CORPORATE GOVERNANCE AND ITS EFFECT ON COMPANY PERFORMANCE– A CASE STUDY OF KENYA’S SMALL SCALE TEA SECTOR

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November 2015
DECLARATION

I, Caroline Muthoni Mukiira, do hereby declare this thesis is my original work and that it has not been submitted elsewhere or is not due for submission for a degree in any other university.

Signed…………………………………….. Date:-…………………………

Registration No: G62/67857/2013

This thesis has been submitted for examination with my approval as the University Supervisor.

Signed…………………………………….. Date:-…………………………

TIM O. A. MWESELI
DEDICATION

This master’s thesis is dedicated:

To my parents Julia and Moses Mukiira, who introduced me to the joy of reading and respect for education enabling this study to take place. You taught me to work hard for the things I aspire to achieve. Thank you for instilling in me a hard work ethic.

To the memory of my mother; I miss your prayers.

To my heavenly Father from whom, all good things come from. You are my strength, light, joy, hope, happiness, and love.
ACKNOWLEDGEMENTS

My most gratitude goes to Almighty God for giving me the grace, courage and the determination, as well as guidance in conducting this research study, despite all difficulties.

I would like to acknowledge and thank my supervisor Tim Mweseli for his guidance and expert advice. His willingness to provide feedback made the completion of this research possible.

I wish to thank my family and friends who offered support and encouragement even in times of crisis as I pushed through with this project.

I wish to thank and extend gratitude to Nelson Waweru for proofreading, support and encouragement throughout the entire process. His steadfast support of this project was greatly needed and deeply appreciated.

I acknowledge my colleagues and supervisors at work who supported me as I juggled between work and studies and without whom this project would not have been successful.

I would like to go on to thank my fellow postgraduate students for their invaluable support and suggestions throughout this process.
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<td>Annual General Meeting</td>
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<td>CACG</td>
<td>Commonwealth Association for Corporate Governance</td>
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<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
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<td>CG</td>
<td>Corporate Governance</td>
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<td>CMC</td>
<td>Commercial Metals Company</td>
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<td>EGM</td>
<td>Extra-Ordinary General Meeting</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>ICT</td>
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<td>Kenya Tea Development Agency Company Ltd</td>
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<td>KUSSTO</td>
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CHAPTER ONE

1.1 INTRODUCTION

1.1.1 Background

The concept of corporate governance has gained much interest globally in the twenty-first (21st) Century following collapse of high profile companies such as Enron and WorldCom in United States and England’s Baring Bank, among others.\(^1\) Similarly in Kenya, corporate governance has gained popularity after the near collapse of Uchumi Supermarket Chain\(^2\) and board room wrangles in AccessKenya,\(^3\) CMC Holdings,\(^4\) and East African Portland.\(^5\) These near collapses have been blamed on weak management, fraud, insider dealing and a lack of accountability. To avert similar and future cases of collapse or near collapse of other companies, corporate governance regulations have been put in place globally and locally.

In the United States, for example, The Sarbanes-Oxley Act was enacted as a reaction to a number of major corporate and accounting scandals in the US

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\(^1\) Chris A Mallin, *Corporate Governance* (Oxford University Press 2013) P.1.
including Enron, Tyco International and Worldcom. Enron one of the largest companies in the US, collapsed due to heavy and unreported debts by the executive directors. Enron, Waste Management, Worldcom, Tyco and Arthur Anderson the auditors of these companies collapsed leading to the enactment of this Act. In Kenya, the Capital Markets Authority\(^6\) has set guidelines on corporate governance practices by public listed companies and the Private Sector Initiative for Corporate Governance has formulated a sample code of best practice for corporate governance.\(^7\)

The small scale tea sector in Kenya has not been spared its share of corporate governance challenges. Poor governance structures have been partly blamed for the low performance of the small scale tea sub-sector. This study will therefore interrogate the effect of corporate governance on the performance of companies and in particular the small scale tea sector in Kenya.

In Kenya, the tea industry is comprised of two distinct sectors; the plantation which is the large scale sector and the small-scale sector. The plantation sector is owned by large scale tea producers and companies while the small-scale sector is owned by small-scale farmers who are shareholders of their tea factory companies. The small-scale sector has registered more than half a million farmers

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\(^7\) CACG Guidelines: Principles for Corporate Governance in Kenya and a Sample Code of Best Practice for Corporate Governance (Private Sector Corporate Governance Trust 1999).
who are located across tea growing areas in the country. The small-scale sector factory companies are managed by Kenya Tea Development Agency Company Ltd (KTDA).

This study concentrates on the small-scale tea farmers who own Tea Factory Companies. About sixty-two percent (62%) of the total tea crop in Kenya is produced by the small-scale farmers who process and market their crop through their management agency, KTDA, which is the largest single producer of tea in the world.

KTDA was incorporated on 15th June 2000 as a private company under the Companies Act, following privatization of the Kenya Tea Development Authority. The privatization was as a result of the 1991 Parastatal Reform Strategy Paper that listed KTDA as one of the parastatals that ought to be privatized. A sessional paper prepared by the Ministry of Agriculture led to the creation of KTDA, a privately owned company. The Sessional Paper noted that major restructuring of Kenya Tea Development Authority would be undertaken to fully face challenges of new international financial lending requirements, modern management techniques and the increasingly competitive international tea market.

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8 ‘The Tea Board of Kenya | Tea Growing and Production’
<http://www.teaboard.or.ke/industry/growing_production.html> accessed 5 February 2015.
10 Chapter 486, Laws of Kenya.
KTDA was subsequently incorporated under the Companies Act as an independent and private tea enterprise owned by all small-scale tea farmers through their respective factory companies. The relationship between KTDA and the tea factories would subsequently be governed by revised management agreements signed with each of the factories. KTDA would offer management services to the individual factory companies and charge a management fee based on minimal percentage of the net value of the proceeds.

KTDA is contracted by the tea factory companies to manage tea cultivation, develop and maintain tea husbandry, collect, weigh, handle and pay farmers for green leaf delivered, manufacture green leaf into tea, market the manufactured tea, develop and provide sound technical, financial and managerial infrastructure. In pursuit of these objectives, KTDA has developed an extensive supportive infrastructure for over half a million small-scale tea farmers who cultivate about 92,000 hectares and deliver tea for processing to the fifty-four (54) factory companies spread all over the Country.\(^{13}\)

The corporate governance structure of the small scale tea factory companies managed by KTDA is very unique and complex and many fail to understand the dynamics surrounding it. The 54 factory companies are owned by the small scale tea growers who hold shares in each factory. The boards of the 54 factory companies meet yearly and on rotation elect zonal directors who constitute the

\(^{13}\) ‘About KTDA’
board of KTDA. KTDA is the managing agent of the 54 companies through its management arm. This structure is expounded in Chapter Two of this study.

The performance of the tea sector in Kenya has come under sharp criticism in the financial year 2013/2014 due to the low tea prices experienced, which has been described as a six year record low. The shareholders’ earnings are on an all-time lowest. KTDA has been accused of mismanagement of the small-scale tea sector with accusations ranging from tea auction price manipulation to theft of farmers’ earnings.\textsuperscript{14} Other accusations include unorthodox practices, poor trade practices, collusion with tea brokers amid other allegations of misappropriation of farmers/shareholders earnings.\textsuperscript{15}

\textbf{1.2 Objectives of the Research}

The object of this paper is to study the nexus between the current structure and practice of corporate governance in KTDA managed tea factory companies and the shareholders’ earnings. In this regard, the study seeks to capture a detailed overview of the corporate governance structure over the years and its relationship with the performance of the small-scale tea subsector. The study seeks to identify best corporate governance practices globally and locally and inadequacies (if any) in the corporate structure of the small scale tea sub-sector. Lastly, the study


\textsuperscript{15} Report reveals how tea brokers and tea agency collude to con small farmers, Sunday Nation newspaper business report, 29-06-2014, p.40 & 43.
identified whether the current corporate governance structure is serving the small scale tea farmer shareholders in terms of bringing them good returns and makes recommendations relating to the structure and corporate governance practices in the small scale tea sub-sector.

1.3 Statement of the Problem

The small scale tea sector in Kenya has faced an all-time low earning in the 2013-2014 financial year which some in the industry attribute to a weak regulatory and governance structure.\textsuperscript{16} The small scale tea earnings consistently increased for five years from the year 2008-2009 when farmers earned Kenya shillings 25.4 billion, the year 2009-2010 when they earned Kenya shillings 38.2 billion, the year 2010-2011 they earned Kenya shillings 54.6 billion, the year 2011-2012 they earned Kenya shillings 61.4 billion, the year 2012-2013 they earned Kenya shillings 69 billion before the tea prices fell to a record low in the year 2013-2014 when the small scale tea farmers earned Kenya shillings 35.5 billion.\textsuperscript{17} This decline was a 44.3% drop from the previous year.\textsuperscript{18} There have been various allegations levied against the managing agent KTDA due to the falling tea prices

\textsuperscript{17} KTDA Annual Report and Financial Statements 2009-2014.
including price fixing, poor management, non-independent directors,\textsuperscript{19} and underhand dealings.\textsuperscript{20}

There are several issues plaguing the small scale tea sector which this study seeks to analyse with a view to assessing their effect on performance of the sector. The issues include an overcrowded board which is seen to increase the agency cost. For example the board size in KTDA is large as it consists of fifteen directors making it difficult to make decisions and therefore negatively affecting the performance of the sector. Similarly, we find the same problem in KTDA managed factory boards where a typical board has eight to nine Board members. These large boards are not efficient due to lack of effective communication and coordination in the Boards. The Board is not able to reach a consensus making the Board just cosmetic and the monitoring function is therefore nonexistence. Consequently, the compensation extended to the Board members constitutes a high percentage of the companies’ expenses eating into the profits of the company. These inefficiencies caused by large boards have led to a number of calls for disbandment of KTDA.\textsuperscript{21}

The small scale tea sector is also plagued with cases of corruption, conflict of interest, and a lack of integrity and ethics among the directors. This is mainly

\textsuperscript{19} Malpractice, low quality imports driving down commodity prices, Sunday Nation, 3\textsuperscript{rd} August 2014.
\textsuperscript{20} Talking Point, p.1, Daily Nation -, 27\textsuperscript{th} July 2014 p.53.
brought about by lack of independence in the Board. Values of integrity, openness, accountability, disclosure and responsibility are lacking to a great extent. The directors are seen to trade with the companies without sufficient disclosure to the shareholders. There has also been a lack of adequate communication to the shareholders leaving them susceptible to rumors on various aspects of management of their tea factories. The shareholders often complain of exploitation.\(^\text{22}\) There is indeed a lot of interference in the management of the tea companies and KTDA by directors raising the question whether there is a clear separation between management and ownership. This is brought about by the fact that the directors are not independent. Most of the non-executive directors own many tea bushes, are the majority shareholders and are right in the middle of the tea business causing a lack of independence. An example is interference in appointment of management and interference in procurement of suppliers where tribalism, nepotism and cronyism reign. The interference goes deep into the marketing of the tea where the directors have associations and affiliations in the tea brokerage firms. In this regard, the shareholders have often complained that their hard earned money is being stolen by the directors.\(^\text{23}\)

Lastly, another issue plaguing the small scale tea sector is lack of proper skills and education in the Board making it very difficult inter-alia for the Board to identify and manage the risks facing the sector, especially in a crisis as has been


recently experienced. The appointment of directors is crucial and should be well thought out to ensure directors with a mix of skills and proper education level are appointed to the Board.

One of the main principles of good corporate governance is to ensure that the shareholders get a good return on their investment. The question arising therefore is whether the current corporate governance structure is serving the owners of the 54 factories and whether it is time to consider restructuring to revolutionize the giant industry.

The challenges faced in the small scale tea sector are brought about by lack of change in the corporate governance structure. The current structure is still based on the recommendations made in the Sessional Paper No.2 of 1999.24 Despite changes in both operations and the macro environment the corporate structure has unfortunately remained more or less the same. In addition, the government of Kenya through the Tea Task Force Report of 200725 attempted to review the structure of KTDA but there is no evidence of implementation of the recommendations. KTDA corporate structure therefore appears to be stuck in the past.

The tea industry is in the worst crisis ever and this has been caused by a shocking fall in tea earnings. This research paper, therefore, examines the relationship

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24 Supra Note 12.
between corporate governance practices and shareholder value in the small scale tea sector more so in light of the current diminished earnings. The fundamental question is whether the said decline in tea prices is directly co-related to the existing corporate governance structure. The existing corporate governance structure has had its shortcomings, such as large board size, lack of integrity by directors, lack of board independence and a lack of ethical behavior by directors. This paper gives recommendations that if implemented will help restore the shareholders’ confidence.

1.4 Research Questions

i) What is the extent of the effect of board size, risk management, directors’ education level and board independence on the performance of the small scale tea industry?

ii) What is the degree of conflict of interest in the small scale tea sector and what needs to be done to address the same?

iii) To what extent can the separation between management and ownership create board independence in the small-scale tea sector and in turn improve growers’ earnings?

iv) What are the most suitable corporate governance practices that the small scale tea sector should adopt to enhance the growers’ earnings?
1.5 Hypotheses

The study is premised on the following hypothesis:

1. Poor corporate governance practices such as a large board size, lack of education, professional skills and director independence in the small scale tea sector has led to diminished returns to shareholders.

2. Adoption of good corporate governance structure and practices including a lean board size, board independence and accountability in the small scale tea industry will increase the earnings of the growers.

1.6 Literature Review

A lot has been written on corporate governance mainly in the European, American and East Asia jurisdictions. There exists a wealth of literature on various aspects of corporate governance including its definitions. Corporate governance has been defined in different ways by different writers. In Kenya, the Capital Markets Authority Guidelines define corporate governance as ‘the process and structure that is used to direct and manage corporations towards enhancement of prosperity and corporate accounting’.\textsuperscript{26} The Organisation for Economic Co-

\textsuperscript{26} The Capital Markets Act (CAP 485A) Gazette Notice No. 3362; Guidelines on corporate governance practices by public listed companies in Kenya, 2002 paragraph 1.2.
operation and Development (OECD) \(^{27}\) defines corporate governance as ‘the procedures and processes according to which an organization is directed and controlled’.\(^{28}\) The corporate governance structure specifies the distribution of rights and responsibilities among the different players in the company, such as the board, managers, shareholders and other stakeholders and lays down the rules and procedures for decision-making.\(^{29}\)

The Cadbury Report\(^{30}\) states that corporate governance is ‘the system by which companies are directed and controlled’.\(^{31}\) The board of directors is responsible for the governance of the company. The shareholder’s role in governance is to appoint the directors and the auditors to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company’s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship.\(^{32}\) The board’s actions are subject to laws, regulations and the shareholders in general meeting.\(^{33}\)

\(^{30}\) The Corporate Governance Committee was set up in May 1991 by the Financial Reporting Council, the Stock Exchange and the accountancy profession in response to continuing concern about standards of financial reporting and accountability. The committee was chaired by Sir Adrian Cadbury and had a remit to review those aspects of corporate governance relating to financial reporting and accountability.
\(^{32}\) Ibid.
\(^{33}\) Ibid.
Shleifer and Vishny give a narrow definition of corporate governance as the ways in which shareholders assure themselves of value for their investment.\textsuperscript{34} In summary, corporate governance is the set of systems, principles and processes by which a company is governed. It provides the guidelines on how a company is directed or controlled so that it fulfills its goals and objectives in a manner that adds value to the company and is also beneficial to all stakeholders in the long term.\textsuperscript{35} Stakeholders include the board of directors, management, shareholders, customers, creditors, employees and community.

Corporate governance is based on principles such as integrity, fairness, transparency, disclosures, compliance with the law, accountability and responsibility towards the stakeholders and commitment to conducting business in an ethical manner.\textsuperscript{36} These are the pillars and basic tenets of corporate governance. The directors must be able to account for the power given to them, be result oriented, honest, faithful and diligent. Responsibility is leadership that is ‘capable, representative and conscious of its obligations’. ‘Responsibility is not only ensuring compliance with laws and regulations, but also fulfilling duties to stakeholders, including employees and by developing an active socially responsible and environmentally sustainable corporate conduct’.\textsuperscript{37} Transparency stands for ‘open leadership with accurate and timely disclosure of information

\textsuperscript{35} Ibid.
\textsuperscript{37} Supra note 27.
relating to all economic and other activities of the company’. Transparency is the ‘timely and quality disclosure of adequate, clear and comparable information concerning corporate performance, governance and ownership’. Fairness is ‘ensuring the protection of shareholder rights and the equitable treatment of all shareholders’. Disclosure may either be mandated by existing laws or may be voluntary. Disclosures most commonly include, but are not restricted to information on the company’s financial situation and performance. The level and extent of disclosures is an important benchmark in measuring the quality of corporate governance. Accountability to the shareholders entails ‘clarifying the roles and responsibilities of the management and also by ensuring the union of managerial and shareholder interests as monitored by the board of directors’. 

There are various reports compiled following various crises that took place in many jurisdictions affecting governance of companies which this study takes into consideration. The reports include the UK Cadbury Report which was formulated following a series of corporate failures in the UK. One example is Robert Maxwell’s companies Maxwell Communications Corporation and Mirror Group Newspapers which collapsed following allegations that Maxwell had siphoned the Pension Fund for his own interest. Maxwell’s companies were eventually declared insolvent and the group collapsed. At around the same time

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40 Supra note 27.
41 Supra note 30.
42 Supra note 38.
the Bank of Credit and Commerce International (BCCI) collapsed and lost billions of dollars of its depositors, shareholders and employees. Following the raft of governance failures, Sir Adrian Cadbury chaired a committee whose aims were to investigate the British corporate governance system and to suggest improvements to restore investor confidence in the system. The Report sets out general principles around which companies are supposed to operate in order to ensure proper governance. The principles are openness, integrity and accountability. This report concentrates on the financial aspects of corporate governance.

One of the most renowned reports on corporate governance is the OECD guidelines, to which Kenya subscribes. The corporate governance principles published by OECD\(^43\) were designed to assist countries to design their own corporate governance codes to counter the global economic problems. The report sets out principles of corporate governance being rights of shareholders; equitable treatment of shareholders; role of stakeholders; disclosure and transparency; and responsibilities of the board.

In Kenya, there has been substantive interest in the area of corporate governance. Nyongesa has carried out a study on the effect of corporate governance practices on financial performance of commercial banks with special reference to Kenya.

\(^{43}\) Supra note 27.
Commercial Bank. This study is limited to the banking industry and specifically to Kenya Commercial Bank.

Dr. Musikali considers the effectiveness of corporate governance in public listed companies in Kenya. The study concludes that there is need for review of the Kenyan codes which are due to a weak legal framework. The focus of the study is on public listed companies. KTDA and its managed tea factory companies are unique and not listed companies and therefore mostly fall outside this study.

Kamau interrogates corporate governance practices within Kenya’s state corporations with emphasis on appointment and dismissal of directors. He concludes that the appointments have been based on non-objective factors such as political interest. This study narrowly concentrates on one aspect of corporate governance being the appointment of directors in state corporations. Appointment of directors in any sector including the tea sector is very crucial to the performance of the sector.


Some writers have also addressed the general welfare of the small scale tea farmers and the factors influencing their earnings. Muthamia sought to establish the influence of attributes of directorship on corporate governance in the small scale tea factory companies in Kiambu County of Kenya. The study addresses the issue of whether the Factory directors’ experience in other boards, possession of professional qualifications and work experience influences corporate governance. This study is limited to qualifications of directors in the small scale tea sector and to the Kiambu County. The study concludes that directors’ experience in other boards, possession of professional qualifications and work experience in other industries significantly influences corporate governance both in as far as it relates to contribution to the board and appreciation of internal and external factors affecting governance are concerned.

Nchebere in his study discusses the causes of erratic and fluctuating tea payments. He looks at the market forces, board of directors, production costs and government policies as some of the factors influencing returns on the small scale tea growers. The study concludes that there are several factors that influence the financial returns of Michimikuru Tea Factory growers including the cost of production, market forces, the Board of Directors, and the government policies.

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This study is crucial to the current study as it touches on the decline in tea earnings to the small scale tea growers. Nchebere’s study is limited to only one Factory out of the 54 Tea Factories in Kenya and only investigates one aspect of CG being the board of directors. This study will concentrate on the effect of corporate governance on shareholder earnings in the 54 Factories.

Karuga reviews poverty among small scale tea farmers. The thesis addresses the challenges faced by small scale tea farmers including changes in the climate, high cost of labor, high cost of inputs and rising cost of living. Karuga concludes that the small scale tea farmer faces a lot of challenges that if not addressed, the farmer will be left with no alternative but to focus his energies on other income generating activities at the expense of tea farming. The study further concludes that if the farmer abandons tea growing there will be loss of foreign exchange for the country, lack of employment for all the people in the supply chain and more poverty for the already impoverished farmer. This study though based on the earnings of the farmers does not cover corporate governance issues.

A study done in India and South Korea by Pooja Gupta and Aarti Mehta Sharma looks at various Corporate Governance practices followed by companies. Their objective was to determine if there is a relationship between corporate governance

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and company performance. The study investigated whether higher and better corporate governance leads to better performance of the companies. The study however concludes that corporate governance practices have limited impact on both the share prices of the companies as well as on their financial performance. This study was limited to Asian countries where companies are mainly family run.

A number of scholars in India sought to investigate the relationship between corporate governance and company’s performance of twenty companies listed at Karachi Stock Exchange using data obtained from the annual reports for the year 2005-2009. The study concludes that companies with good corporate governance measures perform better compared to the companies having no or less corporate governance practices. The findings of this study are agreeable. This study is however based in an Asian country which does not wholly reflect the corporate governance practices in Kenya.

Neculai and Mihaela investigate the relationship between leverage financial performance of the enterprise and corporate governance quality. The aim of their paper is to test the hypothesis and support the idea that companies with better governance systems are more profitable and have a higher market value. The paper also looks at the link between business results, quality of governance, costs of accumulating experience by managers and the degree of performance and

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market value. The paper concludes that improving corporate governance can be a strategy to increasing the overall performance, increasing the stock price of shares on the capital market and hence increasing business value. This conclusion is agreeable with the findings of this thesis. This study paper is however limited to companies in the South-Eastern European Country of Romania.

Charlie Weir, David Laing and Phillip J. McKnight investigate the extent towards which certain aspects of corporate governance affect the performance of 312 large UK quoted companies. The scholars refer to the recommendations of the Cadbury report including adequate non-executive director representation and appointment of an audit committee, the primary purpose of which is to monitor the auditing controls of the company. The paper finds that neither the independence of the committee membership nor the quality of the committee members has an effect on performance. However, it finds that take-over intensity is negatively related to performance suggesting that external control mechanisms are more effective than internal ones. This study is based on quoted UK companies which have adopted the Cadbury Committee’s Code of best practice.

Marashdeh, Zyad Mohammad Saad empirical investigation revealed a mixed set of results. One is that there is not any significant impact for the board size on

company performance. The paper finds that CEO duality tends to have a positive effect on the company performance indicating that the Jordanian companies perform better if the chairman and the CEO roles are combined in a single individual. The paper also found that Non-Executive Directors have a negative impact on company performance, which is inconsistent with the monitoring hypothesis of agency theory, which holds that the NEDs play an important role in the board as a source of experience, monitoring services, reputation and expert knowledge with the likelihood to improve company performance. This thesis agrees with the agency theory and disapproves the findings of this paper that NEDs have a negative impact on performance. This study was limited to three parameters of corporate governance, board size, CEO duality and the presence of NEDs and is based in the Middle East Country of Jordan.

Internationally many books have addressed corporate governance. Bob Tricker provides a comprehensive view of key aspects in corporate governance around the world by examining different models and theories of corporate governance and applies them in a real world context. Marlin adopts an international approach to theory and practice in corporate governance and addresses the latest global developments. Most companies in Kenya are privately owned and there is little or no attention on their control and governance.

55 Tricker and Tricker (n 38).
56 Supra note 1.
There is no empirical study in Kenya that interrogates the nexus between shareholder earnings and practice of best corporate governance principles. Internationally there are various articles which address the effect of corporate governance on companies’ performance. This study sought to fill in the knowledge gap by providing a critique of the relationship between KTDA shareholder earnings and corporate governance practices.

This study filled the gap in the literature by concentrating on the dynamics of corporate governance and its effect on the earnings in the small-scale tea sector in Kenya. The tea industry is one of the most important sectors in Kenya bringing into the country one of the highest earnings in foreign exchange. The results and recommendations of this study can be used in any other large group of companies.

1.7 Theoretical Framework

There are various established theories on corporate governance including the Stakeholder Theory which states that the interests of shareholders are not the only interests that should be considered by directors when carrying out their functions, for there are other important constituencies that warrant consideration from directors. Stake holding is the instrument through which efficiency, profitability, competition and economic success can be promoted on the basis that if one removed cohesion among stakeholders it would not be possible for companies to be competitive. For this reasons, this study paper was based on the Stakeholders
Theory. The instrumental aspect of the theory provides a framework for examining the links between the practice of stakeholder management and a corporation's performance, and is concerned with looking at how stakeholderism can improve a corporation's efficiency and success.57

The Stakeholder Theory views the corporation as a locus in relation to wider external stakeholders’ interests. Stakeholders’ participation in corporate decision making, long term contractual associations between the company and stakeholders, trust relationships and business ethics are the main proposals for stake holding management.58 There are more than just shareholders who contribute to a corporation, and there are others, in addition to shareholders, who are affected by the actions of the corporation. Scholars have referred to persons and groups who contribute to the corporation as stakeholders, constituencies, contributors, or even investors. As far as the small scale tea sector is concerned, I contend that the companies’ affairs are of such broad public concern and affect the lives and interests of so many that the companies can no longer be managed solely for the benefit of shareholders. Stakeholders are inherently valuable to the company and should be treated as such in the management of the affairs of the company.

The theory asserts that there is more to business than just making money and it seeks to ensure that the vision of managers is broadened. For a company to thrive, it must produce competitive returns for shareholders, satisfy customers in order to produce profits, recruit and motivate excellent employees, and build successful relationships with suppliers. Running a modern corporation leads to interdependencies involving many groups for whom the corporation should have a legitimate concern.\(^5^9\) This theory helps us understand the small scale tea industry in totality and how the performance of the sector can be improved. The stakeholders include the tea brokerage firms, suppliers of various goods and services, creditors, the community, the buyers of tea all over the world mainly in Pakistan, Egypt, UK, Sudan, Afghanistan, UAE and Iran and last but not least the employees.

Edward Freeman is regarded as the original proponent of this school and argues that company management should look beyond the shareholders and proposed a stakeholder perspective in managing the company.\(^6^0\) Freeman states that a stakeholder is someone who can affect or is affected by the company or more acceptable a person who contributes to the value creation by the company. This theory states that the focus on shareholders and the company value is misplaced and managers should be concerned with all stakeholders of the company.\(^6^1\)

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\(^{60}\) R Edward Freeman, Strategic Management: A Stakeholder Approach (Cambridge University Press 2010).

\(^{61}\) V. Sivarama Krishnan: Stakeholders and wealth maximization, University of Central Oklahoma, 2008.
company and its managers have an obligation to ensure that the shareholders receive a fair return on their investment, but the company also has obligation to other stakeholders. This theory rejects the primacy of the shareholders in this case the small scale tea growers. Directors in a stake holding system are perceived as trustees of the stakeholders' interests. They are to have a focus on the long-term future of the company, and act as stewards of all that they manage.

Dodd supports the stakeholder theory and argues for a company with a social service as well as profit making function. The company should as well take care of the interests of employees, better quality products for consumers and greater contributions to the welfare of community as a whole.

A leading argument against the Stakeholder Theory, and based on the notion that directors have to consider many interests, is that directors are given licence to do whatever they like, and that state of affairs is likely to lead to directors engaging in either or both of two kinds of behavior. The first is opportunistic activity: directors taking the opportunity to benefit themselves at the expense of others. The second is shirking: not devoting their best efforts to the tasks at hand. These kinds of activity are possible because directors end up accountable to no one.

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64 E Merrick Dodd Jr, ‘For Whom Are Corporate Managers Trustees?’ (1932) 45 Harvard Law Review 1145.
This study utilizes the Agency Theory in explaining the relationship between the small scale tea growers (shareholders) and the directors and managers of the factories and KTDA. The proponents of the Agency Theory include Jensen and Meckling\textsuperscript{65} and Fama and Jensen.\textsuperscript{66} Agency relationship arises between two or more parties, when one designated as agent acts for and on behalf of or as representative for the other designated as principal.\textsuperscript{67} Agency theory is where one party delegates work to another who performs that work.\textsuperscript{68} It is concerned with resolving two problems that can occur in agency relationships namely the desires or goals of the principal and agent conflict and the problem of risk sharing that arises when the principal and the agent have different attitudes towards risk. The principal and the agent usually prefer different actions because of the different risk preferences.\textsuperscript{69}

There is also a problem of information asymmetry whereby the principal and the agent have access to different levels of information. In this agency relationship, insiders (managers) have an information advantage. Owners therefore face moral dilemmas because they cannot accurately evaluate and determine the value of decisions made. The agent may take advantage of the unobservability of his actions to engage in activities to enhance his personal goals. The shareholders in

\textsuperscript{66} Fama and Jensen (n 63).
the small scale tea industry have for a long time complained of lacking information affecting their tea factories and performance of their tea sales.

The remedies to the agency problem involves acceptance of agency cost involved either in creating incentives/sanctions that will align directors self-interest with the interests of the shareholders, or incurred in monitoring directors’ conduct in order to constrain their opportunism. For this to work in the small scale tea sector where there is potential for conflict of interest the Boards must be populated with independent NEDs.

This study falls within the two theories described above as the small scale tea shareholders looks to a maximization of their wealth through an efficient CG structure.

1.8 Methodology

The study involved qualitative data collection and data analysis. In this regard the study was library based and involved analysis and review of relevant primary and secondary data. The data collection included qualitative review of statistics, observation, study of official, historical documents and materials and study of the media. The primary data sources included statutes, Sessional papers and policy documents. The secondary materials analyzed include text books, articles on corporate governance, the internet, law journals, newspaper articles, research
reports, Tea Board of Kenya Reports, and task force reports on the tea industry. Throughout this study the data sources have been acknowledged. This study was based on the qualitative method of case study whereby the corporate governance in the small scale tea industry was examined in-depth. The data collected was examined, summarized, interpreted and a conclusion reached.

1.9 Limitations

This study is limited by the fact that there is very little local literature addressing corporate governance issues affecting the dynamics of the Kenyan companies and especially one with a complex set-up like KTDA. A lot of the literature is European or western based and may sometimes not be applicable here in Kenya. This study is limited to the small scale tea industry in Kenya and the findings may be limited in application in other sectors or companies; but may be applicable for comparative purposes.

1.10 Chapter Breakdown

Chapter One

This is a broad overview and layout of the research. It contains the research proposal. The Chapter provides an overview of the research. It covers the background to the research, the statement of the problem, justification of the study, objectives of the study, hypotheses of the study, theoretical framework,
literature review, methodology, limitations of the study and the chapter breakdown.

Chapter Two
Chapter Two examines the history of the small scale tea sector in Kenya. It gives a comprehensive examination of the corporate governance practices currently employed in the small scale tea sector factory companies. The management of the factory companies by KTDA with emphasis on corporate governance issues is addressed. The earnings of the small scale growers are analyzed vis-a-vis the corporate structure employed.

Chapter Three
This chapter covers good corporate governance practice both internationally and locally. The corporate governance principles were analyzed comprehensively. A study of various corporate governance codes in various jurisdictions was incorporated. This chapter also looks at comparative corporate governance models.

Chapter Four
The chapter analyzes certain aspects of the small scale tea corporate structure and practices and discusses the effect thereof on the performance of the sector. This chapter looked at the effect of corporate governance on performance of the Company.
Chapter Five

This chapter contains the conclusions reached by the study and the recommendations followed. The recommendations are with a view to increasing the earnings of small scale tea earnings by improving on the corporate governance structure and the model employed in the small scale tea sector.
CHAPTER TWO

CORPORATE GOVERNANCE STRUCTURE IN THE SMALL SCALE TEA INDUSTRY

2.1 Introduction

2.1.1 Historical background

Tea was introduced in Kenya in 1903 when a few plants were planted in Limuru and by 1924 tea cultivation had attained commercial production level. The first legal instrument to govern production of tea was enacted as the Tea Ordinance of 1934. This ordinance was revised by the Tea Ordinance of 1948. The objective of the Tea Ordinances was to provide for the control of the production of tea in the Colony. The institution of the Directorate of Agriculture was responsible for controlling the production of tea by issuing licenses and permits to farmers until 1950 when the Tea Board of Kenya was established to regulate the industry.

To promote the cultivation of tea among other cash crops by African farmers the Special Crops Development Authority was formed under the Agriculture Act in 1934.
1960. This body was replaced by KTDA in 1964 when the Kenya Tea Development Order 1964 was promulgated.73

Kenya is the third largest producer and the highest exporter of tea in the world. Tea is the leading agricultural foreign exchange earner in Kenya.74 As stated in chapter one the small scale tea sector is constituted by 54 Tea Factory companies registered under the Companies Act75 and managed by KTDA. This Chapter will give an overview of the current structure of the small scale tea industry in Kenya.

### 2.2 Privatization of KTDA

The history of KTDA dates back to 1964 when Kenya Tea Development Authority was established as a Government parastatal under the State Corporations Act76 to foster and promote the country’s tea growing by small-scale tea farmers in the then forty-five (45) tea factories. KTDA was in the year 2000 privatized which was as a result of the Sessional Paper No. 2 of 199977 prepared by the Ministry of Agriculture. The Sessional Paper highlighted privatization/liberalization of Kenya Tea Development Authority; and privatization and transfer of ownership of Kenya Tea Development Authority to small-scale tea farmers. All the shares of KTDA were to be allotted to the then existing 45 Factory Companies on the basis of a formula developed at the time.

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73 ibid.
74 Supra note 13.
75 Chapter 486, Laws of Kenya.
76 Chapter 446, Laws of Kenya.
77 Supra note 12.
While great strides had been made in the development of the tea industry, especially under the small-scale sub-sector under KTDA, the relevant institutions, the policy and legal framework needed to be reviewed particularly under the liberalized economy. The government of Kenya recognized the important role of agriculture as the major sector in the economy. To effectively manage and enhance the role played by the sector the government undertook significant structural adjustment reform measures such as liberalization and privatization of the various agricultural sub-sectors including privatization of KTDA.  

The Sessional Paper provided that the KTDA Board would be constituted by a minimum of 13 and a maximum of 19 directors, with 12 of the directors elected by the shareholders. Small-scale tea growing areas would be divided into zones and each zone would comprise a minimum of 3 factory companies. Each zone comprising between 3 and 5 factories would elect one director of KTDA; a zone with more than five but not less than ten factories would elect two directors of KTDA and a maximum number of directors representing a single zone would be two directors.

The corporate governance steps taken towards privatization of KTDA included election of six (6) directors out of the maximum nine (9) directors in each Factory Company Board by the farmers. The chairmen of Tea Factories were transferred from KTDA to be elected tea farmer directors. Other steps taken were direct participation by elected directors in management decisions by each factory.

Ibid.
company, direct participation by elected directors in recruitment of factory company employees and direct participation by elected directors in formulation of annual budgets and monitoring of financial expenditures. In addition KTDA sold its equity in factory companies to the tea farmers, empowered the tea factory shareholders through their elected company directors who are now responsible for governance and policy making in their respective factory companies and finally allotted shares to all small-scale tea growers in their respective tea Factory companies.

In 1999, the Kenya Tea Development Authority (Revocation) Order was issued by the then Minister for Agriculture Honorable Musalia Mudavadi and came into force on 1\textsuperscript{st} January 2000.\textsuperscript{79} The effect of the order was that KTDA would be the successor of the Kenya Tea Development Authority and consequently all rights, duties, obligations, assets and liabilities, property rights or instruments, existing contracts, exemptions, undertakings securities of the KTDA Authority, passed on to KTDA Company Ltd.

Today, KTDA is indirectly owned by approximately over five hundred million small-scale tea farmers through the fifty four (54) registered tea factory companies spread out in thirteen (13) of the forty-seven (47) counties in Kenya. The over five hundred million small-scale tea farmers are individual shareholders in the 54 factory companies. The 54 Tea factories are in turn corporate

\textsuperscript{79} The Kenya Tea Development Authority ( Revocation) Order, Legal Notice No. 44 , Kenya subsidiary legislation , 1999.
shareholders of KTDA with each factory holding an average of 2% shares in KTDA.

Fifteen years after the privatization, KTDA has mainly maintained the governance structure recommended in the year 2000 as outlined in the Sessional Paper of 1999. This is can immediately be identified as a problem in an ever changing area such as corporate governance.

2.3 **Structure of privatized KTDA**

KTDA was incorporated under the Companies Act as an independent and private tea enterprise owned by all small-scale tea farmers through their respective factory companies. KTDA offers management services to the individual factory companies. The small-scale tea farmers are owners of KTDA but their influence is exercised through their factory companies. KTDA has eight subsidiary companies with interests in tea production, marketing, tea trading, packing, warehousing, insurance, microfinance and power generation which constitute a large tea development, management and marketing conglomerate.

The current structure is illustrated below:
Figure 1: Small-scale tea sector Structure

- Structured by buying centres, owned & managed by farmers.
- A private company owned by 54 corporate shareholders (factory companies)
- Buying centre committees elected by farmers.
- Responsible for managing factories.
- Directors appointed by the 54 corporate shareholders.
- The 54 factory companies owned directly by the farmers as individual shareholders.
- Directors appointed by the farmers
- Management through Management agreements.

Source KTDA
2.4 Motion in Parliament to reverse privatization of KTDA

Seven years after the privatization of KTDA, Parliament sought to reverse its privatization.\footnote{Kenya National Assembly Official Record (Hansard) Wednesday, 23rd May, 2007 and 4th July, 2007.} This was through a motion passed on 4th July 2007.\footnote{Kenya National Assembly Official Record (Hansard) (2007).} The Motion stated in part that the Minister of Agriculture rescinds the Kenya Tea Development Authority Revocation Order of 1999 contained in Legal Notice No. 44 of 22nd March 1999, which established KTDA. The reasons advanced for the motion included the fact that the change of KTDA from a public to a private entity was rushed and there was no transition period to put the requisite structures in place for proper functioning of the agency. Contributions from the House were to the effect that KTDA could not purport to be a limited liability company serving hundreds of thousands of farmers. There was thus need for Government intervention so as to assist small scale farmers which could only be achieved by revoking the Revocation Order that established KTDA. This it was argued would enable the Government have control in the tea industry by appointing directors to the board of KTDA. The Government would also be in a position to guarantee loans on better lending conditions and supervise construction of factories.

Upon the passing of the above motion, the KTDA Board sought clarification from the then Attorney General on the ramifications of such a motion on KTDA, and if it was indeed legal. KTDA obtained reprieve to the above situation through the Attorney General who gave a legal opinion to the effect that the Resolution
passed by Parliament had neither any force in law, nor did it bind the Government. It was at best an opinion and recommendation to the Government; that legally the defunct Kenya Tea Development Authority could not be legally revived merely by revoking the Kenya Tea Development Authority Revocation Order-Legal Notice No. 44 of 1999. This was by dint of Section 20 of the Interpretation and General Provisions Act\(^\text{82}\) which provides that where a written law is repealing in whole or in part a former written law is itself repealed the last repeal shall not revive the written law or provisions before repealed. Therefore even if the repeal could have been done by a resolution of Parliament it would not have in law revived the Kenya Tea Development Authority; that KTDA was incorporated as a private company under the Companies Act and could only be wound up in accordance with the Companies Act and its Articles of Association; that if indeed the Government desired to take over KTDA it would have to negotiate with KTDA on the modalities of winding it up in accordance with the provisions of the Companies Act.

2.5 KTDA’s Status challenged in Court

The transition of KTDA from a public body to a private entity was with challenges, including legal suits that questioned and challenged its status and privatization. All these suits did indeed confirm the legal status of KTDA as a

\(^{82}\) Chapter 2, Laws of Kenya.
privatized company. *KTDA versus Jackson Karanja & Another*\(^8^3\) was originally filed by Kenya Tea Development Authority in 1993 but was not substantively heard until 2004, where it claimed adverse possession of land that had been purchased in 1980.\(^8^4\) A key argument advanced by the defendant’s counsel was whether KTDA as Kenya Tea Development Authority could move the Court when it had been dissolved by Legal Notice No. 44 of 1999 and its formal designation had subsequently changed to Kenya Tea Development Agency. Justice J.B. Ojwang held that the defendant’s claim that Kenya Tea Development Authority could no longer maintain suit following the publication of Legal Notice No. 44 of 1999, lacked validity as the successor entity, that is, Kenya Tea Development Agency succeeded to all rights, liabilities and choses in action then held by its predecessor.

The second case that ruled on KTDA’s status was *Ismael Ombati Ochieng & 9 others versus KTDA*\(^8^5\) where the plaintiffs filed suit seeking a declaration from the court to the effect that KTDA’s decision to cause its staff early retirement was unlawful and breached Section 74, 80 and 82 of the Constitution of Kenya, and thus prayed that KTDA pay all their dues and entitlements and or they be reinstated in their jobs. The plaintiffs first argued that Legal Notice No. 44 of 1999 was null and void as it contravened section 107 of the constitution; secondly

\(^8^3\) Kenya Tea Development Authority –vs- Jackson Gichuhi Karanja & Eutychus Mwangi Karanja ,Nairobi HCCC No. 4994 of 1993 [2006] eKLR.


that the order that purported to remove the plaintiff from Public service to the private sector had no power to do so. The Court was thus called to interpret Legal Notice No. 44 of 1999 and determine if it was constitutionally issued. The Court directed itself to Section 192 (4) of the Agriculture Act\textsuperscript{86} to determine if the Minister of Agriculture could issue the legal notice that revoked the Kenya Tea Development Authority. The section provides that “The Minister may by order in the Gazette amend or revoke an order and any order of revocation may provide for winding up the affairs of the authority and for distributing transferring or otherwise disposing of the property and liabilities of the authority and for all such matters as appear to the Minister to be corrected with or incidental to the dissolution of the authority”. The court thus held that the Minister had the powers by virtue of Section 192 (4) of the Agriculture Act to dissolve the Kenya Tea Development Authority which power was exercised in order to allow for the liberalization and privatization of the tea industry.\textsuperscript{87}

The third suit confirming the legality of KTDA’s privatization is \textit{Republic versus the Minister of Agriculture & 52 others}.\textsuperscript{88} The applicants filed a notice of motion seeking judicial review of the regulations made by the Agriculture Minister which were contained in the Kenya Gazette Supplement No. 32 of 2000 (Legal Notice No. 43) cited as Tea (Elections) Regulations 2000. The applicant enjoined KTDA and its managed tea factories. The applicants sought for orders to quash these

\textsuperscript{86} Chapter 318 of the Laws of Kenya (now repealed by The Agriculture, Fisheries and Food Authority Act, No. 13 of 2013).
\textsuperscript{88} HC Misc Application No. 621 of 2000, Republic-Vs- The Minister of Agriculture & 52 Others
Regulations and the Tea Elections Program initiated by the Minister. The issue for
determination was whether the Minister had authority to make the Tea Elections
Regulations which the court found had far reaching implications on independent
companies. The Court held that corporations in Kenya were governed by the
Companies Act, which imposed certain requirements but at the same time upheld
freedom of contract which cannot be abridged arbitrarily. It further held that
though it recognized the Government’s desire to promote and protect the tea
industry, the court could not allow a Government Minister to do an act that is
illegal and beyond his authority.\(^\text{89}\) This case therefore confirmed that KTDA was
indeed a private company and that the Minister for Agriculture could not interfere
in the running of a private company.

\subsection{2.6 Tea Task Force Report}

The Ministry of Agriculture in 2007 made recommendations on improvement of
the small-scale factory companies’ structure which recommendations were in line
with good corporate governance as discussed in Chapter Three and Four of this
study. The Task Force recognized that KTDA as an institution was facing
governance issues and there was a perception that it had become exploitative and
inefficient. There was a call for radical change in the structure and more
particularly the shareholding structure where factory companies were
shareholders of KTDA ltd.

The Tea Task Force Report made several recommendations key among them was to enforce a separation of functions of Factory Board of directors and those of the management KTDA\textsuperscript{90}, review and where necessary amend the Articles of Association of Factory Companies to provide for a clear separation of roles and functions of Directors and management and to carry out education and regular training of directors on their role as policy makers. Other recommendations included develop and adhere to a code of best practice by which all directors and management will be bound.

The Articles of Association of the factory companies were to be amended to provide for certain amendments including: The number of directors to be reduced from the current six to three with a maximum of five for bigger factories; The level of education of directors to be included for anyone vying to be elected director and the directors to be elected at the AGMs and the votes to be cast through weighted voting. The Factory companies were required to provide a mix of skills at the Board of Directors with at least a third of the directors having no direct relationship with the Factory. The recommendations included among others that three directors should be elected and two independent directors with skills in the field of Agriculture, Accounts/Finance, Marketing and engineering; and a factory director elected to the board of the management agency KTDA to cease to be a director of the factory.\textsuperscript{91}

\textsuperscript{91} Ibid.
Further recommendations of the report were that Factory Board meetings should be held quarterly and where need arises, directors should form Ad Hoc committees to handle specific issues and move away from standing Board committees. Also the Boards were required to develop and enforce a transparent policy on staff recruitment, consider limiting the tenure of directors to two terms of three years each and the regulator to spell out the minimum qualifications criteria for one to be elected as a director of a tea factory.\textsuperscript{92}

The Task Force recommended that KTDA decentralizes its operations and restructures its corporate and managerial structures in a wide-ranging move designed to steer the sector into a new era of growth and to face emerging challenges. It was noted that concerns raised on KTDA included “structural problems characterized by conflict of interest among the KTDA Ltd and Factory Board members, unclear roles and responsibility of the directors and overall poor corporate governance practices, operational inefficiencies, dual role of KTDA Ltd as a Managing Agent and growers’ investment through their respective factory companies”.\textsuperscript{93}

It was also recommended that the current structure should be restructured in the long run to convert KTDA Ltd into a holding company and some of its shares floated on the Nairobi Stock Exchange in order to unlock value for its shareholders. The farmers through their factory companies would still be the

\textsuperscript{92} Ibid.
\textsuperscript{93} Ibid.
majority shareholder. Due to the complexity of the existing structure, it was recommended that a detailed study by an independent consultant be undertaken to come up with a suitable structure. This was to be done by KTDA Ltd in conjunction with the Ministry of Agriculture. In addition, the small-scale factory directors would not be eligible to be members of the Board of the Agency when the same agency is the managing agent.

The task force recommendations were partly implemented however crucial recommendations such as separation of functions of factory board of directors and those of the management, reduction in the number of directors and a mix of skills at the Board of Directors were not implemented.

2.7 Negative Effects of the Current Structure

The current corporate governance structure in the small scale tea sector has resulted to various negative reports, media coverage and court cases filed against KTDA and its managed tea factory companies. The corporate governance issues identified in the small scale tea farming include lack of transparency, integrity and accountability contrary to Chapter 6 of the Constitution. Other corporate governance issues noted are conflict of interest by directors, inadequate information to small-scale growers on the role, functions and performance levels and the relationship between the grower, the factory and KTDA and inadequate grower representation and involvement in decision making.

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2.7.1 Kenya Tea Board Damning Report

The Kenya Tea Board of Kenya which is the regulator of the Tea Industry wrote a damming report putting blame on KTDA for the current low tea prices.\textsuperscript{95} The report raised various issues on the KTDA structure including the issue that KTDA has used farmer’s resources to develop the subsidiary businesses which currently stand at seven (7) in numbers. The report further states that all the proceeds from the subsidiaries should pay dividends annually to the farmers which the report claims has not been the case. The Tea Board of Kenya further claims in the report that they have received demands from farmers that their resources have to be managed and accounted for effectively and raises the question whether KTDA can be made to be accountable to them.

The report further alleges that the small-scale farmers are not privy to information. “The organization has subsidiary companies that have an established over time which farmers from the grass root seem to be contesting that their involvement in initiating these businesses are poorly represented by way of what the elected directors sensitize them to understand. It is emerging that the accruing benefits from these subsidiaries are not fully felt at farm level” also the report states in part. The report also states that the subsidiaries are conducting overlapping business therefore proving to be an unnecessary cost to the farmers. The report concludes that the small-scale tea sector corporate structure has a

\textsuperscript{95} Tea Industry Status Report compiled at The Tea Research Foundation Of Kenya 29th April, 2014 – 2nd May 2014.
negative impact in terms of unnecessary burden to the small-scale farmers who are financing the elaborate subsidiary business, diminished incomes to the small-scale farmers and conduct of business is not accountable to the farmers since operations are operated on principal basis rather than agency basis. Following this report the Cabinet Secretary for Agriculture vowed to promote good governance in the tea sector.\textsuperscript{96}

2.7.2 Negative Media Publicity

KTDA has received onslaught from all quarters in the recent past from the government, the small scale tea farmers and the media. The Agriculture Cabinet Secretary was quoted as saying ‘mismanagement at KTDA is a major cause of the current problems being experienced in the tea industry;’\textsuperscript{97}

Agitation in the small small-scale tea sector led to the formation of a farmers’ organization known as Kenya Union of Small Scale Tea Owners (KUSSTO) which was registered as a trade union to fight for the alleged rights of the small scale farmers. KUSSTO has been calling for a leaner board of directors. The Chairman of KUSSTO in Kericho County was quoted calling for the Board of


KTDA to be streamlined and the number of directors reduced to cut on costs. The Union has also on several occasions called for disbandment of KTDA on allegations of mismanagement. The calls for disbandment have intensified following the dip in tea prices to a six year low.

Farmers have been protesting what they deem unjustifiable high perks paid to the factory and KTDA directors. These complaints have increased amid low payments made to farmers in the financial year 2013/2014.

2.7.3 Court Cases

There are several court cases filed in court by applicants challenging the corporate structure of the small-scale tea sector. The most recent case is one filed in 2014 by the Governor of Kericho seeking compensation of 87 billion Kenya Shillings from KTDA for the small-scale tea growers. The Governor accuses KTDA of inefficiency and corrupt practices since its privatisation in 2001, with directors

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98 ‘Farmers eye multinationals after KTDA withholds bonus’, Business daily 22nd April 2014 at p.6.


only seeking to enrich themselves while farmers reel in abject poverty. This is a fresh suit whose determination is yet to be made.\textsuperscript{104}

In \textit{Hadson Moffat Kamau versus Makomboki Tea Factory Limited}\textsuperscript{105} the Applicants prayed for the court to appoint competent inspectors to investigate the affairs of the respondent Company so that all the alleged financial misappropriation may be unearthed. They alleged that they were shareholders of the respondent Company, that the Directors of the respondent were defrauding the Company and the shareholders and that the applicants have been prejudiced and affected by the oppressive manner in the conduct of the company's business by the directors. The applicants queried the company directors’ performance, their duties and obligations towards the Company and its shareholders, whether the directors are managing and/or running the Company to the satisfaction of its members. The applicants claimed that the Company was destined to loose substantial amounts of money to the detriment of the shareholders. The respondents opposed the application. This matter has not to date been determined. This is a clear case of shareholders expressing dissatisfaction with the company structure and practices of a KTDA managed Factory.

\textsuperscript{104} Kericho High Court Petition No. 18 Of 2014 The Governor Kericho County versus KTDA & 27 others.
2.7.4 Small-scale tea sector performance

As indicated in chapter one of this study the small scale tea sector performance has gone down affecting the economy of Kenya negatively. This study has strived to show the importance of this sector to the general economy of the country. To articulate the importance of the sector the following is quoted in the Tea Policy Report:

“The agricultural sector plays an important role in the Kenyan economy with an annual direct and indirect contribution to Gross Domestic Product (GDP) of 24% and 27% respectively. Within the sector, the tea industry is a significant contributor to the GDP at about 4% and foreign exchange earnings at about 26%. Tea has emerged as the leading sub-sector within the agricultural sector earning the country Kshs. 114.4 billion in foreign exchange in 2013. The tea industry supports over 10% of the population and contributes significantly to national economic growth by not only providing foreign exchange, but also creating employment and rural development. About 58% of Kenya’s tea is produced by 600,000 smallholder farmers”.

The tea earnings rose steadily for the last five to six years before hitting a low in 2013-2014 as seen in the figure below.

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106 Ministry Of Agriculture, Livestock And Fisheries, State Department Of Agriculture National Tea policy May 2014
Figure 2: Comparative total payments to small scale tea farmers in billion Kenya Shillings

Source: KTDA Financial returns

The percentage returns to small scale farmers rose steadily in the year 2006 to 2013 before dropping to 67% in the year 2014 as seen in the figure below.

Figure 3: Comparative percentage returns to small scale tea farmers 2006-2014

Source: KTDA Financial returns
2.8 Conclusion

As seen in this chapter tea is a leading contributor to Kenya’s economy accounting for about four percent of the GDP. It is also the top export earner ahead of the tourism and horticultural sub sectors. In spite of these achievements, the small scale tea sector in Kenya has increasingly experienced challenges associated with corporate governance. An enabling and supportive environment is a pre-requisite for sustained growth and development of the small scale tea sector.

The creation of a conducive environment is geared towards reducing or removing technical, legal and administrative impediments to sound economic policy, regulatory frameworks and transparency. This would lead to investments and better management of the private sector in the tea industry and spur growth and development in the sub-sector.

The trend of corporate governance in the subsector over the years has been detailed in this chapter. It will be noted that most of the recommendations made in Tea Task Force Report of 2007 have not been effected. The earnings to the small scale farmers have dropped tremendously bringing to light the issues ailing the industry.
CHAPTER THREE

CORPORATE GOVERNANCE PRINCIPLES AND EXTENT OF THEIR APPLICATION IN THE SMALL SCALE TEA SECTOR

3.1 Introduction

This chapter will look at a broad overview of corporate governance principles and extent of their implementation in the small scale tea sector.

Corporate governance is defined as the system by which companies are directed and controlled.\textsuperscript{107} A functional definition of corporate governance adopted by the private sector initiative for CG refers to the manner in which the power of a company is exercised in the stewardship of the company’s portfolio of assets and resources with the objective of maintaining and increasing shareholder value and satisfaction of other stakeholders in the context of its corporate mission.\textsuperscript{108} This definition is relevant to this study as the study seeks to investigate the relationship between corporate governance and performance of the tea industry.

Following the collapse of many companies in the United States the National Association of Corporate Directors (NACD) Blue Ribbon Commission in 2001

\textsuperscript{108} Supra note 7.
made several corporate governance recommendations which are ideal for the small scale tea industry.

The Board of Directors should constitute a substantial majority of independent directors. An independent director is a director independent of management and free from any business or relationship that would interfere with his decision making. In addition, the board should formulate and adhere to a clear conflict of interest policy which is applicable to all board members.

Boards should ensure that the key committees on audit, compensation and nomination are composed entirely of independent directors, and are free to hire independent advisors when necessary. In many companies this is never the case. In the small scale tea sector the committees do exist but their composition does not consist of independent directors.

The recommendations further included that each key committee should have detailed duties. The audit committee duties should include oversight of the quality and integrity of financial reports and the process that produces them and oversight of the management of risk.

The chairman should be independent to lead the board in its most critical functions, including setting board agendas with the Chief Executive Officer (CEO), evaluating the CEO and board performance, holding executive sessions,
and anticipating and responding to corporate crises. In the small scale tea sector the chairman is independent except in one of the subsidiaries.

More principles are discussed further and in detail in this chapter while indicating their application in the small scale tea sector.

### 3.2 Corporate Governance Principles

Principles of corporate governance have been designed as guidelines to assist individual companies formulate their own specific and detailed codes of best practice. The small scale tea industry through its management agency KTDA has formulated a Board Governance Manual, Directors Code of Conduct and Election Manual to guide the corporate governance practice. The best corporate governance principles and how they relate to the small scale tea industry are discussed below.

#### 3.2.1 Effective Board

Good corporate governance says that every company must be headed by an effective Board which is collectively responsible for the success of the company.\(^\text{109}\) An effective Board should exercise leadership, enterprise, integrity and judgment in directing the company so as to achieve continuing prosperity and

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act in the best interest of the organization based on transparency, accountability and responsibility.\textsuperscript{110}

A unitary board structure constituting executive directors with knowledge of the business and independent nonexecutive directors who can bring a broader view to Company’s activities is recommended in the small scale tea sector. The board should be balanced as between executive and non-executive directors. The actual proportion will depend on the circumstances and business of each enterprise, and may well be influenced by local law and regulations.

The fundamental responsibility of each board is to improve the economic and commercial prosperity of the Company. Each director should be diligent in discharging his or her duties to the Company, endeavour to regularly attend meetings and must acquire a broad knowledge of the business of the Company so that he or she can provide meaningful direction to it. Equally, every director should be aware and conversant with the statutory and regulatory requirements affecting the direction of the Company.\textsuperscript{111}

In KTDA, the Board Governance Manual states that the Board will consist of twelve non-executive directors, an independent director in recognition of affirmative action enshrined in the Constitution of Kenya 2010, and two executive directors, the managing director and the finance and strategy director. The Board

\textsuperscript{110} Supra note 7.
is chaired by a non-executive director. The manual recommends that all the
twelve non-executive directors are independent of management and have diverse
range of expertise and experience. Despite the manual recommendations the
independence of the Directors is questionable. The manual further recommends
that the directors are required to disclose all areas of conflict of interest to the
Board and are excluded from voting on such areas of conflict.

The directors’ remuneration should be sufficient to attract and retain directors to
run the company effectively and should be approved by shareholders. The
executive directors’ remuneration should be competitively structured and linked
to performance. The non-executive directors’ remunerations should be
competitive in line with remuneration for other directors in competing sectors.
Companies should establish a formal and transparent procedure for remuneration
of directors, which should be approved by the shareholders.

The KTDA Board Governance Manual provides that the remuneration for non-
executive directors consists of directors’ fees paid on quarterly basis, monthly
honoraria, sitting, mileage and other allowances for attending board and
committee meetings. Information and disclosures relating to the directors
remuneration and salary emoluments paid to key management staff are contained
in the financial statements. The manual does not state how the remuneration
package is arrived at, whether it is benchmarked to the industry or how it is

\[112\] Ibid.
reviewed. Leadership is a fundamental CG Principle which KTDA should strive to achieve.

3.2.2 Appointment of Directors to the Board

Good corporate governance requires that there should be a formal, rigorous and transparent procedure for the appointment of new directors to the Board.\textsuperscript{113} Appointments to the Board should be made on merit and against objective criteria. Best practices say that appointment to the Board of directors should be done through a well-managed and effective process while ensuring that skills and professionals are mixed. The mix brings about value addition and independent judgment to the decision making process.\textsuperscript{114}

This may prove to be difficult in the small scale tea sector because directors are elected by tea farmers according to popularity and number of tea bushes one has. It is therefore difficult to get a good mix of skills and professionals. The election process is managed by KTDA which has formulated an Election Manual which guides on the nomination and election procedure, candidates’ requirements and the dispute resolution process. The Company has established a formal and transparent procedure for nomination and appointment of directors to the Board. The appointment of directors is explained in the election manual of the Company which ensures that the appointments comply with the governing instruments of

\textsuperscript{113} Supra note 111.
\textsuperscript{114} Supra note 7.
the Company. The nominated board members should be qualified and competent and fit to be members of the board. The election manual however does not provide for procedure of ensuring a good mix of skills.

The board should be composed of people of integrity who can bring a blend of knowledge, skills, objectivity, experience and commitment to the board which should be led by a capable Chairman who brings out the best in each director. Crucial to this, is having a proper director selection process to avoid the propensity for cronyism and tokenism. Cronyism is the appointment of friends and associates to position of directorship without merit and tokenism is the practice of doing no more than the minimum to comply with a law. The selection process must be managed by asking what skills are needed on the board to add value to the processes of the board in the context of the business of the company.

Consequently, the composition of the board should be planned with strategic considerations and objectives of the company in mind. Good corporate governance practices says that the board should satisfy itself that plans are in place for orderly succession for appointments to the board and to senior management, so as to maintain an appropriate balance of skills and experience within the company and on the board.

Due to the governance structure in KTDA where directors are first elected at the factory level on the basis of number of tea bushes and minimum secondary school

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115 ‘Corporate Governance Codes and Principles in Commonwealth’ (n 113).
education, it is a challenge to have a mix of required skills on the Board. The skills and experience at the Board is therefore a mere coincidence but not a deliberate effort of governance structure that may be attributable to the level and quality of guidance the Board offers to KTDA.

3.2.3 Company Performance

The board should monitor and evaluate the implementation of strategies, policies, management performance criteria and business plans. The board should reserve specific powers to itself and delegate other matters with the necessary authority to management. The implementation of these strategies, policies, mutually agreed management performance criteria and business plans must be monitored and evaluated to ensure that they remain relevant and dynamic. The board must ensure that internal control procedures provide reliable and valid information for this monitoring and evaluation process. These control procedures and systems of reporting must be appropriately resourced and should be reviewed regularly. Internal controls include not only financial matters but also operational and compliance controls and management of business risk associated with the Company.

The strategies, policies, mutually agreed management performance criteria and business plans of the Company must be clearly defined and measurable in a manner which is precise and tangible, both to the board and management. Each
aspect requires a comprehensive assessment against accurate and relevant information, both financial and non-financial as appropriate, and should be obtained from the Company’s own internal reporting systems as well as external sources so that an informed assessment can be made of all issues facing the board and the Company in monitoring and evaluating the implementation of these objectives. It is within this context that the Company’s governance structures should be monitored with constant vigilance to ensure that the business enterprise operates in a manner resulting in enhanced governance.116

The performance of the small scale sector has declined and though partly attributed to the dynamics in the international tea market, it can also be attributed to the weak governance structure. This aspect has been explored further in Chapter four of this study.

3.2.4 Accountability to Shareholders

The board should serve the interests of the shareholders of the Company and account to them fully. The board should ensure that the business is financially viable and properly managed so as to protect and enhance the interests of the Company and its shareholders over time. The board should seek to understand the expectations of shareholders and fulfill those expectations when deciding upon the best interests of the Company. The board should always ensure that all shareholders are treated fairly and provided with appropriate information on an

116 Supra note 113.
equal basis, irrespective of the significance or otherwise of their interest in the Company. Decisions should consider the interests of future shareholders as well.

The personal interests of a director, or persons closely associated with the director, must not take precedence over those of the Company and its shareholders. A director should avoid conflicts of interests. Full and timely disclosure of any conflict, or potential conflict, must be made known to the board. Where an actual or potential conflict does arise, a director should at least refrain from participating in the debate and/or voting on the matter. In the extreme case of continuing material conflict of interest, the director should consider resigning from the board. A director who is appointed to a board at the instigation of a party with a substantial interest in the Company, such as a major shareholder or a substantial creditor, should recognize the potential for a conflict of interests and accept that his or her primary responsibility is to always act in the interests of the Company.

Directors must not make improper use of information acquired by them in their position as a director. This prohibition applies irrespective of whether or not the director, or any person closely associated with them, would gain directly or indirectly a personal advantage or whether or not the Company would be harmed. Likewise, a director should not obtain, attempt to obtain, or accept any bribe, secret commission or illegal inducement of any sort and this should be actively discouraged throughout the Company with appropriate sanction where it is found
to have taken place. In matters of remuneration, the board should set and implement a remuneration policy that creates a reward system to recruit, retain and motivate high quality executive directors.

In KTDA the director’s code of conduct provides that Directors should handle their affairs so that no conflict arises or is thought to arise between their private interests, financial or otherwise and their official duties. In particular, a Director shall not personally or through an agent or through a Company in which he or she has interests do business directly or indirectly with the Company without first making known his or her interest to the Board. Specifically the Code provides that on appointment to office and while in office, Directors are advised to provide the Company Secretary with a full list of all interests which exist and which arise, which might be thought to give rise to a conflict. The list should cover not only the Director’s personal interests but also those of a spouse or partner, children, trusts of which the Director or a spouse or partner is a trustee or beneficiary, or of closely associated persons. The list should cover all kinds of interest including financial instruments and partnerships, financial interests such as unincorporated businesses and real estate, as well as relevant non-financial private interests such as links with outside organizations and previous relevant employment.

In reality a lot of conflicts and interests have been observed in the small scale tea sector with regard to various contracts. In addition there is no evidence of declaration of interests as provided in the code of conduct.
3.2.5 Board Independence

The Kenyan code of best practices in corporate governance requires that no one person or group of persons has unfettered power and that there is an appropriate balance of power on the board so that it can exercise objective and independent judgment. It is important to ensure that the non-executive directors are of sufficient caliber to bring an independent judgment to bear on issues of strategy, performance, resources, standards of conduct and evaluation of performance. A non-executive director should have courage, wisdom and independence so that he or she acts in the best interests of the company.\textsuperscript{117}

If a director is in doubt as to whether a proposed course of action is consistent with his or her fiduciary duties and responsibilities, then the course of action should not be supported. Independent professional advice should be sought as soon as possible to clarify the position of the director concerned. When a director concludes that he or she is unable to acquiesce in a decision of the board, and all reasonable steps have been taken to resolve the issue, the director should rather accept that resignation or dismissal is a better alternative than acquiescence.

It should always be remembered that as shareholders are responsible ultimately for electing board members, it is in their interests that the board is properly constituted and not dominated by an individual or group of individuals. However,\textsuperscript{117}

\textsuperscript{117}Supra note 113.
in practice the board as a whole usually plays a major role in selecting its own members and should accordingly plan for its own continuity and succession. In KTDA the independence of directors is questionable.

3.2.6 Recognize and Manage Risk

A company must establish a system of risk oversight, management and internal control. The company cannot be run on divine intervention or fluke. The Board should be responsible for determining the nature and extent of the significant risks it is willing to take to achieve its strategic objectives. The Board should maintain sound risk management and internal control system.\textsuperscript{118} The board should identify key risk areas and key performance indicators of the business and constantly monitor these factors.

The board has a critical role to play in ensuring that the business enterprise is directed towards achieving its primary economic objectives of profit and growth. It must, therefore, fully appreciate the key performance indicators of the company and respond to key risk areas when it deems it necessary to assure the long-term sustainable development of the company.\textsuperscript{119}

In 2014 KTDA did risk assessments for all subsidiaries and factory operations. KTDA further reviewed the output of the risk registers and areas identified for

\textsuperscript{118} Supra note 111.
\textsuperscript{119} Supra note 113.
further improvements. Risk champions were identified to continuously monitor risks and take mitigation measures. A revised risk management framework was developed to guide in risk management practices across the organization.Routine audits are usually carried out to appraise adequacy of controls in key risk areas, however one would question the adequacy of the risk and control systems in KTDA. In many instances the risk and control system has been found wanting creating loopholes for loss. A recent case scenario is when the company lost data following collapse of the ICT servers in June 2015.

3.2.7 Stakeholder’s Participation

The King Report of South Africa adopts a participative and inclusive stakeholder approach recognizing that companies are part of the society and environment in which they exist. Good corporate governance requires the company to consider the industry and market standards, industry reputation, investigative media, attitudes of customers, suppliers, consumers, employees, investors and communities, ethical pressure groups, public opinion, public confidence, political opinion. Good corporate governance requires a company to adopt best corporate governance practice by identifying the company’s internal and external stakeholders; agree on a policy or policies determining how the company should relate to and with them, in creating wealth, jobs and the sustainability of a
financially sound company while ensuring that the rights of stakeholders are respected, recognized and protected.¹²⁰

Though the KTDA Board Manual recognizes stakeholders’ satisfaction, a scrutiny of the strategic plan does not give any evidence of how assessment of stakeholders’ interests is addressed in a bid to satisfy the stakeholders.

### 3.3 Weaknesses in Governance of the Small Scale Sector

Weaknesses in corporate governance in the small scale tea sector include: inadequately qualified and experienced directors, directors with significant conflicts of interest, inadequate representation of independent directors on the board. The industry players have also reported insufficient understanding of the nature of the tea sector risks by directors and senior management, insufficient structures for ensuring appropriate scrutiny and management of conflicts of interest as weaknesses.

Other weaknesses include insufficient accountability of directors for the stewardship of the companies, the ability to hold the board of directors to account, inadequate risk management systems, internal controls and internal audit arrangements.

¹²⁰ Supra note 7.
Weak corporate governance in the small scale sector is caused by many factors including: inadequate disclosure requirements and the requirements in relation to conflicts of interest, inadequate enforcement of corporate governance, inadequate development and enunciation of corporate governance principles. Insufficient competitiveness in tea markets would also be a cause of weak corporate governance, thereby reducing market disciplines and weakening the incentives for sound corporate governance practices.

3.4 Conclusion

Weak and inadequate corporate governance has contributed to many corporate collapses. Weak corporate governance in the tea sector exposes the small scale tea industry to a greater risk of loss than would otherwise be the case. Weaknesses in corporate governance reduce the capacity of the tea sector to identify, monitor and manage the business risks.

Given the effect that weak corporate governance and risk management structures can have on the management of risks in the tea sector, it is important that steps are taken to promote effective corporate governance principles as enumerated in this chapter.
Chapter Four assesses in detail specific aspects of corporate governance structure identified in the problem statement and their effect on the small scale tea sector performance.
CHAPTER FOUR

CORPORATE GOVERNANCE EFFECT ON PERFORMANCE OF THE SMALL SCALE TEA SECTOR

4.1 Introduction

Most empirical studies have found a positive correlation between company performance and good corporate governance. This Chapter examines whether there is evidence that changing the small scale tea sector governance structure will lead to subsequent good company performance, and answer the important question on whether the sector can significantly improve its long term performance by implementing changes to its governance structure. This chapter begins by looking at the current decline in performance of the small scale tea sector.

4.2 Performance of the Small Scale Tea Sector

The Performance of the small scale tea industry has been on a decline in the last two years as detailed herein below.
4.2.1 Company Financial Ratios

A company’s financial ratios are a good indicator of the performance of a company. The key performance indicator ratios of KTDA show that the business is declining in profitability and operating efficiencies especially in the year 2013/2014. The Return on Assets (ROA) ratio has registered a decline from 15% in 2009/10 to 10.2% in 2013/2014. The decline is mainly attributable to lower than expected income from management fees from the small scale tea factories. The current ratio is also seen to be on a steady decline from 2:1 in the year 2009/2010 to 1.6:1 in 2013/2014 indicating the companies decreased ability to honour liabilities as they fall due.

Figure 4: KTDA Financial Ratios

<table>
<thead>
<tr>
<th>Year</th>
<th>2009/10</th>
<th>2010/11</th>
<th>2011/12</th>
<th>2012/13</th>
<th>2013/14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Ratio</td>
<td>2.0:1</td>
<td>2.2:1</td>
<td>2.2:1</td>
<td>1.8:1</td>
<td>1.6:1</td>
</tr>
<tr>
<td>Return on Assets % (ROA)</td>
<td>15</td>
<td>20</td>
<td>16</td>
<td>11</td>
<td>10.2</td>
</tr>
<tr>
<td>Cost/Income Ratio (%)</td>
<td>50</td>
<td>36</td>
<td>21</td>
<td>27</td>
<td>26</td>
</tr>
</tbody>
</table>
4.2.2 Tea Auction Prices

The average net selling price per kilogram of made tea at the Mombasa tea auction decreased by 25% in the year 2014 as seen below. The table indicates the decline in Kenya Shillings.

Figure 5: KTDA Auction Average Prices

![Bar chart showing KTDA Auction Average Prices from 2009 to 2014.]

4.2.3 Revenue and Payment to farmers

Total revenue generated from tea sales recorded a continuous growth in the last five years since 2009 in which the revenue was Kenya Shillings 36.4 Billion, a growth rate of 90% to year 2013 which recorded revenue of Kenya Shillings 69.2 Billion. The total revenue generated from tea sales has been on an upward trend; from Kenya Shillings 36.4 Billion in 2011 to Kenya Shillings 69.2 Billion in 2013. There was however a 23% decline to Kenya Shillings 52.97 Billion in 2014 as illustrated in the figure below.
Similarly, the payout to farmers increased steadily between the years 2009/10 and 2011/12 from Kenya Shillings 43.02 per Kg of green leaf in 2009/10 to Kenya Shillings 50.01 per Kg of green leaf in 2011/12. The payout rate in the years 2012/13 and 2013/14 however decreased to Kenya Shillings 45.65 and Kenya Shillings 31.61 per Kg of green leaf respectively as shown below:-

4.2.4 Total average payment rate -5yrs Kg/Green leaf

Figure 7: Payment to farmers
As illustrated above during 2013/2014 financial year, payment to farmers decreased to 67% from 75% of the gross revenue earned in 2012/13 financial year with the balance going to operational, administration, financial and other costs.

Though KTDA has solely blamed the continued decline in performance of the small scale tea sector in 2013 and 2014 to the market dynamics, this study strives to answer the question whether the decline is in fact attributable to poor corporate governance.
4.3 EFFECT OF CORPORATE GOVERNANCE ON PERFORMANCE OF THE SMALL SCALE TEA SECTOR

The performance of the small scale tea sector can be measured by looking at various variables of corporate governance including Board size, Board’s education level, Risk Management and Boards’ independence. These characteristics have been captured broadly in chapter three under good corporate governance principles. There are various empirical studies carried out on these variables whose results are analyzed in this study. The relationship between these leading characteristics and company performance continues to be a fundamental problem in corporate governance literature. Business practice shows that investors are willing to pay a good premium for companies with good governance practices.

4.3.1 Board’s Size

There are two distinct schools of thoughts in relation to the relationship between the size of a board and a company’s performance. The first school of thought argues that a smaller board size will contribute more to the success and value of a company. The second school of thought considers that a large board size will improve a company’s performance. The study by Klein indicates that a large board will support and advise company management more effectively because of

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a complex business environment and an organizational culture. A large board size will gather more information and as a result, a large board size appears to lead to better company performance.

The first school is of the view that Boards of directors may have difficulty of coordination and communicating with each other in a large size board, which undermines board effectiveness in monitoring management. This causes a detriment to company performance proving that board size has a negative relation with company performance.\textsuperscript{123} Additionally, larger boards have been found to be characterised by decreased ability of directors to criticize top managers and to analyse and discuss company performance seriously.\textsuperscript{124} Jensen proposes that large boards are more likely to face high costs of monitoring the company and they are less likely to have effective function with a size of the board of more than seven or eight people.

The agency theory suggests that as the board size becomes large, the agency problem related to director free riding increases and the board becomes more symbolic and less a part of the management process.\textsuperscript{125} In large boards it is more likely to be controlled by the CEO rather than the board monitor and control of the management. This will give the managers the space to pursue their own

interests instead of aligning the interests of the shareholders and managers leading to increase in the agency problems and thereby lower company performance.\textsuperscript{126}

This school argues that as board size becomes larger it will be more difficult for board members to reach a consensus due to the more diverse opinions and ideas. Therefore, large boards are slower and less efficient in making decision. All of these actions might increase the agency conflict, because with less coordination and communications this will lead to decreased board members ability to control and monitor management which might result in worse company performance.

As highlighted in this study the size of the Board in KTDA is large as it consists of fifteen directors which would make it difficult to make decisions and manage the numbers efficiently. This study finds that the large size of the Board in the small scale tea sector negatively affects the performance of the sector. There have been many calls by shareholders in the small scale tea sector for a reduction in the number of Board members.

\subsection*{4.3.2 Board’s Educational Level}

This aspect of Board’s education was covered in the last chapter under the corporate governance principle of appointment of directors. The role of a board is in the internal corporate governance of a company.\textsuperscript{127} A board is also a control

\begin{flushleft}
\textsuperscript{126} ibid.
\textsuperscript{127} Fama and Jensen (n 143).
\end{flushleft}
system in a business. A board of directors supervising management decisions in an efficient manner will improve a company’s performance. To accomplish this each board member should be fully equipped with management knowledge such as finance, accounting, marketing, information systems, legal issues and other related areas to the decision making process. This requirement implies that the quality of each board member will contribute significantly and positively to management decisions which are then translated into the company’s performance.

In KTDA, the Articles of Association of the factory companies provide that the minimum requirement for a director is that he or she has attained O-Level educational qualification. This minimum requirement is a very low threshold and has over the years restricted appointment of directors to persons without management and strategic skills and knowledge. Some directors do not have proper understanding of the market dynamics and risks associated with the tea industry. In fact some tea factories have declined to adopt this minimum requirement in their Articles of Association which means that the directors do not even have O-level education, leading to poor performance of the factories.

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128 ibid.  
4.3.3 Independent Directors

In chapter three under the principle of leadership the study looked at the importance of appointing independent directors. Many empirical studies have agreed on the importance of independent directors to the success of a company and have concluded that companies with a high ratio of independent directors in a board face less frequent financial pressure. This result is expected from theory because outside directors are independent from management of a company which controls self-dealing by insiders. However, Klein finds that company value is insignificantly related to a higher proportion of outsiders on the board.\textsuperscript{130}

The main function of independent non-executive directors is to ensure that the executive directors are pursuing policies consistent with shareholders’ interests.\textsuperscript{131} Non-executive directors possess two characteristics that enable them to fulfill their monitoring function. First is their independence and second is that they are concerned in maintaining their reputation in the external labour market.\textsuperscript{132}

Although non-executive directors may possess certain characteristics such as independence and experience, the evidence relating to their impact on performance tends not to support this positive perspective. Some studies find that the presence of independent directors may actually harm performance. Yermack finds a negative relationship between the proportion of independent directors and

\textsuperscript{130} Supra note 141.
\textsuperscript{131} Supra note 68.
\textsuperscript{132} Supra note 143.
performance.\textsuperscript{133} A study by Bhagat and Black reports that board independence, significantly and negatively, correlates with short-term performance, but board independence makes no difference in improving corporate performance.\textsuperscript{134}

The KTDA Board consists of twelve non-executive Board members who are supposed to keep a check on the management. This study finds that it is difficult to ascertain the impact of the presence of the NEDs on performance of the small scale tea sector. However, theoretically this should improve performance of the sector.

Another aspect of Board independence is CEO duality. CEO duality leads to the entrenchment of the CEO and curbs the independent directors’ ability to monitor and to fulfil their governance role. This will increase the conflict between the principal and agent therefore the CEO duality is more likely to affect the company performance negatively. Therefore, to ensure the board independence it is recommended to split the two positions from each other by providing efficient checks and balances over the managerial behavior. This helps in preventing managers from pursuing their own benefits and self-interests to the disadvantage of the shareholders.

Fama and Jensen argue that separation of the roles of the chairman and the CEO demarcates the boundaries between the management’s decision control function

\textsuperscript{133} Yermack (n 142).

and the monitoring function of the Non-Executive Directors (NEDs). In Kenya, the code of best practice on corporate governance emphasizes the balance of power within a company to minimize any one individual’s influence to the decision making process and to provide balance and an effective and efficient operation of a board.\footnote{CACG Guidelines: Principles for Corporate Governance in Kenya and a Sample Code of Best Practice for Corporate Governance (n 7).}

On the other hand, stewardship theory argues against separation, because it is based on duality. According to the stewardship theory, effective management is based on the principle of the unity of command. This is because when responsibilities and decisions are restricted to one person; this might facilitate greater understanding and knowledge of the company operations and better decisions which will result in reducing the agency costs and positive impact on company performance.

In support of separation one study concluded that, in many businesses with a duality structure, there has been an abuse of power at the expense of the company and the shareholders.\footnote{Chia-Wei Chen, J. Barry Li, Bingsheng Yi , Ceo Duality And Firm Performance—An Endogenous Issue, Corporate Ownership & Control / Volume 6, Issue 1, Fall 2008 58} Fama and Jensen argue that boards dominated by inside directors are more difficult to control, a situation that would clearly apply to duality.\footnote{Fama and Jensen (n 143).} The Cadbury Committee in the UK supported this opinion and regards the practice as undesirable because it gives one person too much power within the
decision-making process.\textsuperscript{138} Jensen concludes that duality would reduce a board’s supervision of the management of a company.\textsuperscript{139} Duality would also result in increase of costs to an agency.\textsuperscript{140}

The agency theory supports the idea of separation between the CEO and the chairman, to increase board independence from management, which theoretically results in better performance due to better monitoring and overseeing.\textsuperscript{141} The chairman has an important role and duties in the board in monitoring, running board meetings, making sure that all the issues that related to the company are listed in the agenda to be discussed in the board meeting, hiring and firing, and replacing the CEO if the latter is deemed to be negligent in serving the interests of the shareholders. On the other hand the CEO ordinarily manages the company and is responsible for implementing the company strategies and policies.\textsuperscript{142} Combining these roles in one person can therefore, result in increasing agency problems by diluting the effectiveness of monitoring the CEO.

This study finds that the argument against CEO duality is sustainable and that CEO duality is negatively related to performance. As seen in chapter three in KTDA, the roles of the CEO and the chairman are separate; however in one of KTDA’s crucial subsidiary which is in charge of managing the tea factories the

\textsuperscript{139} Jensen (n 140).
\textsuperscript{140} Fama and Jensen (n 143).
\textsuperscript{141} ibid.
\textsuperscript{142} Ibid.
company embraces duality. The CEO and the chairman is one person which leads to a lack of independence. This study concludes in-tandem with the first school of thought on CEO duality right that separating the roles of CEO and Chairman leads to better performance of a company and ensures the Board is efficient and effective. The poor performance of the small scale tea sector can be partly attributable to lack of Board independence in the managing agent of the small scale tea sector.

4.3.4 Management of Risks

The UK Cadbury Report recommends that companies should establish internal board sub-committees to oversee amongst other things the audit process. The audit committee’s duties are the appointment of external auditors, reviewing the company’s financial statements and advising on any significant findings of internal audit investigations. In addition to recommending that an audit committee should be established, Cadbury also proposed that the committee should have a minimum of three members and should consist only of non-executive directors, the majority of whom should be independent.\textsuperscript{143}

Relatively little has been reported about the impact of audit committees on performance. Wild finds that the market reacted more favourably to earnings

\textsuperscript{143} Committee on the Financial Aspects of Corporate Governance (London (n 159).
reports after an audit committee had been established.\textsuperscript{144} Klein, however, finds that the presence of an audit committee had no effect on a range of accounting and market performance measures.\textsuperscript{145} She also finds that changes to the composition of the audit committee does not generate abnormal returns neither does it significantly affect performance.

KTDA has established a Risk Assurance and Governance Committee which however, is made up of some executive directors thereby making the Committee not independent. There have been challenges in identifying potential risks in the sector leading to great losses. Though empirical evidence shows that there may be no relationship between Audit Committee and performance of a company this study finds that the existence and efficiency of the audit committee is key in determining the performance of the sector.

4.4 Conclusion

This study indicates multiple effects of corporate governance on company performance. There is however a strong support for a positive and causal relationship between good corporate governance and company performance. Establishment and enforcement of proper corporate governance principles should significantly enhance development of individual corporations and economies as a whole.

\textsuperscript{145} Klein (n 141).
The performance of the small scale tea sector has been on a steady decline in 2013/2014 and 2014/2015 causing a hue and cry among the tea growers who are the shareholders. The poor performance has been blamed on mismanagement of the sector. Having analyzed the various aspects of corporate governance in this Chapter, this study concludes that poor corporate governance has to a large extent contributed to the poor performance.

This chapter indicates that performance of the small scale tea sector has been hindered by the large board size, lack of Board independence, low education level in the Board, limited board skills and mismanagement of risks.

The small scale tea sector would benefit in terms of performance by raising its standards of corporate governance. The sector can no longer turn a blind eye to the glaring corporate governance issues that need to be addressed so as to turn around the streak of poor performance.
CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

Corporate Governance is needed in the small scale tea industry to create a corporate culture of consciousness, transparency and openness. Corporate governance enables a company to maximize the long term value of the company which is seen in terms of performance of the company.

This Chapter will cover the conclusion of the study and thereafter recommendations. The Chapter will distil the key findings made in the various chapters of the study and relate them to the hypotheses and objectives. Lastly the Chapter will cover the recommendations on the best corporate governance practices required to be in place in the small scale tea sector to ensure a good return to the shareholders. The recommendations will be based on the findings of the study.

5.2 CONCLUSION

Chapter One laid a background of the study by discussing introductory aspects of the study including statement of the problem, research objectives, research
questions, hypothesis, literature review, theoretical framework, research methodology, limitations and chapter breakdown. The Chapter gave a background and brief history of the small scale tea sector in Kenya. The small scale tea sector has a complex structure which this study has endeavored to demystify. The problem of the study was identified as the low earnings in the small scale tea industry which could be attributable to a weak regulatory and governance structure. The weak governance structure has been contributed to by lack of accountability, a large sized Board, mismanagement of risks and lack of an independent Board.

The decline in tea price was a 44.3 \% drop from the previous year which is catastrophic in any industry. This study set out to answer the main research question which is whether there is a relationship between corporate governance practices and performance of the sector. The Chapter indicated that the study would be based on the Stakeholders theory which mainly states that business is about putting together a deal so that suppliers, customers, employees, communities, managers and shareholders all win continuously over time. Another theory identified in the chapter is the agency theory which was used to explain the relationship between the small scale tea growers, the directors and the managing agent KTDA.

Chapter two gave a historical background of the corporate governance structure in the small scale tea industry, privatization of KTDA from a government parastatal
and the current structure of KTDA. The chapter also gave details of the attempt to reverse the privatization of KTDA through parliament and details of court cases where the status of KTDA was challenged. The chapter also looked at an important document known as the Tea Task Force Report of 2007 which made recommendations on improvement of the small scale tea factories structure.

Chapter three looked at the Corporate Governance principles and their applicability in the small scale tea sector. Corporate governance codes were examined and included the UK Cadbury Report, Kenya’s Private Sector CG principles of 1999, CG Codes and Principles in the Commonwealth, Capital Markets Act Guidelines on CG Practices, UK Combined Code and OECD Code on CG. This Chapter also set out the weaknesses in the CG Structure in the small scale sector including large board size, unqualified directors, conflict of interest and inadequate independent directors.

Chapter four analyzed the effect of corporate governance on performance of the small scale tea sector. The small scale tea sector’s performance was analyzed in terms of key performance indicator ratios, tea auction prices, revenue and payment to farmers, total average payment rate and average percentage payout to farmers. The analysis brought the study to a clear conclusion that the return to shareholders has declined tremendously in the recent past. In this chapter various aspects of corporate governance were analysed to determine their effect on
performance of the small scale tea sector including Board size, Board’s education level, Management of Risks and Boards’ independence.

The study has therefore proved the first hypothesis right that poor corporate governance structure in the small scale tea sector has led to diminished returns to shareholders. It has also been seen through the study that indeed adoption of good corporate governance structure and practices including a lean board size, board independence and accountability in the small scale tea industry will increase the earnings of the growers thereby proving the second hypothesis right.

5.3 RECOMMENDATIONS

Based on the conclusion in 5.2 above the following recommendations are made for reforms needed to heal the deficiencies in the corporate governance of the small scale tea sector so as to increase the shareholders’ earnings.

5.3.1 Lean Board Size

In KTDA the Board size is large making it more symbolic and therefore with less Board monitoring and control of the management. There is empirical evidence that a large Board size as seen in KTDA and its managed tea factory companies would lead to increased agency problems and thereby lower company performance. This study recommends that KTDA adopts a leaner Board size of
about 10 from the current 15 to ensure efficiency in decision making. The Factory companies can have a maximum of 5 directors from the current 9 directors.

5.3.2 Increase Board’s Education Level and Mixed Skills

This study recommends that KTDA increases the minimum requirements for a director to tertiary education qualification. This way the directors can acquire management and strategic skills to enable them contribute positively to management decisions which will then translate to increased company’s performance.

The nomination and election process should be managed in a manner that ensures a mixed skill and professional Board. There should be a blend of knowledge, skills, objectivity and experience to increase the Board’s efficiency.

5.3.3 Increase Board independence

The need for independent directors cannot be overemphasized in coming up with measures to increase accountability and reduce conflict of interest with an aim to improve performance of the small scale tea sector. KTDA has non-executive directors however their independence is questionable and needs to be increased. A lot of interference by the NEDs in the operations of the sector is experienced mostly because they hold the highest percentage of shares thereby have a lot of
control and influence. This study recommends that the NEDs should be independent of management and free from any business or relationship that would interfere with their decision making. The Board should adhere to the conflict of interest policy developed by KTDA.

In KTDA and most of its subsidiaries the role of the CEO and Chairman are separate, however, in the most crucial subsidiary in charge of management services to the tea factory companies, the role is combined. This study recommends a separation of the role of CEO and Chairman in KTDA Management Services Company so as to increase independence of the Board. This action will ensure that the non-executive director holds the management accountable thereby ensuring the sector performs better and therefore increasing yields to the shareholders.

5.3.4 Recognize and Manage Risks

Following the fall in tea prices the Board needs to identify and assess key risk areas so as to ensure sustainable development of the small scale tea industry. The risk and control system needs to be adequate to avert future price declines.

For the above recommendations to take effect, a total paradigm shift in the governance structure of KTDA and its managed tea factories needs to be implemented through trainings and developments, alterations of the articles of
associations to include minimum tertiary education level and cap number of directors and lastly ensure the independence of the NEDs.
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