Coffee Growers Co-operative Society Limited

F. C. S. Ltd. – Farmers Co-operative Society Limited

Jeans School - Todays Kenya Institute of Education (K.I.E.)

K £ - Kenya pound, referring to Kshs. 20. By then K is said to trade at par with sterling pound.

Mau Mau - A rebellion against the colonial Government so as to allow Kenya be an independent state.

Monitoring cost - Cost incurred to control or curbs the rogue behaviour of managers or shareholders due to separation of ownership and control e.g. systems audit.

Pulped Coffee Beans – Coffee berries fresh from coffee tree is normally green, it ripens to be red. At this stage it is harvested, taken to factory, where the outer skin is removed by a machine, a process called pulping. The pulped coffee beans are dried before being further processed by millers. The dried beans are milled to coffee powder, which is human consumable.

Split – A word used interchangeably with demerger. It means forming other societies to take over the membership, assets and liabilities of the parent society.

Working Capital Cost – All the amount the society spend to pulp coffee berries, dry the beans, transport to the millers and marketing charges incurred on behalf of its members. It is a rotating fund for societies.

White Settlers – Term to refer to the British people who settled in the Highland East and West of the Rift Valley and the Rift Valley itself.

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APPENDIX 1

SPECIMEN TABLE FOR DATA AND PURPOSES ANALYSIS - DETAILS OF DEMERGED SOCIETY LOCATION AND MEMBERSHIP OF EACH SOCIETY AND SAMPLE SELECTED

Name of all society that have been split	Administrative District	Administrative Division	No of Members	Sampled
Kagima	Murang'a	Mathioya	20454	Yes
Kiriti	"	"	4053	Yes
New Mugoiri	"	Kiharu	7750	-
Murarandia	"	"	6692	Yes
Irati	Maragua	Kigumo	4708	Yes
Njora	"	"	6994	-
Kiangoma	"	"	2866	-
Irera	"	Kandara	3622	-
Gatanga	Thika	Gatanga	8321	-
Gatukuyu	"	Gatukuyu	9641	Yes
Gatundu	"	Gatundu	6271	Yes
Kiamwangi	"	Gatundu	8870	-

APPENDIX 3

TOTAL COST AS A PERCENTAGE OF SALES BEFORE AND AFTER DEMERGER

Name of Society	Sales as % of total cost - before demerger		Sales as % of total cost - after demerger	
	90/91	91/92	93/94	94/95
Kagima (Mother societies)	344%	386%		
New societies				
Kiru			619.8%	390.7%
Kamacharia			627.3%	416.8%
Kwaikamba			742.9%	401.8%
Kiriti			766.9%	438.5%
Gaturi			650.8%	376.5%
	Average		681.54%	404.86%

APPENDIX 4

PAYMENT TO MEMBERS AS A PERCENTAGE OF SALES BEFORE AND AFTER DEMERGER

Name of Society	1990/1991	1991/1990	1993/1994	1994/1995
Kagima (Mother society)	70.9%	74.1%	83.8%	74.4%
New societies				
Kirui			84.0%	76.0%
Kamacharia			86.5%	75.1%
Rwaikamba			86.9%	77.1%
Kiriti			84.6%	73.4%
Gaturi				
	AVERAGE		85.16%	75.20%